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MOVING UP THE LADDER

POVERTY REDUCTION AND
SOCIAL MOBILITY IN NEPAL

EXECUTIVE SUMMARY

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Nepal is emerging from a series of crippling shocks. Barely recovered from the devastation and loss wreaked by the earthquakes in April 2015, the country experienced a near total economic seizure between September 2015 and January 2016 as cross-border trade with India came to a halt. The shortages of fuel, raw materials and other essential commodities caused prices to soar, businesses to curtail operations and the economy to register the lowest growth experienced in the last fourteen years.

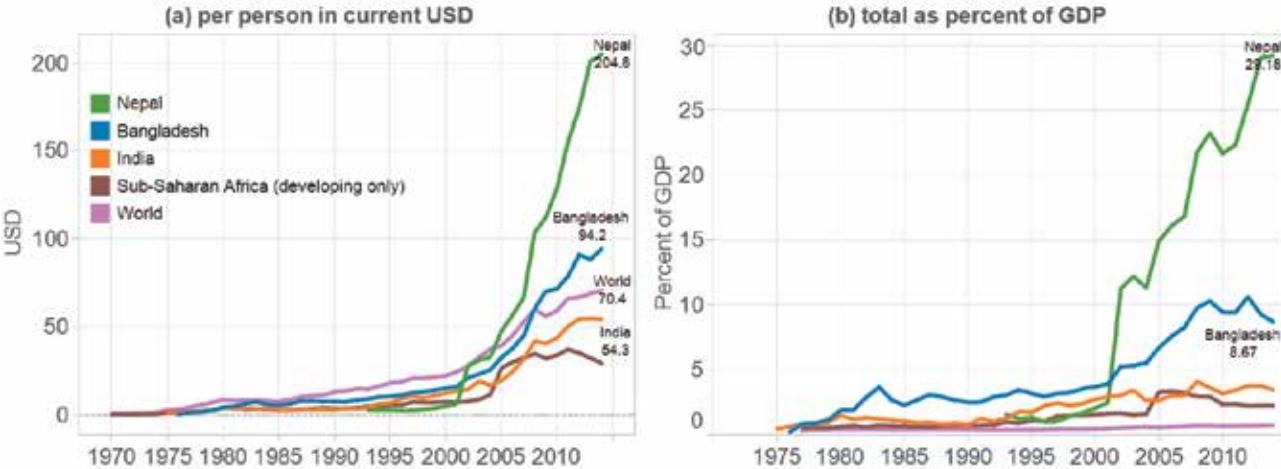
As devastating as these recent shocks have been, in a way, they are perhaps dramatic manifestations of how conflict and fragility have more generally impinged on Nepal's development potential for the last two decades. The Maoist conflict between 1996 and 2006, and the turbulent decade of transition that followed, took a heavy toll on the country's investment climate and growth. Throughout this period, the economy operated at a low level equilibrium, sputtering in fits and starts around an average per capita growth rate of 2.5 percent, which is very low, especially in comparison to progress made by other South Asian neighbors.

Yet, despite overwhelming odds, Nepal made remarkable progress on improving living standards and reducing poverty during this period. Absolute poverty rate declined by an average annual rate of 2.2 percentage points between 1995-96 and 2010-11 and currently stands at 25.2 percent. Though there are some emerging signs that the pace of the decline is slowing down, the rate of poverty decline seen in Nepal, particularly between 2003-04 and 2010-11, was among the fastest in the world.

The improvement in overall welfare has been accompanied by improvements in non-income dimensions of well-being as well. Nepal met all of its MDGs and the Multidimensional Poverty Index (MPI) has also been in a steady decline. A significantly larger fraction of Nepalis today have better access to water and sanitation services, electricity and tele-connectivity than two decades ago. Fewer Nepali children are malnourished and overall child and maternal mortality rates have declined as well. Households with school-aged children (6 to 15 years old) out of school declined from 55 percent in 1995-96 to 16 percent in 2010-11. This is pre-

Poverty rate declined by an average annual rate of 2.2 percentage points between 1995-96 and 2010-11 and currently stands at 25.2 percent.

FIGURE 1: PERSONAL REMITTANCES RECEIVED IN NEPAL AND SELECTED COUNTRIES



Source: World Development Indicators (World Bank, 2016), using personal remittances received as % of GDP, personal remittances received in current US dollars and the total population.

This report deepens the understanding of the key processes that have driven improvements in living standards and identifies some of the challenges that lie ahead.

sumably due to improvements in accessibility to and availability of schools, as households with children spending more than 20 minutes to reach primary school declined from 84 percent to 33 percent during the same period. But much of it is also likely due to increased ability to afford schools, including private schools.

How can these recent gains be cemented and made sustainable and how can progress be accelerated to improve the living standards of those who remain in chronic poverty? Going forward, this is one of the most important challenges facing policymakers in Nepal today. This report attempts to contribute to this debate by deepening the understanding of the key elements of the processes that have driven improvements in living standards and identify some of the challenges that lie ahead. One key question that arises is: how sustainable is the de facto migration-remittance based development model in terms of generating growth for the economy as well as for those that constitute the bottom 40 percent?

The report also performs a careful analysis of the levels as well as the trends in inequality in last two decades in an attempt to understand the economic underpinnings of the demand for inclusion that has so fundamentally shaped Nepal’s contemporary socio-political landscape. How high is inequality in Nepal? How does it

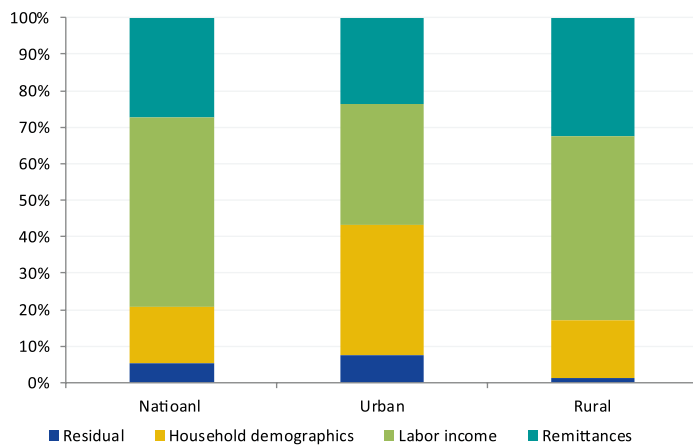
compare to the rest of the world? Has inequality been increasing? What kinds of inequality do the Nepali people care about the most and what can be done about it? Finally, the report also presents some novel insights on social and economic mobility experienced by Nepalis across generations as well as over a lifetime. Have Nepalis today done better than their parents? How does this mobility experience vary across the population? Who does better and who remains stuck? Are Nepalis today better off than they were five years ago? How much movement along the proverbial socio-economic ladder is there in the society? What characteristics are associated with these movements? That is, who moves up and who moves down? Has the success in reducing poverty over the last two decades translated into commensurate success in building a middle class? How large is the Nepali middle class and has it been growing over this period?

Drivers of Poverty Reduction

Remittances dominate the narrative on what has driven poverty reduction in Nepal. The most commonly cited driver of the progress on living standards and poverty reduction is the drastic increase in remittances sent by hundreds of thousands of Nepalis working overseas since the late 1990’s. Not only did more Nepali households start receiving remittances, the amount of remittances received by the remittance receiving households also increased over the period. The size of remittances increased from 1.3 percent of GDP in 1995 to 23 percent in 2010. Today remittances are around 30 percent of GDP. As a share of household income, remittances went up from 6 percent to 16 percent during the same period. Given this growth, it is entirely plausible for this to be the primary engine behind the improvements in living standards witnessed in Nepal.

Households with migrants have obviously benefitted from private receipts of remittances. But even non-migrant households have benefitted from opportunities created by the changes in the structure of the domestic economy brought about, indirectly, by migration and remittances. Our decomposition exercises show that the direct effect of remittances accounts for about 27 percent of the overall poverty reduction ob-

FIGURE 2: DRIVERS OF POVERTY REDUCTION BETWEEN 1995-96 AND 2010-11



Source: World Bank staff calculations based on data from NLSS 1995-96 and 2010-11
 Note: Capital income and public transfers are under residual.

served nationally and 33 percent of the reduction in rural areas. In comparison, increase in labor income - or income derived from wage and non-wage employment within Nepal – accounts for 52 percent of the observed change in poverty nationally. Further, breaking down the sources of income between farm and non-farm activities, the growth in non-farm activities has been more important for the observed reduction in poverty than farm incomes. Changes in the demographic structure of the household – which captures, among others, the number of household members that participate in the labor market relative to the number of dependents they have – also appears to have been important for poverty reduction.

The role of labor income in the observed reduction of poverty is explained in part by rising wages. Real wages grew by about 4.2 percent per year between 1995-96 and 2010-11 with agricultural wages growing slightly faster than non-agricultural wages. The growth in agricultural wages was driven by the tightening of the supply of labor due to overseas migration of working age males

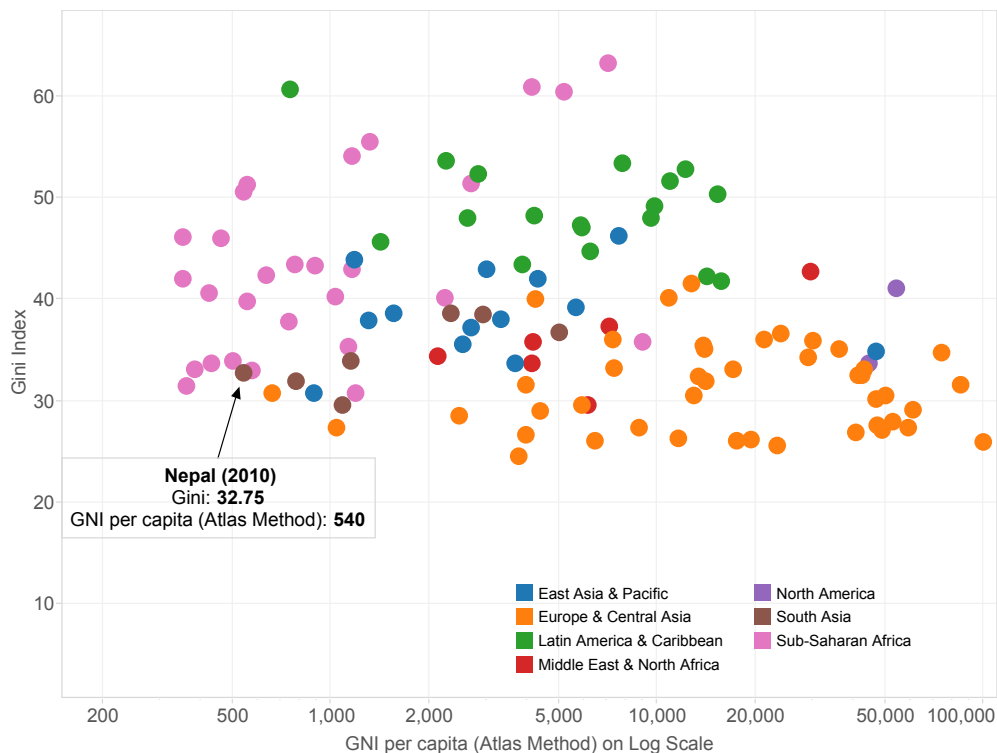
and increasing non-farm activity. The increase in non-agricultural wages, on the other hand, was largely due to the growth in the demand for non-farm labor which was in turn driven by economic diversification and increase in non-farm activities brought about by remittance induced growth in incomes and the associated changes in demand for goods and services. Non-wage employment in off farm sectors has also increased suggesting that opportunities created outside of agriculture, particularly in rural areas has been the key ticket out of poverty in the preceding two decades.

Inequality and the Demand for Inclusion

The demand for inclusion that pervades political and economic discourse in Nepal today is a consequence of deep structural inequalities perceived by some segments of the population. The 10-year long Maoist conflict, abolition of a 250 year old monarchy, and the wholesale reconfiguration of the state structure, are all direct or indirect expressions of a demand for a new, more inclusive social contract. Even though there has been some progress on this in the newly promulgated constitution,

The demand for inclusion that pervades political and economic discourse in Nepal today is a consequence of deep structural inequalities perceived by some segments of the population.

FIGURE 3: GINI INDEX BY THE LEVEL OF DEVELOPMENT



Source: World Development Indicators (World Bank, 2016), using all countries for which Gini Index is available between 2009 and 2013.

Leveling the playing field for all could move the debate forward because what is a minimum criterion for fairness and justice for the left happens also to be the foundation for meritocracy for the right.

lingering dissatisfaction continues to fuel unrest among some groups. But despite obvious implications it has for the risk of protracted conflict and political instability, which would weaken investment climate and hurt growth further, existing debates on this issue appear to provide very little basis on which to forge a constructive path forward.

One challenge – at least on the part of the inclusion agenda that overlaps with economic outcomes – is that even though there are persistent gaps between urban and rural areas, between regions and the various social groups, conventional measures of inequality, such as the Gini index of consumption, show overall inequality in Nepal to be fairly low and stable over the long run. The Gini index for consumption for Nepal was 0.33 in 2010/11, which is at the lower end of global range seen for this number. This measure of inequality also remained virtually unchanged between 1995-96 and 2010-11 both at the national level and in rural areas. In the urban areas, there has actually been a sharp decrease.

Inequality in Nepal measured this way is not only low in absolute terms, it is low also relative to the level of economic development. Nepal's Gini index is one of the lowest among the countries with a similar level of GNI per capita, most of which are countries in Sub-Saharan Africa, and well within the range of more advanced countries in Europe and Central Asia. If one is to imagine a cross-country Kuznets curve over this plot, it would appear that Nepal is at very early stages of development and that the engine of growth has not started cranking up to the extent where this growth acceleration would begin to generate a widening consumption distribution.

The other part of the challenge is that addressing inequality through ex-post redistributive policies is difficult, particularly at Nepal's level of development. Redistribution through progressive tax policies (in the space of income) or through quotas and other forms of affirmative action in higher education (e.g. medical and engineering colleges) and employment for the disadvantaged groups are typical policy measures taken to redress inequality. The newly promulgated constitution and the recent amendment to the Civil Service Act contain a

number of provisions for reservations and quotas to expand opportunities for the historically disadvantaged groups. But while a segment of the population may see this as an effort (if only in intention) in the right direction, another may object on the grounds of violation of principles of meritocracy and perverse incentives these may create. Yet another group may acknowledge the need for redistribution but disagree on the principle that guides the decision on who the beneficiary of such policies should be. Expressed in the form of a familiar refrain in Nepal, that "class and not caste" should determine who benefits from redistribution, this point of view contends that any affirmative action policies should be based on economic disadvantage, as opposed to social disadvantage.

Equity, not Equality

But framing the debate along the lines of equity as opposed to equality could provide a way forward and that is the central thrust of this report. A society may have disagreements about the sources of past injustices and what to do about them. But looking to the future, everybody can agree that opportunities for a better life for Nepali children should not depend on which part of the country they happen to be born in, or to what caste /ethnicity group their parents happen to belong to or what language they speak or other such characteristics essentially determined by the lottery of birth. This requires making a distinction between inequality of opportunities and inequality of outcomes.

Although the focus of development debate is often on inequality of outcomes, recasting the same discussion around inequality of opportunities has an intuitive appeal and could potentially transcend deep ideological differences and effect action. An inclusive society is necessarily also an equal opportunity society (even though the converse many not be true). So working towards leveling the playing field for all could move the debate forward because what is a minimum criterion for fairness and justice for the left happens also to be the foundation for meritocracy for the right.

In a society in which opportunities are equal, a girl (let's call her Goma) born to a poor and illiterate Dalit couple in rural Kalikot should

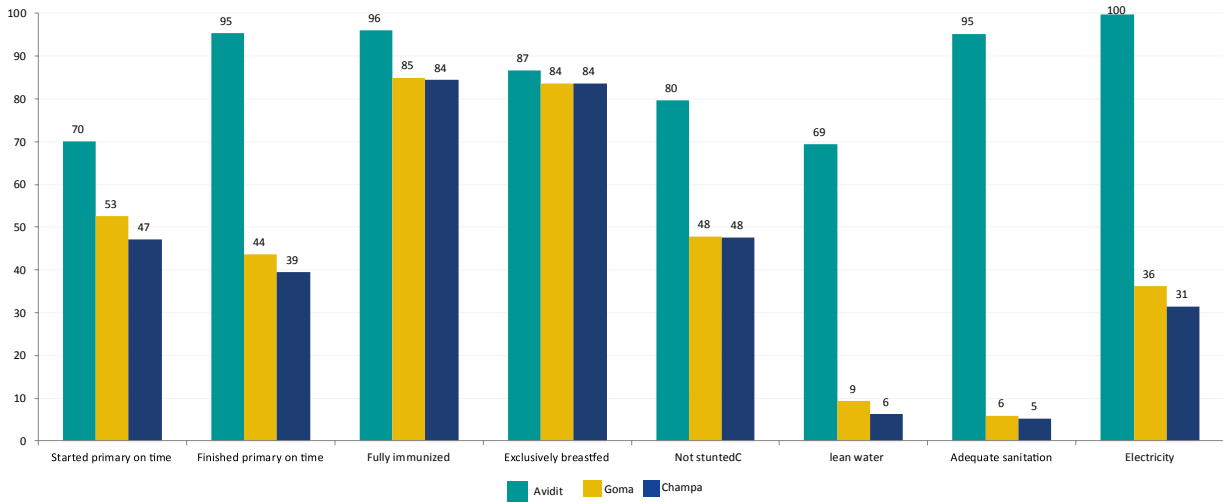
BOX 1: OPPORTUNITY FOR A BETTER LIFE FOR GOMA, CHAMPA AND AVIDIT

Goma is a girl, born in rural Kalikot. Her parents are illiterate, belong to the Dalit community and are in the bottom 20 percent of Nepal’s wealth distribution. Champa is also a girl born to a household otherwise very similar to Goma’s. But Champa’s parents are from a village in Siraha. Avidit is a boy born to an upper caste household in urban Kathmandu. Both his parents have a university education and come from affluent backgrounds.

more likely to start primary school late, drop out of school, be stunted and grow up with limited access to basic amenities such as clean water, sanitation and electricity than Avidit. Even in the 40 percent chance that Goma and Champa complete primary school and go on into secondary and tertiary education, the quality of the education they receive is likely to be vastly poorer than what Avidit will receive in Kathmandu.

In a society where opportunities are equally available for children of all socio-economic backgrounds, Goma, Avidit and Champa would all have equal odds becoming doctors, or engineers or successful entrepreneurs and businessmen. But in Nepal, the life trajectory of these children begins to diverge very early in life. Goma – whose life chances appear marginally better than Champa’s – is significantly

There may be disagreements about what to do about the social and economic processes that led to their parents’ being where they are in the current socio-economic ladder of Nepal. But everyone will agree that that position should not determine the children’s life chances. Efforts to equalize basic opportunities for these children can be a critical part of Nepal’s inclusion agenda.



have an equal shot at becoming a doctor, or an engineer as a boy (let’s call him Avidit) born in a well-educated, affluent and upper caste household in urban Kathmandu. And so should a girl (let’s call her Champa) born to parents of otherwise similar characteristics as Goma but living in rural Sarlahi. But how equal/unequal are basic opportunities for children such as Goma, Avidit and Champa in Nepal?

Addressing this question empirically would be difficult without some methodological advances that have been made in the academic literature

in this field in the last decade. Applying this methodology to a variety of datasets in Nepal, this report finds that basic opportunities such as starting primary school on time, finishing primary school on time, escaping the scourge of chronic malnutrition in early childhood, having clean water to drink, clean and adequate sanitation facilities and electricity at home appear to be far from universal and unevenly distributed even among those who have it. The size of the inequality in opportunities we report implies a significant divergence in life trajectories of Nepali children based simply on the characteristics

A mobile society is necessarily also a meritocratic one and such a society is better able to mobilize and utilize talents from all segments of the population.

of the parents. There is quite a bit of variation in the circumstances that contribute to these inequalities, but parental wealth, place of birth/residence (whether its urban or rural, in the mountains, hills or terai, or if it is the central and eastern region or the mid and far western region) and other parental characteristics (such as age, gender and education) appear to account for most of the observed inequality.

Inequalities are further pronounced when the underlying quality of the opportunities are taken into account. A child may live in a household connected to a tap that is never serviced. She may go to schools but not learn the material adequately enough to progress through the grades in the timely manner and eventually acquire the skills rewarded in the labor market. An ideal measure of opportunity should also account for differences in quality. Data limits the extent to which we can fully explore this, but using performance in national examinations such as the SLC or the National Assessment of Student Achievement (NASA) administered to eight-graders, we find the odds of passing to be skewed in favor of children with favorable birth circumstances: children whose parents can afford to send them to private schools, whose parents are themselves educated and who happen to live in certain parts of the country more so than others.

Relative to some of the other drivers such as parental wealth and education and region of residence, the direct contribution of caste/ethnicity status of children appears to account for small shares of total inequality. Interestingly, the language spoken at home (whether or not it is Nepali) commands a non-trivial amount in the inequality of passing the Nepali language (10 percent) and science (6 percent), but not for mathematics. Given that the medium of instruction in public schools is almost always Nepali, this suggests the possibility of non-native Nepali speakers having a disadvantage in subjects

that require free form expressions as opposed to those that require the solving of numerical and logical problems. This supports the idea that equalizing opportunities for children in Nepal today is every bit about leveling playing fields along the geographic and economic divide, as it is about closing the social divide.

This is not to say that there are no gaps in opportunities by caste/ethnicity of children. Even though the direct effects are small, the indirect effects could be larger. Caste/ethnicity status of parents could be correlated with other characteristics like education level or wealth status. For instance, a large part of why a Dalit couple is poor or uneducated in the first place could be because of limited opportunities they had in their childhood. But distinguishing the effect on their children's opportunities of being from the Dalit community (direct effect) versus being from a poor family with uneducated parents who are potentially poor and uneducated because they are Dalits (indirect effect) is difficult with the data we are using here. Evidence on social differences in intergenerational mobility suggests that these indirect effects could be quite large.

Intergenerational Mobility

Inequality of opportunities is intricately linked to intergenerational mobility as both encapsulate the idea of origin independence. In an equal opportunity society life chances do not depend on the social and economic identity of one's parent. In a society with high mobility across generations, the economic and social position realized by sons and daughters are independent of the economic and social positions of their parents. In both kinds of societies, who one's parents are is irrelevant to the success one can expect to achieve.

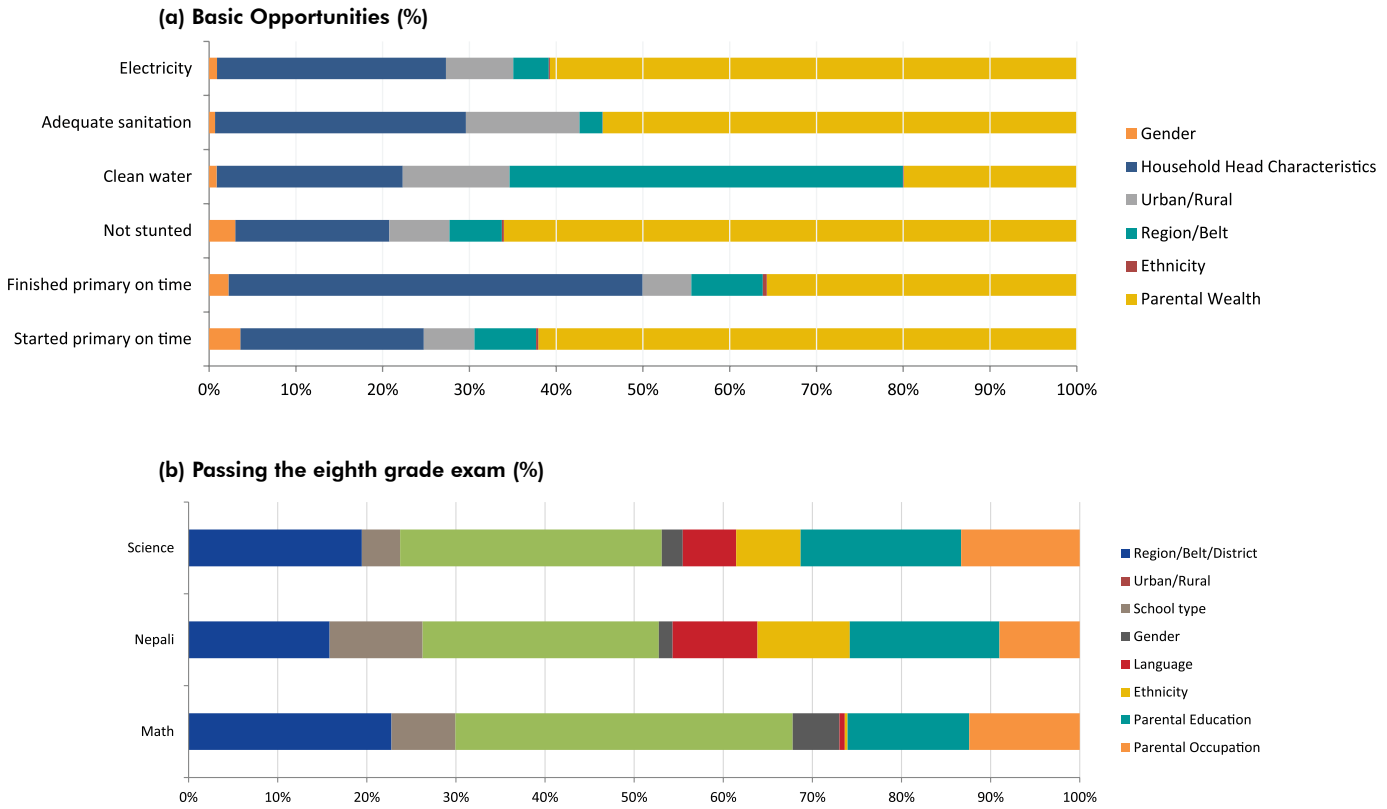
Perceptions about inequality get amplified in societies that lack mobility. Conversely, societies with high degree of mobility are able to heal the wounds of "structural inequalities". In an in-

TABLE 1. UPWARD AND DOWNWARD MOBILITY IN EDUCATION AND OCCUPATION, RELATIVE TO FATHERS

SECTOR	Education (% of population > 30 yrs.)	Occupation (% of population)
Up	61.9	43.6
Same	29.8	46.8
Down	8.3	9.6

Source: World Bank Staff estimates based on data from *Perceptions of Poverty, Prosperity and Economic Mobility in Nepal, 2014*

FIGURE 4: WHAT CONTRIBUTES TO INEQUALITY OF BASIC OPPORTUNITIES FOR CHILDREN IN NEPAL?



Source: World Bank Staff calculations. Panel (a) uses data from DHS 2011; and Panel (b) is based on data from NASA Survey (2013), Ministry of Education, Government of Nepal

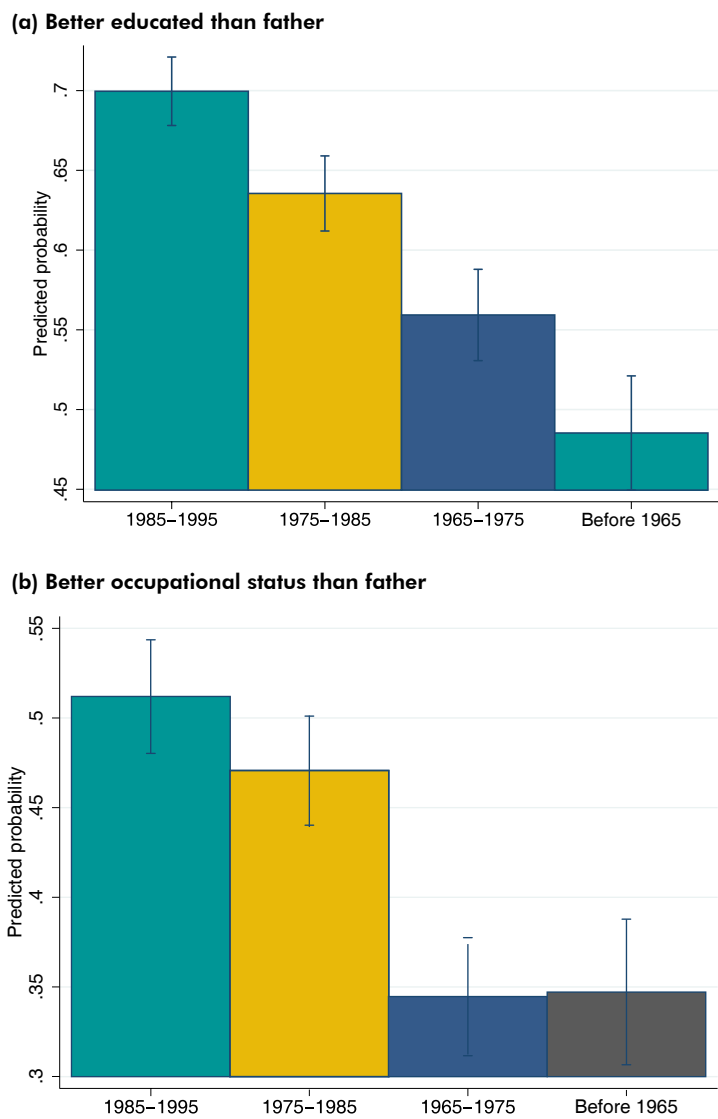
tergenerational sense, when children can aspire to achieve and indeed achieve levels of education, jobs, and living standards that are materially different from the levels enjoyed by their parents, inequality begins to decline over time. Mobility is important also from the perspective of dynamic efficiency. A mobile society is necessarily also a meritocratic one and such a society is better able to mobilize and utilize talents from all segments of the population. This is good for growth.

Studying intergenerational mobility in the space of income demands data that is hard to get, not just in Nepal but also in most other developed countries. But we attempt to make some progress on this using educational attainment and occupation, two strong proximate correlates of income. Defining upward mobility as attaining a higher level of education than one’s father or being in a better occupation, we see that about

61.9 percent Nepalis (above the age of 30) experienced upward mobility in education. In comparison, about 29.8 percent stayed at the levels of their fathers and about 8.3 percent had levels of education lower than their fathers. There is less mobility in occupation than in education: 47 percent of the overall population remains in the same occupation as their father. But about 43.6 percent of the population realized upward mobility.

Prospects for upward mobility have been increasing in Nepal for both education and occupation. Point estimates suggest that while the likelihood of being better educated than one’s father was below 50 percent for those born before 1965, the number is closer to 70 percent for the cohort born between 1985 and 1995. The pattern is similar for occupation as well except there is quite a discontinuous jump up (roughly a 10 percentage points) in predicted probability

FIGURE 5: UPWARD MOBILITY BY AGE COHORTS



Source: World Bank Staff estimates based on data from *Perceptions of Poverty, Prosperity and Economic Mobility in Nepal, 2014*
 Note: The lines around the bars show 95% confidence interval and the x-axis denotes cohorts based on year of birth.

of upward mobility for the 1975-1985 birth-cohort. One possible explanation for this is the fact that in contrast to the earlier cohorts, this group of children would have been in school around the time Nepal’s economy was liberalizing (1990-1994) and thus may have been in a favorable position to seize the opportunities created by the consequences of this liberalization. In any case, younger cohorts have been more upwardly mobile than the cohorts born before 1975 who appear to have a low steady state transition probability of around 33-34 percent of doing better than their father.

However, prospects of upward mobility vary among the various social groups and some have done better than others. In particular, Newars, followed closely by hill Brahmins and Chhetris have the best odds of surpassing their father’s education and occupation levels. In contrast, Nepalis in Muslim and other minority caste categories followed by Terai Brahmin/Middle Caste, and Dalit categories have the lowest odds of upward mobility for education as well as occupation.

Movements along the Ladder – The Vulnerable and the Middle Class

Recent events (earthquakes and the trade disruptions) have put a global spotlight on the fragility of lives and livelihoods of Nepalis. But even beyond these major events, a majority of Nepalis grapple with smaller and more mundane disasters on a routine basis. As important as it is for the Government to respond to the specific emergency of the earthquake related reconstruction and rehabilitation, this should also serve as an opportunity to galvanize support for the design of systems that can respond in a more agile and efficient manner, not just to catastrophic disasters of similar scale (if need be) but also to smaller but more frequent shocks many Nepalis endure. These “dull disasters” take a heavy toll on poor households by limiting their ability to maintain investments in the human capital of children and depleting their savings and assets. Inadequate protection from these shocks limits the ability of households to take risks and make productivity enhancing investments in both agriculture and non-agricultural activities.

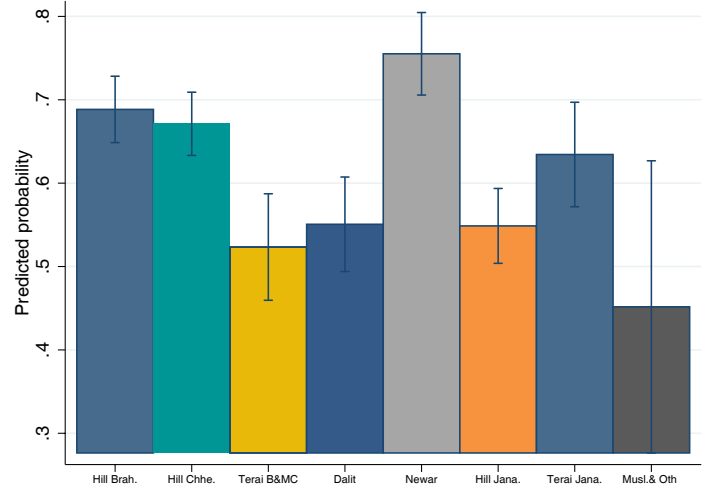
One statistic that makes these vulnerabilities apparent is the statistic on the movements in and out of poverty. The commonly reported poverty trends (poverty declined from x percent to y percent) often obscure two crucial and confounding phenomenon of people moving out of poverty and falling into poverty. These two are distinct processes with different implications for policy. Our analysis shows that between 1995-96 and 2003-04, 26 percent of the population moved out of poverty while 17 percent moved in the opposite direction and fell into poverty during the process. Likewise, between 2003-04 and 2010-11, 29 percent moved out of poverty while 14 percent fell back in. This essentially implies that that for every 2 Nepalis that escaped poverty in 2010/11, one slid back.

Health and weather shocks often represent the most common factors leading to a downward slide into poverty in South Asia. This is likely to be the case for Nepal as well, although a multi-year study the World Bank has initiated will generate richer information on the range of vulnerabilities Nepalis face. Those escaping poverty constitute a ballooning vulnerable class. Considering households with a larger than 10 percent probability of falling back into poverty as “vulnerable” households, we see that as the proportion of the poor has declined over the years, there has been a corresponding growth in the size of the vulnerable population from 28 percent in 1995-96 to 45 percent in 2010-11.

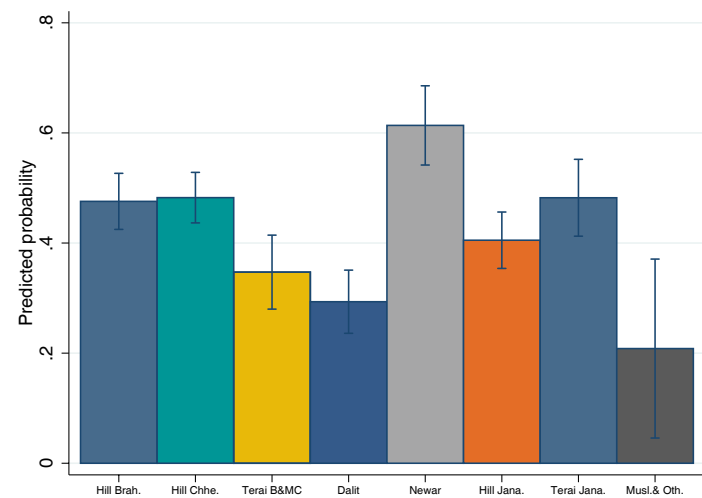
During the same period, there has also been quite a remarkable growth in the size of the middle class population in Nepal with the proportion increasing from 7 percent in 1995-96 to 22 percent in 2010-12. Close to half of the urban population is in the middle class while half of rural areas is in the vulnerable category. Middle class prevalence is highest in the central region while the mid and far western regions have the highest incidence of poverty and vulnerability. Middle class households are significantly more likely to be headed by those with more than 11 years of education, generally further away from agricultural employment and more likely to be in white collar jobs. Vulnerability on the other hand is highest among those self-employed in agriculture and service sector employment, most likely in blue collar occupations. Overall, pov-

FIGURE 6: UPWARD MOBILITY BY CASTE/ETHNICITY

(a) Better educated than father



(b) Better occupational status than father



Source: World Bank Staff estimates based on data from *Perceptions of Poverty, Prosperity and Economic Mobility in Nepal, 2014*

Notes: Caste/Ethnicity categories are hill Brahmin, hill Chhettri, Terai Brahmin and Middle Castes, Dalit, Newar, Hill Janajati, Terai Janajati, Muslim and Others.

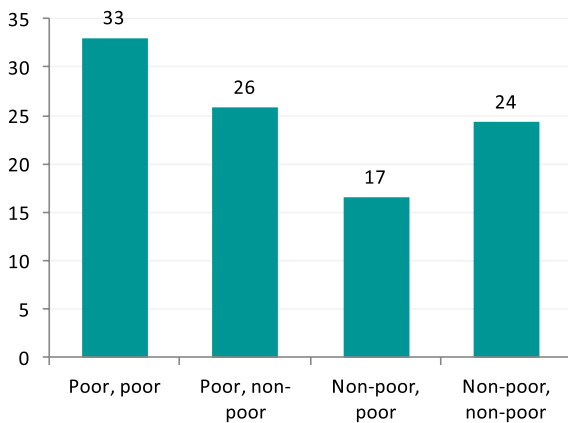
erty and vulnerability is highest among households deriving their livelihoods from wage employment in agriculture.

Results from perceptions surveys such as Gallup suggest that this budding middle class is fundamentally insecure about the prospects of continued improvements in its living standards. Gallup World Survey asks respondents questions about their perceived position in an 11-step ladder denoting various parts of the economic distribution within each country. Respondents are asked about current position as well as positions five year before the survey and

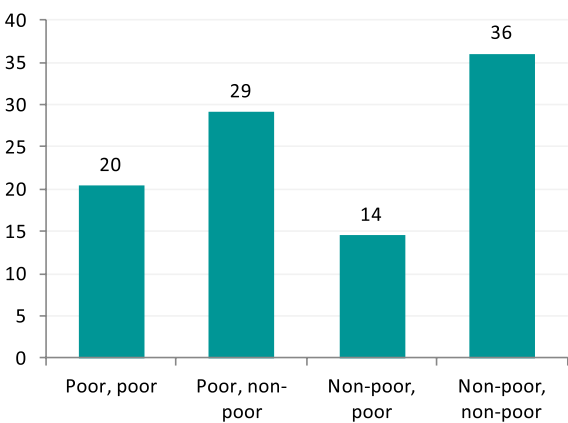
expected position five year hence. Based on responses to these three questions, Gallup defines household as thriving, struggling or suffering. Thriving households have strong current life situation and have positive views about the next 5 years. Struggling households have wellbeing that is moderate but inconsistent while suffering households have well-being that is at high risk, they report poor ratings of their current life and also poor outlook for the future. Based on this data, 90 percent of Nepalis are either suffering or struggling. This result suggests that even though there is a nascent middle class building up in Nepal, at least half of this middle class is fundamentally insecure about the prospects of continued improvements in living standards.

FIGURE 7: EPISODES OF MOVEMENTS IN AND OUT OF POVERTY (% OF POPULATION)

(a) Episode between 1995/96-2003/04



(b) Episode between 2003/04-2010/11



Source: World Bank staff calculations using data from three rounds of NLSS data for 1995/96, 2003/04 and 2010/11. The methodology used is called the synthetic panel methodology

In the qualitative survey carried out for this analysis, respondents were asked about what they saw as key characteristics of the middle class in Nepal. In in-depth interviews and focus group discussions, an overwhelming majority of respondents/participants associated being in the middle class with being engaged in relatively secure professions such as government jobs, teaching, medical and engineering professions, and other forms of private sector salaried employment. This association was reinforced by widespread recognition among respondents that economic prospects of those in this group hinges more critically on professional skills and labor as opposed to things like inherited capital and other forms of financial assets.

The Productivity Constraint

One of the main findings of this report is that living standards have improved but not sufficiently enough to move those who have escaped poverty to a more secure middle class. As a result, a majority of the population today constitutes a vulnerable group that is either perilously close to falling back into poverty or otherwise struggling to cement their economic security. Building prosperity for a majority of Nepalis will entail not just safeguarding the gains already made, but also boosting productivity of the economy in a manner that will help them realize higher income levels. The direct and indirect effects of work related migration, primarily to overseas destinations, has been a critical driver of mobility experienced by Nepalis over their lifetimes and across generations. But one

key limitation of the welfare improvements that have been realized has been that these private gains have not translated into an aggregate improvement in the productive potential of the economy in a manner that would generate good jobs for those that remain in Nepal.

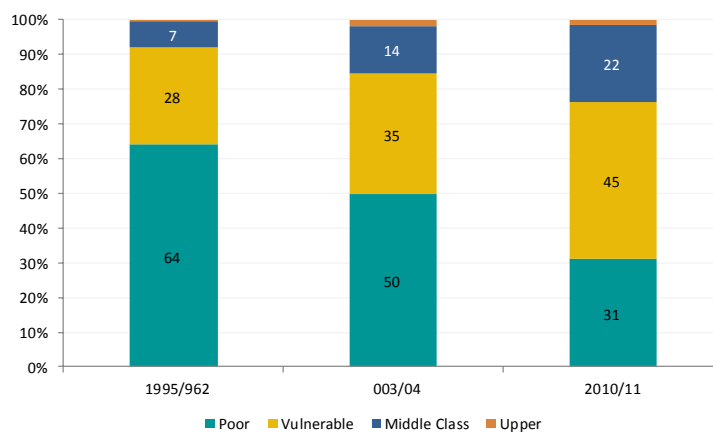
Nepal's atypical structural transformation has been one major impediment to the development of the middle class. Agriculture, which used to command a dominant share of the total value added in the economy has declined to 34 percent. The share of industries rose and reached a peak of 23 percent around the beginning of the Maoist conflict in 1996, but has dwindled to a low 16 percent since then. In the context of shrinking agriculture and timid industries, services have grown in prominence and account for more than half of the GDP today. The typical story of structural transformation is one through which workers leaving low productivity agriculture in favor of higher productivity jobs in manufacturing agglomerate in cities which act as production centers and engines for growth. In the case of Nepal, the economy has diversified away from agriculture over the long run, but it appears to have skipped the intermediate manufacturing phase and gone directly to services. This "premature graduation" from industries towards low skilled services is one potential reason for the apparent disconnect between private income growth and the formation of a robust middle class.

Despite the dramatic shift in the production base of the economy, the change in employment patterns have been relatively modest. A sizeable majority of rural Nepalis continue to be self-employed in agriculture. The most significant change in the rural areas is the increase in off-farm self-employment which has roughly doubled from 4.5 percent in 1995 to 8.1 percent in 2010. Focusing only on wage jobs, the most dramatic increase in wage employment in rural areas has come in construction which is mostly of a casual nature. White collar jobs in professional services and manufacturing have increased in urban areas but in terms of skill content of all wage jobs, this has been stagnant over the period.

Given the low level of job creation in the economy, overseas work and remittances have

provided a much needed safety valve for the economy. At the micro level, the flow of remittances has directly benefitted migrant households. Even households without migrants have benefitted from the growth in labor income. On the one hand, wages in agriculture have gone up as a result of the tightening of labor supply. On the other hand, increase in the demand for non-agricultural goods and services has led to an increase in demand for non-farm labor and pushed up non-farm wages. In the urban and newly urbanizing areas, remittances have been the critical source of liquidity fuelling growth in banking and financial services, restaurants and trade as well as real estate and construction. The latter in particular, has generated tremendous growth in rents to the owners of land and capital within cities perpetuating a multiplier effect on the demand for goods and services. This has aggregated up to the macro level where the remittance receipts have been critical to maintaining Nepal's current account position, despite a widening trade deficit as the country imports a growing amount of consumer goods ranging from the most basic such as rice and petroleum products to telecommunications equipment, luxury cars and parts. The overall surplus position in the balance of payments, largely due to remittance inflows have been a critical buffer against global macroeconomic shocks.

FIGURE 8: THE POOR, VULNERABLE AND THE MIDDLE CLASS IN NEPAL



Source: World Bank staff estimates based on data from three rounds of NLSS data for 1995/96, 2003/04 and 2010/11

Note: The consumption aggregate used for this part of the analysis is the 30-day recall version which is not the version used for official poverty estimates for 2010/11.

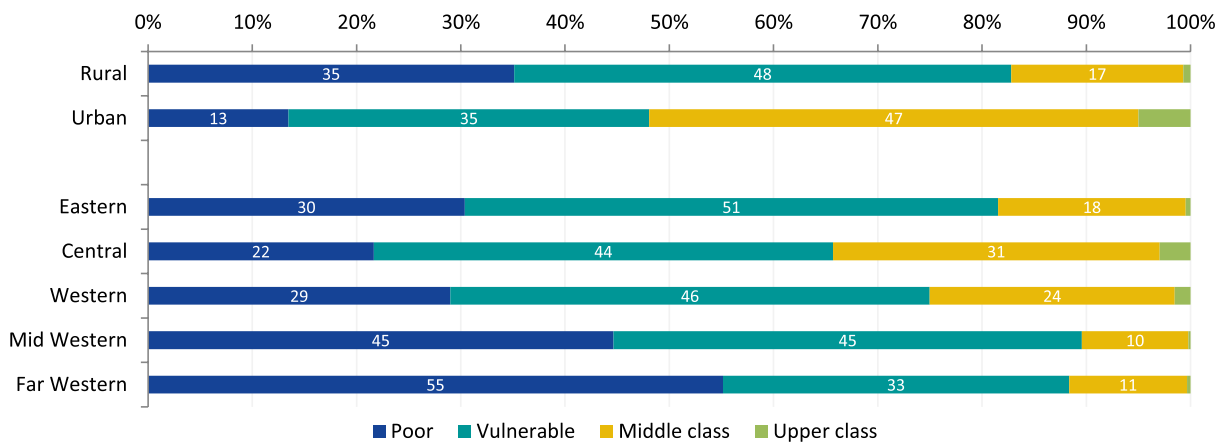
But in a perverse way, remittances have also weighed down on Nepal’s development potential. First, the buoyant influence remittances have had on the purchasing power of a majority of Nepalis has inadvertently also resulted in the appreciation of the country’s real exchange rate which has in turn eroded the competitive edge of manufacturing industries, further undermining the employment generation potential of this sector. Second, the steady outflow of young and potentially restless youth and the cushion of remittances could have also lulled policymakers into not seeing the immediate urgency of key reforms necessary to unlock Nepal’s longer term

development potential. A stable, positive balance of payment position and a strong fiscal position maintained in part by the revenues from taxes on an ever growing base of imports have been the bulwarks of Nepal’s overall macroeconomic stability over the last decade.

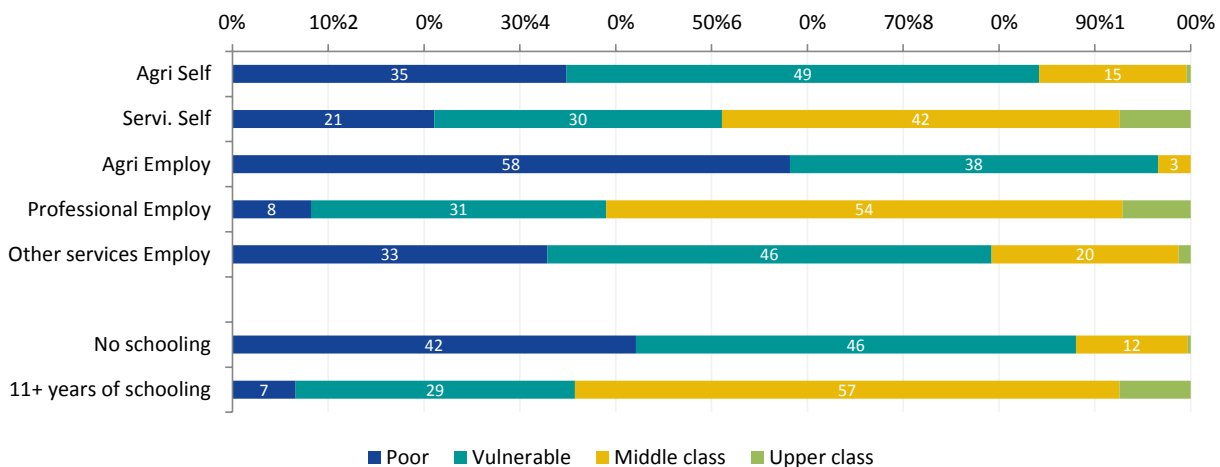
But remittance driven growth is not likely to continue forever, especially given the already high base. Further, there are signs that the rate of migrant outflow is beginning to taper off as the major host countries show signs of stress in the face of declining crude oil prices. While the strategy has – by default – served as a useful buf-

FIGURE 9: CHARACTERISTICS OF THE POOR, VULNERABLE AND THE MIDDLE CLASS, 2011

(a) By geographic region



(b) By education and occupation



Source: World Bank staff estimates based on data from three rounds of NLSS data for 1995/96, 2003/04 and 2010/11

fer during turbulent times for Nepal, it cannot be the durable source of growth required to turn Nepal into a middle income country with a vibrant middle class by 2030.

Urban agglomeration – A Missed Opportunity?

Urbanization has increased quite rapidly. In fact, Nepal is the fastest urbanizing country in South Asia. Greater rural-urban migration and the emergence of urban sprawls around main highways bordering India and district headquarters have been the key characteristics of urban growth. One crucial driver of the recent urbanization trends has been the growth in rural incomes and the transmittal of tastes and preferences for certain amenities including basic services such as better education and health that are more likely to be serviced in urban clusters. While rural-urban migration, together with migration to India, still represents an important income diversification strategy for households not directly able to participate in international migration due to cost constraints, most of these domestic migrants find employment in low skilled services such as construction, trade and retail and hospitality sectors in the cities.

The pull of a dynamic urban economy generating good jobs appears to be largely non-existent and the dominance of push-factors in driving urban growth implies that the consumer advantage of cities and newly emerging towns has not translated into a productive advantage. One evidence on this is the spatial pattern of wage growth. Wages have grown across the country, but the pace of growth has been faster in rural areas and the newer towns than in core metropolitan areas of Kathmandu and other urban centers. Taking into account the cost of living differences across the country, the pace of wage growth in Kathmandu in particular, relative to the rest of the country has been miniscule. The negative effects of agglomeration, on the other hand, have been highly visible as the unplanned and unregulated growth of the city has not only led to the deterioration of basic services such as drinking water and sanitation but also polluted the city's rivers and air to highly toxic levels.

As the primary seat of the government, Kathmandu has enjoyed historical primacy among

cities but over the last two decades, its share of total urban population has been declining. In 1991, Kathmandu accounted for 25 percent of Nepal's urban population. By 2011, this number was down to 22 percent. Considering Kathmandu valley as a whole, i.e., municipalities of Kathmandu, Lalitpur, Bhaktapur, Kirtipur and Madhyapur Thimi taken as a single urban cluster, the decline is even sharper and goes from 39 percent in 1991 to 32 percent in 2011. Cities play an important role in driving growth. For Nepal, the emergence of unplanned urban clusters and secondary towns raises the question of whether the loss of primacy of the country's pre-eminent urban cluster is an entirely desirable outcome from the point of view of growth.

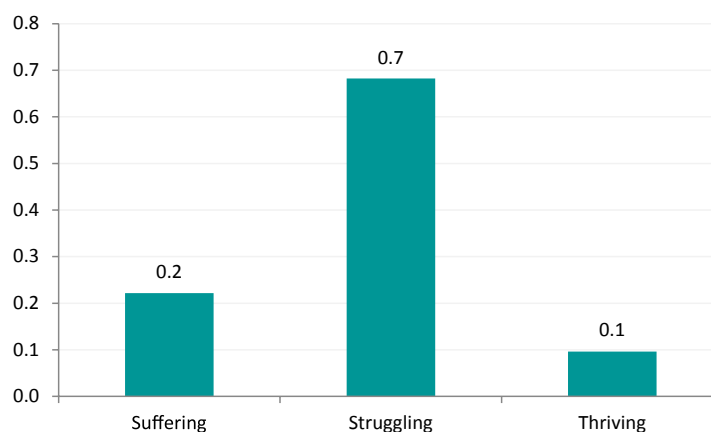
Directions for Policy

So what does Nepal need to do to consolidate the gains on improving living standards, reducing poverty and boosting shared prosperity? Three main policy directions emerge from this analysis.

First, **equalizing opportunities** and leveling the playing field to enable Nepalis from all walks of life to participate to economic life is not only a sensible way to move forward on the inclusion agenda, but it is also likely to be good for growth. All children, including Champa and Goma must have as much as a decent shot at realizing their life's potential as Avidit. This will require a three pronged effort. First, improving the quality of

Greater rural-urban migration and the emergence urban sprawls around main highways bordering India and district headquarters have been the key characteristics of urban growth.

FIGURE 10: THE PROPORTION OF NEPALIS STRUGGLING, SUFFERING AND THRIVING



Source: World Bank staff estimates based on data from Gallup World Survey.

Nepal's decentralization efforts have been stunted for a long time due to conflict and political turmoil.

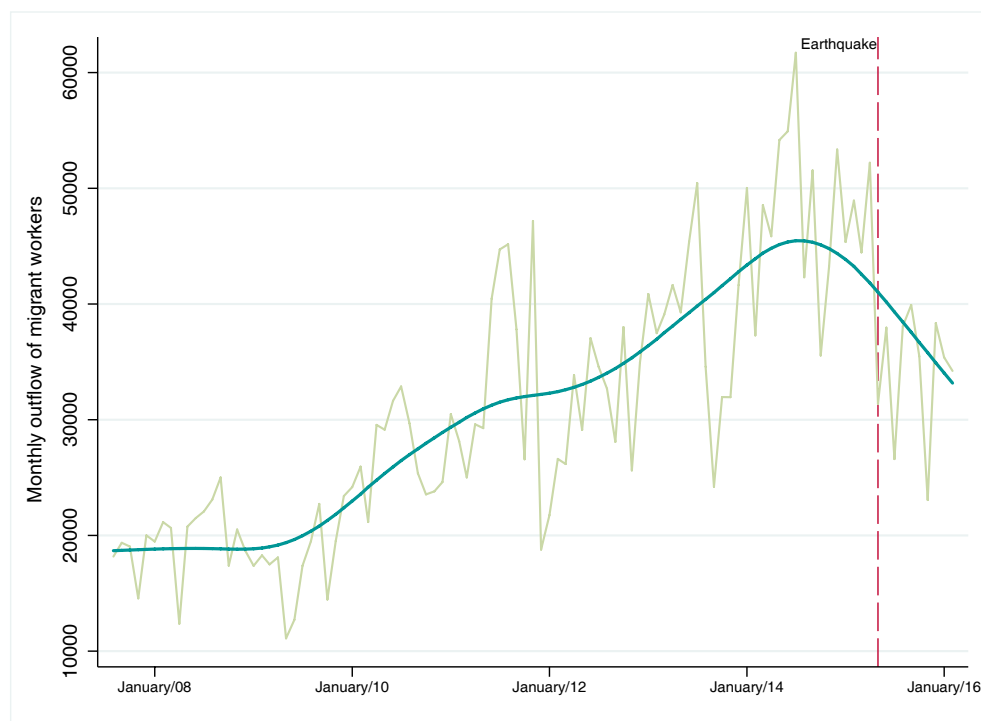
service delivery generally remains a critical part of the agenda on improving opportunities. Nepal's decentralization efforts have been stunted for a long time due to conflict and political turmoil. But with the country having adopted a federal structure in its new constitution, strengthening local accountability through the electoral process and building in the inequality of opportunities into the formulas that will guide intergovernmental fiscal transfers will be two possible ways of improving services, particularly in the underserved regions. Second, given inequalities within regions, there is also an urgent need to strengthen equalizing investments, through scholarships, health insurance and social safety nets that should ideally be targeted on the basis on economic need. Finally, in order to redress the residual effects of past disadvantages, some form of affirmative action may have to be maintained. The new constitution has made provisions for representation of a variety of underserved groups in various levels of political and public office and there are already provisions for affirmative action in civil

service appointments. But ensuring adherence to these principles in legislation and practice would go a long way.

To **reduce vulnerabilities** Nepal needs to strengthen safety nets systems, particularly those that insure households against a variety of income shocks. There is a high degree of vulnerability and transitions around the poverty line with one person falling back into poverty for every two that escape. Given the experience of the recent earthquake, one area that appears particularly important is the design of systems that will enable the government to respond in a more agile and efficient manner, not just to catastrophic disasters of similar scale but also to smaller but more frequent shocks, or the dull disasters.

Designing safety net systems that are able to target and deliver assistance based on broader, income based notions of poverty and vulnerability is also an important agenda because the existing programs have had very limited impact

FIGURE 11: CHARACTERISTICS OF THE POOR, VULNERABLE AND THE MIDDLE CLASS, 2011



Source: Ministry of Foreign Employment Database
 Note: The solid line represents the trend obtained by applying the Hodrick-Prescott filter to the raw data.

on poverty. Investments in these activities may appear to be a drain on the budget and indeed the issue of fiscal space is an important consideration. But two mitigating arguments need to be considered. First, significant savings may be possible by rationalizing the highly fragmented current portfolio of social assistance. Second, given the scale of vulnerabilities Nepali households routinely deal with, helping protect their savings and assets during times of crisis, could potentially enhance their ability to take risks and make productivity enhancing investments in both agriculture and non-agricultural activities which could actually help growth.

Finally, on **enhancing productivity**, three key policy directions are identified. First, as most of Nepal's chronic poor remain in agriculture, there is an urgent need to boost productivity in this sector. This will require among others, promoting diversification from cereal crops to cash crops, greater commercialization and better integration with markets and value chains. As the overseas migration experience deepens, the pool of migrant returnees is also likely to increase over time. These migrants will come not only with resources but also with creative ideas and visions formulated through rich experiences working abroad. Having the right policy and investment environment as well as a whole host of complementary inputs such as better connectivity through rural roads and financial services will help leverage their creativity and entrepreneurial spirit to boost growth in this sector.

Second, in order to accelerate the creation of productive jobs, Nepal must figure out a way to generate more and better jobs within Nepal. Whether this is by putting in place policies to rekindle growth, particularly in its industrial/manufacturing sectors or through exploring avenues for promoting higher value services that have some degree of tradability or a combination of the two is something that should come out in a clearly articulated growth strategy. The

lack of adequate number of good jobs appears to be the fundamental constraint to the formation of a robust middle class in Nepal. To that end stabilizing the political environment, carrying out the necessary reforms to improve the investment climate and addressing the crippling infrastructure deficit would be equally essential entry points.

Leveraging the agglomeration potential of Nepal's cities would also be an important policy direction. The current industrial policy provides tax incentives and subsidy for investment in the development of the plant for firms to locate their productive activities in lagging regions. These "spatially targeted" policies represent the government's deliberate efforts to de-concentrate productive activities. But locating production activities in remote locations with lower population densities is seldom effective in propping up lagging regions or generating growth. In fact, if enforced, such policies could be detrimental for the growth of the industrial sector. Instead, from the perspective of growth, a better policy would be to invest in enhancing connectivity of the remote regions to the emerging growth centers or to invest in the development of these growth centers themselves.

Finally, it must also be recognized that there is no level of growth Nepal can realistically generate in the medium term that will generate jobs at a fast enough pace to completely overturn the flow of migrant workers. A more realistic outlook is that a steady state level of overseas migration will remain a critical dimension of Nepal's jobs environment in the medium to long run. For this reason, building a better understanding of not just the migration process in general but also of what can be done to make the process more efficient and less costly so that successive cohorts of Nepali migrants have better information of opportunities abroad, can become more productive and can have access to better quality jobs abroad appears an important part of the jobs agenda.

The lack of adequate number of good jobs appears to be the fundamental constraint to the formation of a robust middle class in Nepal.

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