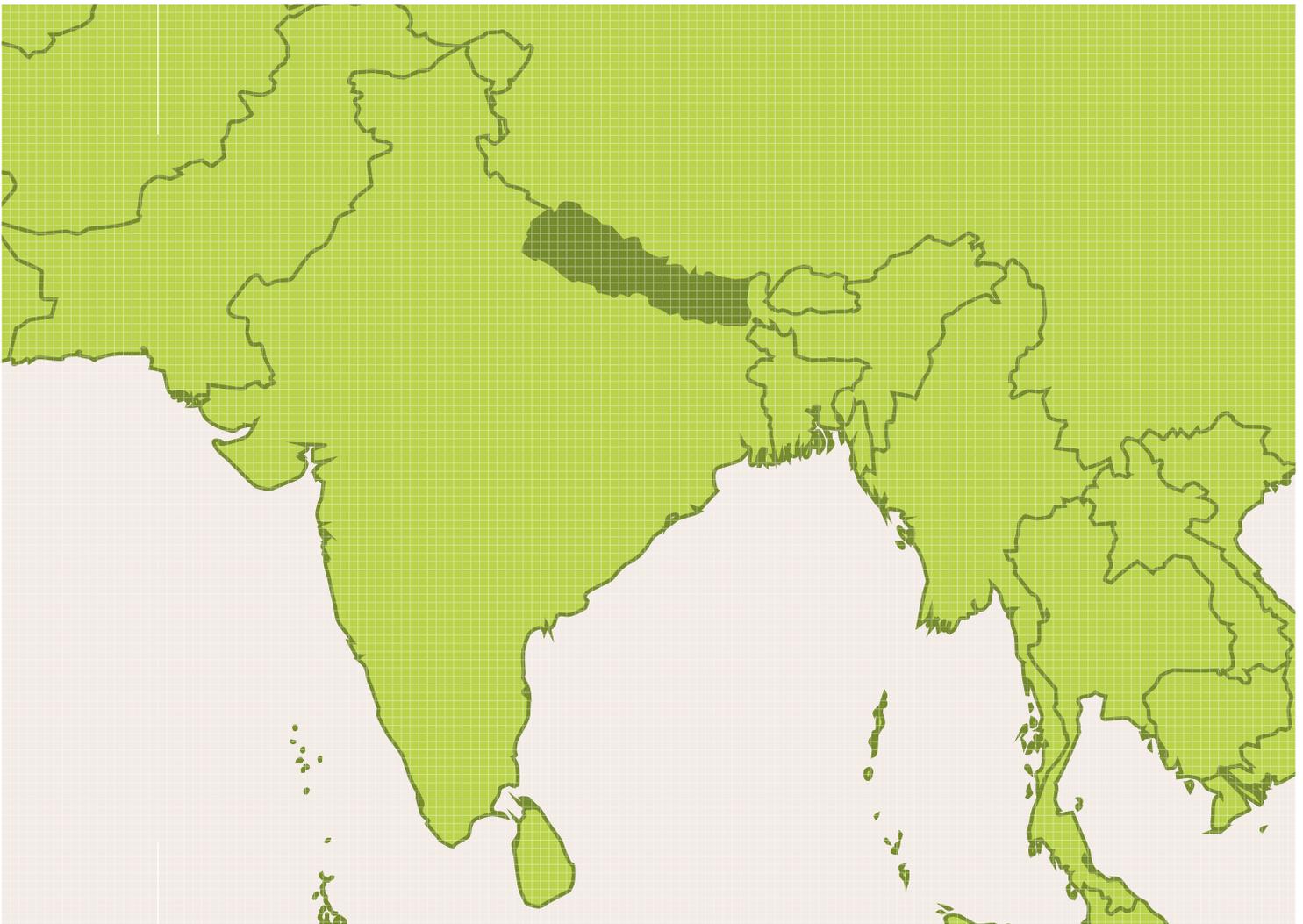


# Nepal: A Political Economy Analysis

Magnus Hatlebakk



Report commissioned by the Norwegian Ministry of Foreign Affairs

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Visiting address: C.J. Hambros plass 2d  
Address: P.O. Box 8159 Dep.  
NO-0033 Oslo, Norway  
Internet: [www.nupi.no](http://www.nupi.no)  
E-mail: [post@nupi.no](mailto:post@nupi.no)  
Tel: [+ 47] 22 99 40 00

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*Magnus Hatlebakk*

Report commissioned by the Norwegian Ministry of Foreign Affairs  
November 2017

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## About the report

In June 2016, the Norwegian Ministry of Foreign Affairs (MFA) commissioned NUPI to provide political economy analyses of eleven countries (Afghanistan, Ethiopia, Haiti, Malawi, Mali, Mozambique, Myanmar, Nepal, Somalia, South Sudan and Tanzania) deemed important to Norwegian development cooperation. The intention was to consolidate and enhance expertise on these countries, so as to improve the quality of the MFA's future country-specific involvement and strategy development. Such political economy analyses focus on how political and economic power is constituted, exercised and contested.

Comprehensive Terms of Reference (ToR) were developed to serve as a general template for all eleven country analyses. The country-specific ToR and scope of these analyses were further determined in meetings between the MFA, the Norwegian embassies, NUPI and the individual researchers responsible for the country studies. NUPI has also provided administrative support and quality assurance of the overall process. In some cases, NUPI has commissioned partner institutions to write the political economy analyses.

# List of acronyms

ADB	Asian Development Bank
CA	Constituent Assembly
CMI	Chr. Michelsen Institute
CPA	Comprehensive Peace Acord
CPN	Communist Party of Nepal
CPNM	Communist Party of Nepal - Maoist
DAC	Development Assistance Committee
DDC	District Development Committee
DFID	Department for International Development - UK
DHS	Demographic and Health Survey
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
GNI	Gross National Income
IDA	International Development Association (World Bank)
INGO	International Non-Governmental Organization
INSEC	Informal Sector Service Center
LGCDP	Local Governance and Community Development Program
LGP	Liquefied petroleum gas
MFA	Ministry of Foreign Affairs
MP	Member of Parliament
MPRF	Madhesi People's Rights Forum
MW	Mega Watt = 1000 kilo watt
NEA	Nepal Electricity Authority
NEFIN	Nepal Federation of Indigenous Nationalities
NGO	Non-Governmental Organization
NIBR	Norsk Institutt for By og Region Forskning
NLSS	Nepal Living Standards Survey
NORAD	Norwegian Agency for Development Cooperation
NUPI	Norsk Utenrikspolitisk Institutt
OBC	Other Backward Caste (official term in India)
OECD	Organization for Economic Co-operation and Development
PLA	People's Liberation Army
PM	Prajatantrik Mahasabha (early monarchist party)
RIM	Revolutionary Internationalist Movement

## List of acronyms | Magnus Hatlebakk

RPP	Rastriya Prajatantra Party (monarchist party)
SPA	Seven Party Alliance
TFP	Total Factor Productivity
TMLP	Tarai-Madhesh Loktantrik Party
TU	Tribhuvan University
UML	Unified Marxist-Leninist
UN	United Nations
UNIDO	United Nations Industrial Development Organization
UPF	United People's Front
VAT	Value-Added Tax
VDC	Village Development Committee
WDI	World Development Indicators
YCL	Young Communist League

# Preface

The Ministry of Foreign Affairs has commissioned a number of political-economy analyses of the main partner countries for Norwegian development cooperation. The studies are coordinated by the Norwegian Institute of International Affairs (NUPI). CMI conducted some of the studies including the Nepal study. The purpose is “to provide information that will strengthen MFA and the relevant embassies’ general understanding of the political, economic and social power structures and actors in the focus countries. The aim is to increase the quality and effectiveness of Norwegian development cooperation. The main user groups would be personnel directly involved in Norwegian cooperation with Nepal”.

To ensure that the Nepal report would cover essential topics of interest for the main users, a meeting was held in the Ministry of Foreign

Affairs with representatives from NORAD and the Norwegian embassy in Kathmandu. After the meeting a detailed table-of-contents was agreed upon. The analysis is based on the author’s 20 years of experience in Nepal. Events and developments are documented in footnotes and appendices. The author thanks Stein Sundstøl Eriksen (NUPI), Chaitanya Mishra (Tribhuvan University), Astri Suhrke (CMI) and the Ministry of Foreign Affairs for extensive comments. They can, however, not be held responsible for the analysis, conclusions, or any remaining errors.

Magnus Hatlebakk  
Chr. Michelsen Institute (CMI),  
Bergen, Norway  
June and November, 2017

## Executive summary

The report is an integrated political economy analysis as defined by OECD-DAC: “Political economy analysis is concerned with the interaction of political and economic processes in a society: the distribution of power and wealth between different groups and individuals, and the processes that create, sustain and transform these relationships over time”<sup>1</sup>.

The main finding is that economic growth and poverty reduction have been steady in Nepal since the mid-1980s independently of a number of political upheavals, including ten years of civil war. There has been a steady per-capita growth rate of about 2% with no major change in inequality. As a result, poverty has declined and social indicators have improved. Despite an apparent disconnect between the political and economic domains, political decisions and institutions arguably matter for economic development, and political stability and participation are important targets independently of their impact on economic development.

In the political domain the ongoing local elections will reintroduce local democracy after 20 years. Elected local politicians are expected to boost local development efforts. Furthermore, Nepal has a vibrant public debate due to a large number of independent newspapers and radio stations at the national and local levels, which constitute the main channels of influence for civil society. The leading political forces in Nepali society are, however, the political parties. They penetrate all parts of society, ranging from civil society, via universities and research institutions

to the bureaucracy and the business community. There are close links between politicians and business leaders, the political parties control the trade-unions, have links to civil society organizations, and the parties select high-level government officials.

The Congress, UML and Maoist parties compete for power. The Maoist party established itself as a third force through the civil war. The war was followed by a post-war ethnic uprising in the plains of Nepal, where a fourth political force was established with a number of parties representing the diverse Madhes community. A main demand, which also had support from ethnic activists in the hills and the Maoists, was to establish Nepal as a Federal Republic. The formal decision was made by the first Constituent Assembly in 2008, while a compromise federal map was decided in 2015, with provincial elections scheduled for the fall of 2017. There are concerns that the ethnic agenda may escalate ethnic conflicts, and it will be essential for all parties to work for participation of all social groups within the recently established local units, as well as in the economy at large.

Regarding the economic domain the report concludes that international labor migration has been a driving force behind Nepal’s recent development. Large-scale remittances mean that Nepal has good access to foreign currency. In contrast to other capital flows, these funds go to the lower middle classes, which may explain why inequality has not increased in Nepal. The lack of labor at home has also contributed to increased wages for the poor, who cannot afford to take up jobs in the Gulf region. Despite the availability of private capital and increases in

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<sup>1</sup> [/www.odi.org/sites/odi.org.uk/files/odi-assets/events-documents/3797.pdf](http://www.odi.org/sites/odi.org.uk/files/odi-assets/events-documents/3797.pdf)

wages for the poor, there is still a massive need for public investments in infrastructure, agriculture, health, and education. Roads, transmission lines for electricity, agricultural inputs, hospitals and education (in particular quality of primary education and vocational training) are heavily underfunded, and donors can make a difference in all these sectors.

To summarize, Nepal has had a good economic growth since the mid 1980s. There is, however, a potential for higher growth if more is invested in public goods, including roads, transmission lines, and education. A new constitution is now in place securing female representation and minority rights. The first steps are taken towards de-facto implementation of a federal state, with provincial elections coming up. The powers of the provincial governments are still to be implemented, in particular the difficult

reallocation of economic resources from rich to poor provinces. Local elections, which were postponed for 20 years due to the war, have now been held, allowing for local accountability. The new local units are, however, larger than earlier, and a provincial level is added, with both developments opening up for larger shares of public funds being controlled at the local level. With new levels of bureaucracy and local government there is an increased risk for misuse of public funds that needs to be taken seriously by the authorities and the donors. With the constitution in place, a vibrant public debate, led by an independent media, and the potential for a more stable government after the upcoming national election, there is, however, reason for optimism when it comes to public investments and thus higher economic growth.

# 1. Introduction

During the last three decades Nepal has had a tumultuous political life, but at the same time a stable, although slow, economic growth: multiparty democracy was introduced as a result of decades of political struggle that ended with the people’s movement in 1990<sup>2</sup>. The continued slow economic progress may have contributed to the support, although limited, for the far-left (5% of the votes in the 1991 election) and ultimately the ten-years of Maoist insurgency (1996–2006). The peace-solution led to a transition from monarchy to a federal republic, and was followed by a rise in ethnic conflicts in the plains along the border to India. The civil war, where 13 000 people died, was a main factor behind a massive increase in foreign labor migration, which led to a large inflow of remittances and an upward pressure

on wages in local labor markets. Despite these developments, where introduction of democracy and removal of the “feudal” monarchy assumedly would lead to economic growth, while the war would slow down the economy, there has been a stable economic development (of 2.6% growth per capita per year) that started with the economic reforms in the mid-80s. The five-years moving average growth rate was at its lowest (1.8%) in 2004 at the height of the civil war, and at its maximum (3.6%) in 2010 following the peace-agreement (Figure 1).

Over 30 years a growth rate of 2.6% will double real incomes. We know that the poor have benefited as the population share below the poverty line declined from 42% in 1995 to 25% in 2010, with all indicators pointing towards fur-

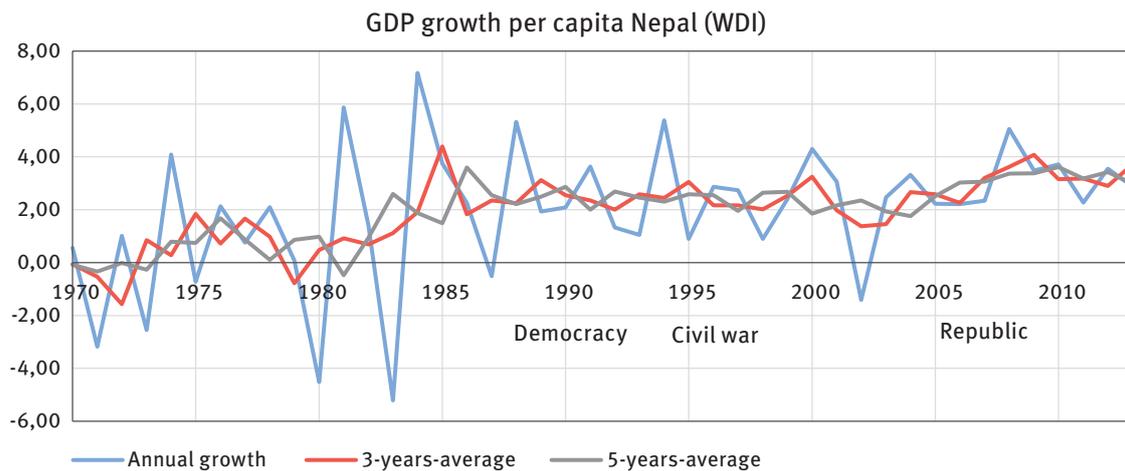


Figure 1. GDP growth (1968–2015)

2 See Appendix for a time-line of major events in Nepali history.

ther decline after 2010. The economic growth and poverty reduction do not seem to be related to foreign aid. The aid level was relatively low until 2001. Measured in constant-2014-USD the aid level was at 376 million in 1986 and at 371 million in the year 2000. During the height of the civil war, from 2000 to 2006, the aid increased to 507 million (5.4% growth per year), and after the peace-agreement it doubled during the next decade to 1026 million in 2015 (8.1% growth per year). But even during recent years, aid has constituted only 5% of Nepal's GDP.

The purpose of the report is: “to systematically analyze political, economic and social power structures and actors in an integrated political

economy analysis, with the aim of improving the effectiveness of development cooperation”. The report will discuss the underlying causes of the relatively low, but stable, economic growth, as well as the driving forces behind the turbulent, and still ongoing, transition from monarchy to a federal republic. We shall see how economic life in Nepal is deeply interwoven with political interests, and discuss the difficulties international donors may face in spending aid under such circumstances. As a basis for the analysis, we start with introductions to the Nepali economy and the history of political and social conflict in Nepal.

## 2. The Nepali economy

### 2.1 Growth, poverty and inequality

As noted above Nepal has had a good economic growth since the mid-80s. Real incomes have doubled over these 30 years. GDP per capita, measured in 2010 prices, was USD 320 in 1985, USD 403 in 1995 and USD 690 in 2015<sup>3</sup>. The doubling of incomes has also benefited the poor, the poverty rate in 1995 was as high as 42%, while in 2010 it was down to 25%, and as low as 12% if we use an adjusted poverty-line<sup>4</sup>. At the same time inequality increased from 1995 to 2003 and then declined from 2003 to 2010 (see Table 1)<sup>5</sup>.

In a growing, but still poor, economy a decline in inequality is unusual, we would, rather, expect inequality to increase as people get richer in the modern part of the economy. In Nepal it appears that the economic growth is driven by labor migration. This leads to increased incomes for the lower middle classes in villages that send migrants to the Gulf and Malaysia, instead of the urban classes employed in the modern sector. Labor shortages also lead to upward pressure

Table 1. Poverty and inequality in Nepal

	1995	2003	2010
Poverty (%)	41.8	30.8	25.2
Gap up to poverty line (%)	11.8	7.6	5.4
p25/p75	0.48	0.43	0.48
Gini	0.35	0.44	0.33

NLSS1, NLSS2, NLSS3

on domestic wages for unskilled labor, which directly helps the poor. Thus the lower range of the income distribution will be lifted more than we would expect during a transition period. This analysis is supported by a detailed study conducted by the World Bank<sup>6</sup>, which found that labor incomes and remittances were the main drivers of the poverty reduction.

The poverty gap shown in Table 1 is the average gap between the poverty line and the incomes of the poor (counting also the zeros for the non-poor), which in 2010 constituted 5% of the poverty line. With 25% being poor this means that the average poor household had an income about 20% below the poverty line. This, in turn, means that Rs 4200 (USD 58) per poor person per year, or about USD 350 million in total, would have removed all poverty in Nepal. This amounts to about 42% of the foreign aid received that year, or about 14% of domestic government expenses.

The gap can also be compared to private incomes in Nepal. If we use the same survey, then the poverty gap adds up to the reported incomes of the 0.3% with the highest incomes. Similarly an 8% income tax on all non-poor households

3 All macro data are from World Development Indicators with most series ending in 2015.

4 Regional poverty lines are used to allow for different costs of living, and in particular the poverty line for Kathmandu is the double of other urban areas. In general it appears that the cost increases are over-estimated, thus the real poverty rate is probably lower than 25%, and maybe as low as the adjusted estimate of 12%. For further presentation of methodology and poverty levels in Nepal see: NLSS (2012) *Poverty in Nepal. 2010/11*, World Bank (2016). *Moving Up the Ladder: Poverty Reduction and Social Mobility in Nepal*, and Hatlebakk and Ringdal (2013). *The economic and social basis for state-restructuring in Nepal*. Himal Books.

5 Poverty and inequality data are based on the World Bank measurement standard of using expenditure data from living standards measurement surveys. In Nepal the last survey was in 2010.

6 World Bank (2016). *Moving Up the Ladder: Poverty Reduction and Social Mobility in Nepal*.

Table 2. Poverty by areas (%)

Region	1995–96	2003–04	2010–11
Kathmandu	4.3* [0.7; 7.9]	3.3* [0.4; 6.1]	<b>11.5*</b> [8.6; 14.3]
Other urban	31.6 [13.9; 49.3]	13.0* [7.3; 18.8]	17.5 [12.7; 22.3]
R.W. Hill	55.0* [47.2; 62.8]	37.4* [30.5; 44.3]	<b>32.3*</b> [27.2; 37.4]
R.E. Hill	36.1 [29.2; 43.1]	42.9* [35.4; 50.4]	<b>24.0</b> [17.3; 30.6]
R.W. Terai	46.1 [38.0; 54.1]	38.1* [29.1; 47.2]	<b>26.8</b> [20.4; 33.2]
R.E. Terai (ref)	37.2 [30.5; 43.8]	<i>24.9</i> [20.0; 30.0]	<b>22.2</b> [18.2; 26.2]
Nepal	41.8 [38.1; 45.4]	<i>30.8</i> [27.7; 34.0]	<b>25.2</b> [23.0; 27.3]
N	3373	3912	5580

This is Table 4.1 in Hatlebakk and Ringdal (2013). Himal Books.

\* indicates a significant difference from reference category within the same period at the 95%-level.

**Bold** indicates a significant difference from first period at the 95%-level.

*Italics* indicates a significant difference from previous period at the 95%-level.

The figures in brackets are 95% confidence intervals.

would in theory remove the poverty gap. These calculations demonstrate that removing poverty in Nepal is, in theory, financially feasible. We know, however, that transfer programs have serious incentive and implementation problems, and we will discuss some of these later in this report. Before we go on to the complications of policy, we will first describe the distribution of poverty between regions and population groups.

Poverty declined from 1995 to 2010 in all areas of Nepal, except for Kathmandu<sup>7</sup>, where the poverty level was low already in 1995 (Table 2). Poverty is still highest in the remote western Karnali hills of Nepal. This is a large region covering about 50% of the landmass, but less densely populated than the rest of the country. In Karnali the poverty rate was 32% in 2010, but it was also high elsewhere in rural Nepal, ranging from 22% in the eastern terai to 27% in the western terai.

Since it is not straightforward to measure incomes in poor countries, an alternative is to use the daily wage of agricultural labor as an indi-

cator of poverty levels<sup>8</sup>. This is also an imprecise measure as number of days worked will vary, but a low wage will normally indicate not only low incomes per day, but also the presence of surplus labor, and thus that each worker may get less work. Wages will normally be at its lowest in the agricultural sector, which will be the backup solution for people who do not get other unskilled or semi-skilled work in factories, brick-lanes, or construction work.

In 1995 the most common wage among farm laborers was 30 rupees, including the value of in-kind payments<sup>9</sup>. Adjusted for the increase in the price of rice, this was equivalent to 75 rupees

<sup>7</sup> As discussed above we believe the poverty line for Kathmandu is set too high for 2010, and as a result the poverty level should be lower.

<sup>8</sup> Deaton, A. and Dreze, J. (2002). "Poverty and Inequality in India. A Re-Examination". *Economic and Political Weekly*. 37(36): 3729–3748.

<sup>9</sup> A standard payment was one kilo of rice and 0.5 kilo of wheat-flour. For details on the variation in mode of payments see Hatlebakk (2004). *Attached labor in Nepal: A field-study of landlord-labor relations that are misrepresented in the Nepal-LSMS data*. CMI.

Table 3. Poverty by social identity

	1995	2003	2010
Hill-BC	34.9 (28.9–40.8)	<b>18.8***</b> (14.3–23.3)	18.0** (14.6–21.4)
Hill-Janajati (ref)	42.2 (34.2–50.1)	35.0 (29.0–41.0)	<b>24.3</b> (20.1–28.5)
Hill-Dalit	58.2*** (49.9–66.5)	<b>44.9**</b> (36.8–53.0)	43.0*** (36.9–49.1)
Terai-caste	28.3** (18.9–37.6)	24.5** (17.5–31.4)	28.3 (23.4–33.3)
Terai-Janajati	53.4 (42.2–64.5)	<b>35.2</b> (26.3–44.1)	25.6 (20.1–31.1)
Muslim	44.3 (33.7–55.0)	41.3 (31.3–51.3)	<b>20.2</b> (11.6–28.7)
Terai-Dalit	45.9 (38.7–53.2)	49.2** (39.5–58.8)	39.4*** (30.2–48.6)
Nepal	41.8 (38.1–45.5)	<b>30.8</b> 7(27.7–34.0)	<b>25.2</b> (22.9–27.4)

Author's calculations based on NLSS data as used in Hatlebakk and Ringdal (2013)

In 1995 the terai categories were few, in particular "Terai-Dalit" includes some non-Dalit groups

95%-confidence interval in parenthesis

\*\*\* Significant different from hill-janajati at 1%-level

\*\* Significant different from hill-janajati at 5%-level

**Bold** means significantly different from previous round

in 2010<sup>10</sup>. While in 2010 the agricultural wage had doubled to 150 rupees<sup>11</sup>. Wages are slightly higher in the hills, but here people depend less on work as day laborers. In the terai, where we find more day laborers, the wage was 150 rupees in both the west and the east in 2010. If we go back to 1995, then wages were slightly lower in the eastern terai than in the west. This can be explained by more landless farm laborers and thus excess supply of labor in eastern terai.

When we compare farm wages to non-agricultural wages, we find that farm wages in the east were even lower in relative terms, as non-

farm work gave higher wages in eastern than in western terai. Eastern terai has more industry, which may explain an upward pressure on wages, while in 1995 there was surplus rural labor. In 2010 there was still a mark-up in non-farm sectors, but wages are no longer the double of farm-wages, and there were only small within-sector differences between eastern and western terai.

## 2.2 Variation in welfare between social groups

As for distribution of poverty between castes and ethnic groups, the Dalits are, as expected, the poorest, with about 40% being poor in 2010, while the hill high caste groups, the traditional elite, have the lowest level of poverty at 18% (Table 3). Poverty has declined for all groups, but with different timing. The ethnic (Janajati) groups of hill-origin had a (slow) decline, ultimately probably explained by labor migration to the Gulf. The other groups had benefitted from a decline already in 2003, probably explained by the general economic progress discussed earlier.

10 If we instead of rice-prices use the price index implied by the NLSS poverty line for 2010, then the 1995 farm wage would be higher than the 2010 wage, which seems unlikely based on the improvements in living standards documented by the NLSS surveys. While 75 and 150 was the most common wage, the average farm wages were 90 and 160. A report from ODI that uses the consumer price index report an increase in average farm wages from 100 rupees in 1995 to 160 in 2010 (ODI, 2014, *Rural wages in Asia*), thus about the same as our calculations using rice-prices.

11 This and all other information, where we do not provide a reference, are calculations or tabulations by the author using NLSS raw-data.

Table 4. Literacy of household head by social identity

	1995	2003	2010
Hill-BC	51.4*** (47.1–55.7)	<b>64.1***</b> (60.6–67.7)	68.7*** (65.8–71.7)
Hill-Janajati (ref)	40.9 (35.9–45.9)	46.4 (42.2–50.6)	<b>59.3</b> (56.0–62.6)
Hill-Dalit	22.7*** (17.1–28.4)	<b>32.7***</b> (26.5–38.8)	<b>44.5***</b> (39.7–49.4)
Terai-caste	29.2* (18.1–40.3)	39.9 (32.4–47.4)	43.3*** (38.2–48.3)
Terai-Janajati	27.5*** (18.8–36.2)	<b>44.9</b> (37.1–52.6)	46.6*** (40.9–52.3)
Muslim	22.5*** (14.1–30.8)	29.6*** (21.9–37.4)	35.9*** (26.3–45.6)
Terai-Dalit	32.8** (27.7–37.8)	<b>15.1***</b> (9.5–20.7)	<b>29.8***</b> (23.6–36.1)
Nepal	39.7 (37.0–42.5)	<b>47.7</b> (45.1–50.3)	<b>55.8</b> (53.7–57.9)

Author's calculations based on NLSS data as used in Hatlebakk and Ringdal (2013)

In 1995 the terai categories were few, in particular "Terai-Dalit" includes some non-Dalit groups

95%-confidence interval in parenthesis

\*\*\* Significant different from hill-janajati at 1%-level

\*\* Significant different from hill-janajati at 5%-level

\* Significant different from hill-janajati at 10%-level

**Bold** means significantly different from previous round

Thus, although labor migration may explain the more recent decline in poverty, this is far from certain when it comes to the decline from 1995 to 2003, before the civil war intensified and migration took off. The previously discussed increase in inequality also indicates that the first period was a more typical broad-based growth process that we find in other poor countries.

While the decline in poverty is found in all social groups, we have discussed elsewhere how the progress in social indicators differ from economic progress<sup>12</sup>. The main conclusions were that the Madhes<sup>13</sup> groups had lower levels of education than the hill-identity groups, and we also found some evidence of poorer health out-

comes among the Madhes groups, in particular a low weight for height score, which is a measure of short-term malnutrition. Similar findings are reported in the 2011-DHS, for both children and their mothers<sup>14</sup>. Yet the DHS report indicates that according to height for age, a measure of malnutrition as a child that normally have more long-term consequences, the health outcomes are better among the Madhes groups, as compared to the hill-origin groups. This seems to reflect the fact that there is serious malnutrition in the western hills that for this measure outweigh the better health conditions among hill-identity groups living elsewhere in Nepal.

Madhesi Dalits still have the lowest literacy rate in 2010 (Table 4), despite an improvement since 2003. Such a rapid improvement, a doubling of literacy from 15% to 30% in seven years, must reflect very high primary school attendance also among the Madhesi Dalits, which gradually

12 Das, A. and Hatlebakk, M. (2010). *Statistical Evidence on Social and Economic Exclusion in Nepal*. Kathmandu: Himal Books.

13 We use the term for all terai (the plains along the border to India) origin groups, including the ethnic groups of the terai, as well as terai Dalits and the so-called higher castes. The most numerous higher castes are groups that in India will tend to be categorized as OBC (other backward castes), such as Yadav, which is the largest of these groups in Nepal. The word Madhes comes from Madhya Desh (middle country). The English spelling varies, with Madhes being common in English-language newspapers. The spelling of terai, also varies.

14 DHS (2013). *Maternal and child health in Nepal: The effects of caste, ethnicity, and regional identity*. Further analysis of the 2011 Nepal DHS.

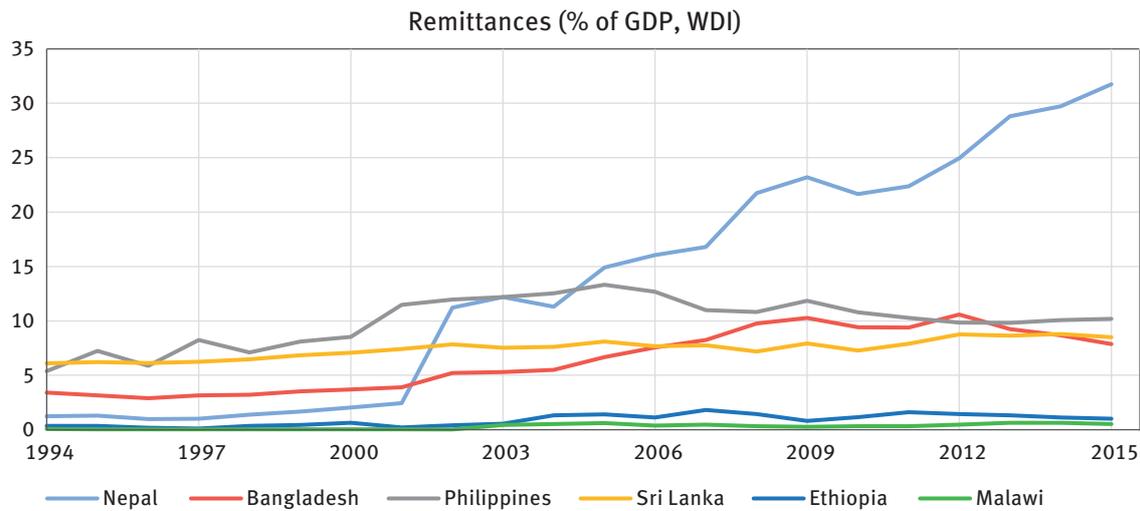


Figure 2. Remittances (1994–2015)

will improve the literacy rate. There has been a similar improvement for hill Dalits, from 33% to 45%, and for hill Janajatis from 46% to 59%. For all groups we still find that the literacy level is lower among the Madhesi groups, whether we look at Dalits, Janajatis, or the higher castes, thus the hill Dalits have the same literacy rate as the higher-caste Madhesi groups. The largest of these Madhes groups is the Yadavs, with a 38% literacy rate, while the largest terai Dalit group, the Chamars, had a 33% literacy rate in 2010.

### 2.3 Drivers of economic growth and development

As discussed, the broad-based economic growth that started with the economic reforms in the mid-80s can explain the gradual decline in poverty and increase in inequality for all population groups until the height of the civil war. After the escalation of the war, which started in 2001 when the Maoists attacked army camps and not only the police, we have seen a massive increase in labor migration<sup>15</sup>. This has led to an increase in remittances (Figure 2) as well as an upward pres-

sure on local wages<sup>16</sup>, which in turn had led to a decrease in poverty<sup>17</sup>.

The broad-based economic growth is driven by the same factors as in many other countries. The exchange-rate reforms in 1985 led to an immediate drop in the GDP-share of agriculture, and a corresponding increase in the others sectors. The long-term trend is an increase in the importance of the service sector, from 20% of GDP until 1975 when it started growing, till about 50% from 2007 onwards (Figure 3). Similarly, the agricultural share was around 70% until 1975. Since then it has declined gradually, and has been around 33% from 2008 onwards. The share of industry started out at 10%, was at 23% at its maximum in 1996, and is now down

15 The tendency is clear at the aggregate level, but there is a need for more detailed analysis. One study finds an effect of the conflict level on migration among more wealthy urban households: Shrestha, M. (2017). *Push and pull. A study of international migration from Nepal*. Policy Research WP-7965. World Bank.

16 There is research documenting the within-family effect of migration on the labor supply of remaining family members, but still a lack of research documenting the effect on equilibrium wages. The main studies this far are: Lokshin, M. and Glinskaya, E. (2009), "The Effect of Male Migration on Employment Patterns of Women in Nepal", *World Bank Economic Review*, 23(3): 481 - 507. Lokshin, M., Bontch-Osmolovski, M. and Glinskaya, E. (2010), "Work-Related Migration and Poverty Reduction in Nepal", *Review of development economics*, 14(2): 323–332. Phadera, L. (2016). *International Migration and its Effect on Labor Supply of the Left-Behind Household Members: Evidence from Nepal*. University of Illinois Urbana-Champaign. Libois, F. (2016), *Households in Times of War: Adaptation Strategies during the Nepal Civil War*, CREDE-WP, University of Namur.

17 World Bank (2016) *Moving Up the Ladder: Poverty Reduction and Social Mobility in Nepal*.

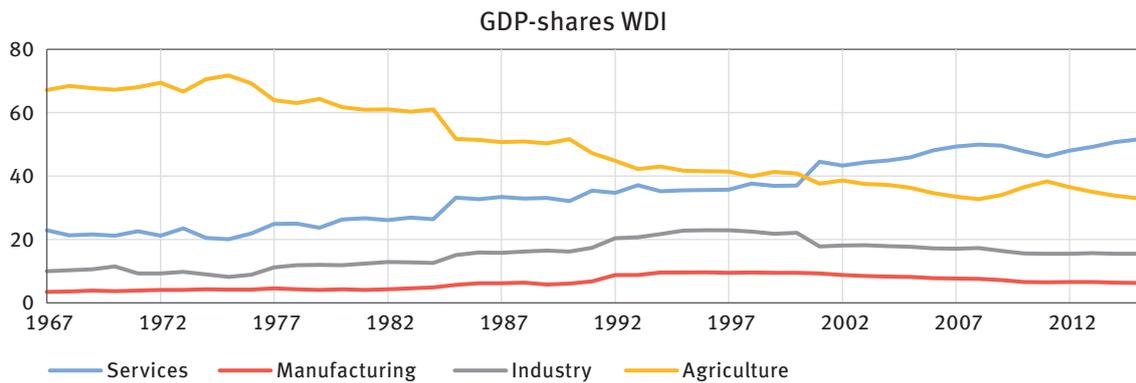


Figure 3. Sectoral composition of GDP (1967–2015)



Figure 4. Sectoral composition of employment (1991–2013)

to 15%, out of which manufacturing constitutes 6% of GDP (Figure 4 for employment shares).

During this 50 years period the GDP increased from 3 to 20 billion measured in constant-2010-USD. Thus despite that the national economy is now six to seven times larger (only double if we take population increase into account), the importance of the industrial sector has not increased. This is a general trend in all countries (in US the service-sector is now 78% of GDP), as the economy grows a smaller part of income is spent on food, and the agricultural sector is bound to decline as a share of national incomes (GDP). There is a similar trend for industrial goods as the share of income spent on material goods decline. People instead spend additional

incomes on other needs, such as education, health, bank and insurance services, and luxuries such as restaurant meals and entertainment.

Even more important for the long-term development of a country is the increase in the savings-rate that tend to follow increased incomes. Figure 5 shows the savings-rate for Nepal, as well as neighboring India and Bangladesh. The total savings are calculated as GDP minus consumption plus net transfers from abroad, while domestic savings are defined as just GDP minus consumption. The low domestic savings rate is included here to demonstrate the importance of the transfers, while total savings is the important measure when it comes to the potential for economic growth.

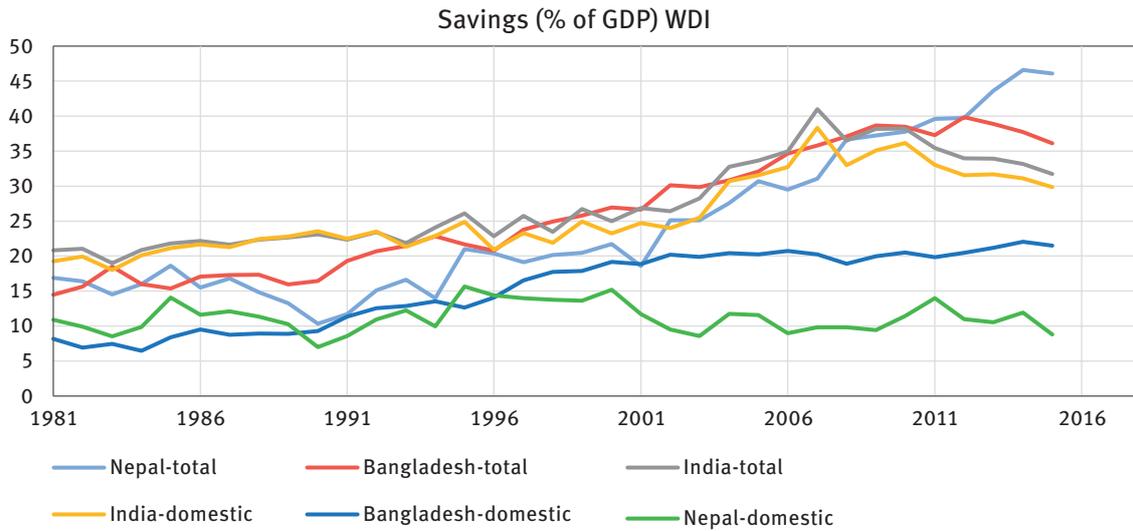


Figure 5. Savings rates in South Asia

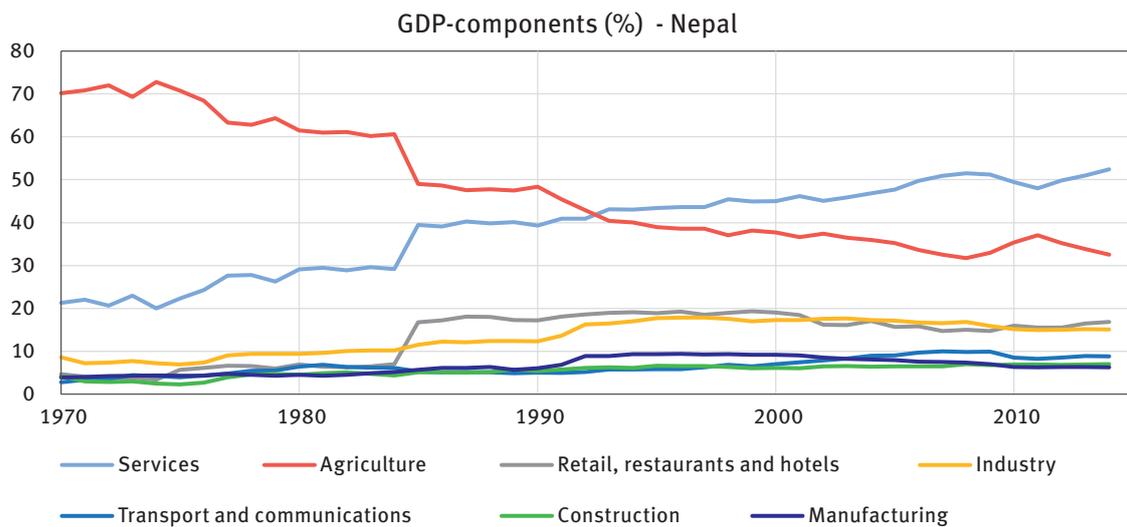


Figure 6. GDP by industry, Nepal

In Nepal the massive transfers from abroad have allowed for a solid increase in the savings rate, and thus ultimately investments. Since 2002, when the remittances started to increase, the capital formation has constituted between 80% and 90% of total savings<sup>18</sup>. And since 2010 capital formation has constituted as much as 38% of GDP. Capital formation includes everything

from inventories of goods, purchase of machines, construction of roads, and buildings of all types including schools, hospitals, private houses, and factories. In Nepal we know that construction of buildings constitutes a larger share than in many other countries<sup>19</sup>. Figures 6–8 show the composition of GDP in Nepal and neighboring India and Bangladesh. In all three countries the service

18 Earlier the percentage was higher than 100%, probably due to foreign aid, but the level lower since savings were lower.

19 Note that buildings also gives income in terms of rent, as even imputed rent on own housing is included in the GDP.

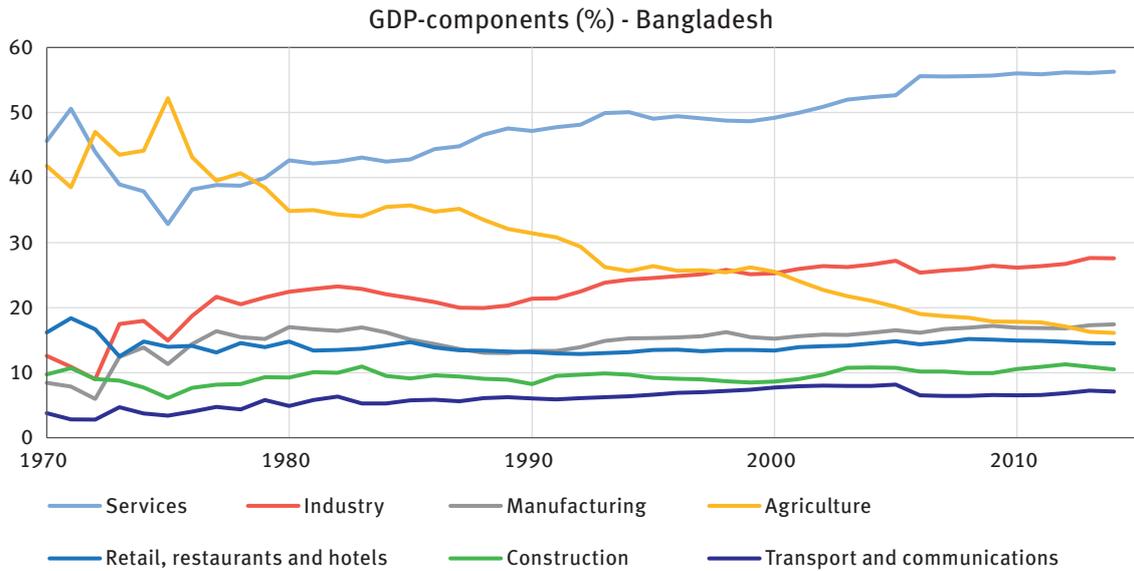


Figure 7. GDP by industry, Bangladesh

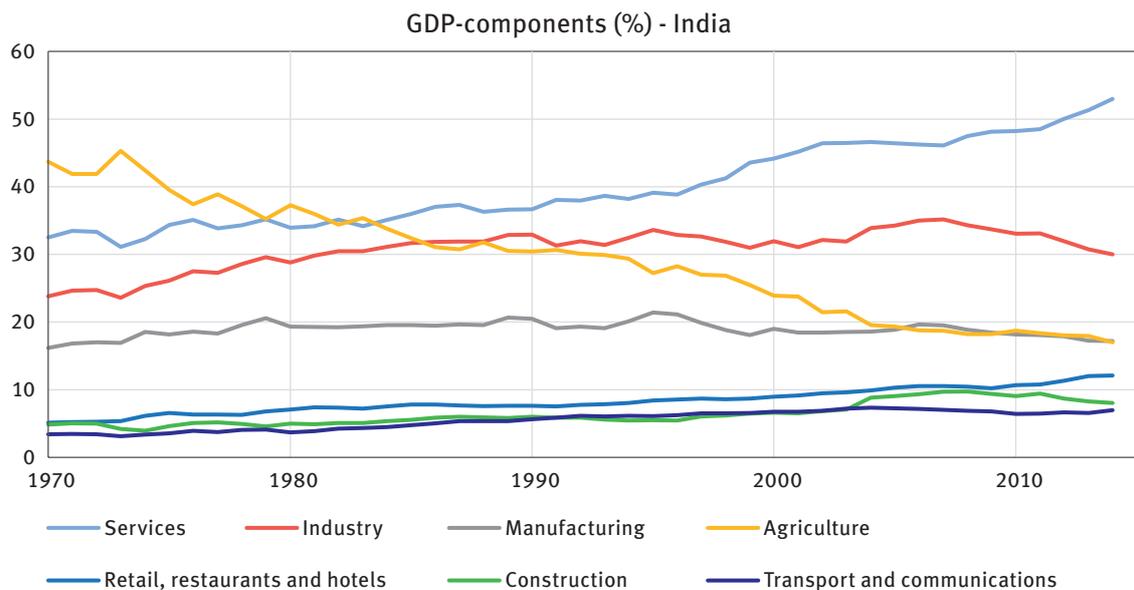


Figure 8. GDP by industry, India

sector has grown to more than 50%. Agriculture is still more important in Nepal (more than 30%) than in the two other countries (less than 20%). Industry is around 30% for India and Bangladesh, while it is only 15% in Nepal. Among the industries, construction is equally important in all three countries (about 7% of GDP), while manufacturing differs between the three, with 17% in India

and Bangladesh, and only 6% in Nepal. These differences have been stable since the early 70s, and there appears to be no tendency for Nepal to follow the other two. Nepal has always had a small manufacturing sector, a relatively larger construction sector, and more dependence on agriculture. As agriculture has gradually declined, the service sector has increased.

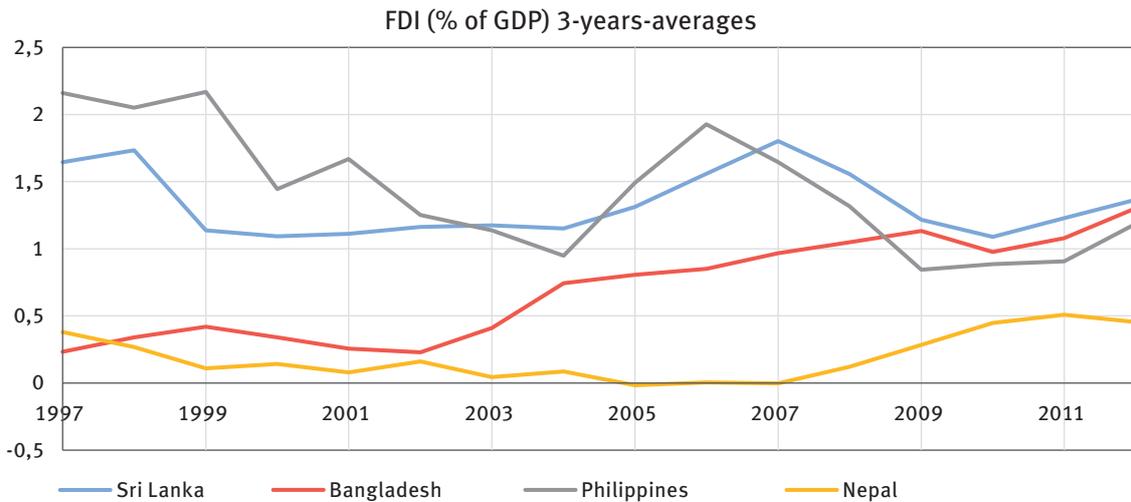


Figure 9. FDI as a percentage of GDP in countries with large outward migration

In terms of value added the main manufacturing industries are (at the four-digit level): tobacco, building materials, iron and steel products, and grain-mills. While in terms of employment the main industries are building materials, jute, textiles and grain-mills<sup>20</sup>. In terms of export, we find that cardamom is a major item (India), carpets (US), man-made fibers (India), apparels (many countries), iron and steel (India). In many ways Nepal is integrated with the Indian economy by supplying low paid labor both to factories in India, as well as to factories in Nepal that produce for the Indian market<sup>21</sup>. Nepal also imports many products from India, including raw material for the iron and steel production, as well as petrol and other petroleum products. Rice from India is also a major import.

#### 2.4 Constraints on economic growth and development

What are the main constraints on the manufacturing sector that may explain why it is lacking behind neighboring countries? We shall see that the main constraints are the lack of investments in infrastructure and quality education. As discussed,

the savings-rate is high, and money flows in from labor migrants working abroad. FDI, as measured in official data, is, however, low (Figure 9).

Some business houses in Nepal are, however, closely linked to India, which implies that it is not straightforward to measure FDI. In theory FDI is well defined, but in reality one will have to separate investments made by Nepali citizens from investments made by family members, or business entities, registered in India or elsewhere. Many Nepali business houses are run by families from the Madhes community, which includes the Marwaris, who for generations have migrated from India. Most of them are now Nepali citizens, but with economic interests in both countries. Similarly, the traditional business houses of the Kathmandu valley<sup>22</sup>, where the Newari community have been involved in the lucrative trade between India and China for centuries, will also have interests abroad<sup>23</sup>.

20 National Census of Manufacturing Enterprises 2011/12. Central Bureau of Statistics, Kathmandu. In particular jute-mills appear to have many employees.

21 UN Comtrade data as shown at <http://wits.worldbank.org/CountrySnapshot/en/NPL> And at: [www.tradingeconomics.com/nepal/exports-by-category](http://www.tradingeconomics.com/nepal/exports-by-category)

22 The dominating business house in Kathmandu is the Chaudhary group, with Binod Chaudhary being the only Nepali dollar-billionaire on the Forbes list. The family migrated from India two generations ago, and started in textile trade, built up a major instant-noodle brand, and is now active in many industries in many countries.

23 The main trade union GEFONT (2001), *The big business houses in Nepal*, gives a short introduction to the history of the large business houses in Nepal. A recent news story mentions many of the same houses: Lamsal, M and Sharma, S. (2016). "Are we catching up with the world? Nepali Business Houses in New Economy". October. [www.newbusiness.com](http://www.newbusiness.com).

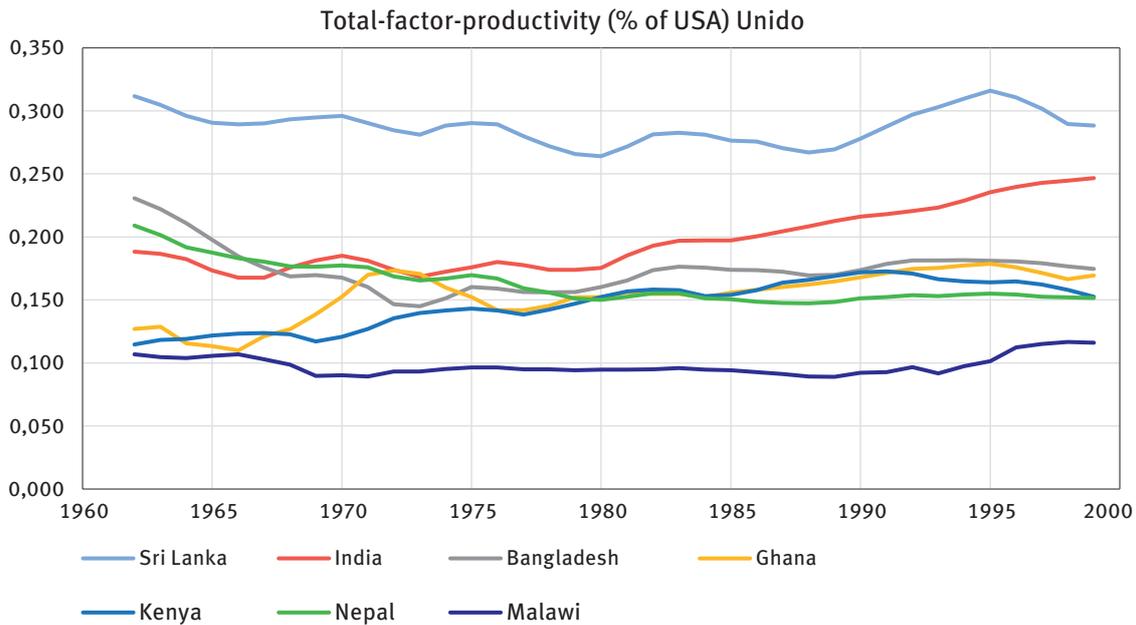


Figure 10. Total factor productivity in selected developing countries

In addition to the problems of measuring intra-company and intra-family transactions, there is also extensive non-official trade and money transfers between Nepal and India. Thus, the official FDI numbers are likely imprecise, and are most likely too low. But even if Nepali FDI is at the level of other countries with large outward migration, such as Bangladesh and Sri Lanka (Figure 9), it will still only be a fraction of domestic savings. Despite being marginal in percentage, FDI may still involve embedded technology transfers, which potentially makes it more essential for long-run development.

It is not straightforward to measure technology transfers. One can measure the results, by for example total-factor-productivity (TFP), which is a residual measure of production levels that cannot be explained by factor inputs alone. For example the Penn World Tables do not report TFP for Nepal, maybe due to data quality. UNIDO reports TFP till end of the 1990s (Figure 10): productivity is relatively low in Nepal, while it is, in particular, increasing in India. Figures 9 and 10 together indicates that there is no clear correlation between FDI and productivity. Nepal's low productivity is similar to Bangladesh, while FDI in Bangladesh is at the level of Sri Lanka, which

has a much higher productivity level. We should still be concerned with the low productivity level, and the potentially low FDI level, which in turn may be a result of the low productivity level.

Let us thus turn to the deeper constraints on economic growth and development in Nepal, with a particular focus on the manufacturing sectors, which has a particularly low share in Nepal. In addition to capital investments, modern production requires transportation of material inputs and products, energy and availability of labor of different skill levels. All three factors are critical constraints in Nepal<sup>24</sup>.

The road connections to India are relatively good, but there is still no relevant train connection. The road connections to China are not good, which also reflects the poor internal road connections in the hills and mountains of Nepal. Even the main transport route from Kathmandu to the Indian border is not very good. Nepal has for decades planned for a fast direct track from Kathmandu to Birgunj on the Indian border (which will allow for further transportation to

<sup>24</sup> Some of the issues discussed here are the same as in Hatlebakk (2008). *Inclusive Growth in Nepal*. Report commissioned by the Norwegian Embassy in Nepal.

the sea). Different routes have been gradually upgraded, but heavy vehicles still need to use the winding detour via Chitwan and Mugling. There is first of all a need for a fast track to India that can be used by heavy vehicles, and there is a need for an upgrade of the road to China. In the rural areas there is a need for improvements of most north-south roads from the terai into the hills, and the east-west highway throughout the hills of Nepal should be completed<sup>25</sup>.

For decades there has been so-called load shedding of electricity, cutting electricity according to a schedule for up to 12 hours per day. In the fall of 2016 this problem was solved overnight. A new director of the Nepal Electricity Authorities (NEA) decided to cut the prioritized access for some large businesses that appear to have paid officials for access<sup>26</sup>. Moreover, import from India has finally improved due to new transmission lines<sup>27</sup>. Transmission lines to India has been on the agenda for decades. The issue has been closely linked to the hope of exporting electricity, which may explain why the projects have been postponed for long. It appears that the large theoretical potential for hydropower in Nepal has led to a reluctance to import electricity. As a result increased transmission capacity has been postponed along with the hydro power plants<sup>28</sup>.

In addition to increased import from India, production capacity within Nepal is on track. The largest existing government owned plants are

in Kali Gandaki (144 MW), two in Marsyangdi (70+69 MW), and two in Kulekhani (60+32) rivers. The largest private ones are in Khimti (60 MW, Norwegian owned) and Bhote Koshi (36 MW, US-funded and sold to Nepali owners) rivers<sup>29</sup>. One major plant under construction is the Upper Tama Koshi project (456 MW)<sup>30</sup>, which is Nepali-owned with the government having the majority share and Chinese companies as the main contractors. Another large project under planning is Tama Koshi III (650 MW), where Statkraft was involved but ultimately pulled out<sup>31</sup>. A Japanese company (Kansai) has now shown interest in building Tama Koshi III<sup>32</sup>. Many other large hydropower projects are planned for Nepal, although they have been postponed for years. These projects normally involve Chinese<sup>33</sup> and Indian companies<sup>34</sup>, and are planned primarily for export of electricity to India (as in the case of the Tama Koshi III, where Statkraft was involved). In contrast to the smaller hydropower projects for domestic consumption, which more or less seem to be on track, the large export oriented projects have met political difficulties.

In the short run, gradual increase in production capacity from hydro and solar power, import of electricity from India and a well-functioning distribution system within Nepal, without favored access for large consumers, is essential to avoid returning massive rationing of electricity.

Another constraint on development is education in a broad sense. The level of education is

25 The main donors on roads are UK, Switzerland, Japan, IDA (World Bank), and ADB (Asian development Bank). The World Bank has the Road Sector Development Program. DFID has the Rural Access Program, focusing on the western hills. Japan has prioritized access to Kathmandu.

26 <http://nepalitimes.com/article/editorial/Power-struggle-Kulman-Ghising,3399>.

27 <http://nepalitimes.com/article/nation/corruption-in-electricity-industry-of-Nepal,3408>

There is also a more recent coverage in: [www.csmonitor.com/World/Asia-South-Central/2017/0116/How-Nepal-got-the-electricity-flowing](http://www.csmonitor.com/World/Asia-South-Central/2017/0116/How-Nepal-got-the-electricity-flowing).

28 <http://nepalitimes.com/article/nation/nepal-india-thermal-power,3570>

29 For a short introduction to the electricity cooperation between Nepal and India, see Singh, A. et al. (2015). *Cross-Border Electricity Cooperation in South Asia*. Policy Research Working Paper 7328. World Bank. For a description of the plans for electricity export (where import is never mentioned), see Nepal Government (1992, 2001). *Hydropower Development Policy*.

29 Nepal Electricity Authority (2016). *Annual Report for fiscal year 2015/16*, page 146.

30 Nepal Electricity Authority (2016). *Annual Report for fiscal year 2015/16*. See page 148 for a list of projects under construction, and discussions of the progress of Upper Talakoshi and other projects throughout the report.

31 <http://nepalitimes.com/article/nation/delay-in-big-projects,2838>

32 <http://kathmandupost.ekantipur.com/news/2016-12-18/japan-firm-shows-interest-in-building-tamakoshi-iii-hydro.html>

33 <http://www.hydroworld.com/articles/2017/01/nea-ctgc-agree-to-joint-venture-to-construct-nepal-s-750-mw-west-seti-hydropower-plant.html>

34 <http://www.hydroworld.com/articles/2014/09/nepal-india-firm-sign-development-pact-for-900-mw-upper-karnali-hydro-project.html>

<https://thehimalayantimes.com/nepal/600mw-upper-marsyangdi-ii-in-limbo/>

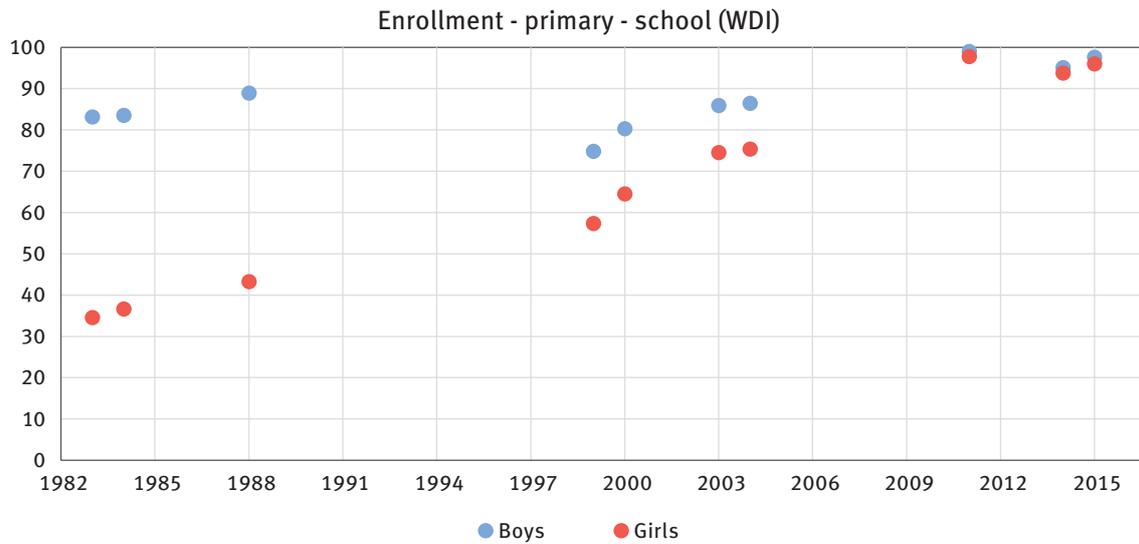


Figure 11. Primary school enrollment by gender

still very low in Nepal, despite massive improvements during the last decade (Table 4), as literacy rates for the population at large has gradually improved, from 40% in 1995 to 56% in 2010. More children go to school and they constitute a larger share of the population. In terms of school enrollment (Figure 11) the improvement has, of course, been more rapid, with enrollment for girls increasing from 35% in 1983 to 96% (boys from 83% to 98%). This improvement is likely explained by the migration fueled income growth that has allowed families to send the girls to school instead of keeping them at home to do household chores and farm related work. Better prospects in the labor market for educated girls, and potentially a higher demand for educated women in the marriage market may also be important drivers.

Despite improvement in enrollment the quality of education is still questionable. This is a general problem in poor countries, and as the literature indicates it is not easy to solve<sup>35</sup>. Today,

and for years to come, this will be a major obstacle for economic growth in Nepal. The lack of high quality education is in particularly noticeable when Nepalis get jobs abroad, they tend to (although of course with important exceptions) end up in the lowest paid jobs. This seems to be the case in India, but also in the more attractive labor markets in the Arabian Gulf<sup>36</sup>. Even basic reading and math skills may improve the earning potential for many of the low-skilled jobs at home and abroad. Basic vocational skills are also likely to improve the earnings of otherwise unskilled labor. Donors and the government are gradually recognizing this, as is the private market for education, and a number of vocational training programs have started in Nepal<sup>37</sup>. Quality is also an issue in higher education, where there may be a need for more extensive international collaboration to raise the standards. Both the government owned Tribhuvan University, as well as private institutions, may benefit from

35 Glewwe, P., Hanushek, E., Humpage, S. and Ravina, R. (2012). *School resources and educational outcomes in developing countries: A review of the literature from 1990 to 2010*. WP12-1. Center for International Food and Agricultural Policy. Later published as chapter two in Glewwe, P. (ed.) (2014). *Education policy in developing countries*. University of Chicago Press. Also see a recent discussion in: Mbiti, I.M. (2016). "The Need for Accountability in Education in Developing Countries". *Journal of Economic Perspectives*. 30(3): 109–132.

36 Gardner, A. et al. (2013). "A Portrait of Low-Income Migrants in Contemporary Qatar". *Journal of Arabian Studies*. 3: 1–17. In Qatar we have, ourselves, interviewed employers in the construction sector who said that Nepali workers normally have fewer skills than workers from other countries. The workers told us that they could get better pay as they learned new skills.

37 <http://ctevt.org.np/page.php?page=1>.  
<http://projects.worldbank.org/P104015/nepal-enhanced-vocational-education-training?lang=en>

more collaboration with international scholars when it comes to research based education.

To summarize, access to financial capital seems not to be a binding constraint in Nepal, but a number of coordinated efforts are needed to develop public goods that are essential for accelerated economic growth. The government is on the right track: the roads from Kathmandu to the terai and the Indian border are gradually improving, and there are plans for a direct route that will allow for heavy-load trucks. The roads to China will have to be developed further. The decades-long problem of rationing of electricity has been solved, and it will be essential to continue the gradual development of hydro and solar power, as well as a gradual improvement of the electricity transmission capacity to India. School enrollment at the primary level is now near 100% also for girls. The next step is to improve quality at all levels of education, from primary, via vocational training, to the university level.

### 2.5 Public finance and foreign aid

Tax incomes (customs, VAT, income tax) and user payments (electricity, and to some extent health and education) are essential to finance infrastructure developments and social expenditures. In Nepal the main sources of government incomes are import duties (15%), VAT (14%, with the majority coming from VAT on imports), and profit and capital gain taxation on private firms (14%)<sup>38</sup>. Less important income sources are: foreign grants (7%) individual income tax (6%), and taxes on alcohol (4%)<sup>39</sup>. Additional foreign grants that are not channeled through the government almost doubles the foreign aid. Official OECD statistics normally report the Official Development Aid (ODA) as a percentage of central government expenditures only, which adds up to about 30%, while ODA is reported in the OECD statistics as about 4% of gross national incomes (GNI)<sup>40</sup>.

38 Nepal Rastra Bank (2016). *Quarterly Economic Bulletin*. 51(1). October.

39 For the grants data we also used: Nepal Rastra Bank (2016). *Macroeconomic Indicators of Nepal*. November.

40 International aid data is downloaded from the OECD-DAC database: <http://stats.oecd.org>

The main donors to Nepal have been (aggregated over the period 1986–2015): UK, Japan, Germany, US, Denmark, IDA and Norway (Table 5). More recently (according to 2014 data) the top donors are: UK, IDA, US, ADB, Japan, Switzerland and Norway. The total amount of aid has been increasing, and at a higher rate from 2000, which was at the height of the civil war, and at an even higher rate from 2007, after the peace agreement. But at the same time the Nepali economy has been growing, thus as a percentage of GNI the aid level was at its maximum (above 10%) from 1986 to 1994 and has since gradually declined.

We know that foreign aid is fungible, thus if the donors want to prioritize, let us say, education, then the government can reallocate domestic funds to other sectors<sup>41</sup>. Keeping this in mind we know that donors have prioritized health, education, transportation and agriculture, while Norway has prioritized energy, education, and the civil society (Table 6). We note the division of labor between donors, with the large donors prioritizing health (UK), transportation (Japan, UK) and agriculture (IDA, US, Switzerland). On energy, Germany is the big donor, followed by Norway, Denmark and IDA. Many donors are active in education with IDA being the largest donor. On governance and civil society UK is the largest donor, followed by US and Norway<sup>42</sup>.

41 Feyzioglu, T., Swaroop, V. and Zhu, M. (1998). "A panel data analysis of the fungibility of foreign aid". *World Bank Economic Review*. 12: 29–58. There is some evidence of fungibility between development and regular spending in Nepal: Bhattarai, B.P. (2007). "Foreign Aid and Government's Fiscal Behaviour in Nepal: an Empirical Analysis". *Economic Analysis and Policy*. 37(1): 41–60.

42 All references are to the period 2006–2014 and data are from OECD-ODA-Stats. 2015 is excluded due to the extraordinary allocation for emergency aid after the earthquake.

Table 5. Aid disbursements (million constant 2014 USD) to Nepal (OECD-DAC, consistent with the NORAD database)

Major events:	From:	Net-ODA		Grants from (ranked) major donors during the last 30 years (1986–2015)														
		Current	2014	Net-ODA	Grants	UK	Japan	Germany	US	Denmark	IDA	Norway	Switz.	ADB	EU Inst.	Finland		
	Year				Norway	Norway	- USD	1	2	3	4	5	6	7	8	9	10	11
	1986	3.9	13.3	13.3	38.9	78.3	48.0	31.6	15.7	0.0	13.3	25.3	3.6	4.4	11.5			
	1987	3.1	8.9	8.9	37.4	81.1	49.6	36.3	17.3	0.0	8.9	21.9	2.7	9.7	17.9			
	1988	3.8	10.0	10.0	37.9	61.8	120.9	26.3	19.0	0.0	10.0	27.5	4.6	6.9	9.8			
	1989	5.0	13.3	13.3	56.2	66.2	70.1	23.6	17.3	0.0	13.3	45.3	9.6	4.1	28.3			
Democracy	1990	9.8	22.7	22.0	43.9	56.3	52.9	27.7	13.6	0.0	22.0	30.3	6.4	6.6	20.2			
	1991	5.8	13.8	14.1	53.7	64.8	57.1	22.1	16.6	0.0	14.1	21.0	4.3	5.2	24.4			
	1992	8.6	19.5	19.8	39.4	77.5	51.1	27.7	15.3	0.0	19.8	23.0	2.8	2.5	24.0			
	1993	7.1	18.1	18.3	31.3	90.7	30.9	30.1	28.6	0.0	18.3	24.0	4.7	9.7	11.1			
	1994	5.2	13.1	13.4	41.2	92.6	30.5	29.5	45.7	0.0	13.4	28.5	4.1	6.4	10.7			
	1995	3.8	8.3	8.7	41.4	93.1	22.8	27.4	34.8	0.0	8.7	22.2	3.5	5.8	8.2			
Maoist insurgency (Feb-)	1996	11.2	24.2	14.2	36.8	82.1	31.4	21.3	34.3	0.0	14.2	22.1	0.0	8.4	7.8			
	1997	7.7	17.6	17.7	42.0	78.8	34.6	29.3	30.0	0.0	17.7	19.8	0.0	12.6	10.4			
	1998	8.8	21.8	19.8	40.1	59.5	34.7	23.3	38.2	0.0	19.8	23.5	0.0	6.7	20.4			
	1999	7.4	17.7	18.1	38.2	59.1	32.6	22.6	40.7	0.0	18.1	24.4	0.0	15.9	9.2			
Norwegian embassy	2000	8.9	20.8	20.8	34.8	63.3	37.3	21.2	48.1	0.0	20.8	23.4	0.0	26.7	10.2			
	2001	11.5	27.0	27.0	52.1	69.3	65.9	26.3	50.3	0.0	27.0	24.7	0.0	20.2	8.6			
	2002	13.1	27.9	27.9	54.4	105.7	56.3	41.7	45.4	0.0	27.9	26.6	0.0	22.6	9.7			
	2003	20.2	37.0	36.3	69.9	56.0	84.7	47.4	58.9	0.0	36.3	22.8	0.0	22.3	7.6			
	2004	23.0	37.9	38.1	75.0	52.3	63.5	43.2	44.9	0.7	38.1	22.6	0.9	27.2	8.1			
Peace-agreement (Nov)	2005	25.1	36.4	36.4	68.8	90.0	75.7	61.5	35.1	15.7	36.4	23.1	0.2	11.8	11.5			
	2006	41.0	54.3	33.1	80.1	74.8	39.1	70.6	40.5	25.3	33.1	24.7	0.0	28.6	10.2			
	2007	40.9	48.0	52.1	91.1	67.5	53.7	60.4	54.8	46.6	52.1	24.9	3.0	25.9	13.8			
	2008	41.9	43.4	45.8	101.6	144.9	64.3	85.1	46.7	72.9	45.8	27.0	70.3	45.1	17.8			
	2009	45.3	54.5	54.8	120.7	46.5	62.8	79.9	44.7	158.3	54.8	28.9	137.4	44.1	21.0			
	2010	47.2	51.6	51.2	126.6	74.3	46.7	55.3	40.7	170.8	51.2	31.6	32.8	48.3	24.7			
	2011	49.4	46.9	46.9	112.6	59.2	40.0	67.5	41.8	145.3	46.9	38.8	130.8	32.7	26.7			
	2012	40.6	38.7	40.9	118.7	44.9	69.5	67.3	44.7	115.2	40.9	40.9	51.6	29.0	25.6			
	2013	32.4	30.4	30.9	156.3	45.8	45.1	73.2	28.3	100.1	30.9	46.4	93.4	40.4	27.6			
	2014	42.0	42.0	42.3	184.2	55.7	37.3	76.3	30.5	111.0	42.3	45.3	71.5	35.2	37.4			
Depreciation of NOK	2015	61.0	78.9	79.1	143.6	53.3	45.6	160.2	26.0	68.4	79.1	56.8	47.3	56.7	31.7			
	<b>Sum:</b>	897.8	875.0	2168.9	2145.4	1554.8	1415.4	1030.2	875.0	685.5	621.6	506.2						
			<b>Rank in 2014:</b>		1	5	9	3	11	2	7	6	4	10	8			
	<b>Sum 2006–2015:</b>	488.6	477.1	1235.5	666.8	504.1	795.5	398.7	1013.8	477.1	365.3	638.1	385.8	236.6				
			<b>Rank last 10 years:</b>		1	4	6	3	8	2	7	10	5	9	11			

## 2. The Nepali economy | Magnus Hatlebakk

Table 6. ODA grants disbursements (%)

Sector	All donors			Sector	Norway		
	2013	2014	2015		2013	2014	2015
Education policy	2.0	2.9	2.2	Education	17.3	25.2	23.1
Primary education	3.5	4.0	3.0				
Vocational training	1.1	2.9	0.8				
Higher education	3.0	3.3	1.8				
Basic health	5.0	10.2	5.0				
Reproductive health	6.1	5.1	6.2				
Water supply	4.3	4.6	3.7				
Decentralisation	1.0	5.1	3.1	Civil-Society	5.0	11.8	8.2
Human rights	1.7	2.4	1.9	Human-rights	13.3	8.5	4.4
Peace-building	6.0	1.6	1.7	Peace-building	14.8	1.0	0.3
Transportation policy	2.7	2.7	2.3				
Roads	7.3	6.7	2.7	Energy-generation	0.4	11.6	9.5
Energy	2.6	2.8	2.5	Electricity transmission	0.0	18.8	11.6
Agriculture	4.8	7.1	5.7				
Environmental policy	3.7	5.0	1.5				
Humanitarian aid	3.7	2.1	26.7	Humanitarian aid	0.0	0.0	23.3
Other minor sectors	41.4	31.6	29.4	Other minor sector	49.3	23.1	19.5
	100	100	100		100	100	100

Compiled by the author based on data from OECD-ODA-Stats.

### 3. The history of political and social conflict<sup>43</sup>

#### 3.1 Regional and ethnic conflicts

The history of Nepal has been formed by a number of intersecting political and social conflicts. Historically Nepal was ruled by a Brahmin-Chettri elite that took control of a unified country starting with the conquest of the Kathmandu valley in 1768. The Shah dynasty, originally from a Chettri warrior caste, that took control of the country was originally based in the Gorkha kingdom of the western hills. Ultimately their religion and language became dominant, and to some extent set the basis for some of present grievances of other ethnic groups. Later the Rana family, with a similar caste background, took control of the country and ruled Nepal for about hundred years, ending in 1951. During their regime the caste system was formalized by law in the Muluki Ain of 1854, with Brahmin-Chettris at the top, a variety of ethnic groups in the middle, and the Dalits at the bottom of the hierarchy. The Brahmin-Chettris have continued to dominate the bureaucracy and political life after the Rana regime was dissolved and even after democracy was established in 1990. The same groups have dominated the political parties, including the different communist parties of Nepal, such as the Maoist parties.

For the ethnic groups the discrimination by the state has been the main reason for grievances. Ethnic groups from the hills have not had the same access to education and jobs, they had to learn the Nepali language on top of their native

tongue, and they met with systematic discrimination at school and in the public sector labor market. Some of these groups did, however, relatively well in selected occupations. In Kathmandu, and other towns and cities, the upper caste Newars did well in trade. Some other ethnic groups have established a good reputation as traders and soldiers (Thakali, Gurung).

Located at the bottom of the caste-system, the Dalits do not only lack access to the government system, they have been systematically discriminated against in all sectors of life, including access to public services (health, education, water), and the market (in jobs and public spheres such as the all-important tea-houses). As a result, there are large differences in economic and social outcomes according to caste and ethnicity<sup>44</sup>, and the caste dimension will thus to a large extent, at least traditionally, coincide with the class dimension. Although we do find laborers and marginal farmers also among the upper caste groups.

As noted, there is an ethnic dimension to the caste-hierarchy. There are numerous ethnic groups with their traditional territories within Nepal. To some extent the so-called upper-caste groups also originated in one of these groups, the Khas, before they took control of the country. In the present political context the ethnic (Janajati) dimension is, for many, as essential as the upper-lower-caste dichotomy. On top of the caste-class-ethnic dimensions comes the regional dimension.

43 The standard introduction is: Whelpton, J. (2005). *A history of Nepal*. Cambridge University Press. For an early discussion of many of the Madhes related issues, based on extensive fieldwork in the terai in 1967/68, see: Gaige, F.H. (1975). *Regionalism and national unity in Nepal*. University of California Press. Reissued in 2009 by Himal Books.

44 Das and Hatlebakk (2010). *Statistical evidence on social and economic exclusion in Nepal*. Himal Books. Bennett, L. and Parajuli, D. (2013). *The Nepal Multidimensional Exclusion Index*. Himal Books. Gurung, Y.B. et al. (2014). *Nepal Social Inclusion Survey*. Tribhuvan University.

Nepal has a long border with India, with a relatively narrow strip of the Gangetic plains on the Nepal side of the border. Large parts of the plains used to be covered by tropical forest, which was gradually cleared, and rapidly so from the 1950s onwards. During that period the rulers in Kathmandu settled hill migrants along the border<sup>45</sup>, and at the same time invited in mostly Dalit laborers from India. Other Madhesi caste groups from India followed as traders and settlers. Historically the area was inhabited by different ethnic groups, including groups that had historically migrated from India. As a result, the plains of Nepal has a very mixed population, but with higher degrees of homogeneity at the village level. If one travels the few kilometers from south to north in the plains one will normally first find Madhes villages, dominated by the same caste groups that we find in Bihar and UP of India. The full Indian caste-system will be represented ranging from the Dalits (Musahar, Chamar), via groups that would be classified as OBC in India (Yadav, Teli, Kurmi), to Madhesi Brahmin groups. Further north one will find terai-Janjati groups, often classified as Tharu, but also other groups such as Rajbansi and Satar (Santhal in India). Along the east-west highway the hill migrants of all ethnic and caste groups will dominate.

The Madhes dimension of present-day politics is thus very complicated. In the core-Madhes area from Birgunj to Biratnagar the Madhes caste groups tend to dominate politics, quite similar to Bihar. Biratnagar is a melting pot in the sense that hill high-castes have dominated local and national level politics, as exemplified by the Koirala family. In the surrounding villages there are strong Madhesi communities and political leaders. To the east (Jhapa) and west (Chitwan, Nawalparasi) of the Madhesi belt we find strong hill-migrant communities dominated by resource-rich migrants from the hills, many of whom have invested in commercial agriculture. Further to the west in

terai we find a similar mix, but with mostly terai ethnic groups alongside the hill migrants.

In sum there are three to four overlapping dimensions to the political and social life of Nepal: high versus low caste interests that to some extent coincide with class interests; the ethnic dimension, with its separate dynamics in the hills and the terai, and the Madhesi versus Pahade dimension with its particular dynamics in the plains where the hill migrants are now in the majority in many districts.

### 3.2 Pre-democracy protests

After the Rana authoritarian regime was dissolved in 1951, Nepal experienced a short spell of democracy with the Congress party establishing itself as the leading democratic force, before the king suspended the newly elected parliament in 1960. For thirty years onwards the Congress party, and gradually the Communist party, built up the opposition to the king, with the Congress party as the leading force. The struggle included episodes of armed action as in the famous airplane hijack in 1973 in Biratnagar, with Girija Koirala in the background, when the Congress party stole millions of rupees from the Rastra (Central) Bank of Nepal.

Similar to the Congress party, the Communist party (CPN) was formed in India in the late 1940s<sup>46</sup>. The party split into different factions, with the dominant reformist faction seeking collaboration with Congress during the decades of struggle leading up to the People's Movement in 1990. The radical Maoist-leaning faction formed CPN (fourth congress) in 1974, and only joined the United Left Front during the final struggle in 1990. The Congress party was still the dominating political force in the 1990 People's Movement, and received, maybe unexpected, support from India in the form of a blockade due to a border and trade dispute between Nepal and

<sup>45</sup> For a good description of the complexities of migration into terai from the hills and from India, see Chapter 4 in Gaige (1975).

<sup>46</sup> For the history of the communist parties, although with a focus on the Maoist factions, see: Thapa, D. (2002). "Maobadi of Nepal", in Dixit, K.M. and Ramachandran, S. (ed). *State of Nepal*. Himal Books.

Table 7. Parliamentary elections - Nepal (parties that received 2% or more votes)

Party	1959		1991		1994		1999		2008		2013	
	Seats	Votes (%)										
Congress	74	37.2	110	37.8	83	33.4	111	37.2	115	21.1	196	25.6
<b>Left:</b>												
CPN (UML)	4	7.2	69	28.0	88	30.9	71	31.7	108	20.3	175	23.7
Maoist (UPF)			9	4.8	0	1.3			229	29.3	80	15.2
CPN (U)			2	2.4								
CPN (ML)							0	6.6	9	2.3	5	1.4
Praja Parishad-1	2	2.9										
Praja Parishad-2	1	3.3										
<b>Monarchist:</b>												
Gorkha Parishad	19	17.3										
United democratic	5	9.9										
PM	0	3.3										
RPP-1			1	5.4	20	17.9	11	10.4	8	2.5	24	6.7
RPP-2			3	6.6							13	2.8
<b>Madhes:</b>												
Madhesi Forum									54	6.3	14	2.9
TMLP									21	3.2	11	1.9
Sadbhavana			6	4.1	3	3.5	5	3.2	9	1.6	6	1.4
Tarai Congress	0	2.1										
Madhesi Forum-2											10	2.3

There is no consistent source on number of votes and seats, we report recent numbers that appear to be consistent across different sources.

India<sup>47</sup>, which helped in mobilizing the people. Ultimately the People's Movement won and multiparty democracy was established in Nepal.

Out of the United Left Front the reformist faction formed CPN-UML, while the Maoist faction formed the United People's Front and the CPN-Maoist party, which later started the civil war. The first election in 1991 was won by Congress with 38% of the votes, and more than 50% of the seats (Table 7). UML received 28% of the votes, while the Maoists received 5% of the votes, and 9 seats (4.4%). The combined strength of the communist parties had drastically improved since the 1959 election, while the Congress party had about the same support and, as expected,

the Monarchist parties had less support than in 1959. The terai regional party, Sadbhavana, received 4% of the votes in 1991.

### 3.3 Bandh and local protests

With the introduction of democracy, there was also an increase in local protests, with bandh (literally "closed") being an important way of protest. Basically any political group can declare a bandh, and depending on the degree of support, and the expectations from the public regarding the group's ability to enforce the bandh, there will be no traffic and all shops will close. An efficient bandh will be enforced by militant activists that vandalize any open shops, and put vehicles on fire. A bandh can be local, or nationwide. During the civil war, a Maoist bandh would always be enforced, and only the armed police or the army

<sup>47</sup> <http://www.nytimes.com/1989/04/11/world/nepal-s-economy-is-gasping-as-india-a-huge-neighbor-squeezes-it-hard.html>

would travel. Bandh announced by less powerful groups would gradually dissolve throughout the day as shops opened and motorbikes and cars gradually filled up the roads. Still, this is a powerful instrument even for small groups with limited popular support.

### 3.4 Maoist insurgency

During the 1991 election campaign the political parties promised that democracy would lead to development and improved economic conditions for everyone. As we have seen, the economic growth of Nepal has been stable at around 2% per capita per year since the mid-80s, with no particular change in 1990. This is also to be expected, even if we believe democracy is good for economic growth, we shall not expect any noticeable effects in the short run. As the voters did not experience any change, there was a growing discontent that may explain the drop in the support for the Congress party from 38% in 1991 to 33% in the 1994 election. The reformist CPN-UML had a small increase in support from 28% to 31%, but won more seats than Congress and formed the government. This was, however, a minority government and it stepped down in September 1995 after a non-confidence vote, and Congress again formed the government.

In parallel the Maoists<sup>48</sup> built up their support in Rolpa and Rukum, in the western hills. The new Congress government cracked down on the Maoists through the infamous Operation Romeo<sup>49</sup>. A few months later, on February 13, 1996, the Maoists launched the so-called People's War by simultaneously attacking police posts in Rolpa, Rukum and Sindhuli districts<sup>50</sup>. During the first years of the war there was only limited coverage in Nepali media. One would read about

attacks on the police, and about politicians and other local leaders being murdered by the Maoists, similar to the coverage of the Naxalites in India. Still, even during fieldwork in rural Nepal the civil war would not be an issue.

The crackdown on the Maoists during the Kilo Sierra 2 operation starting in 1998 was probably a main force behind the increased support for the Maoists<sup>51</sup>. The human rights organization INSEC have registered all deaths, and we see an increase in the number of people killed by the state in 1998–99. This was followed by more intense attacks from the Maoists, with a gradual increase in number of people killed by the Maoists from year 2000 with a peak in 2002. There was major attacks on police stations in April 2001, then the Maoists attacked army barracks for the first time in November 2001, and the war again escalated with new attacks in February 2002. Despite the increase in killings by the Maoists during these attacks, the loss of life on the Maoist side was even larger. In 2002 INSEC recorded 1200 killed by the Maoists, and 2400 killed by the state. Even at the height of the conflict, the Maoists had limited access to weapons and any major attack would include also unarmed or barely armed Maoist militia members.

One of the major victories of the Maoists was the attack, in 2004, on the town of Beni, near Pokhara, hundreds were killed on both sides, and the Maoists held the town for about 12 hours. This reflects the general pattern of the war. Maoists had control of the countryside during the night, while the security forces patrolled during day. If you, as a westerner, did fieldwork during those years you were advised to leave the villages before dark. In the Maoist strongholds there appeared to be a standstill in the sense that local army units did not attack even well-known major Maoist camps, only special forces (army rangers) from Kathmandu would be used in offensive operations at the height of the war. The 2004 attacks were basically the last efforts by the Mao-

48 The Maoists were inspired by the international Maoist movement, including the Naxalites in India, the Shining Path in Peru, and influences through RIM, for details on the roots of the movement see: Thapa, D. and Sijapati, B. (2003). *A kingdom under siege*. Printhouse, Kathmandu; Muni, S.D. (2003). *Maoist Insurgency in Nepal*. Rupa. Delhi; Mishra, C. (2014). *The Maoist Crossroads in Nepal*: [www.cmi.no/file/2570-.pdf](http://www.cmi.no/file/2570-.pdf).

49 This was a massive police crackdown on Maoist cadres in villages of Rolpa. For details see Thapa and Sijapati (2003).

50 Thapa and Sijapati (2003).

51 Thapa, D. (2002). "Maobadi of Nepal", in Dixit, K.M. and Ramachandaran, S. (ed). *State of Nepal*. Himal Books.

ists. INSEC counted 1000 killed by the Maoists that year, and 1500 by the state.

The offensive to capture the state that started with the attacks on army barracks in November 2001 had by end of 2004 led to 5000 Maoists killed, and still no major breakthrough in the war. Even Libang, the district headquarter of the Maoist stronghold Rolpa, was never controlled by the Maoists during the war<sup>52</sup>. In 2005 the Maoists started peace talks with the democratic parties, and an agreement was reached in November 2005.

With the peace-agreement in place the political parties could take on the king, who in February 2005 had dissolved the parliament. In April 2006 there was a new People's movement, with massive street protests, and the parliament was ultimately reinstated with Congress leading the government. The Maoist Chairman Prachanda came over ground and a Comprehensive Peace Accord was signed in November 2006. In Janu-

ary 2007, the Maoist entered an interim parliament and an interim constitution was declared. This was, at the same time, the start of the Madhes conflict in the plains of Nepal. The Maoists had mobilized based on ethnicity, and in particular Madhes leaders now expected Nepal to be turned into a federal state<sup>53</sup>. When this demand was not properly covered by the interim constitution Madhes leaders burnt the constitution on the streets of Kathmandu and initiated a People's movement in the terai. This ultimately ended a year later, after another Madhes movement with a declaration of Nepal as a federal republic.

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52 The town was, however, highly militarized and surrounded by barbed wire: <http://nepalitimes.com/news.php?id=14230#.WTPsj0SweEg>

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53 They even drew the map of ethnic based states: Sharma, S. (2002). *The Ethnic Dimension of the Maoist Insurgency*. Prepared for DFID, Nepal. This paper is not easily accessible, but is the only proper English language reference on the Maoists' ethnic policy, and is thus referenced by many, including: Hatlebakk (2007). *Economic and social structures that may explain the recent conflicts in the Terai of Nepal*. Commissioned report for the Norwegian Embassy; Aalen and Hatlebakk (2008). *Ethnic and fiscal federalism in Nepal*. Commissioned report for the Ministry of Foreign Affairs, Norway; Hangen, S.I. (2007). *Creating a "New Nepal". The ethnic dimension*. East-West Center Washington.

## 4. Political actors and their economic and other interests

### 4.1 Main actors

#### 4.1.1 Political party leaders

Political party leaders are the main actors in Nepal. With no party having a majority there is a continuous bargaining between the different party groups. Over time, basically any coalition seems to work, in May 2017 the Maoists were leading a government together with Congress. The media has named the governance system as the party-cartel<sup>54</sup>. The three main forces are Congress, UML and the Maoists, with shifting support from the monarchist parties, and/or the regional Madhesi parties. The word cartel is no coincidence, the parties are closely linked to business interests, which in turn operate as cartels in many sectors, often at or beyond the limits of the law<sup>55</sup>. The parties are all-important for appointments to leading positions in the government and affiliated institutions, with more-or-less official quotas for each party at institutions ranging from university institutes to Nepali embassies abroad. With solid incomes from different sources the parties employ numerous party workers, with the Maoist party having the strongest organization. The parties' youth organizations have been important for security,

54 <http://nepalitimes.com/article/editorial/politics-party-time,3188>

55 These ties have never been properly documented as they are inherently difficult to identify. The Nepali media is, however, active, and you regularly read about price collusion, illegal extraction of natural resources, political parties that run businesses, political leaders who visit jailed mafia bosses, political leaders arrested with illegal arms, and forced donations. The most recent coverage has been on the so-called medical-mafia and their links to politicians and the anti-corruption agency: <http://nepalitimes.com/blogs/kundadixit/2016/07/18/lethal-politics-of-a-sick-nation/>

again with the Maoists YCL as the strongest<sup>56</sup>. YCL leaders were recruited from the People's Liberation Army (PLA)<sup>57</sup>.

#### 4.1.2 Bureaucracy

With shifting government coalitions, and a focus on distribution of government related jobs and contracts to the private sector, it is unclear what realms of governance the political leaders in fact control. In day-to-day politics, including the important issues of fiscal (government budget) and monetary policies, the *bureaucracy* has extensive power and has demonstrated discipline. In contrast to many countries, poor and rich, the Nepal government sector has a problem of being able to spend the available budget<sup>58</sup>. And the central bank is careful not to print money, so that the tie to the Indian rupee secures a relatively low inflation and interest rates<sup>59</sup>. This careful policy is a major reason why Nepal has maintained a stable 2% per capita growth rate. The under-use of money may be a problem, but only if the alternative is a wise use of funds allocated to critical infrastructure as discussed in the previous section.

56 For recent coverage of the links the prime minister has to street politics: <http://www.myrepublica.com/news/14118/>

57 <http://kathmandupost.ekantipur.com/printedition/news/2012-04-19/1700-fighters-had-joined-ycl.html>

<http://kathmandupost.ekantipur.com/printedition/news/2012-02-06/now-ycl-members-seek-their-share.html>  
<http://nepalitimes.com/news.php?id=13455#.WPHm8E-SweEg>

58 <http://kathmandupost.ekantipur.com/news/2016-05-23/unspent-budget.html>

59 The economists of the Asian Development Bank will not use the term sound macroeconomic policy for a poor country like Nepal, but they have to say sound public debt management, and their main concern is the lack of public spending: ADB (2016). *Macroeconomic Update. Nepal*. August.

One can easily imagine that increased spending would lead to higher inflation and more corruption, rather than development. In sum, Nepal has a powerful bureaucracy, and thus probably its share of corruption<sup>60</sup>, but still a sound macroeconomic policy.

#### 4.1.3 Local level leaders

At the local level, where until May 2017 there had been no election since 1997, we still see that the political parties are strong. As no election was held for two decades, the local bureaucrats, first of all the VDC secretary, gradually increased their influence. Still, in many villages the VDC secretary was in contact with the previously elected politicians, as they were local leaders who in many places were held in high esteem by the voters. In strong Maoist areas, however, the VDC office (which in many places was bombed) was moved to the district headquarter and the local political dynamic also changed with the increased power of the Maoist insurgents. With the peace solution there was again a need to formalize party rule at the local level, and an all-party-mechanism was established in each village and district. Representation reflected the local strength in the 2008 national election, but still with small parties also being represented. Although potentially a good idea, it appears that the mechanism led to increased corruption as the parties divided the spoils of increased allocations to the local units<sup>61</sup>, and the mechanism was eventually dissolved. After this there has been an increase in particularly foreign aid to local governance, but still with no elected local officials that can be held responsible for the use of funds. On May 14, 2017, the first round of local elections was, however, held in the core

hill areas. The second round was held in the terai and the eastern- and western-most hills, on June 28, 2017, and the third round was held in the core Madhes areas (Province 2) on September 18.

#### 4.1.4 Civil society

Nepal has an active civil society, but with limited influence due to the dominance of the political parties. An important exception may be the ethnic organizations, as will be discussed in more detail below. Trade unions are strong, but they are under control of the political parties, while the main human rights organization, INSEC, is considered to be close to UML<sup>62</sup>. The media, on the other hand, is independent of the political parties, and quite diverse both at the central and local level. The media, including newspapers and radio stations, have been essential in building democracy in Nepal. Some commentators are concerned that the media is under increased commercial and political pressure, and even recommend government regulation as a counter-measure<sup>63</sup>.

#### 4.1.5 Western donors

Although the level of foreign aid is relatively low in Nepal, as compared to many other poor countries, the allocation of foreign aid to specific sectors may still affect the local power dynamics. The allocations to decentralization, human rights and peace building, as they appear in the OECD-DAC statistics (Table 6), are in particular so large, relative to the spending by the Nepal government, that we shall expect the *donors* to have influence. The donors have, in particular, focused on “social inclusion”. An important example is the DFID-supported Social Inclusion

60 Nepal is ranked between Russia and Kazakhstan on Transparency International's corruption index, better than Bangladesh, but below Pakistan, and much lower than India. As indicated above we believe politicians are more prone to corruption than government officials. In public opinion, however, it appears that the Nepali population rank them as equally bad: <http://admin.myrepublica.com/politics/story/35824/politicians-bureaucrats-seen-as-most-corrupt.html>

61 Asia Foundation (2012). *Political Economy Analysis of Local Governance in Nepal*.

62 This is common knowledge, see for example: Stokke, H, Sissener, T.K. and Lama-Tamang, M.S. (2003). Review of the Nepal Human Rights Yearbook 1993–2002. CMI-Report-2003:5

63 Bhandari, K., Bhattarai, D. and Deane, J. (2016). *Accountability, nation and society: the role of media in remaking Nepal*. Policy Briefing #17. BBC Media Action; Rijal, N.P. (2014). *Media development in Nepal since 1990: challenges and central role of regulation and reform*. PhD-thesis. Royal Melbourne Institute of Technology University.

Action Fund that over the period 2006–2012 spent USD 4.3 million<sup>64</sup>. This was implemented as part of the much larger Enabling State Program. In particular DFID, but also the World Bank and Norway<sup>65</sup>, has been criticized for pushing the ethnic agenda, and thus ultimately also ethnic-based federalism<sup>66</sup>. It appears that some of this criticism has been taken onboard, and these programs are now scaled down.

The academic community has been active on both sides of the debate, as well illustrated by a conference volume from the Central Department of Sociology and Anthropology at Tribhuvan University<sup>67</sup>. The department has had solid Norwegian funding for its research on social inclusion, both directly ([www.siaep.org](http://www.siaep.org)) and indirectly as faculty has been involved in other research funded by the Social Inclusion Research Fund ([www.socialinclusion.org.np](http://www.socialinclusion.org.np))<sup>68</sup>.

#### 4.1.6 India and China

Beyond the western donors, *India* has a particular role in Nepal. It is said that no Prime Minister in Nepal will be appointed without consent from Delhi. India has played a role, sometimes unclear, at all critical turning points in Nepali history. At the end of Rana rule, the king took refuge in the Indian embassy in Kathmandu. The People's Movement in 1990 received indirect support from India in terms of the economic blockade.

The Maoist leaders lived in India during the civil war, with the second-in command Baburam Bhattarai living relatively permanent in Delhi. India supported a five-month blockade of Nepal in 2015 as they, and Madhesi activists, did not approve the new constitution<sup>69</sup>.

*China* plays a smaller role in Nepal, evidently as China considers Nepal as being in India's sphere of interest. China's main concern is Tibet, and Nepali politicians will regularly endorse a "One-China Policy". Some Nepali politicians have attempted to play the "China-card" against India, but with very limited success<sup>70</sup>. China has, however, an interest in trade, particularly easy access to Indian ports for which transit through Nepal is one of many options. Trade and improved infrastructure will be beneficial for Nepal. During the Indian blockade Nepali politicians travelled to Beijing to open up for in particular import of petroleum products from China<sup>71</sup>. Nepal Oil Corporation has been dependent on purchases from the Indian Oil Corporation. It remains to see whether China will become a regular supplier of petroleum to Nepal, although this does not seem likely given the easier access from India.

## 4.2 Main interests of different actors

### 4.2.1 Political affiliation

As discussed, even the Congress party of Nepal has a history of armed resistance. The party is today a member of the socialist international together with the social democratic parties of Europe<sup>72</sup>. The other major parties of Nepal are to the left of Congress, that is, the Unified-Marxist-Leninists (UML) and the Maoist party. Together these three parties, which to some extent all are

64 Data from the Nepal Aid-Management-Platform. We are not able to find details on the spending neither there, nor in the DFID dev-tracker, beyond different amounts to consultancy, technical and advisory services. There is still need for research on the impacts of this, and similar programs, on Nepali society.

65 <http://www.telegraphnepal.com/national/2014-06-25/scandinavia-international-community-interests-and-nepal.html>

66 For one supportive comment, that is still a good illustration of the debate, see: <http://kathmandupost.ekantipur.com/print-edition/news/2012-08-22/on-the-shelf.html>. For a more academic discussion see: Sapkota, M. (2014). "Emerging ethnic movements and contested rural development in Nepal", in Sharma SR, Upreti BR, Manandhar P, and Sapkota M. Contested Development in Nepal: Experiences and Reflections. Kathmandu University.

67 Mishra, C. and Gurung, O. (2012) (eds). Ethnicity and federalisation in Nepal.

68 Some of this research, including our own, has also been critical to the ethnic agenda. For SIRF funded research at CMI see: <https://www.cmi.no/projects/785-social-exclusion>

69 <http://www.nepalitimes.com/blogs/thebrief/2016/02/08/morcha-calls-off-border-strike/>

<http://nepalitimes.com/regular-columns/Between-the-lines/blockade>

<http://www.bbc.com/news/world-asia-34280015>

70 <http://economictimes.indiatimes.com/news/politics-and-nation/why-india-shouldnt-worry-about-nepals-china-card/articleshow/51549780.cms>

71 <https://thehimalayantimes.com/nepal/nepal-china-seal-deal-for-import-of-fuel/>

72 Or rather, today, the Progressive Alliance, where most social democratic parties are now active.

social-democratic<sup>73</sup>, received 65% of the votes in the 2013 election (71% in the 2008 election). The three parties are by many considered as “main-stream” and representing the ruling male hill Brahmin elite. The alternatives to the three parties are the monarchist parties that received about 10% in 2013, and the Madhesi parties that received in total about 9% of the votes. The remaining 16% voted for another 20 plus parties, with the largest being one of the smaller communist parties, the CPN-ML, with 1.4% of the votes, and one of the new political forces in support of the federalist agenda, the federalist socialist party, with 1.3% of the votes<sup>74</sup>. In terms of seats, Congress and UML have more than 50%, but they need support from the Maoists to muster the two-thirds needed for amendments of the constitution.

#### 4.2.2 Regional interests

The major parties have their core support in different parts of the country, as indicated by the first-past-the-post seats in the 2013 election<sup>75</sup>. The four Madhesi Forum seats were, as expected, elected from core Madhesi districts in the Eastern terai, while three out of four Terai Madhes Loktantrik seats were elected from western terai. The party with most seats from terai was Congress. Congress also had support in some hill areas, including Lalitpur and Kathmandu. UML is dominating the hills from Darchula in the west to Taplejung in the east, while the mountain districts were picked up by Congress. The Maoists won their core districts of Rolpa, Rukum, Kalikot, Gorkha, Sindhuli and Ramechhap in the hills, Bardiya in western terai, and parts of Rautahat and Saptari.

These are the traditional strongholds<sup>76</sup>, and in the upcoming local elections we expect the Congress party to win many seats in the local councils of the terai, and in particularly so if the Madhesi parties end up boycotting the local elections. In the hills we expect UML to pick up many seats in the rural local councils, while there may be more competition in urban areas<sup>77</sup>. There are two newcomers that may do well in urban areas, the Baburam Bhattarai led New Force Party (that may also win Gorkha and potentially some other rural areas), and the Sajha Party led by (previous) BBC journalist Rabindra Mishra<sup>78</sup>. Regarding the Madhesi parties, some of them have all formalities in place for participation, while others have not taken all steps<sup>79</sup>. At the time of writing (June 2017), we believe that some Madhes parties will participate, and thus win seats in the terai. Regarding ethnic parties in the hills, the outcome in Ilam is of particular interest, as the Federal Socialist Forum and Khambuwan Rastriya Morcha stand for election<sup>80</sup>. Based on previous election results we shall not expect them to win many seats. Some have questioned whether the elections will take place at all, and at the time of writing we believe so<sup>81</sup>. In conclusion, we expect Congress to do well, as usual, in the terai, and UML in the rural hills.

73 Mishra, C. (2008). “Common ground: Social democracy”. *Himal Newsmagazine*, 1–28 May, 2008, Pp. 14–16. <https://www.cmi.no/file/?605>.

74 The federal socialist party later merged with a Madhesi party so that they now have 15 seats (2.5%) in the CA.

75 The CA/parliament had 240 seats elected according to the British system, 26 appointed by the government (normally proportional according to votes), and 335 seats picked proportionally from national party lists.

76 We find the same pattern in the 1991, 1994 and 1999 elections, although UML has traditionally had more support in the eastern hills than in the west, see Annex 7 of Hachhethu, K. (2006). *Political parties of Nepal*. Social Science Baha. For an analysis of the 1991 election, including the potential influence from India (with Congress benefitting in the terai, and UML potentially in the eastern hills, near communist-led West-Bengal), see: Gaige, F. and Scholz, J. (1991) “The 1991 Parliamentary Elections in Nepal: Political Freedom and Stability”. *Asian Survey*, 31(11): 1040–1060. For details on the 1994 election, see: IIDS (1996). *The third parliamentary election*.

77 In the last (1997) election UML secured more than 50% of the vote, although Congress secured more than 50% of the seats. Annex 1b in Hachhethu (2006).

78 In the first round they did not get any seats.

79 <http://kathmandupost.ekantipur.com/news/2017-04-13/madhesi-parties-failed-to-participate-in-election-process.html>

80 <http://www.myrepublica.com/news/18224/>. There has later been a merger with a Madhesi party.

81 At the time of writing, the May 14 election has been held, but not the June 28 round. The predictions held for the central hill districts where elections have been held, with UML picking up most seats even in urban areas.

### 4.2.3 Caste, ethnic and economic interests

In previous elections Brahmins have been heavily over-represented in the parliament<sup>82</sup>. For 1999 we have information on the party-wise ethnic representation: Congress had relatively more Madhesi MPs, while UML had more hill-Janajati MPs, in accordance with their regional support. UML had, in particular, six Limbu MPs in a total group of 71<sup>83</sup>.

Dalits had basically no representation. In 1991 there was a single Dalit MP, in 1994 and 1999 there was none, while in the 2008 CA it had increased to 50 (8%)<sup>84</sup>. Most Dalit groups are still, as expected, underrepresented as compared to their population. Still, in this most inclusive parliament in the history of Nepal, the Dalits had a relatively good representation, in particular the Sarki and Damai of hill origin, and the Dushad/Paswan and Bantar, of Madhes origin. The Kami of the hills had most representatives (16), but they were still under-represented relative to their population. In Madhes, the relatively numerous Dalit caste of Chamar was heavily under-represented, and the Musahars had no MPs. In 2013 the number of Dalit MPs was down to 40, with about the same (lack of) representation from Madhesi Dalit groups, from what we can judge based on their names<sup>85</sup>. A count of Dalit members in the three main parties executive committees, shows that the Maoists have only 4%, as compared to 6% for UML and 7% for Congress<sup>86</sup>. All committees have 6–7 Dalit members, but the Maoists have a larger central committee.

Turning to the other Madhesi groups in the 2013 CA, we have not seen a tabulation, but the names of the MPs from the core Madhes districts indicate that terai Janajatis and non-Dalit Madhes castes are well represented<sup>87</sup>. In Saptari, for example, the six directly elected MPs are named Chaudhary, Yadav and Mandal, the same is the case for Siraha (except for Prachanda), and in other Madhes districts we find other non-Dalit Madhes names, such as Jha, Sah and Teli. Thus when INSEC, or for example the Carter center<sup>88</sup>, report on the Madhesi representation, it must be kept in mind that the Madhesi community is very diverse, and will normally be represented by the traditional land-holding elite<sup>89</sup>. The Madhes community has a caste-system that in many ways is even more restrictive than in the hill-community, and it is misleading, as many NGOs and INGOs do, to place Dalits, Janajatis and Madhesi in the same category of socially excluded people. In particular the Madhesi Dalits have for centuries been discriminated by their Madhesi higher caste neighbors, and we find extensive inequalities in land-holdings, wages, interest rates paid for consumption loans, and social indicators within the Madhes community<sup>90</sup>.

To conclude, the Congress party has a relative stronghold in the terai, while UML is strong in the hills, in particular in the east. The Maoist party is strong in some hill areas, where they also started their armed resistance. All parties tend to select upper-caste people to represent them in parliament. The Madhesi movement is, in the same way, led by higher caste people. Despite the dominance of high-caste people in all parties, they still made sure to include other population

82 Gurung, H. (2001). *Nepal social demography and expression*. New Era.

83 The Limbu people have their traditional areas in the eastern-most hill districts. This author visited this area in 1997, at the time of the last local election, and vividly remembers the red-UML flags in the village market center where he stayed. While in the terai belt, the author had to leave the market center to find UML leaders.

84 Khanal, K., Gelpe, F.S. and Pyakurel, U.P. (2012). *Dalit representation in national politics of Nepal*. Nepal National Dalit Social Welfare Organisation.

85 <https://nepaldalitinfo.wordpress.com/2014/01/07/dalit-communitys-representation-in-ca-2070/>

86 Khanal, K., Gelpe, F.S. and Pyakurel, U.P. (2012).

87 INSEC (2014). *Constituent Assembly Election 2013*.

88 Carter Center (2013). *Observing Nepal's 2013 Constituent Assembly Election*.

89 Hatlebakk (2007). *Economic and social structures that may explain the recent conflicts in the Terai of Nepal*. Available at: [www.cmi.no](http://www.cmi.no).

90 Das, A.K.L. and Hatlebakk, M. (2010). *Statistical evidence on social and economic exclusion in Nepal*. Himal Books. Kathmandu. Hatlebakk, M. (2011). "Triadic Power Relations in Rural Nepal". *Journal of Development Studies*. 47(11): 1739–1756. Hatlebakk, M. (2009). "Capacity constrained collusive price discrimination in the informal rural credit markets of Nepal." *Review of Development Economics*. 13(1): 70–86.

groups already in the 1991 election: Madhesi high caste groups were over-represented in the parliament, as compared to their population share, the same was the case for Limbus, while Dalits and some Janajatis (Magar and Tamang) were underrepresented.

The social, economic and political discrimination of Dalits, and the discrimination of some ethnic groups along some of the same dimensions, is closely linked to class position. There are obviously poor Brahmins, but on average the upper-castes have more wealth and will more often be in a position where they hire labor, rent out land, and raise loans for people in need, quite regularly at high interest rates. In these markets, caste can be used to separate the market so that different prices and wages can be offered to different people<sup>91</sup>. In this sense caste interests are also linked to economic interests.

### 4.3 Power analysis

#### 4.3.1 The role of social networks

Caste and family networks make it easier for the powerful to coordinate their joint interests at the intersection of politics and economy. Bista used the term *aphno-manche* (my-people) for these networks<sup>92</sup>. Deals are typically made within your social network, and lower ranked people will need to tie themselves to these networks to get a good job or a business relation. With many business contracts being decided by politicians and government officials, it is particularly important to have your own people in these positions. The patronage system extends to all spheres of society, so that the same personal network will include politicians, bureaucrats, and businessmen. You become a part of these networks through family relations, or if you, by other means, end up in an attractive position. To some extent you can pay yourself into position. This can be a straightforward cash payment, or reciprocal benefits over time. Media reports indicate the range: any government position linked to regulated businesses,

91 Hatlebakk (2009, 2011).

92 Bista, D.B. (1991). *Fatalism and Development: Nepal's Struggle for Modernization*. Orient Longman. Calcutta.

including health<sup>93</sup>, education<sup>94</sup>, transport<sup>95</sup> and oil import<sup>96</sup>, as well as sectors that require large contracts, such as roads, hydro-power<sup>97</sup> and defense<sup>98</sup>, will open up for future incomes, and will normally require an up-front payment<sup>99</sup>. The same will be the case for lucrative foreign jobs at embassies and, for more people, in international peacekeeping operations<sup>100</sup>. With such a range of corruption, there will be lucrative posts at many different levels of government, from local roads department to the parliament and ministries. The highest up-front payment we have seen mentioned in the media was for a seat in the recent CA, where the rate supposedly was 10 million rupees (about USD 100 000)<sup>101</sup>. As for all forms of corruption, media reports will normally be the main source of information. Surveys can add information, but we shall not expect people to report large-scale corruption in surveys.

#### 4.3.2 The role of corruption and price discrimination

Payments to politicians and government officials can in theory improve efficiency in highly regulated economies. In the absence of market forces, it may help to let the illegal market work, as payments under the table will re-establish market prices. Petty corruption may illustrate the gray areas, with the recent currency reform in neighboring India providing a good example.

93 <http://nepalitimes.com/article/nation/corruption-and-greed-in-nepali-health-sector,1075>

94 <http://kathmandupost.ekantipur.com/printedition/news/2015-01-31/education-most-corrupt-sector.html>

95 <http://www.economist.com/blogs/banyan/2012/08/public-transport-nepal>

96 <https://thehimalayantimes.com/nepal/joint-secretary-nepal-oil-corporation-top-official-sent-to-judicial-custody/>

97 <https://thehimalayantimes.com/business/report-spells-factors-behind-nepal-hydropower-corruption/>

98 <http://kathmandupost.ekantipur.com/news/2011-09-05/corruption-in-royal-nepal-army-high.html>

<http://nepalitimes.com/news.php?id=14005#.WPdiUUSweEg>

99 For a broad commentary on the extractive government and the role of donors, see Thomas Bell at: [www.aljazeera.com/indepth/opinion/2015/03/nepal-failed-development-150322052502920.html](http://www.aljazeera.com/indepth/opinion/2015/03/nepal-failed-development-150322052502920.html)

100 <http://nepalitimes.com/news.php?id=2819#.WPdheUSweEg>

101 [www.nepalitimes.com/blogs/thebrief/2015/10/07/blatant-nepotism](http://www.nepalitimes.com/blogs/thebrief/2015/10/07/blatant-nepotism)

It is standard practice in India to pay people to stand in line on your behalf. Then you turn up in the last minute and switch place so that you can conduct your business, of, in this case, depositing your old bills. This is a borderline case, if your servant had done the full job it would be fine, while if you paid directly to the office worker to cut the line it would be petty corruption. Similarly for large contracts, one can easily imagine cases where payments under the table will cut short the bureaucracy.

A similar example is price-discrimination. Most small cities of Nepal have hotels dedicated for the donor community, where foreigners will never be able to bargain for lower prices. The hotels will charge the announced rates, while they may give discounts to Nepali citizens. This two-price policy is institutionalized by the domestic airlines, and exist for basically any product where foreigners can easily be separated from Nepali citizens, ranging from bananas to airline tickets and hotel rooms. Now, shall we expect this common practice not to exist for other purchases? Embassies in Kathmandu pay full price for airline tickets and hotel rooms, but consider a two-price policy for car-repairs and petrol to be corruption. Similarly for larger contracts: contractors will tend to charge full prices in offers to embassies, and may regularly communicate on the prices offered. A zero-tolerance policy in these cases may be problematic: a person who knows how these markets work will have to avoid working in organizations supported by donors (to avoid getting entangled in corruption cases), and as a result these organizations may not be able to hire the most qualified personnel.

This said, corruption will in many cases have large costs for the society, and the art of policy-making is to identify the serious cases. The most serious example that have recently been revealed in Nepal is the case of load shedding discussed above. Large users of electricity paid under the table to have electricity during many years of electricity rationing. With up to 12 hours without electricity per day this has been a major constraint on economic development and people's welfare. The problem was solved over-night by an

honest civil servant, who also had the necessary political protection from Prachanda, the Maoist Prime-Minister<sup>102</sup>. This single case can alone lead to election victory for the Maoists, despite the moderate predictions we provided above<sup>103</sup>.

#### 4.3.3 The role of business interests

In addition to cases of straightforward corruption, we shall in Nepal, as elsewhere, expect that strong business interests affect government policies (taxation, regulations, investments) through more or less legitimate contacts and lobbying. Nepal has some strong business houses and cartels where the bottom-line will depend on decisions made by government. The largest business houses run food industries, hotels including the casinos, steel and textile. The most powerful are probably: the Chaudhary group (with Binod Chaudhary being on the Forbes list), the Khetan group (major banks and insurance, production of Carlsberg beer), Jyoti (steel industries, major hospital)<sup>104</sup>. We expect all these to be lobbying politicians and bureaucrats.

There are also more direct links between political leaders and business in Nepal. Political leaders own shares in businesses, this has in particular been reported for the hospital sector with UML leaders involvement in the Manmohan Memorial Institute of Health Sciences as the most prominent case<sup>105</sup>, but also Congress politicians are reported to have shares in the health sector<sup>106</sup>. The Maoists appear to be extensively involved in different businesses, but the media coverage is not very solid. There appears to be a clear link to

102 <http://nepalitimes.com/article/nation/corruption-in-electricity-industry-of-Nepal,3408>

103 The Maoist won, however, no major city, and only 17% of the Mayor-positions in the first round of local elections.

104 <http://www.newbusinessage.com/MagazineArticles/view/1614>

<http://bossnepal.com/top-group-companies-nepal/>

105 <http://kathmandupost.ekantipur.com/news/2016-01-02/manmohan-institute-bill-mps-call-for-making-hospital-state-entity-see-to-change-the-name.html>  
<http://m.setopati.net/opinion/359/>

106 <http://admin.myrepublica.com/society/story/24527/rs-589-5m-to-hospitals-with-politicians-stake.html>

businessman Ajay Raj Sumargi<sup>107</sup>, who is, in turn, linked to the Teliasonora scandal<sup>108</sup>. Beyond this link, the Maoists appear to be involved in a wide range of businesses<sup>109</sup>, although direct evidence is hard to find. There appears, however, to be ample evidence for the result of wealth accumulation among Maoist leaders<sup>110</sup>.

#### 4.3.4 The role of forced donations

Apart from any corruption related incomes, direct incomes from ownership of businesses, and regular incomes from government positions, maybe the largest source of income for the political parties are donations. As in other countries, donations from business houses may be given in expectation of future benefits, but may still be considered legitimate, and voluntary. Still, forced donations seem to have been a major source of incomes, in particular, for the Maoist party<sup>111</sup>. Forced donations continued for a while after the peace solution, but seem to have been gradually replaced by more voluntary contributions after the Maoist party came in power.

In particular in the core Madhes districts, forced donations, including those enforced by direct use of violence and kidnappings, remain

a major concern. The Maoist insurgency and the following Madhes uprising led to a number of smaller armed groups popping up in the Terai<sup>112</sup>. Some of these groups, which combines politics with criminal activities, are still active and extort money, in particular from Madhesi businessmen<sup>113</sup>. There are similar extortion activities in Kathmandu<sup>114</sup>, with criminals allegedly being connected to political parties<sup>115</sup>. More research and journalistic investigation is needed of the importance of these links between businessmen, politicians and criminal groups for the politics of Nepal. In the view of this author, these linkages are heavily underestimated, not by ordinary Nepalis, but in particular by the international community. The parties need strongmen for security, and tie themselves to more or less criminal groups, in return these groups get more or less legal business contracts, or protection against prosecution. The Maoists, but also to some extent the other parties, will have such security services “in-house”<sup>116</sup>.

- 107 <http://nepalitimes.com/news.php?id=19640#.WPsbRESEh>  
<http://indianexpress.com/article/news-archive/web/prachandas-house-may-get-confiscated/> <http://www.newbusinessage.com/Articles/view/2067>
- 108 <https://www.svd.se/affarsman-i-nepal-fick-2-miljarder-av-telia/om/mutmisstankarna-mot-telia>  
 Hedelius, P. (2015). *Telia: alliansregeringen och korrup-tionen*. Massolit Förlag.
- 109 [http://www.abhiyan.com.np/article-6\\_7\\_page\\_25\\_april-3#.WPtEB0SweEg](http://www.abhiyan.com.np/article-6_7_page_25_april-3#.WPtEB0SweEg)
- 110 <http://www.telegraph.co.uk/news/worldnews/asia/nepal/9049032/Nepali-Maoist-leader-adopts-millionaires-life-style.html>  
<http://www.hindustantimes.com/world-news/prachandas-rise-from-maoist-to-leader-of-nepal/story-AKB7x7jg-w46Yq47C7OU7hK.html>  
[https://www.telegraphindia.com/1131118/jsp/foreign/story\\_17582795.jsp#.WPoOjESweEg](https://www.telegraphindia.com/1131118/jsp/foreign/story_17582795.jsp#.WPoOjESweEg)
- 111 National Business Initiative (2014). *Forced donation, political funding and public security in Nepal*.

- 112 Hatlebakk, M. (2007). *Economic and social structures that may explain the recent conflicts in the Terai of Nepal*.
- 113 <https://thehimalayantimes.com/kathmandu/former-minister-shyam-kumar-gupta-arrested-charge-extortion/>  
<http://kathmandupost.ekantipur.com/news/2015-09-13/captors-held-3-hostages-freed.html>  
<https://thehimalayantimes.com/nepal/four-nabbed-extortion-abduction-charges/>  
<https://thehimalayantimes.com/nepal/indian-criminal-wanted-suresh-kedia-abduction-shot-dead-encounter-nepal-police-birgunj/>
- 114 <https://thehimalayantimes.com/kathmandu/police-intensify-combing-ops-gangsters/>  
<http://www.myrepublica.com/news/4751/>
- 115 <https://thehimalayantimes.com/kathmandu/gangster-gainte-injured-n-police-firing/>  
<http://www.nepalitimes.com/blogs/thebrief/2015/08/20/ghaite-killed/>
- 116 For a discussion of the gradual decline in the importance of the internal youth forces see: Carter Center (2001). “Clashes Between Nepal’s Political Party Youth Wings Have Decreased. But YCL and UML Youth Force Continue to Seek Financial Gain”.

## 5. Political culture

In this section we will discuss some characteristics of Nepali society that affect the conduct of politics, which may in turn have implications for implementation of development programs.

### 5.1 Clientelism

We have already discussed the *aphno manche* patronage system, where connections are required to get good jobs and contracts. The system has implications for how decisions are made in both the private and public sector. Within such a system of reciprocal behavior, any openly announced vacancy will lead to a wide range of expectations within the networks of people with some, even minor, influence on the selection process. This will be the case for any well-paid job, from housekeeper, via driver to top-level positions. As a result it may be more difficult to find the most qualified person if a vacancy is openly advertised.

For large contracts, similar mechanisms come into play as discussed earlier: potential contractors may know each other and communicate on all elements of their bids. Within a patronage system, the local community will also expect to benefit from large contracts. It will be difficult to implement new development programs unless the local community find that they get sufficient benefits from the program. The Melamchi water supply project is a good example<sup>117</sup>, with its extensive delays<sup>118</sup>. But also many hydropower projects, roads and transmission lines are delayed due to local protests.

This has implications for implementation of development programs. All actors from top-level politicians, via bureaucrats, down to regular employees and villagers expect to receive their fair share of donor funding. Contractors expect a better price on donor-funded projects, villagers expect a higher compensation for lost land, employees expect better pay, or other benefits, when they work on donor-funded projects, and politicians may expect pay-offs, or other benefits, from contractors. With respect to political outcomes, the politicians also expect the electorate, who have been allocated a program by the same politicians, to support them in the next election. The outcome of this political game is that political parties channel projects to their core villages, which in turn return the favor in elections. This mechanism tend to be quite localized in Nepal, with neighboring villages supporting different parties.

### 5.2 The culture of consensus

Many in the donor community in Kathmandu tend to become frustrated with the political process in the parliament. The process of creating a new constitution, in particular, started in 2008, and is still ongoing. The details on how to implement federalism is only in the early stages of discussion. There is a proposal for the federal map that may still be adjusted<sup>119</sup>, and many details on powers allocated to the federal units remain to be decided.

117 [http://www.iwra.org/congress/resource/abs626\\_article.pdf](http://www.iwra.org/congress/resource/abs626_article.pdf)

118 <http://nepalitimes.com/article/nation/Melamchi-flows-to-Kathmandu,3397>

119 With the provincial and national elections coming up in some provinces on November 26, and the rest on December 7, the map now (at the time of revision of this report in early November) appears more settled.

The normal bargaining process, on basically any issue, will be to sit for days, weeks and months, until some deadline approaches. Then the deadline will be extended a couple of times, before suddenly, late at night, a compromise is found. There appears to be a need for a broad consensus. Thus all parties from the Maoists to the monarchist parties may be in on a consensus, although not always, and what party that opposes will vary from case to case, normally depending on the need to muster support from the voters in the next election. In a country with many latent, and overt, conflicts this may be a good strategy. The bargain continues until as many interests as possible are on board, while keeping the voters in mind<sup>120</sup>. It may however be frustrating to observe, and not only for international observers. The people are dissatisfied with their politicians<sup>121</sup>, although they do normally get re-elected, as discussed earlier. Some commentators argue that the consensus strategy implies a lack of an opposition, but that appears to be a mis-understanding of the Nepali context. There are many parties, and they regularly change partners in governance and go in opposition.

### 5.3 India's role in Nepali politics

Many observers appear to underestimate India's role in Nepali politics. India is surprisingly active. India has an obvious long-term interest in Nepal's hydropower resources, similar to Bhutan. But this potential has been discussed for decades, and have not yet materialized. This in itself cannot explain India's day-to-day involvement in Nepali politics. India also has a security interest relative to China, with Nepal being effectively a buffer zone towards the northern neighbor. China has, however, always respected that Nepal is under

India sphere of interest<sup>122</sup>. Although some Nepali politicians, at times, play the "China card", this is always with very limited success. An example is the very limited oil import from China during the Indian blockade<sup>123</sup>. China has no serious economic interests in Nepal, and their security interests are basically to defend their own borders in Tibet.

India's active role in Nepali politics must nevertheless be understood within this broader context. Nepal is under India's wings, similar to Bhutan, and the Himalayan states (Kashmir, Sikkim, Assam, Nagaland) that are within India's borders. India is particularly active during political transitions in Nepal, both at the micro level during appointments of new prime ministers, and during constitutional changes (from the end of Rana rule, via introduction of democracy in 1990, to the recent constitutional changes).

The recent UML prime minister KP Sharma Oli was considered anti-India<sup>124</sup>. He was maybe the first prime minister in many years that was not approved by Delhi. His active stand against India was still to a large extent symbolic, but probably explains why the Indian blockade lasted for five months. Even parts of the Indian media ended up criticizing India's attempts to micro-manage Nepal<sup>125</sup>. The start of the blockade demonstrates India's micro-management. When Nepali politicians, in their usual manner, suddenly agreed on a new constitution in September 2015, India was not on board, and as a result the border was blocked<sup>126</sup>. This was never admitted by Delhi,

120 The bargaining can be between two parties, or many, with continuously shifting coalitions. Bargaining will go on behind closed doors, but the press will normally report that discussions are going on.

121 The political parties have the lowest level of trust, far below the police, army, judiciary, labor unions and the media. The parliament has, though, a higher level of trust, although not as high as the other institutions mentioned here: IDA (2015). Nepal Contemporary Political Situation Opinion Survey.

122 <https://www.foreignaffairs.com/articles/china/2016-02-25/nepals-balancing-act>

123 <http://kathmandupost.ekantipur.com/news/2015-10-29/nepal-inks-historic-oil-agreement-with-china.html>  
<http://kathmandupost.ekantipur.com/news/2016-07-24/nepals-imports-shrink-to-rs-782b-in-2015-16.html>

124 <http://timesofindia.indiatimes.com/world/Olis-fall-is-good-news-for-India-Prachanda-likely-to-be-next-PM/article-show/53370448.cms>

125 <http://www.thehindubusinessline.com/opinion/delhis-disastrous-play-in-kathmandu/article8897956.ece>

126 <http://www.nepalitimes.com/blogs/thebrief/2015/09/25/unofficial-blockade/>  
<http://nepalitimes.com/article/editorial/editorial-proxy-war-blockade-is-not-about-the-constitution-anymore,2637>

but as usual high-level involvement in Delhi five months later solved the issue<sup>127</sup>.

As Nepali Times commentators note<sup>128</sup>, it is surprising how little coverage the Indian blockade received in the international media, despite the new interest in Nepal that followed the earthquake. Although the costs are hard to estimate and compare (they hit very differently with the earthquake hitting particular villages very hard), it is quite likely that the aggregate costs of the blockade were as high as the costs of the earthquake<sup>129</sup>.

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127 <http://www.nepalitimes.com/blogs/thebrief/2015/10/03/blockade-lifted/>  
<http://nepalitimes.com/article/editorial/autopsy-of-a-blockade%20,2863>

128 <http://nepalitimes.com/regular-columns/Between-the-lines/blockade-%C2%ADis-%C2%ADa-%C2%ADblockade,597>

129 <https://thehimalayantimes.com/opinion/nepalese-economy-earthquake-blockade/>

## 6. Governance issues

This section elaborates on three essential governance issues, the role of the bureaucracy and the potential for corruption, the need for local elections, and the contentious issue of federalism.

### 6.1 Bureaucracy and corruption

As discussed above, the bureaucracy in Nepal is quite influential in regular governance matters. The bureaucracy manages a sound macro economic policy. Nepal has tied the currency to the Indian rupee (1.6 NC per IC), and the central (Rastra) bank makes sure not to print money and thus keep the inflation in place. The Finance Ministry is responsible and makes balanced budgets, and other ministries and local governments have in fact problems spending the allocated funds. In sum this has contributed to a relatively stable, but low, growth rate, which since 1985 has led to a doubling of people's income and a solid reduction in poverty.

As we have also discussed, there is room for corruption in the bureaucracy, which in some cases will have negative effects on the economy. Prioritized access to electricity for a few large users for decades is maybe the most important example. Selection of contractors for public works can also be affected by corruption, and in the worst cases the projects may not even be implemented despite being paid for<sup>130</sup>. Selection of contractors, and lack of follow up, may severely damage the quality of the projects, the costs, and the timely implementation<sup>131</sup>. We have already discussed how the Melamchi water project and the highway from

Kathmandu to Birgunj have been heavily delayed. But there is also a twist to this issue, when combined with the fear of too much India influence.

It is quite likely that the fast track to terai has been delayed because the Nepal government did not want Indian contractors involved<sup>132</sup>. The same is likely the case for some of the larger hydropower projects. The major Arun valley hydro project was stopped partly due to the involvement of Indian contractors, although we have to read this between the lines<sup>133</sup>. The Arun project is now again a possibility, with Indian contractors onboard<sup>134</sup>.

The potential for corruption, and the potential for contracts, work and final products to be controlled by foreign powers, may lead to a reluctance to start large-scale projects in Nepal. This may be perfectly rational, both corruption and foreign influence are real threats. To implement both small and large projects with a minimum of corruption is a difficult task in a country where salaries for politicians and public servants are very low. The potential extra incomes from embezzlement are very high compared to regular incomes. Independent control mechanisms are part of the solution, but will move the problem one level up<sup>135</sup>, as the monitors may

130 <http://www.economist.com/blogs/banyan/2011/05/aid-and-corruption-nepal>

131 <http://nepalitimes.com/news.php?id=3775#.WPyNHUSweEg>

132 <https://thehimalayantimes.com/business/fast-track-road-project-runs-into-controversy/>

133 For two opposing views of why Arun was stopped, and with no mentioning of India, see: <http://nepalitimes.com/news.php?id=1879#.WPyPp0SweEg>  
<https://nepalstudycenter.unm.edu/MissPdfFiles/The%20Loss%20of%20Arun%20IIIRevised.pdf>

134 <http://kathmandupost.ekantipur.com/news/2016-01-15/what-could-have-been.html>

135 This motivated Kaushik Basu's idea of only punishing the person who offers a bribe: <http://www.outlookindia.com/website/story/my-experiment-with-corruption/296714>

also be corrupt<sup>136</sup>. The long run solution, which will gradually be feasible as Nepal develops and thus can afford it, is to pay civil servants a decent salary. The more you lose if you get caught, the less likely you are to enter corrupt deals<sup>137</sup>.

## 6.2 Local democracy and civil society

A well functioning local democracy is essential for development, as local leaders can be held accountable to the people. The last local election was in 1997. A new election was scheduled for 2002, but this was at the height of the Maoist conflict and Congress prime minister Sher Bahadur Deuba postponed the election<sup>138</sup>. With the peace solution the first priority was to elect a new parliament. After the 2008 CA election there was a need for local elections, but in particular the political forces in favor of federalism wanted the new federal system in place before local elections were held. As we know, the first CA was not able to agree on a constitution and was dissolved in 2012. A new CA elected in 2013 ultimately passed a new constitution in 2015, which will replace the 1991 constitution. In 2017 the parliament decided on the new local units, with the 3000 plus VDCs being replaced by 480 local units<sup>139</sup>, and local elections were to be held in May and June 2017, twenty years after the previous elections.

These postponements contrast with the introduction of democracy in the early 1990s. After the People's Movement in 1990, a new constitution was declared the same year, the first parliament was elected in 1991, and local elections were held in 1992, and then again in 1997, in both cases two years before the national elections. The local democracy seemed to work well, based on this author's observations. There were elected representatives from the different parties, and a VDC secretary responsible for the administra-

tion. During the 1990s local democracy was gradually developed. The UML government introduced a block grant in 1994, the "build your village yourself" scheme<sup>140</sup>, and the local self-governance act was in place in 1999<sup>141</sup>. During fieldwork in the late 90s this author found that he in most villages could expect good discussions with local politicians and civil servants regarding village development.

Not unexpectedly local democracy deteriorated during the war. Local politicians and other local leaders<sup>142</sup> were targeted by the Maoists<sup>143</sup>. The Maoists built up competing power structures in the villages where they had some degree of military presence, and specifically targeted the VDC offices, which in turn had to move to the district headquarters. Similarly, the land registration offices were attacked. Villagers consequently had to travel further to get in contact with civil servants, and with no elections they no longer had elected people representing them. This all affected access to services (such as collection of old age pensions), and development work. For an excellent study of the implications of the insurgency for local democracy see Annelies Ollieuz's PhD thesis based on extensive fieldwork in a village in eastern terai<sup>144</sup>.

In response to the deteriorating local democracy, and more generally the perceived need for strengthening democracy in Nepal in the post-conflict period, the international community has doubled the support to governance and civil society. The flagship program at the local level has been the Local Governance and Community Development Program (LGCDP). This has been an extensive program with many

136 As in the case of the anti-corruption agency in Nepal: <http://nepalitimes.com/article/from-nepali-press/Lokman-disqualified,3479>

137 <http://voxeu.org/article/higher-government-wages-may-reduce-corruption>

138 <http://nepalitimes.com/news.php?id=18331#.WPYn0USweEg>

139 <https://thehimalayantimes.com/kathmandu/pm-pushpa-kamal-dahal-inaugurates-operation-of-744-local-levels/>

140 Whelpton (2005) page 193.

141 <http://setopati.net/opinion/5694/Reviving-Local-Democracy/>

142 <http://nepalitimes.com/news.php?id=4375#.WPzBSESweEg>  
<http://nepalitimes.com/news.php?id=1484#.WPzA50SweEg>

143 Data from Insec shows that the Maoists killed 1184 farmers (about the same as the state), 1752 police, 948 soldiers and 465 politicians. Most killings by the state (6128) is registered as politicians, with only 33 soldiers, indicating that Insec recorded Maoist soldiers and militia as politicians. Data is available at: <https://dataverse.harvard.edu/dataset.xhtml?persistentId=doi:10.7910/DVN/RGRCCJ>.

144 Ollieuz, A. (2012). Authority, leadership and democracy in southern Nepal. A village ethnography. PhD. Thesis. University of Oslo.

components, potentially vulnerable to local elite capture<sup>145</sup>. There has been a massive growth in local NGOs in Nepal, with a jump in registrations from 1995 onwards, and then a new jump from 2007 onwards<sup>146</sup>, there are now more than 30 000 NGOs in the country.

In any village there will be students, teachers and other social entrepreneurs that do social work. Many of them do so without any donor support, it is an expectation from the local community that people with education and higher incomes do social work, which quite often involves politics, as described by Ollieuz. But many entrepreneurs start NGOs with the main purpose of collecting foreign aid. This problem was mentioned as early as in 1983<sup>147</sup>, and with the increase in foreign aid and the number of NGOs since then, we shall expect elite capture to be an even larger problem today. Seen from the villagers' point of view this may not be a bad thing, they will see the entrepreneurs as people who bring in projects to the village, from which the villagers will also get a share. Outside observers may rather see the rent-seeking activities of entrepreneurs competing for the same available budgets. A main arena for this competition will be at the district level (again well described by Ollieuz), where politicians and activists from the villages meet in the DDC, the elected council, but also are in direct contact with local development officers, who may work in offices that are subsidized by the LGCDP program. These offices will be well stocked with English language information on the villages of the district.

145 For a detailed discussion of the potential for elite capture of local governance programs, see Platteau, J.-P. (2008). *Information Distortion, Elite Capture, and Task Complexity in Decentralised Development*. CRED. University of Namur.

146 New registrations by year: [www.swc.org.np/wp-content/uploads/2015/08/by-yearwise.pdf](http://www.swc.org.np/wp-content/uploads/2015/08/by-yearwise.pdf)

147 Two leading Nepali scholars wrote: "It is ironic that for the first time .... foreign aid has enabled the upperclass to extend its reach and make itself felt in the very far flung and heterogeneous villages and hamlets in the country". At that time less aid was allocated to NGOs, but the phenomenon is still the same, there is a local elite that will attempt to pick up the benefits of aid. Mishra, C. and Sharma, P. (1983). "Foreign aid and social structure: Notes on intra-state relationships" in *Foreign aid and development in Nepal*. IDS, Kathmandu.

The problem of elite capture is likely to multiply as a result of the new layers of local governance. The new provinces will have income sources far beyond the present regions and districts, although the de-facto re-allocation of resources between provinces is yet to be decided. New income sources open up for new ways of extraction of surplus among local politicians. At the local level, the present VDCs have been merged into larger units, again allowing for larger surplus for medium level politicians. Many of the previous VDCs will now be wards in the larger rural and urban municipalities. This implies that the lowest level of political representation will be more centralized, with previous ward-level politicians now fighting for more resources in the larger geographical units. And with donors being willing to allocate funds to the local level, in the name of support to the federal units, the problem of local elite capture will potentially be in a different league in the future. With the provinces having very different economic potential, there will at the same time be a massive need for redistribution between provinces by the central government. The donors should consider to fill necessary financial gaps in the centralized redistribution system, rather than allocating funds directly to the new provinces.

### 6.3 Federalism

There were signs of demands for ethnic based federalism in the 1990s<sup>148</sup>. First of all, in 1995 the Maoists announced "an ethnic policy in Nepal", and in 2001 they announced nine autonomous regions, with most having ethnic names<sup>149</sup>. In 1996 Krishna Battachan wrote: "The time bomb of ethnic violence is already ticking and no one knows when it will detonate"<sup>150</sup>. Still, a book written by a number of Nepal scholars in 1997 on "Nationalism

148 See: Aalen, L. and Hatlebakk, M. (2008). *Ethnic and fiscal federalism in Nepal*. Commissioned report for the Ministry of Foreign Affairs, Norway.

149 Sharma, S. (2002). *The Ethnic Dimension of the Maoist Insurgency*. Prepared for DFID.

150 Bhattachan, K.B. and Pyakuryal, K.N. (1996). "The issue of National Integration in Nepal. An Ethnoregional Approach". *Occasional Papers on Sociology and Anthropology*. 5: 17–38.

and ethnicity in Nepal<sup>151</sup> has only one reference to federalism. This was John Whelpton writing on the Maoists ethnic demands and mentioning a Gurung leader who advocated division into ethnic regions. In general, however, the demand for ethnic based federalism was not strong at that time.

This changed quickly around 2002, when the Maoist insurgency was at its peak, and NEFIN, the organization of mostly hill ethnic groups, changed its tactics, according to Susan Hangen, and became more overtly political in its demands<sup>152</sup>. Around the same time the donors picked up on the issue, in the name of social inclusion, including funding of NEFIN. From 2006 DFID funded the Social Inclusion Action Fund. NORAD started its support in 2004 with a call for “Project preparation grants for research cooperation on Social Inclusion and Nation Building in Nepal”.

Ethnicity was not mentioned in the 2005 peace agreement with the Maoists, but after the UN became involved and the Comprehensive Peace Accord (CPA) was in place in 2006<sup>153</sup>, we can read: “Pledging for forward-looking restruc-

turing of the state by resolving the prevailing problems related to class, ethnicity, regional and gender differences”. The interim constitution gradually opened for ethnic based federalism with the first amendment in 2007, after the first Madhes uprising, and completely so after the second Madhes uprising. The relevant formulation read: “Recognizing the desire of the indigenous peoples and of the people of backward and other area including Madhesi people towards autonomous provinces Nepal shall be a federal democratic republican state. Provinces shall be autonomous and vested with full authority. The boundaries, number, names and structures, as well as full details of the lists, of autonomous provinces and the center and allocation of means, resources and powers shall be determined by the Constituent Assembly, while maintaining the sovereignty, unity and integrity of Nepal”. In 2012 two main alternative models for organizing the country into federal states were presented and ultimately a compromise was decided upon in September 2015, which in turn led to the five months unofficial Indian blockade.

The compromise model consists of seven provinces, where all have a border with India (except for the “Karnali” region, but here there will be access via the western-most region). Access to India appears to have been important for UML and Congress. The access will allow import from India to flow in one province even if there is a blockade or transportation strike in another. Except for the Madhes province, all provinces will have both hill and terai areas, although one province will have only a narrow corridor through Nawalparasi. The argument for having both terai and hill districts in each province has been to ensure economic diversity, and within each province road access following the north-south road corridors.

Ethnic demands have to a large extent been incorporated in the compromise model. The eastern province contains the Kirat region, including the eastern-most terai districts, with all its hill migrants. There is a similar situation in the western province, and also the three “hill” provinces in the middle are relatively ethnically homogenous.

151 Gellner, D.N., Pfaff-Czarnecka, J. and Whelpton, J. (ed) Nationalism and Ethnicity in a Hindu Kingdom. Harwood Academic Publishers.

152 Page 40 in Hangen, S.I. (2010). The rise of ethnic policies in Nepal. Routledge.

153 While the 2005 peace agreement was an agreement between the seven largest parties in the parliament and the Maoists, the CPA was an extensive agreement where UN was deeply involved: <http://peacemaker.un.org/nepal-comprehensiveagreement2006>. UNs work in Nepal was first led by Thamrat Samuel from 2003, and then from 2005 by Ian Martin, first as the head of the OHCHR office, and then at UNMIN. UNMIN was criticized for taking an active political stand and ultimately the mission ended in 2011, despite efforts from the Maoists to extend the term. For a report on some of the controversies at the time of one of UNMIN's extensions see: <https://thehimalayantimes.com/opinion/fifth-unmin-extension-inevitable/>. For a critical analysis by Kanak Mani Dixit see: <http://nepalitimes.com/news.php?id=17760#.WUTvHEQUmEg>. For an early analysis of UNMIN's role, written by Aditya Adhikari after the third extension in 2007, see: <http://old.himalmag.com/component/content/article/904-shackled-or-unleashed-unmin-in-nepals-peace-process.html>. For full analyses of the transitions that has taken place in Nepal by the same authors, see: Dixit (2011). *Peace Politics of Nepal an Opinion from Within*. Himal Books. Kathmandu; Adhikari (2014). *The bullet and the ballot box*. Verso. London. For a comparison with similar processes in other countries see: Suhrke (2014). *Restructuring the state: Federalist Dynamics in Nepal*. CMI-Report-2014:02.

The western terai province is less homogenous in the present version of the map, as it also includes the core Maoist hill areas (and the core Maoist areas in the terai). UML has in particular favored this version of the map, potentially because they now expect to win these areas in the next election. The Madhes province is in many ways the most homogenous, although also here there is an extensive representation of hill migrants, in particular in the northern parts of the plains. As this author has discussed elsewhere<sup>154</sup>, all provinces will be ethnically heterogeneous, with no group being in majority in any province (with the potential exception for the Chhetris in the western hill provinces).

The role of the international community in the ethnic agenda has been extensively debated in Nepal, but there are relatively few academic analyses of the issue<sup>155</sup>. Donors supported research on social inclusion, funded ethnic organizations, organized seminars with ethnic activists, and the UN and others were active during the peace talks from 2005 onwards. But to what extent the international community affected the debate, and ultimately the outcome, is still open for further investigation and debate.

There is a broad-based support in Nepal for federalism, although not ethnic-based federalism<sup>156</sup>. The support for federalism must be interpreted as a support for local democracy and within the context of clientelism, with federal-

ism allowing local politicians to control more resources, which in turn is expected to benefit their vote-bank. Ethnic policy, on the other hand, is not supported out of fear for communal violence. With the compromise federal solution, and the local elections showing that different ethnic groups can collaborate within the mainstream parties, this fear has now weakened<sup>157</sup>, but communalism is still a potential threat, in particular in the Madhes region. The mainstream UML and Congress parties, that have always opposed the ethnic agenda, won the local elections with 76% of the mayors, which is a result similar to the pre-war elections. As discussed in chapter 4, the western donors are now gradually pulling out of programs related to the ethnic agenda, which has always been a minority agenda in Nepal.

It was necessary to make compromises with the Maoists to end the war, and this included compromises on social inclusion, federalism and end to the monarchy. Many of these developments have wide-spread support, although not always majority support. There is support for language and cultural rights for minority groups, although there is a fear that Indian interests will have too much influence in the terai, explaining resistance against Hindi as a national language. There is also wide-spread support for political representation for women, ethnic groups and Dalits in the parliament, as specified in the new constitution. And caste-based discrimination is on the decline in educational institutions, the market place and in the labor market. Thus essential elements of the demands for social inclusion are on the right track, with the exception for demands that have always been a minority agenda, in particular the demand for ethnic based federalism based on the traditional areas of a few selected ethnic groups.

154 Hatlebakk, M. (2014). The population basis for ethnic provinces in Nepal. Setopati-online news-portal.

155 The role of the international community is to some extent covered in analyses of the rise of ethnic politics (Hangen, 2010), and the transition more in general as represented by a number of contributions to: Einsiedel, Malone and Pradhan (2012). *Nepal in Transition: From People's War to Fragile Peace*. Cambridge University Press.

156 The most reliable opinion polls are conducted by IDA, with the latest one being: IDA (2015). Nepal Contemporary Political Situation Opinion Survey.

157 For news coverage of this issue, see: <http://nepalitimes.com/article/nation/the-battle-for-birganj,3944>

## 7. The space for development cooperation

### 7.1 Opportunities and constraints

Above we have described a political and business climate where powerful people collaborate within their social network in a cobweb of mutual exchanges of services and money. These ties may be between relative equals, such as in the relation between a powerful businessman and a high-level political leader, or it may be part of a patronage system where a political leader provides a village with a development program knowing that the villagers will vote for him in the future. Many important, and less important, transactions in Nepal are of this kind.

It is important to be aware of these relations. Of course, there are similar transactions everywhere, but the extent of personalized transactions in Nepal are quite marked and evident even on an everyday level. For instance, if you ask someone to take you to a copy-shop, or a gas station, they will take you to the nearest one, within their network. The same may happen if you look for professional help, or a business partner. And this partner will repay the person who brought your business not necessarily with money today, but maybe with a favor next year.

What implications does this have for development cooperation? Many such relationships will not be considered illegal by those who are engaged in them, although the outcome may be interpreted as corruption by the Nepali society. Thus many will see politicians as corrupt, although they may not see the businessmen who are “forced” to pay as corrupt. People will, at the same time, expect their politicians to deliver development, and will expect them to do what is necessary to this end. A de-facto zero-tolerance policy for corruption in this environment would

require a weak definition of corruption. Direct payments under the table may be avoided, but price collusion, favoritism and reciprocal benefits over time would be difficult to completely avoid. One may even risk that honest people will stay away, as they will know that zero-tolerance is impossible. They may thus not apply to, or stay, in an organization where they can get fired if, let us say, an audit at some point discovers that contractors have colluded on price in a project they were responsible for. Donors should rather gradually implement new business standards that favor merit rather than networks, but not expect to implement this everywhere overnight.

### 7.2 The role of donors and foreign aid in Nepali politics and the economy

What should be the donors’ role in Nepali society? As we have seen, some donors have played an active role in promoting social inclusion. From the Nepali point of view this has been seen as an active support for the ethnic agenda of Madhes and Janajati activists, and thus also a support for ethnic based federalism, a version of federalism with very limited support in Nepal. There seems to have been a shift among donors away from this policy, and at the same time also a shift among intellectuals and high-level politicians in Nepal from ethnic to identity based federalism, maybe in an attempt to find a compromise. The donors may consider reorienting their support towards more broad-based civil society organizations, as an alternative to supporting identity based organizations. As most such organizations are linked to political parties, this is problematic as well. Nevertheless, the political connections are unavoidable, and some support, in particular to

broad-based organizations, may be useful. This may include trade unions, media organizations, and cultural organizations. As a more general rule, financial support should constitute only a fraction of the total budget to avoid dependency on donors.

Donor funding is potentially more important for the national economy. There is still under-funding, in particular of public goods and safety nets in Nepal. We know also from richer countries that it is difficult to raise the necessary funds for roads and other infrastructure, as well as for, in particular, the health sector. Any service where full user-fees cannot be easily charged will tend to be under-financed. This is the case for public goods, such as roads and to some extent education, and it is the case for services where the users tend to be poor due to the condition that defines them as users, such as in particular health services. In these sectors, the donors can play an important role. Nepal still lacks good roads throughout the country, health services are weak, and the quality of education is relatively low. With the majority of the population still living in rural areas, and with many depending on low-productivity agriculture, there is room for support within this sector as well.

### 7.3 Risk assessment summary

Norway has been active in supporting governance, energy and education. As the above analysis indicates, there is considerable risk related to elite capture in local governance programs. This is also discussed in more detail below in section 7.5.1. Governance programs are different from other aid programs as the aim is to change the behavior of local actors, whether that is by way of less corruption, selection of candidates from broader population groups, or interaction with voters and representation of broader views. Behavioral change, in terms of improved quality, is also an issue within education, but here, and even more importantly within the energy sector, underfunding is the main concern. In underfunded sectors one can more easily find useful ways to spend development aid. In a sector where behavioral change is the aim, including more effective use of

public funds, there is less need for financial support. The aid budgets allocated to governance are, however, relatively large in Nepal, which implies substantial risk. Donors are likely to reallocate funds to other activities in the name of supporting local governance, such as microcredit and livelihood activities within local NGOs, opening up for extensive rent-seeking activities among local players. A number of local NGOs are set up to compete for funding, and the Nepali population has little respect for such players, beyond their capacity to bring in donor funding.

This does not imply that donors should cut all funding for governance programs, but funding should be kept at a minimum, so that no organization becomes dependent on the donors. One should target NGOs and government programs that appear to improve governance at both the local and central level. Large amounts of aid in this sector can thus do damage, while small amounts of seed-money can do good. This may conflict with the target of reducing the number of aid projects, but there may be administrative ways of solving that problem, for example, a single media-support program can ultimately support many media organizations. Similar programs may provide small funds to civil-society organizations.

### 7.4 General versus sector support

As noted above there are good arguments for supporting specific under-funded sectors, such as roads, health and the quality of education. In Nepal there is some division of labor between the donors. Some of the large donors build roads, many donors have collaborated on basic education, while some donors have supported respectively the health sector, agriculture and energy production. It appears that this partial division is not the result of a coordinated effort, but the sum of country priorities. This may be perfectly fine, as long as the sum adds up to a reasonable policy. It seems, however, that education has been well funded (although there is still work to be done on the quality of education), while roads, health and agriculture remain under-funded. Subject to this conclusion, it appears that sector programs

are preferable to general budget support. Still, there are arguments for leaving large-scale infrastructure, in particular roads, for the multilateral development banks as they have more experience in implementing large infrastructure projects.

## 7.5 Development cooperation within specific domains

The rest of the report will discuss particular issues related to Norwegian development cooperation.

### 7.5.1 Good governance

As discussed above, foreign aid may be used as seed-money to support civil society, while keeping in mind the rent-seeking problems discussed. There is the danger that social “entrepreneurs” chase aid funds, and the larger the sums the more likely the rent-seeking costs will outweigh the benefits. Rent seeking will exist at the local level, but also with national level NGOs and even in the central government. At the central level there may be units built up basically only as a response to donor priorities, or there may be individuals who chase aid money either in terms of positions, or just travels and seminar participation. Some of the institutions that were started to support the peace- and constitution process may be examples of this. There has been widespread criticism in Nepal with, in particular, the non-military components of the UN efforts, which included support to local governance and peace-building<sup>158</sup>. And numerous INGOs set up office in Nepal to support the constitution writing process. The main responsibility for this taking seven years, and in many ways the process is still not completed, must be placed with the politicians, but external funding may have contributed.

What should a mid-size donor like Norway do to promote good governance? Any change in governance culture should come from within. Heavy donor funding is likely to make things worse by delegitimizing the groups, or offices, that receive funding. There may be exceptions

to this rule for particular groups whose need for funding is less controversial. Examples in Nepal will be particularly discriminated ethnic groups (the semi-nomadic Raute, for example), particularly poor Dalit groups (Musahar, Dom), disabled people, gay-groups, and projects supporting national heritage (music, dance, museums). But even for these groups one should be very careful and not fund the majority of the budget, and rather work together with local philanthropists to ensure that there is local support also in terms of where people put their money.

The same problems exist at the local level. The donors spend the local governance funding in strange ways. Many NGOs channel funds into micro-finance and income-generating activities. These may be sensible for their own sake, but we cannot see how they promote good governance, they probably just reflect the need to spend program funds allocated to the local level. Local youth-clubs have been another major activity, where the youth get training in democratic practices of debate and organization. This is a more targeted activity where donor support ideally can make a difference if funds, for example, lead to higher participation among girls, Dalits and other groups that may otherwise be less represented. It may also contribute to, if at all feasible, politically neutral youth groups.

### 7.5.2 Social inclusion

The discussion above of donors’ role in the social inclusion and ethnic agenda does not mean that the donors were main actors. The Maoists built their political organization around ethnic fronts, and had an army to support their claims. But the Maoists have traditionally not been strong supporters of ethnicity as an organizational principle, and without the strong pressure from Madhes activists in particular, we believe that the ethnic agenda would have fizzled out during the constitution writing process. The first draft was weak on ethnicity, and major amendments came as a result of the two rounds of Madhes uprisings. Madhes activists were given legitimacy by the donor community, which probably was important for them, but still it is hard to argue that this

158 Among many critical commentators C.K. Lal was quite outspoken: <http://nepalitimes.com/news.php?id=16480#.WQMefkSweEg>

support in itself was critical. The Madhes uprising in combination with the massive support for social inclusion via donor-supported institutions and activist organizations in Kathmandu may still have made a difference. In sum, the Maoists and the Madhes activists were the driving forces behind the ethnic/social inclusion agenda, but with support from the international community.

The two mainstream parties, Congress and UML, which now are back with 62% of the seats in parliament, have never supported this agenda<sup>159</sup>. There is extensive lip service, but these parties are concerned first of all with national unity, and accepted a federal solution first of all as part of the peace bargain with the Maoists. Thus the international community has supported a minority agenda<sup>160</sup>. Many Nepali citizens will agree that the Maoist demands of introducing a federal republic had to be met to secure peace, but the opinion polls show that more people even today support a unitary state, rather than a federal one. Federalism was probably unavoidable, and recognition of minority rights when it comes to language and cultural rights, as well as active policies for access to education and jobs, were important. The donor community may thus have made a difference in pushing positive changes, but may also have contributed to what may become a federal state organized along ethnic lines. We do not know how far Nepal will go along these lines, but there is a real danger that ethnic conflicts will intensify in the future.

Today the main Norwegian support for social inclusion is indirect via the multilateral support to the constitution process discussed above. At the seed-money level Norway has supported a large research program for social inclusion, first with support to CMI, NIBR and their Nepali partners, then in a second round to the department of anthropology and sociology at Tribhu-

van University. As a beneficiary this author will not comment further on this support. But in line with views from the Planning Commission, future support along these lines may well be used to support a social-science research foundation, with a broader program than only social inclusion, and where Nepali research institutions could compete for funds together with their international partners.

There is need for continued support to the most excluded population groups, including seed money to their organizations. As we have described, there are large differences between Dalit and Janajati groups. Dalit groups such as Musahar, Dom and to some extent Chamar in the terai still need extensive support to get access to land, education and other assets, including simple assets like livestock. The same is the case for very remote hill villages, in particular in the far-west, where even many Chettris are poor. Thus in the hills a targeted policy might focus on economic destitution rather than on caste, although targeted interventions towards Dalits and particular ethnic groups (Tamang, Magar) also make sense there.

### 7.5.3 Human rights

The main present human rights issue, beyond economic and social rights that we discuss elsewhere, is impunity for crimes during the war. There were excesses on both sides of the conflict. On the government side there were, as discussed, some major operations in the early phase that probably escalated the conflict. Later there were a high number of disappearances of suspected Maoists. In some cases people were arrested and tortured for some time, in other cases killed (and the bodies burnt or buried), with the special forces at the Bhairabnath barracks having the worst reputation. On the Maoist side there were killings of local activists and politicians from other parties, as well as the infamous bomb attack on a public bus in Chitwan. The international community is obliged to keep the pressure on such cases, but it is at the same time problematic. The strategy of the Maoists of attacking local leaders was deliberate. Baburam Bhattarai has said publicly that

159 Prior to the Maoist uprising the terms social inclusion/exclusion and marginalization were barely in use in Nepal. The seventh periodic plan (the first one after introduction of democracy) of more than 400 pages never used the terms.

160 Opinion polls have showed a large, and increasing, opposition among the people to ethnic-based federalism: IDA (2015). Nepal Contemporary Political Situation Opinion Survey.

if the direct perpetrators are arrested, he should himself be arrested. Thus the responsibility goes all the way up to the prime minister level.

On the then-government side, one can argue that the police (in the early phase) and then the army only defended the state against an armed rebellion. But this being government forces they are obligated to comply with international law, and police and army officers should be punished for crimes conducted during the war. The transitional justice process will probably drag out as there is a balancing act where perpetrators on both sides may fear punishment, and one need to recognize the complexities of impunity when it involves elected parliamentarians, including two previous Maoist prime ministers.

The records on human rights violations in Nepal are outstanding, thanks to INSEC. In contrast to the National human rights commission, and UN agencies, INSEC has from before the war reported every single incidence<sup>161</sup>, with the help of their contacts in basically every village of Nepal. In particular their English language reporting, and the availability of data to the outside world, may depend on donor funding.

#### 7.5.4 Humanitarian needs

The main humanitarian needs are the follow-up after the 2015 earthquake. Many lost their houses, and have not rebuilt as they are waiting for the government support. The first installments are now released, but for many it may still be insufficient to start building<sup>162</sup>, while others have already finished rebuilding, and may get the support ex-post<sup>163</sup>. There are ongoing discussions regarding the promises made by the donors that we will not go into here<sup>164</sup>. There is a need to rebuild houses in an earthquake resistant way, but there are many different ways of doing this, including relatively inexpensive designs that use

local resources. Flexibility is needed to try out different technologies. This also appears to be the policy of the government<sup>165</sup>. Beyond funding, the role of donors may be to bring in alternative low-cost solutions, although it appears that many well functioning alternatives are already in use.

A more long term humanitarian effort is food aid to districts in remote parts of the western hills. There is a concern that food aid will lead to less local production. But with staple food supplied from outside, one may also imagine a shift to cash-crop production, and there is some evidence of this in Jumla<sup>166</sup>. Thus, if the locals exploit the opportunities this entail, the potential negative effects of food aid may be turned into a positive. It is still a concern that the locals become dependent on subsidized rice, instead of maintaining the local food crops.

A third regular humanitarian problem is the lack of good housing in the terai. In the mountains people are used to very cold temperatures, although people today tend to move out during winter. But in the tropical zone of the terai, where temperature rarely go below zero, the housing of poor people can be very simple. As a result there are regular reports of people dying from cold during cold spells. More generally, respiratory illness is a main cause of premature death in Nepal, together with other easily preventable health problems such as diarrhea. There may also be need for humanitarian aid following major floods in the terai, and landslides in the hills, such as during the floods this summer,

#### 7.5.5 Education

Quality education is still a concern in Nepal. The primary education program has been a multi-donor program with changing names over the years. The program was implemented during a period of economic growth and structural change. Nepal has had a civil war, and massive labor migration abroad together with migration from the hills into the cities and to the terai. As a result there is

161 [http://nepalconflictreport.ohchr.org/subindex/incident\\_killing/incident\\_killing\\_by\\_maoist.html](http://nepalconflictreport.ohchr.org/subindex/incident_killing/incident_killing_by_maoist.html)

162 <http://kathmandupost.ekantipur.com/news/2017-01-19/2nd-tranche-of-aid-distribution-begins.html>

163 <http://www.myrepublica.com/news/15082/>

164 <http://nepalitimes.com/article/nation/broken-promises-reconstruction,3627>

165 <http://kathmandupost.ekantipur.com/news/2015-12-25/17-earthquake-resistant-house-designs-proposed.html>

166 McDonough, P. (2014). The effects of food aid on agricultural practices in Jumla. Master thesis, Ohio State.

now less need for family labor on the farm, easier access to schools and in general less need for the incomes from child labor. Structural change and increased incomes have also led to an increase in the demand for skilled labor, and education has become a goal in itself, in particular related to the marriage market. All these parallel trends of development have contributed to the rapid increase in school enrollment for girls. We have not seen any study that attempts to estimate the contribution of foreign aid to this increase, but our hypothesis will be that it has played a minor role. First of all, the Nepali government would have increased the allocations to education along with the general increase in government budgets, and secondly school enrollment would increase due to increased demand for schooling.

Donor support may still be needed, and maybe more technical, rather than financial support, when it comes to school quality. As in many poor countries the quality of education is still lacking behind. As the literature on other countries show<sup>167</sup>, improving quality is not an easy task. Pedagogical changes have worked, but more often in slightly richer countries than Nepal, such as China and India<sup>168</sup>. Availability of updated schoolbooks, as well as libraries, are important, as are incentives for teachers. There is a link here to well-functioning local democracy, as school management committees and elected local politicians should be involved in maintaining school quality.

Private schools now play a major role in Nepal, including in remote areas. These schools are allowed to use English as the language of teaching, which attract many parents. The quality of private schools is very diverse, some are excellent, and some even at relatively low costs, while others may cost even less, but will also have low quality. Many otherwise unemployed students now make their living as schoolteachers and tutors. The private sector is now so large that it is not conceivable that the government can take

over. In some ways the private sector provides necessary competition on quality, and provides excellent education, although for the few who are lucky to get into the best schools. We believe it is good for Nepal to have top schools, as adolescents will stay home instead of leaving for good schools in India and elsewhere. Some of them will ultimately leave to get a good university education, but the longer they stay home, the more responsibility they may feel for Nepal, and some of them do move back after some years of education and job experience abroad. The private schools are, however, private, and we cannot find any argument for taking resources away from the government sector to fund private schools.

### 7.5.6 Energy

As discussed, Norway has been a major donor in the energy sector, although the aggregate grants have been only half the size of the German support to the sector<sup>169</sup>. Norway started early in this sector with the Butwal hydropower plant from 1970, built by missionaries. Later the Norwegian state energy company Statkraft built Khimti. Norway has also successfully been involved in technical assistance and education within hydropower, and Norway has supported alternative energy including solar energy, biogas and improved cooking stoves. The latter three will help reducing the dependence of poor rural households on firewood and kerosene, and will thus contribute to better health. Although higher income households will solve many of these problems themselves by installing electricity, purchasing solar panels and using LPG for cooking, subsidies may still be important for poor households.

With respect to hydropower development Norway competes with Nepal's two giant neighbors. Both India and China have agreements on development of hydropower in Nepal and large companies are now competing with Statkraft, which recently pulled out of one major project, where a Japanese company now seems to take

167 Glewwe, P. (2014).

168 <http://documents.worldbank.org/curated/en/516191468172488103/What-really-works-to-improve-learning-in-developing-countries-an-analysis-of-divergent-findings-in-systematic-reviews>

169 If we add loans then the Asian Development Bank and IDA are also major donors.

over. Statkraft can be expected to make such decisions based on commercial criteria, and like other countries Norway may promote Norwegian business interests, but there is no clear rationale for the use of Norwegian aid to support this sector in competition with India and China.

Transmission and distribution of electricity is a different issue as this has an element of being a public good that tend to be under-financed. In addition Nepal may need help from the international community to find a good solution when it comes to cross-border transmission capacity. At present Nepal depends on import of electricity from India, while in the long-run Nepal aims to become a major exporter of electricity. Third-country support in building transmission capacity may help Nepal in their bargaining process with India. Regarding distribution there are still villages without electricity, and Norway may provide funding either for extension of the grid or by subsidizing small local hydropower plants or solar power.

#### 7.5.7 Poverty

An over-arching aim of Norwegian aid policy is poverty reduction. In Nepal the policy choices seem to be based on the trickle down theory, as improved governance, investments in energy, and improved primary education may in the long-run lead to poverty reduction. Good governance and hydropower may indeed impact on poverty. Education may increase the incomes of the educated, and may also have a positive growth effect in the long run<sup>170</sup>. Yet a strong case can be made that more immediate interventions are needed for continued poverty reduction and improved social safety nets. The main income shocks of poor households are serious health emergencies. Hospital treatments are expensive, including

transportation, living costs, and loss of labor incomes. Donor support to hospitals can go a long way in establishing a safety net in Nepal. Similarly, vaccinations and other preventive interventions are important.

The majority of the poor still live in villages both in the hills and in the plains. These are very different ecological regions. The hills will need improved infrastructure, in particular roads. There is already progress in some regions when it comes to production of high-value products, such as fish, vegetables, fruits, cardamom, tea and coffee that increase family incomes. These areas can be extended, possibly with targeted support from the donor community. In addition to roads, the support may be for research and extension services.

In the plains agriculture is easier, and even staple food production may have a potential. Main constraints there are the farm structure with fragmentation of land and (thus) lack of investments. An extensive land reform is probably needed to consolidate plots. This will not necessarily mean either larger or smaller land-holdings per farm, but larger consolidated plots that allow for more mechanization. Different parts of terai have mechanized to different degrees, and the eastern and the western terai can learn from the central terai. Here is also space for donor support, in particular for research and extension services. For the poorest of the poor direct support in terms of assets, such as livestock, and if feasible also land-rights, will be beneficial.

The division of labor between donors may imply that Norway should not be engaged in health and agriculture, but if the target is poverty reduction then these would be good sectors to consider for future development cooperation.

170 For a more detailed discussion of the impact of aid, see Hatlebakk (2016): *Hva virker i utviklingspolitikken? En gjennomgang av forskningslitteraturen*. CMI Report R 2016:7.

## Appendix. Timeline-Nepal

**1768:**

King of Gorkha, Prithvi Narayan Shah, takes control of Kathmandu

**1846:**

Rana family takes control of Nepal

**1951:**

End of Rana rule, Nepali Congress forms government led by M.P. Koirala

**1959:**

B.P. Koirala of Nepali Congress becomes prime minister after first multiparty election

**1960:**

King Mahendra Shah dismisses the government and takes control

**1990:**

February: People's Movement starts

April: K.P. Bhattarai of Nepali Congress becomes prime minister

**1991:**

May: Second multiparty election, G.P. Koirala of Nepali Congress forms the government

**1994:**

May: Split in CPN (Unity Centre) and their political front, United People's Front (UPF). The Maoist faction of UPF, led by Baburam Bhattarai, was not recognized by the Election Commission.

November: Third multiparty election, Manmohan Adhikari of UML becomes prime minister

**1995:**

March: The Maoist faction of Unity Centre, led by Prachanda, renamed itself to CPNM.

July: CPNM announces "Ethnic Policy in Nepal"

September: UML leaves the government, Sher Badahur Deuba of Nepali Congress becomes prime minister

September: CPNM adopts "Plan for the historic initiation of the People's war"

November: Police launches Operation Romeo against Maoist supporters in Rolpa

**1996:**

February 13: CPNM starts People's War

**1997:**

Last local elections

**1999:**

May: Nepali Congress wins the election and K.P. Bhattarai becomes prime minister

**2001:**

April: Major attacks on police stations

June 1: Royal Massacre

June-November: Ceasefire

November 23: CPNM attacks army barracks for the first time

November 26: Deuba government declares state of emergency

**2002:**

February: Escalation of the war

May: Deuba dissolves the parliament

October: King Gyanendra dismisses the Deuba government, and appoints Lokendra Bahadur Chand as prime minister

**2003:**

January-August: Ceasefire

**2004:**

March: Escalation of the war again

**2005:**

February 1: King Gyanendra dismisses the parliament and government, declares state of emergency, arrests political leaders, and curbs media and all communication

November 22: 12-point peace agreement between CPNM and SPA (the six main parliamentary parties)

**2006:**

April 5–24: People's movement

April 24: King reinstates House of Representatives, G.P. Koirala becomes prime minister

May: Army under civilian control, Nepal declared as a secular state

June: Prachanda arrives in Kathmandu for peace talks

November 21: CPA is signed between the government and CPNM

**2007:**

January 15: The Interim Constitution is proclaimed, and Maoists enter the Interim Parliament

January 16: MPRF burns the Interim Constitution, 28 people arrested in Kathmandu

January 18: MPRF announces indefinite Terai-bandh

January 19: Maoist cadre kills a student in a scuffle with MPRF

January 20: MPRF activists, and others, start a violent campaign

February 9: MPRF leader Upendra Yadav suspends the protests, 24 people killed in total

March 21: 26 Maoists killed in Gaur by MPRF supporters, possibly including hired criminals

April 1: Maoists enter the Interim Government

**2008:**

February: Second Madhes uprising end with an agreement with the government that included “an autonomous Madhes state”

April: First CA election, Maoist becomes the largest party with 29% of the votes

May: Nepal becomes a republic

August: Prachanda forms government

**2009:**

May: Madhab Kumar Nepal of UML forms government

**2011:**

August. Baburam Bhattarai of CPNM forms government

**2012:**

January: State restructuring Commission of the CA presents two competing federal models

May 15: Parties agree on an 11-states federal model

May 17-onwards: Maoists and Madhesi parties seek a revision of the agreement

May 27: CA-term not extended, and CA dissolved

May 29: Bhattarai government continues as a caretaker government

**2013:**

November: Second CA election, Nepali Congress becomes the largest party with 26%, UML receives 24% and CPNM receives 15%.

**2014:**

February: Sushil Koirala becomes prime minister

**2015:**

April: Massive earthquake

June: Agreement on an 8-states federal model

August 8: Same parties go for a 6-states model

August 21: After protests, primarily in the terai, the three major parties go for a 7-states model

September: New constitution is passed in the CA, including the 7-states model

September: “Unofficial” blockade of imports from India and protests in Madhes

October: K.P. Oli of UML becomes prime minister

**2016:**

February: Blockade lifted

August: Prachanda becomes prime minister

**2017:**

February: Local elections are announced for May 14, 2017, still protests in Madhes against the federal model

May: Local elections were held in the central hills. Local elections in the western and eastern hills/terai are announced for June 28, and for September 18 in Madhes.



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**NUPI**  
Norwegian Institute of International Affairs  
C.J. Hambros plass 2D  
PO Box 8159 Dep. NO-0033 Oslo, Norway  
[www.nupi.no](http://www.nupi.no) | [info@nupi.no](mailto:info@nupi.no)