

BTI 2008 | Nepal Country Report

Status Index	1-10	4.48	# 94 of 125	
Democracy	1-10	3.80	# 97 of 125	➔
Market Economy	1-10	4.96	# 81 of 125	➔
Management Index	1-10	5.02	# 61 of 125	

scale: 1 (lowest) to 10 (highest) score rank trend

This report is part of the Bertelsmann Transformation Index (BTI) 2008. The BTI is a global ranking of transition processes in which the state of democracy and market economic systems as well as the quality of political management in 125 transformation and developing countries are evaluated.

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Key Indicators

Population	mn.	27.1	HDI	0.53	GDP p.c.	\$	1,379
Pop. growth ¹	% p.a.	0.2	HDI rank of 177	138	Gini Index		47.2
Life expectancy	years	63	UN Education Index	0.51	Poverty ³	%	68.5
Urban population	%	15.8	Gender equality ²	-	Aid per capita	\$	15.8

Sources: UNDP, Human Development Report 2006 | The World Bank, World Development Indicators 2007 | OECD Development Assistance Committee 2006. Footnotes: (1) Average annual growth rate 1990-2005. (2) Gender Empowerment Measure (GEM). (3) Percentage of population living on less than \$2 a day.

Executive Summary

On 1 February 2005, King Gyanendra of Nepal once again declared a state of emergency and, with the assistance of the Royal Nepal Army (RNA), seized power. The king dismissed the cabinet, detained opposition leaders and NGO activists, and appointed a crisis cabinet that reports directly to him. Following more than two years of conflict escalation and nineteen days of mass protest, King Gyanendra re-instituted parliament in April 2006, creating a new opportunity for conflict resolution. A loose political alliance formed in November 2005 between the Seven Party Alliance (SPA) and the Maoist insurgents, a mostly non-violent pro-democracy movement, forced King Gyanendra to accept the principles of popular sovereignty and to invite the SPA to implement its “roadmap to peace,” which includes the election of a constituent assembly to rewrite the constitution in line with SPA’s agreement with the Maoists. Former Prime Minister Girija Prasad Koirala (NP) was appointed new prime minister. In June 2006, Nepal’s government and the Maoist rebels agreed to draft an interim constitution and dissolve the parliament, which had been reinstated by a populist uprising in April 2006.

The interim constitution, promulgated on 15 January 2007, established a framework for constitutional change and enshrined the guiding principles agreed upon in earlier negotiations. The new constitution’s drafting process offers an opportunity to cement the Maoists’ integration into mainstream democratic politics, to determine the monarchy’s fate and to tackle long-standing ethnic, regional and caste fissures. But successful constitutional processes require a delicate balance of elite accommodations and broad public participation. However, due to the competing demands of mainstream political parties and Maoist rebels, violent conflict may emerge once more in the future. On the economic front, political stalemate and escalating conflict since 2000 have had a negative impact on the economy, which grew on average by around 2%

over the past few years. GDP grew by an estimated 1.9% in 2006. The lackluster growth was noted throughout the economy. Agricultural growth slowed down, as did manufacturing, transport and communication, finance and real estate. The recent peace agreement has brought new hope, and Nepal is expected to return to a new phase of sustained growth and development. However, it remains to be seen if the kingdom's elites can improve the quality of their management, especially when it comes to the economy, reconciliation and social development. In the long run, improving the lot of the poor and marginalized sectors of the society, including minority groups, will be crucial for achieving lasting peace and sustainable development in Nepal.

History and Characteristics of Transformation

The modern Nepali state was created in 1768 by conquest. In the post-unification period, Nepali court politics was characterized by weak personal rule and acute political instability. The queens and kings and their courtiers engaged in conspiracy, murder and killings, which led to the rise of Jan Bahadur Rana in a bloody massacre, known as Kot Parba, in 1846. The rise of Jan established the Rana oligarchy for 104 years, until it was challenged by an anti-Rana armed movement led by the Nepali Congress Party (NC). This movement was terminated after a compromise was reached in Delhi (India) between the Congress, the king and the Ranas, through the mediation of the Indian government. The Delhi compromise guaranteed a multiparty system, fundamental rights and a democratic constitution. However, the first attempt at parliamentary governance ended with the intervention of the king through a military-backed coup in 1960. The so-called Panchayat system was introduced in the same year. At its core, Panchayat meant direct rule by the king himself.

After three decades of royal autocracy, a pro-democratic people's movement brought down the Panchayat system in early 1990. The constitution introduced on 9 November 1990 transformed Nepal into a constitutional monarchy and established a multiparty democracy with a bicameral legislature, an independent judiciary and a catalogue of fundamental human rights. Since then, Nepal has experienced a succession of weak governments, most of which have lasted less than a year. Despite this turmoil, all elections held since 1991 were viewed as free and fair by international observers. The Nepali Congress won the first parliamentary elections in 1991. The Communist Party of Nepal (Unified Marxist-Leninist), or CPN (UML), established itself as second force. The NC government under Prime Minister Koirala collapsed in mid-1994 due to dissent within the party. In the next elections, no party won an absolute majority. This led to chaotic conditions in the following years. The elections of May 1999 once again gave the NC a majority in parliament, but longstanding rifts within the party made the pursuit of stable policies impossible. Three NC governments under different prime ministers failed within as many years. The Maoist rebellion, which erupted in February

1996 in a few mountainous districts of west-central Nepal, caused increasing problems for the government. When the government did not respond to the insurgents' demands, the Maoists began a "people's war," targeting security forces, government facilities and those they saw as "enemies of the people." The movement increasingly found support among the impoverished and largely disadvantaged masses of the rural population. Nearly every one of the country's 75 districts has been affected by the fighting between the Royal Nepali Army (RNA) and the Maoist's People's Liberation Army (PLA). The insurgency has contributed to the decline of democracy and human rights in the kingdom, causing considerable concerns among Westerners and Nepali about the future of the country.

The entire royal family of King Birendra was murdered on 1 June 2001 under mysterious circumstances, and the dead king's brother, Gyanendra, was crowned king on 4 June 2001. A brief cease-fire and dialogue after the massacre of the royal family ended in November 2001 with a renewed escalation of violence. The government declared a state of emergency. This, however, did not suffice to quell the insurgency. In May 2002, when it became evident that the conflict could not be solved militarily, members of parliament from all parties showed reluctance to prolong the state of emergency. Therefore, on a recommendation of the prime minister, the king dissolved parliament, set new elections and issued a decree extending the state of emergency for three months. When it became clear that parliamentary elections could not be held as scheduled due to the continuing Maoist rebellion and the resulting lack of security, the prime minister and the leaders of other parties agreed to ask the king, under Article 127 of the constitution, to postpone the elections and form a government with representation from all parties.

King Gyanendra seized this opportunity to stage a royal coup. Accusing Prime Minister Deuba of failing to carry out his duties, the king claimed sovereignty and assumed executive authority. He disbanded the cabinet, postponed elections indefinitely and appointed a new government made up largely of technocrats and dissident members of major parties, but not the party leaders. In May 2004, King Gyanendra re-installed Sher Bahadur Deuba as prime minister. Disappointed by the lack of success in combating the insurgency, the king again declared a state of emergency and with the assistance of the Royal Nepal Army (RNA), seized power on 1 February 2005. The king dismissed the cabinet, detained opposition leaders and NGO activists, and appointed a crisis cabinet that reports directly to him. Following more than two years of conflict escalation and nineteen days of mass protest, King Gyanendra reconvened parliament in April 2006, creating a new opportunity for conflict resolution. A loose political alliance formed in November 2005 between the Seven Party Alliance (SPA) and the Maoist insurgents, a mostly non-violent pro-democracy movement, forced King Gyanendra to accept the principles of popular sovereignty and to invite the SPA to implement its "roadmap to peace," which includes the election of a constituent assembly to rewrite the constitution in line with SPA's agreement with the Maoists.

Former Prime Minister Girija Prasad Koirala (NP) was appointed new prime minister. In June 2006, Nepal's government and the Maoist rebels agreed to draft an interim constitution and dissolve the parliament, which had been reinstated by a populist uprising in April 2006. Since then, the parliament has drafted an interim constitution (promulgated in January 2007), and the Maoist insurgents have declared their will to end the armed rebellion against the central government. However, the peace process remains fragile. The fate of the monarchy remains uncertain and elections – the first held in eight years – have yet to be scheduled.

Transformation Status

I. Democracy

1 | Stateness

Nepal has been experiencing a multidimensional crisis of stateness for several years. The nature of its stateness is contested because the state is linked with the religion, language and culture of the upper Hindu castes, especially the Brahmins (Bahun), who dominate the government elite. Due to many years of Maoist rebellion, there is no state monopoly on the use of force. Civil war has eroded public safety and law and order, and even the increasing involvement of the Royal Nepalese Army (RNA) in the counterinsurgency has been unable to restore order. It remains to be seen whether the recent transition back to parliamentary democracy will allow for a sustainable peace deal, which is a prerequisite for improving the central government's ability to develop an effective monopoly on the use of force.

Monopoly on the use of force

The 1990 constitution is in part contradictory. Article 11 stresses the fundamental equality of all citizens, regardless of religion, race, gender or other characteristics, but citizenship depends solely on the nationality of a person's father. Women have only limited rights. People of Indian birth or ancestry living in the Tarai region, bordering India, are often denied citizenship even after living for generations in Nepal. Members of numerous ethnic groups and the so-called untouchable Hindu castes experience manifold discrimination. It remains to be seen whether the current reform process will reach out to the various minority groups and broaden citizenship agreements. Unfortunately, recent anecdotal evidence suggests that this may not be the case.

State identity

Although the population practices a dozen different religions, the Kingdom of Nepal is the world's only official Hindu kingdom. Accordingly, the political process is only formally secularized. While the Maoists demand a totally secularized political system, all political parties and actors are deeply influenced by the legacies of the Hindu caste system.

No interference of religious dogmas

The administrative system is moribund, riddled with corruption and urgently in need of reform. Working administrative structures exist only in those parts of the country that are still under government control. Even there, the state infrastructure is too weak to provide a sound administrative basis for political, social and economic development.

Basic
administration

2 | Political Participation

Constitutionally, Nepal has a bicameral Westminster-style parliament consisting of the National Council (60 seats; 35 appointed by the House of Representatives, 10 by the king, and 15 elected by an electoral college) and the House of Representatives (205 seats; members elected by popular vote to serve five-year terms). Suffrage is universal and equal for all Nepali citizens of at least 18 years of age residing in Nepal. The last election was held in May 1999. Parliament was dissolved in May 2002 but was finally reconvened in April 2006 with most of the members that were elected in 1999. At the time of this writing, it is unclear when the long-postponed parliamentary elections will be held. Even under highly optimistic scenarios, preparations for the polls would take place against a background of widespread insecurity. As long as the Maoists do not allow any real political activity and unfettered media access in areas under their control, the prospects of conducting sufficiently free and fair elections are not promising. In addition, it is unclear if the government can ensure that the Royal Nepali Army (RNA), and associated vigilante groups, will not interfere with campaigning or voting processes

Free and fair
elections

Although Nepal is in transition from royal emergency rule to parliamentary democracy, democratic rule remains fragile. In fact, the transition process has not reached a level at which the political system of Nepal can be classified as democratic. With the formation of an interim legislature incorporating mainstream parties and Maoists, Nepal's peace process hinges on writing a constitution that permanently ends the conflict, addresses the widespread grievances that fuelled it and guards against the eruption of new violence. Most political actors have accepted the Maoist demand for a constituent assembly charged with framing a new dispensation, although royalists are worried over the future of the monarchy, which has in effect been suspended. The Royal Nepalese Army – always the monarchy's prime source of power – has never been under effective democratic control or oversight. The RNA's loyalty is bound exclusively to the monarchy, not to democracy or an elected government. As is the case with all state institutions, ethnic groups from western Nepal are heavily over-represented in the upper ranks of military and police. In recent years, the RNA took over the central role in battling the insurgency from the police. It has played a crucial role in enforcing the state of emergency and overseeing the

Effective power
to govern

country's civil administration. The RNA's abusive record led the United Nations to threaten to restrict the participation of Nepali troops – the fifth largest contingent of UN peacekeepers in 2006 – in peacekeeping operations. However, a first step towards putting the RNA under democratic control was undertaken on 18 May 2006, when parliament approved a resolution that strips the king of his command of the army.

Before 24 April 2006, the government prevented political parties from operating freely. Following the king's takeover in February 2005, thousands of political activists were arrested; many were held in preventive detention under the Public Security Act. People suspected of involvement with the Communist Party of Nepal (Maoist) were also arrested and detained under the Terrorist and Disruptive Activities Ordinance (TADO). Following the king's 24 April 2006 proclamation, the situation for political parties has significantly improved. However, the fragile security situation is still a serious obstacle for political activities of members and supporters of legal political parties. Although the human rights situation was serious before King Gyanendra declared a state of emergency in February 2005, it worsened markedly in 2005. Professing himself a champion of multiparty democracy, the king suspended the constitutional freedoms of assembly, press, speech and expression, the right to privacy, and constitutional protections against news censorship and preventive detention. The right to assemble and associate peacefully is seriously infringed, especially in regions affected by the ongoing conflict. In 2005 alone, security forces arrested 6,363 people for exercising their rights to assembly and association; of these, 3,400 persons were detained. Excessive use of force by security personnel against people exercising their rights to free assembly and expression was particularly severe in April 2006 during mass demonstrations against the direct rule of the king. Several persons were injured by security personnel gunfire or post-arrest violence. Since then, at least the legal situation improved in 2006 when the new government annulled the media ordinances and the code promulgated by King Gyanendra, as well as four other ordinances promulgated by the king that were deemed "regressive."

Association /
assembly rights

Reporters Sans Frontiers ranked Nepal at 160 out of 167 countries in 2005 and at 159 out of 168 countries in 2006. Freedom of opinion and expression has been curtailed by the state under the TADO and the media have faced various threats. In addition, the Maoist rebels violate the freedoms of press, expression and speech. The government has systematically attacked the media through censorship and oppressive laws, making free press in Nepal virtually nonexistent. Reporters Sans Frontiers reported at least 273 cases of arrests of journalists and 567 cases of censorship in Nepal in 2005 – half of the total number of censorship cases reported worldwide - while 145 journalists were physically attacked or harassed. Freedom of speech and association are essentially nonexistent in Maoist-held areas. However, once Prime Minister Koirala's government was in

Freedom of
expression

place, public freedoms were restored one by one. For instance, in May, the Supreme Court annulled Article 8 of the law on radio and television and Article 15(1) of the law on publications and newspapers. In May 2006, the government cancelled the media order banning FM radio from broadcasting news, and quashed the anti-terror law which had been used on frequent occasions to imprison journalists. In 2006, the Maoist insurgents carried out fewer attacks on journalists than in previous years. Still, from April to December 2006, Maoist militants detained, assaulted and abusively summoned or censored at least 15 journalists. In total, at least 245 journalists were arrested in Nepal in 2006, while 180 others were injured, attacked or threatened. Finally, at least 30 media were censored and four others destroyed as a result of clashes between the army and the Maoists.

3 | Rule of Law

In the absence of a parliament between October 2002 and April 2006, Nepal was governed at all levels by executive fiat. Beginning in 2005, there was no system of democratic checks and balances, formal or informal. The king ruled absolutely by royal decrees; judicial review or legislative oversight of royal ordinances (which constitutionally have to be ratified by parliament) was impossible. Palace influence over the appointment of judges led to a breakdown of judicial review. For example, the Nepali attorney general declared in November 2005 that divine right places the actions of the Hindu king beyond legal questions. Various senior judges, including the chief justice, attended crown council (Rajparishad) meetings, demonstrating the lack of judicial independence. The 1990 constitution provided for horizontal separation of powers between a bicameral legislature, an executive branch and a judiciary. However, since King Gyanendra dissolved the legislature in May 2002 and assumed direct rule in October 2002, separation of powers did not mean much in practice. All key decisions were taken by the king and his cabinet of handpicked pro-royalist politicians and technocrats. In addition, the king issued numerous decrees to subvert the constitution and legislation that limited his authority and strengthened his power by undermining the independence of the judiciary by maneuvering committed supporters into key positions in the judiciary. In addition, the king strengthened the role of the Royal Council (Rajparishad), composed largely of elderly royalists and supporters of the pre-1990 Panchayat system, and the palace secretariat. The interim constitution promulgated on 15 January 2007 grants the prime minister and cabinet sweeping authority, subject to minimal checks and balances. The compromised independence of institutions such as the judiciary has weakened the principle of separation of powers.

Separation of
powers

Even before 2005, rule of law was at best ineffective in Nepal. The judiciary has always been constrained by royal prerogative. For example, the 1990 constitution bars any cases against the royal family. In addition, the palace has the final say in the selection procedure for justices and judges. Furthermore, democratization in 1990 further led to the politicization of the courts, with certain judges openly biased towards a particular political party. The kingdom's judiciary has been further weakened since 2005, as judges were pressured by the government and many lawyers who challenged government actions faced harassment and even arrests. Security forces ignored judicial orders to release detainees. Nepali human rights organizations have documented several cases of people who were rearrested immediately after they were ordered released by the courts. The security forces operate with impunity and disregard for the rule of law. Impunity has been a serious obstacle in ensuring rule of law and protection of human rights, since judges and lawyers face intimidation and harassment by the security forces.

Independent
judiciary

Even before 2005, rule of law was at best ineffective in Nepal. Impunity has been and still is a serious obstacle in ensuring rule of law and protection of human rights, since judges and lawyers face intimidation and harassment by the security forces. The emergence of so-called village defense forces in the early 2000s has led to further erosion of the rule of law and significantly worsened the human rights situation. Corruption is another key threat to the rule of law. Corruption is endemic among the nation's political and business elite. The Royal Commission for Corruption Control was formed in 2005 for political reprisals; unsurprisingly, the commission has remained ineffective in curbing corruption. The inclusion of provisions into the new interim constitution such as the unrestricted authority of the government to grant pardons suggests that interim arrangements may enable the political elite to sweep past misdeeds under the carpet.

Prosecution of
office abuse

The judicial system and other state mechanisms for human rights and civil rights protection in Nepal are dysfunctional. Established in 2000, the National Human Rights Commission of Nepal (NHRC) has tried to deal with issues relating to human rights abuses. However, in 2005, the National Human Rights Act was amended and the selection procedure of the commission was revised by ordinance. Violations of human rights in Nepal take many forms. The main violations of human rights by the state are widespread disappearances, torture, extra-judicial killings, rapes, illegal and arbitrary detention, and severe restrictions on freedom of assembly, speech, association and movement. The RNA frequently ignores the Supreme Court's habeas corpus orders. Even after the king reconvened the parliament in April 2006, this practice continued. There were also many incidents where the Maoists have disregarded civil and human rights with frequent abductions. The Maoists are also engaged in widespread torture and intimidation of people living in the areas under their control. Data

Civil rights

collected by the Nepali human rights organization INSEC shows that between 1 January 2005 and 29 June 2006 alone, 1,717 people were killed, either by the state's security forces or the Maoists. A breakdown of the victims by occupation suggests that political workers were particularly threatened by state violence, whereas the guerrillas primarily targeted police personnel, civil servants and army personnel, as well as civilians. In addition to extra-judicial violations of human rights, there were several legal restrictions which before April 2006 undermined constitutionally guaranteed protections of human and civil rights. However, in 2006 and early 2007, international pressure has contributed to promoting greater respect for human rights by both the RNA and the Maoists. According to Human Rights Watch, the armed forces seem to reduce the practice of extra-judicial executions and disappearances and now turn detainees over to police custody within a month. In May 2006, the government formed a commission to probe human rights violations and abuses of power from February 2005 through April 2006.

4 | Stability of Democratic Institutions

Since the mid-1990s, a steady decline in political institutions such as parliament, parties and bureaucracy were noticeable. Eventually the ambitious king intervened on the pretext of the elected government's failure to hold elections in time. The institution of the prime minister could not be effectively established despite the provisions and spirit of the constitution. Along with the violent Maoist insurgency, these were the factors that precipitated the political crisis that, with the help of the army and police, the king took advantage of. Finally, since 2002, Nepal's democratic institutions were gradually rendered ineffective. The current reform process has stimulated some hope that the situation may improve in the future. However, the current interim government was not elected through democratic elections. Checks and balances to control the government are either weak or are based on a fragile and informal elite consensus between mainstream political parties and Maoist insurgents.

Performance of
democratic
institutions

Due to the incomplete state of democratic transition, democratic institutions are in a nascent stage. Managing the transition in the palace's role presents difficulties. A decisive alteration of traditional power structures will still encounter resistance from conservative institutions such as the palace, elements of the army and the bureaucracy. Recent unrest in the Tarai plains illustrates the dangers of ignoring popular discontent. The constitutional process has concentrated on building elite consensus at the expense of intense political debate or extensive public consultation. A handful of SPA and Maoist leaders have controlled closed-door negotiations; limited parliamentary scrutiny has not even extended to recognizing the concept of an opposition.

Commitment to
democratic
institutions

5 | Political and Social Integration

Before 24 April 2006, the government prevented political parties from operating freely. Following the king's 24 April 2006 proclamation, the situation for political parties has significantly improved. However, all of Nepal's political parties still lack adequate democratic and participatory mechanisms. Most are personality-oriented organizations with an authoritarian power structure. All power is concentrated in the party headquarters in the Kathmandu valley; any participation at the local level or in rural areas is very limited. None of the established parties make any effort to achieve balanced popular participation in their own leadership posts or in the country's political institutions. The upper Brahman and Chetri castes (especially the former) dominate in all areas.

Party system

The 1990 constitution prohibited political parties from representing the interests of minority ethnic groups and the untouchable Hindu castes. However, its well-formulated catalogue of basic rights has contributed to the establishment of numerous civic organizations. Civic organizations, functional interest groups and, especially, NGOs supported by foreign donors, exist and play a certain role in representing social interests and interest mediation. However, civil unrest, the anti-democratic measures taken by the king, repression by the security forces and the continuing economic downturn have all had a negative impact on the topography of civil society organizations and organized interest groups. But there are signs of increasing political activism among non-governmental organizations and civil society groups. The broad political participation of various sectors of society and various social organizations – professionals, civil society leaders and activists, the media, human rights workers, students, political activists, and even government bureaucrats – was the defining feature of the anti-Royalist/pro-democracy movement of April 2006. However, the topography of interest groups still has several blank spots, and important social interests are either underrepresented or completely excluded.

Interest groups

Although reliable public opinion polls are not available, anecdotal evidence suggests that there is a broad pro-democracy movement among Nepalese citizens. However, consent to democracy among elites and citizens seems to be fragile, and there is a strong tendency for politics to be played out in the streets rather than through institutional mechanisms.

Consent to democratic norms

The associative life of Nepalese society is anemic. The insurgency in the 1990s and 2000s has impeded the stronger civic self-organization of various social groups. Overall, it is unsurprising that civic self-organization is rudimentary and social trust is weak (at least according to anecdotal evidence). It is plausible to assume that political violence and economic decay in recent years have contributed to the decline of social capital in a society already marked by deep cleavages based on social class, religious caste and ethnicity.

Associational activities

II. Market Economy

6 | Level of Socioeconomic Development

Nepal is one of the poorest countries in the world, with a per capita GDP of about \$1,490. The protracted insurgency has adversely affected development efforts. Nepal ranked at 138 out of 177 in the UNDP's 2006 HDI, which places Nepal within one of the lowest categories of development with a score of 0.527. At least 24.1% of the population is estimated to live on less than \$1 per day, and as much as 68.5% on less than \$2 per day. The GNI value of 47.2 indicates a rather high level of income inequality (significantly higher than in other South Asian nations such as India, Pakistan or Bangladesh). Pervasive social exclusion results from poverty, unequal access to education and deeply rooted ethno-religious and gender discrimination. For instance, with a GDI value of 0.513, the kingdom ranked at 103 out of more than 170 nations included in the UNDP's Human Development 2006 report. Throughout the period under consideration, Nepal was not able to improve social disparities, significantly lower poverty levels or reduce income inequality. However, in September 2005, the government of Nepal launched the Leasehold Forestry and Livestock Project, which is the second phase of the Hills Leasehold Forestry and Forage Development Program. It is designed to address rural poverty in 22 districts of Nepal through the allocation of leasehold forest lands to increase the production of forest products and livestock. The project is expected to target some 44,300 poor and food-insecure households in the hill areas adjacent to degraded forest land. In addition, the employment of women group promoters to mobilize, support and train leasehold groups, is expected to ensure that women participate in and benefit from the program.

Socioeconomic
barriers

Economic indicators		2002	2003	2004	2005
GDP	\$ mn.	5,501	5,870	6,732	7,391
Growth of GDP	%	-0.6	3.4	3.7	2.7
Inflation (CPI)	%	3	5.7	2.8	6.8
Unemployment	%	-	-	-	-

		2002	2003	2004	2005
Foreign direct investment	% of GDP	-0.1	0.3	0.0	0.0
Export growth	%	-	-	-	-
Import growth	%	-	-	-	-
Current account balance	\$ mn.	215.2	180.3	100.0	153.1
Public debt	\$ mn.	2,928.5	3,237.2	3,401.2	3,217.5
External debt	\$ mn.	2,972.3	3,261.8	3,459.4	3,284.9
External debt service	% of GNI	1.9	1.9	1.7	1.6
Cash surplus or deficit	% of GDP	-	-	-1.5	-1.2
Tax Revenue	% of GDP	9.3	9.3	9.7	10.1
Government consumption	% of GDP	10.0	10.2	10.1	10.2
Public expnd. on edu.	% of GDP	3.4	3.4	-	-
Public expnd. on health	% of GDP	1.7	1.3	1.5	-
R&D expenditure	% of GDP	0.7	-	-	-
Military expenditure	% of GDP	1.5	1.6	1.7	2.1

Sources: The World Bank, World Development Indicators 2007 | UNESCO Institute for Statistics | Stockholm International Peace Research Institute (SIPRI), Yearbook: Armaments, Disarmament and International Security

7 | Organization of the Market and Competition

Nepal's constitution guarantees a market economic system. Although the foundations of a competitive market economy exist pro forma, practical implementation remains uneven. Despite efforts at privatization and deregulation in past years, market competition still operates under a weak institutional framework. As in every South Asian economy, the informal sector is significant. For instance, according to UNDP data (2004), employment in the informal sector as a share of non-agricultural employment is 73.3% (men: 67.4%; women: 86.5%). Thus, major areas and populations in the country are kept outside the market net.

Market-based competition

Article 26(12) of the 1990 constitution declares that the state shall adopt policies to attract foreign capital and technology while at the same time promoting indigenous investment for the purpose of national development. However, the formation of monopolies and oligopolies is regulated inconsistently.

Anti-monopoly policy

As a rule, foreign trade is liberalized. The country's trade with India is an exception, as this trade is subject to special regulations and somewhat restrictive requirements. Liberalization began with the relaxation of quantitative restrictions in 1985 under the IMF's structural adjustment program. It gained momentum in the late 1980s, when tariffs, including sales taxes, were gradually reduced and discrepancies in tariff rates were narrowed. In addition, the tariff regime has been substantially simplified.

Liberalization of
foreign trade

Financial sector reforms in recent years affecting both the central bank (Nepali Rastra Bank) and the largest commercial banks in the country have contributed to the development of a better-functioning banking sector and capital market. The implementation of financial sector reform included the enactment in 2002 of legislation to increase central bank autonomy and strengthen its supervisory and regulatory functions. The capital market is efficiently overseen by a securities board. However, further improvements must be made in corporate governance, accountability and transparency in order to successfully tackle problems such as strong government ownership, rather high ratios of non-performing assets (NPAs of at least 7-8% of GDP in 2005, most with public banks), insufficient regulation and supervision, inadequately developed financial markets, quality deficits in corporate governance in the banking system, the lack of a competitive environment resulting from fragmentation of the banking system, a poor banking culture, and, of course, ineffective banking services for the rural sector. In addition, Nepali Rastra Bank must modernize and professionalize its staff

Banking system

8 | Currency and Price Stability

Between the fiscal years 2000 and 2003, consumer prices rose from 3.5% to 5%. Motivating factors of this cost-push inflation included increasing wholesale prices, upward adjustments in educational fees and petroleum prices and supply shortfalls, particularly of agricultural products whose transport was affected by domestic transport disturbances caused by the Maoist insurgency. Prices for food and beverages in particular went up in recent years. Inflation was estimated at a moderate 3.8% in fiscal year 2004. As in most countries in South Asia, Nepal felt inflationary pressures in 2006 due to high oil prices. Food prices also rose significantly, hurting the poor in particular. In Nepal, inflation went up by 3.5 percentage points to 8% in 2006, driven mainly by rising petroleum and food prices. The Nepalese government's anti-inflationary policies included managing supply and demand for essential consumer goods and raw materials by means of a liberal imports policy.

Anti-inflation /
forex policy

Nepal's economy remains in a fragile state. Both the insurgency and political instability are exacting an enormous toll in terms of lost output and missed opportunities for investment. The fiscal situation remained weak with growing

Macrostability

recurrent expenditures, low capital spending and a high budget deficit, which increased from 3.4% in 2005 to 4.3% in 2006. The central bank (NRB) sought to tighten monetary policies, but this had a weak impact. While exports grew by 8.9% and 14.1% in 2004 and 2005 respectively, they declined by 1.1% in 2006. Simultaneously, imports increased by 15.6% (2005) and 11.2% (2006). Thanks to remittances from overseas workers, Nepal recorded a current account surplus of 2.4% in 2006. Mainly driven by rising petroleum and food prices, inflation went up by 3.5 percent points to 8% in 2006.

9 | Private Property

Property rights and the regulation of property are adequately defined. Of course, property rights are only guaranteed in those regions of the country still under the control of the central government's security forces, while the Maoist insurgents in the "liberated" areas are attempting to implement their vision of a socialist economy based on the confiscation of private property, especially land.

Property rights

The privatization and sale of public enterprises and state companies has advanced in recent years. The acquisition of private property by foreigners, as well as the right to purchase property and to invest funds, is restricted, except in the case of native Nepalese living abroad.

Private
enterprise

10 | Welfare Regime

Nepal has no welfare regime outside of social networks based on familial structures. Private initiatives are limited to isolated cases at best, and public social services are underdeveloped and insufficient, although access has been improved in recent years. Public health expenditure is at about the same level as in the Philippines and Vietnam (in 2003, 1.5% of the GDP), which puts Nepal at an average position among the other countries in Asia and Oceania. Again, the protracted insurgency has adversely affected the already marginal social safety net, because it weakens community- and family-based structures as well as the public health system.

Social safety nets

There are only a few institutions to compensate for gross social differences, and they are very ineffective; thus, equality of opportunities is not realized. The opposite is the case; gender-based violence and discrimination remains pervasive and deeply entrenched in Nepal. Data collected by the Nepali organization INSEC shows that the Maoists abducted thousands of children in the past. In its December 2005 report, INSEC suggested that, between September and December 2005 alone, the guerrillas abducted 8,777 people, including teachers, students and children. There are also reports that the Nepalese army uses children as spies and

Equal opportunity

messengers, which military officials deny. Exploitative child labor is also a major problem. Social and economic caste-based discrimination is widespread and is an important underlying cause for the rise of Maoist insurrection in the 1990s, as is evident from the participation of a large number of marginalized people in the insurrection. While the Kamaiya (bonded labor) system in July 2000 freed at least 100,000 people from near-slavery conditions, most ex-Kamaiyas were forced to return to their past masters due to the absence of proper policies and implementation problems.

11 | Economic Performance

In Nepal, the political stalemate and escalating conflict since 2000 have had a negative impact on the economy, which grew on average by around 2% over the past few years. GDP grew by an estimated 1.9% in 2006. This lackluster growth registered throughout the economy. Agricultural growth slowed down, as did manufacturing, transport, communication, finance and real estate. The recent peace agreement has, however, inspired new hope, and Nepal is expected to return to a new phase of sustained growth and development. GDP is expected to grow around 4% in 2007.

Output strength

12 | Sustainability

In September 1996, parliament passed the Environment Protection Bill, the long-awaited umbrella legislation on the environment. Since comprehensive legislation already exists, its immediate and effective implementation will require equally comprehensive rules and regulations that clearly specify the authority, responsibility and jurisdiction of various government agencies, local bodies, private sector and NGOs. It will also be necessary to decentralize the authority for execution and implementation functions to line agencies, so that the Ministry of Population and Environment can concentrate on policy integration, coordination, facilitation and legislation. So far, however, environmental protection suffers from the lack of effective implementation, as well as the absence of the political will to take ecological concerns more seriously into account in economic development planning, not least because of their relevance to tourism, one of the country's major sources of income. However, because of weak stateness and the insurgency, institutional support for environmental protection is weak.

Environmental policy

Nepal's public infrastructure and education system is underdeveloped, especially in the areas of higher education and research and development (R&D). Nepal's government spends an annual 3.4% of its GDP on education, which amounts to approximately 14% of total government expenditure. Investments in R&D are insignificant, as is the number of researchers and scientists employed in that field.

Education policy / R&D

With a U.N. education index value of 0.51, the kingdom ranks better than Bangladesh, Pakistan or Bhutan, but significantly lower than India and all East and Southeast Asian countries, including countries at about the same level of human development, such as Laos.

Transformation Management

I. Level of Difficulty

A number of highly unfavorable conditions for economic and political transformation persisted throughout the review period and created massive structural constraints on governance. These included a low level of economic and social development, a poorly educated population, the geographical disadvantages of a landlocked state, resource scarcity, and weak stateness.

Structural
constraints

Although Nepal is one of the major recipients of ODA, it has a fairly large sector of international and national NGOs. Indigenous traditions of civil society are extremely weak.

Civil society
traditions

Massive structural constraints on governance are further aggravated by widespread political violence and ethnic and religious discord, as well as the highly polarized conflict over income distribution that erupted into open civil war in 1996.

Conflict intensity

II. Management Performance

14 | Steering Capability

Though the structural constraints on governance are high, the political leadership's low steering capability is another important cause for Nepal's current crisis. Until mid-2006, the royal government lacked both a clear strategy for affecting economic and political reform, and a viable solution to the insurgency problem. After the April 2006 mass demonstrations and the signing of a comprehensive peace agreement (CPA) between government and Maoists in November 2006, the political elites focused on the reform process. Maoist representatives were sworn into legislature in January 2007, and a new U.N. cease-fire monitoring and electoral assistance mission began the work of

Prioritization

disarming combatants. Apart from shaping future institutional arrangements, the talks have achieved agreement on proposals for social and economic transformation, which are topics of immense public concern. However, only free and fair elections can give a government the necessary decisive mandate.

The government's capability to implement reform policies effectively was hampered by weak political leadership, confrontational tactics and a lack of clear strategic priorities. The extreme partisanship of Nepalese officials exacerbated these shortcomings. Nepal's reform goals achieved a measure of consistency only under pressure from international organizations and financial donors, whose contributions account for some 60% of Nepal's total budget. The government continues to prioritize combating poverty. However, since politics during the review period focused exclusively on retaining power, the expectations of those advocating social and economic reform were not fulfilled. The reform policies of one government after another have failed due to the inability to successfully implement these plans. As a rule, the goals set in the five-year plans were far too ambitious. Before April 2006, the royal government hardly learned any lessons from past mistakes. Political instability and frequent changes of government fostered this negative tendency. In addition, the Maoist rebellion has made it almost impossible to pursue purposeful reforms in rural areas. On the other hand, Nepal's government and Maoist rebels have signed a comprehensive peace agreement declaring an end to the 10-year civil war, paving the way for the inclusion of the rebels in mainstream politics, and enabling their participation in the June 2007 elections to the assembly charged with writing a new constitution. An optimistic public has welcomed this deal, but implementation will not be straightforward; some central questions remain, and there is a serious risk that the elections could be delayed, which would strain the entire process. The U.N.'s credibility in Nepal is very high, but it will not last indefinitely, especially if there are delays. International support for the monitoring of both armies and the elections will be critical.

Implementation

Under the royal government before April 2006, hardly any lessons were learned from past mistakes. Since then, the new government and mainstream political parties have shown some degree of learning, not the least by brokering a peace deal with the Maoist insurgents. However, important hurdles remain. Most political actors have accepted the Maoist demand for a constituent assembly (CA) tasked with framing a new dispensation, although royalists are worried over the future of the monarchy, which has in effect been suspended. The major challenge is to maintain leadership-level consensus while building a broad-based and inclusive process that limits spoilers and ensures long-term popular legitimacy. Key political actors need to prepare more seriously for the CA. Beyond the "high politics" of peace negotiations and constitutional reform, the bureaucracy and the political leadership have shown little willingness (or ability)

Policy learning

to learn from past errors. In daily politics, the routines of policy-making still do not enable more innovative approaches to deal with the manifold problems of social and economic development in this country.

15 | Resource Efficiency

The government does not make efficient use of available economic and human resources for its economic and social policies. During the period under study, resources intended for development were continually and increasingly misappropriated to finance military expenditures, or simply vanished because of corruption. Some public services had to be discontinued, especially in western regions. Available cultural resources are not used to the country's advantage; rather, they are more often misused to block reforms.

Efficient use of assets

The institutional framework and political environment of governance in Nepal does not provide for a high degree of coordination among conflicting political objectives to form coherent policies. Political instability and frequent changes of government before 2006, as well as the increasing involvement of the armed forces in domestic politics and government administration, only fosters this negative tendency. Under the new "civilian" government, coordination has not increased, partly because of the heterogeneous nature of the current party government, and partly because of the main political actors' need to "deliver" on their promises to their competing constituencies and supporters.

Policy coordination

Corruption is rife in Nepal, both in the public and private sectors. In all key public sectors, petty corruption is endemic and officials are known to demand bribes even for routine services. Grand corruption in the political system, with political parties functioning as tools of the high-caste Kathmandu-based elite, is institutionalized. The Corruption Control Act has established sanctions for corrupt practices, but the laws are weakly enforced and impunity is widespread among high-profile government officials. A survey of the country's anti-corruption institutions shows a significant lack of consistency in approach, and they are all regarded as largely ineffective. Several of the current anti-corruption institutions lack a clear jurisdiction and frequently overlap with other institutions. In practice, the existing anti-corruption system serves to target only low-level bureaucrats, with minimal impact upon the political elite. Foreign companies and domestic observers have identified pervasive corruption as an obstacle to maintaining and expanding investments in Nepal. Corruption among government officials in the distribution of permits and approvals, in the procurement of goods and services, and in the awards of contracts, have all been identified as significant obstacles to doing business. Things are further complicated by the fact that government services are in scarce supply outside the capital. Most of the countryside lacks basic public services and local offices.

Anti-corruption policy

Bribes are often the only way to get access to public services and “get things done.” Poor Nepalese lack access to the courts and have no means to seek redress for corruption or abuses of power. Lower-level courts are known to bribe judges and court staff. Court employees and public prosecutors are even perceived as the main facilitators of corruption.

16 | Consensus-Building

Two of the three core players in domestic politics, the royalists and the Maoist insurgents, vacillate between ambivalence to democracy and socially responsible market economy as the ultimate goals of transformation, and open denial of these goals. Although the Maoists have signed a peace agreement and joined the constitutional assembly, it remains to be seen if they can be integrated into the political system. On the other hand, while there is a minimal consensus among mainstream political elites, these elites have not implemented social reforms capable of disarming the socioeconomic roots of the insurgency. Indeed, economic development has almost no place in the country’s political discourse. So far, the monarchy, the government, the political parties and the insurgents have failed to find a way to bridge differences that have proved irreconcilable. As of now, the government’s initiatives to promote the representation of women’s interests and ethnic minorities have done little to eliminate social disadvantages. The future of the monarchy is uncertain; in fact, it is effectively suspended.

Consensus on goals

The “democratic” political parties were able to force the king and the royalist camp to accept a return to parliamentary government; furthermore, their “democratic” alliance between social organizations, mainstream political parties and Maoists was strong enough to check the power of the king and to proceed with their own political agenda after parliament was reconvened in April 2006. The Maoists want their fighters to comprise half of a new downsized national force; however, the royal army is still loyal to the king and does not view itself as defeated. A first step towards putting the RNA under democratic control was undertaken on 18 May 2006, when parliament approved a resolution that strips the king of his command of the army. Nevertheless, veto actors are still active in both political camps. Lack of progress may cause unrest among cantoned Maoist soldiers, while the abolition of the monarchy may trigger resistance among the military. With conservative-rightist actors suspicious of the peace process and the army’s reluctance to embrace democratic control, the Maoist demand for more solid guarantees is understandable. However, at least until November 2006, the Maoists have continued with extortions and abductions while showing few signs that they are ready for meaningful power sharing and the creation of democratic space. Demilitarizing their politics will require more than just laying

Anti-democratic veto actors

down their weapons; without this, the chances for “democratic” reformers to control actors with veto power remain limited.

There has been significant improvement in the quality of political management in 2006, particularly with regard to the political leadership’s ability to defuse the conflict between the Maoists and the mainstream political parties. However, the recent peace process and the transition to parliamentary democracy will only lead to a sustainable depolarization of Nepalese society if the political elites, including the Maoist leadership and the royalist camp, will be able to address the age-old socioeconomic and ethno-religious cleavages, social exclusion, and regional inequalities which undermined the historic achievements of the democratic transition in 1990. After 10 years of conflict between the Maoists and the state, and 12,000 lost lives, it will take more than just a new constitution and parliamentary elections to build sustainable peace in Nepal. Even before April 2006, activists, academics, and common educated citizens were nearing consensus on the fact that significant changes in the character, composition and functioning in the state are necessary before democracy in Nepal can produce the results that citizens expect.

Cleavage / conflict
management

Undoubtedly, the engagement of NGOs that try to influence political reforms, economic and social policies has been more effective since the democratic breakthrough of April 2006. In the realms of women’s rights and ethnicity, language and cultures, civil organizations continue to advocate reforms. The struggle to improve the representation of women’s interests and those of ethnic and religious minorities is still an uphill battle; the dominant upper-caste elite refuses to allow the appropriate participation of all societal groups. In particular, this greatly affects the Dalits, whose lack of representation has only recently received greater public attention. However, the impact that civil society groups have on public policies is still limited. Maoists and mainstream political parties remain rather reluctant to acknowledge the role of civil society and to allow meaningful participation in the political process, even when the population’s opinions differ from their own positions.

Civil society
participation

Although the Maoist insurgents have joined the political process under the interim constitution - a draft of which the former rebels and the governing seven-party alliance signed in January 2007 – and have about a quarter of the nominated unicameral parliament’s 330 seats and have jointed the interim government in February 2007, national reconciliation and the discussion of past injustices remain major tasks for political reform and democratic development. In the ten years of the Maoist rebellion, especially after the state of emergency was declared, both the Maoists and the state security forces committed gross violations of human rights. To date, the state has made hardly any efforts to investigate these offenses. This makes it harder to achieve any reconciliation of victims and perpetrators. Thus far, insurgents and royal army and police have

Reconciliation

shown little willingness to engage in reconciliation, and the mainstream political parties are focused on institutional reforms and give little priority to reconciliation measures.

17 | International Cooperation

Nepal has a long history of working with international partners. Although this partnership has yielded good results especially in areas of education, health, drinking water, telecommunications, road construction, and power generation, there is still a need to improve coordination and harmonize aid and debt relief to increase efficiency and effectiveness, and to channel development assistance towards traditionally neglected regions and groups. After the first royal coup d'état in 2002, major international donors became assertive in putting pressure on the government to formulate and implement policies regarding developmental projects and administrative efficiency. International financial institutions and bilateral donor agencies openly voiced their dissatisfaction with the country's problems, including its rampant corruption and ineffective decision-making. Since the April 2007 transition, relations between the new government and donors and Western governments have considerably relaxed. In January 2007, supported by the new government, a U.N. cease-fire monitoring and electoral assistance mission began the work of disarming combatants. The new government acknowledges the important, if ancillary, role of the international community in supporting the constitution-making process. In addition to funding grassroots education, donors should build on the country's considerable intellectual capital by funding publications, radio shows and news articles by local scholars, lawyers and activists.

Effective use of support

Compared to the period between King Gyanendra's seizure of power in February 2005 and the April 2006 transition, the credibility of the new government has improved. In fact, the government tries to act as a reliable partner. However, due to the nature of the current interim government, major international actors (the United States, India) and international organizations doubt the reliability of parts of the government, specifically the Maoists.

Credibility

The Kingdom of Nepal has only two neighboring states: India and the People's Republic of China. Sandwiched between these two states, Nepal has improved its bilateral relations with both China and India since the democratic transition. Traditionally, Nepal provides one of the largest national contingents of U.N. peacekeepers (the fifth-largest contingent in 2006).

Regional cooperation

Strategic Outlook

King Gyanendra's proclamation of 24 April 2006 marked a victory for democracy in Nepal, and the start of a serious peace process with a cease-fire between the new government and the Maoists now in place. However, this is only the start of a long and challenging road to peace. While negotiations in parliament between mainstream political parties and Maoists continue, violations of fundamental human rights persist. The simultaneous process of re-democratization and conflict settlement will only produce sustainable outcomes if political parties, the palace and the Maoists have the political will and skills to keep the peace process on track. They must implement constitutional changes that allow for the containment of royal prerogatives and control of the armed forces, for the planning and implementation of administrative as well as judicial reforms, and they must tackle the economic and social root causes of the armed conflict. At the time of this writing, the prospects for democratization and peace in Nepal are uncertain, and it remains to be seen whether the country's political forces can deal effectively with these challenges. However, it is clear that socioeconomic and political reforms aimed at addressing significant flaws in the 1990 political compact will have to be pursued and adopted as the basis for both national reconciliation and the reconstruction of the nation and its frayed institutions. Systematic reforms are necessary to stabilize the state and to make it devolutionary, just and participatory. Such a system should ardently promote and protect personal liberty, free speech, and social justice, and must place a high value on the rule of law and economic freedom. Above all, the new Nepal must be a nation of full and equal opportunity for all its citizens, including those excluded on the basis of caste, ethnicity, gender and political conviction. A liberal democracy is the only viable political alternative for a heterogeneous country like Nepal. In order to achieve this transformation goal, several measures should be taken. First, the political leadership should proceed with institutional reforms, including the reduction of the role of the monarchy to ceremonial status and the holding of general elections. Second, the Royal Nepalese Army and the Maoists should end the practice of disappearances and renounce the use of vigilante groups, village militias and child soldiers. In addition, parliament and government should strengthen the legal framework for human rights by repealing or amending relevant legislation and ensuring full compliance with existing commitments under domestic and international law. Third, the government must address social and political discrimination against ethnic groups, castes, regional groups and women, and take steps to deliver minority rights.