

Nepal's Political Settlement and Inclusive Growth: Not Quite Business as Usual

Pallavi Roy¹

Mushtaq Khan²

SOAS, University of London and ACE RPC

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¹ Centre for International Studies and Diplomacy, SOAS, University of London.

² Department of Economics, SOAS, University of London.

Executive Summary

This paper provides an analysis of the opportunities and challenges facing the institutionalization of inclusive growth in Nepal. It uses a political settlements framework to identify policies that may have a significant impact on accelerating inclusive growth and that may be feasible to implement. There are numerous challenges to a sustainable trajectory of inclusive growth, including mobilizations based on divisive identities that could increase tensions in the medium term. The federal transition will push institutions to support a more decentralised pattern of rent allocation, due to a greater emergence and mobilisation of the 'intermediate classes'. These constitute around 30-40% of the population, and include e.g. village school teachers, middle peasants, small-town lawyers, NGO workers, educated unemployed. This group has shown to be important in the evolution of political settlements elsewhere in South Asia, providing critical organising capacity for political parties.

This will mean that power, and competition for rents will also become more decentralised. Political and government institutions will be challenged to support a more decentralised pattern of rent allocation and management. Exactly how this will evolve depends on a number of factors, including the relative emphasis placed on the local and provincial levels of government in the federal transition. Large sources of rents will continue to distort some markets, and critical constraints such as property rights, rule of law and infrastructure may be unlikely to dramatically improve given Nepal's current level of governance. However, the low productive capacities of enterprise is a key binding constraint to inclusive economic transformation in Nepal that (unlike others) may be feasible to address in the short- to medium-term.

The paper identifies the characteristics of the Nepali political settlement, its evolution, and the implications for the implementation of institutions supporting inclusive growth. Institutions create new incomes (or rents) and the implications of the competition over rents depends on the distribution of power described by the political settlement. The latter therefore constrains the types of institutions that will work best in particular contexts. The political settlement in developing countries means that the governance structures and institutions that work in advanced capitalist countries are not immediately enforceable or effective in developing ones. Moreover, the specific institutions that will work in a developing country depend on a deeper understanding of its particular political settlement and how that is evolving.

Existing policies ignore the political settlement and have largely failed because the rents that were created to induce investments and productivity growth were captured without delivering good results in most cases. Better designed policies can use policy rents more innovatively to create new organizational capabilities in SMEs, and in sectors with good employment prospects. Key measures to consider include policies that incentivise foreign investment and knowledge transfer in a way that delivers rents after productivity increases have been achieved. This can support devolution and make inclusive growth a sustainable strategy. Nepal's recent history of successful social mobilizations, its ongoing transition to a federal structure and near-completion of historic elections (at the time of writing) reflect dramatic changes in its political settlement. It is *not* business-as-usual in Nepal.

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1. Introduction

How can Nepal accelerate and sustain inclusive growth? What are its most promising economic opportunities? What are the feasible governance structures that could enable their achievement? Was the Maoist insurgency a blip in the unchanging flow of unstable Nepali politics? Or has the Nepali 'political settlement' changed as a result, and how does that affect the design of inclusive growth policies? This study addresses these interrelated questions using the lens of the political settlements framework and the rents analysis that underpins it. We argue that the Nepali political settlement has indeed changed and is likely to keep changing in ways that will affect future development prospects. Some of these changes offer opportunities for new institutional interventions that can sustain more inclusive economics and politics, particularly by combining devolved political institutions with economic policies and institutions supporting the growth of SMEs in different regions.

We make our case by looking at two interrelated issues and the implications for policy. The first concerns the characteristics of Nepal's political settlement and the likely direction of its evolution in the future. The second is the set of institutional constraints that have limited inclusive growth in the past. The two are closely related. Our definition of a political settlement is the distribution of organizational power. This matters because it determines the bargaining power of different formal and informal organizations competing for rents. Rents refer to the incremental incomes associated with particular institutions or policies, including the ones promoting growth. The distribution of organizational power then determines how specific institutions and policies are distorted or overturned as a result of the competition to capture rents. The political settlement therefore determines the types of institutions and policies that are most likely to work in that political settlement, given feasible improvements in governance capabilities. We identify the characteristics of the political settlement in Nepal that made it difficult in the past to overcome some of the most important constraints on inclusive growth. Finally, we discuss feasible ways of breaking out of some of these constraints given the characteristics of the political settlement.

Table 1 shows that Nepal's growth has lagged behind its South Asian neighbours, particularly after 1990. The lagging growth undoubtedly has something to do with the decade-long insurgency and conflict in the country that began in the mid-1990s. The other South Asian country with poor performance in recent years is Pakistan, which has also suffered from conflict. But of greater concern is that growth has not rebounded after the end of conflict in 2006. Table 1 ends in 2014/15. The earthquake of 2015 had a further negative effect, offset by an uptick in growth 2016/2017 to 7.5 percent, largely as a result of recovery from a low base, and reconstruction largely funded by foreign inflows. Longer term prospects, however, depend on the development of productive sectors, and in particular of

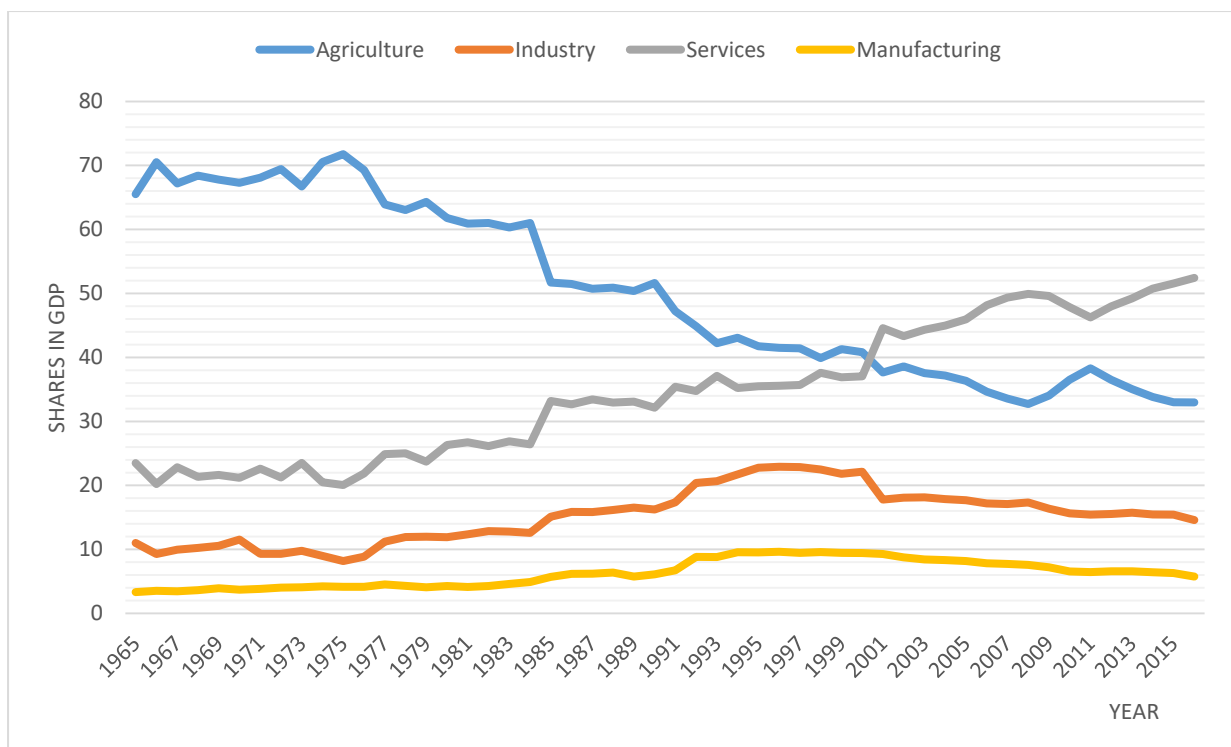
manufacturing. Nepal is currently around 2 percentage points behind Bangladesh and India In terms of per capita growth rates and this can rapidly compound into significant differences in welfare over time.

Figure 1 shows that structural transformation in Nepal towards greater industrialization has been virtually blocked since the 1990s, with the shares of industry and manufacturing actually shrinking. For countries at low levels of per capita income like Nepal, sustainable growth should lead to *rising* shares of industry and manufacturing, and indeed the rapid growth of labour-intensive manufacturing is important for ensuring that growth remains inclusive. At early stages of development, the share of agriculture should also decline (but agricultural output should rapidly increase) and the share of services should increase. The latter two changes are indeed happening in Nepal. But the expected rises in the shares of industry and manufacturing have *not* been happening, and instead services have grown faster. This matters because manufacturing creates employment for relatively less educated workers, and creates tradable products that can be exported to import technology and consumer goods.

Table 1 Nepal Comparative Growth in South Asia

	Nepal	Bangladesh	India	Pakistan
GDP Growth Rates				
1960-80	2.3	2.4	3.5	5.9
1980-90	4.5	4.0	5.6	6.3
1990-00	4.8	4.7	5.6	3.9
2000-05	3.2	5.1	6.7	5.0
2005-10	4.4	6.1	6.7	3.4
2010-15	4.3	6.3	6.7	4.0
Per Capita GDP Growth Rates				
1960-80	0.4	-0.3	1.2	3.1
1980-90	2.2	1.3	3.2	2.9
1990-00	2.4	2.5	3.6	1.4
2000-05	1.7	3.3	5.0	2.8
2005-10	3.4	4.8	6.5	1.3
2010-15	3.1	5.1	5.4	1.8

Source: World Bank. World Development Indicators. <http://data.worldbank.org/data-catalog/world-development-indicators> (accessed September 2017) and Handbook of Statistics on Pakistan Economy, 2015.



Source: World Bank. World Development Indicators. <http://data.worldbank.org/data-catalog/world-development-indicators> (accessed September 2017)

Figure 1 Nepal: Sectoral Shares in GDP

Some of the constraints on inclusive growth in Nepal are well known. The literature has identified weak governance and a poor investment climate, political instability that has resulted in governments changing frequently, regional and ethnic tensions that have resulted in violent conflicts, poor infrastructure and power supply constraints, the difficulties of accessing international ports, shortcomings in skills and education, poor labour relations and frequent strikes (Asian Development Bank 2009; Xu and Hager 2017). None of these constraints are easy to overcome, and some are very difficult to address.

While governance weaknesses are very important, the literature is often very misleading in identifying the types of governance capabilities that countries like Nepal need to acquire. The misleading advice often comes from looking at the ‘good governance’ characteristics of advanced capitalist countries and arguing that achieving these governance characteristics will ensure inclusive growth. These include the capability to enforce stable property rights and a rule of law. However, these institutions are very difficult to enforce in poor countries because their political settlements are such that powerful organizations do *not* support the achievement of these governance characteristics (Khan 2012b). Instead, history shows that successful developing countries did not have ‘good governance’ at an early stage of development. Rather, they had capabilities that we have described as ‘developmental governance’, which helped them to sustain and accelerate inclusive growth and maintain

political stability while *gradually strengthening* their rule of law, the enforcement of formal rules and property rights, systemic anti-corruption and rule-following democracy. The critical policy question is therefore to identify the appropriate governance capabilities that may be feasible for a country like Nepal to aim for in the short to medium term.

Political instability in Nepal has also often manifested itself as short-lived governments. This has been bad for coherent policy-making but this problem too cannot be easily addressed by policy if it reflects the organization of political power. But fortunately the organization of politics has been changing and there is a possibility that more stable governments may emerge in the future. At least part of the problem in Nepal has been the *relatively limited* inclusion of the middle and lower strata of Nepali society in traditional political parties. In such a polity, parties can get votes with limited organizational and mobilizing capabilities. As the organizational power of winning parties has often not been very clear, power and resource sharing arrangements at the top were based on understandings between elites rather than their real capabilities of organizing large numbers of people. These types of ruling coalitions can obviously be unstable. However, the insurgency and the characteristics of the subsequent peace have brought into mainstream politics parties of the left that have been much better at organizing people. This is likely to set up competitive pressures in Nepal for parties to become more organized. It is likely that Nepal will move in the direction of other South Asian countries where political parties compete to include organizers from a variety of classes and constituencies in large (formal and informal) organizational structures. In the typical South Asian scenario, the capacity to win votes is closely related to the capacity to attract large numbers of organizers within the party and therefore to its organizational power. Winning parties are therefore generally more powerful, and to the extent that the distribution of power remains stable, it is difficult to change governments through elite pressures and negotiations. While there are some indications that Nepal is travelling in this direction, government instability may still persist for some time.

Other major constraints, like infrastructure and electricity are also only likely to be gradually addressed. Overcoming these constraints to a significant extent requires large investments as well as demanding governance capabilities, for instance to acquire land without triggering huge conflicts and to ensure that huge investments can be mobilized and managed. These governance capacities are limited in poor economies and so early development has to happen in a context of relatively poor infrastructure and power supplies but with continuous incremental improvements over time. What is more, the development of infrastructure does not by itself guarantee that competitive enterprises will emerge to use this infrastructure. The missing capabilities of enterprises is usually a far more binding constraint in most developing countries and policy needs to prioritize that. As capable competitive enterprises emerge and begin to generate wealth and taxes, and the organizational capabilities of society improve, the governance capabilities and resources of

governments also tend to improve so that more ambitious infrastructure and public good projects can be effectively implemented.

An identification of a list of constraints is therefore not useful in itself, as there are very many constraints in a developing country. To be useful, the analysis has to identify the constraints that may be *feasible to address* over the short to medium term, and have a *relatively high impact* on triggering inclusive growth. If such constraints can be identified and addressed, other constraints can be sequentially addressed as the growth generated creates the resources and capabilities that make other problems more feasible to address, in turn sustaining the inclusive growth process. The aim of a political settlements analysis is to identify the constraints that can be feasibly addressed to trigger growth, and the types of policies that are most likely to work to achieve these goals in particular contexts.

The paper is organized as follows. Section 2 summarizes the political settlements and rents framework that we use to examine policy challenges for sustaining inclusive growth in Nepal. Section 3 provides an introduction to the major rent and policy challenges in Nepal and outlines why we believe the political settlement is at an extremely interesting phase in its evolution, offering both challenges but also opportunities for reform to sustain inclusive growth. Section 4 describes relevant characteristics of the Nepal economy and the challenges of inclusive growth. Section 5 provides a brief history of how politics has evolved in Nepal over the last few decades as the backdrop to our political settlements analysis. Section 6 refers to an important development that is likely to influence the evolution of Nepal's political settlement in the future, the intensifying competition between China and India in Nepal. Section 7 uses all this information to provide a mapping of how the political settlement in Nepal has evolved from the Rana period to the current day, together with some scenarios of possible directions of further evolution. Section 8 uses this analysis of the political settlement and its evolution to look at the major rent management issues in Nepal that are pertinent for inclusive growth. The aim here is to provide a qualitative analysis both of the scale of each problem but also the feasibility of addressing it. Our underlying theory of change is that reform must begin with relatively high impact but feasible changes that make other changes more possible later on. Finally, in Section 9, the major policy implications from the previous section are summarized.

2. Nepal's Economy and the Inclusive Growth Challenge

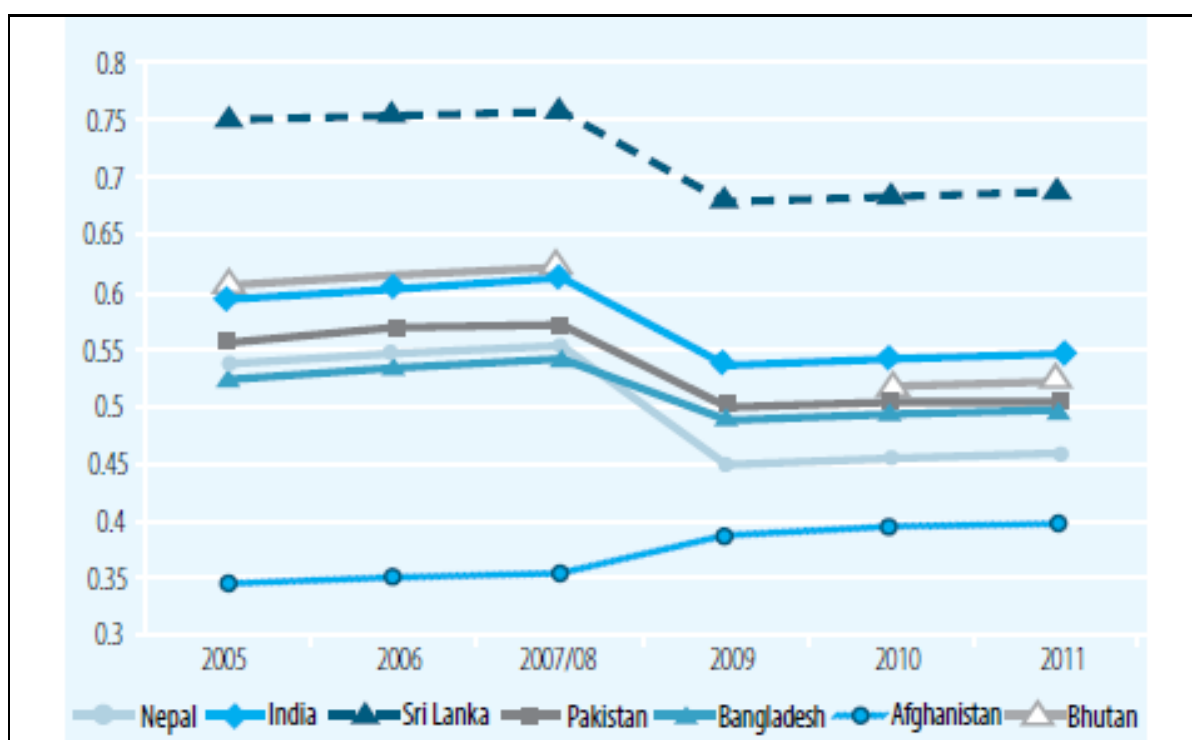
- *The Nepali economy is driven by high levels of remittances but this also makes it potentially vulnerable*
- *The excessive dependence of the economy on India is on balance detrimental*
- *improving growth rates while reducing inequality is a serious challenge*

Nepal is a low income country in the classification of the World Bank and has achieved less than the average performance of low income countries for most years since 1950. GDP growth was severely affected by the earthquake in 2015 as well as the economic blockade by India, and during the years from 1996 to 2006, growth was affected by the Maoist insurgency. Even though the situation is now much improved, political instability and lack of a productive workforce are two of the constraints for the Nepali economy that are most frequently identified by 'opinion makers', and labour and business representatives according to a perception survey conducted by the IFC (South Asia Enterprise Development Facility 2013). Both problems are linked to the Nepali political settlement where governments change frequently and the lack of good employment opportunities in productive organizations drives a large segment of the young population abroad as economic migrants. The share of the services sector has been growing at the expense of manufacturing as we saw in Figure 1. The growth of the service sector is common to all South Asian countries, but the low and declining share of manufacturing in Nepal (5.8% of GDP in 2016) puts it at odds with comparator countries like India (16.5% of GDP in 2016) and Bangladesh (17.9% of GDP in 2016) according to World Bank figures. In common with other South Asian countries, but again to a greater extent, its informal economy is substantial and employs 96 percent of the country's employable population (Suwal and Pant 2009). While the service sector contributes over half of Nepal's GDP it has low productivity overall as in most developing countries. Expanding high-value services requires very serious investments in human capital and is unlikely to create jobs on the scale required. Table 1 also shows that Nepal has performed less well in terms of per capita GDP growth when compared to neighbouring India and Bangladesh.

There has, however, been very good progress in poverty reduction. In its transition to democracy since the 1990s, Nepal has made much progress in reducing absolute poverty. Studies have shown that the poverty gap index (measuring how far poor sections of the population are from the poverty line) is declining (Asian Development Bank 2012). The proportion of the population living under \$1.25 a day declined from 68 percent in 1996 to 24.8 percent in 2011 (Asian Development Bank 2012). The government has targeted a reduction to 17 percent by the end of 2018/19 and wants to graduate out of being a Least Developed Country (LDC) to a developing country status by 2022 (Dhungana 2017). However, growth has remained sluggish, and in particular labour-intensive manufacturing that is a key driver of inclusive growth has not made very significant progress. According to the World Bank, Nepal is unlikely to become a lower middle income country before 2030. Even that will require sustaining growth and raising productivity in an economy with low productive capabilities across industry, agriculture and services.

Poverty in the economically backward mountainous regions is the highest amongst Nepal's geographical regions and displays a rising trend (Asian Development Bank 2012). In terms of

its performance on the Human Development Index, Nepal is currently the worst performing South Asian country with the exception of Afghanistan, as we see in Figure 2. The HDI values within Nepal are improving overall, though inter-regional inequalities are increasing largely driven by caste and ethnicity-based disparities (Government of Nepal National Planning Commission and UNDP 2014). Indeed HDI disparities based on caste and ethnicity are wider than geographical disparities.



Source: Figure 2.1 Nepal Human Development Report 2014.

Figure 2 Human Development Indicator Trends in South Asia

Table 2 Ethnicity and Poverty in Nepal

Caste / Ethnicity	% of population	Poverty incidence 1995/6	Poverty incidence 2003/4
Hill Brahman / Chhetri	30.9	34	19
Terai Brahman / Chhetri	1.9		
Newars	5.5	19	14
Terai Middle Castes	12.9	29	21
Hill Dalits	7.1	59	41
Terai Dalits	4.7		
Hill Janajatis	23.0	49	44
Terai Janajatis	8.7	53	36
Religious minorities (Muslims)	4.3	44	41
Unidentified	1.0		

Source: Table 2.2 OPM Working Paper 2010-03, based on DFID and World Bank figures

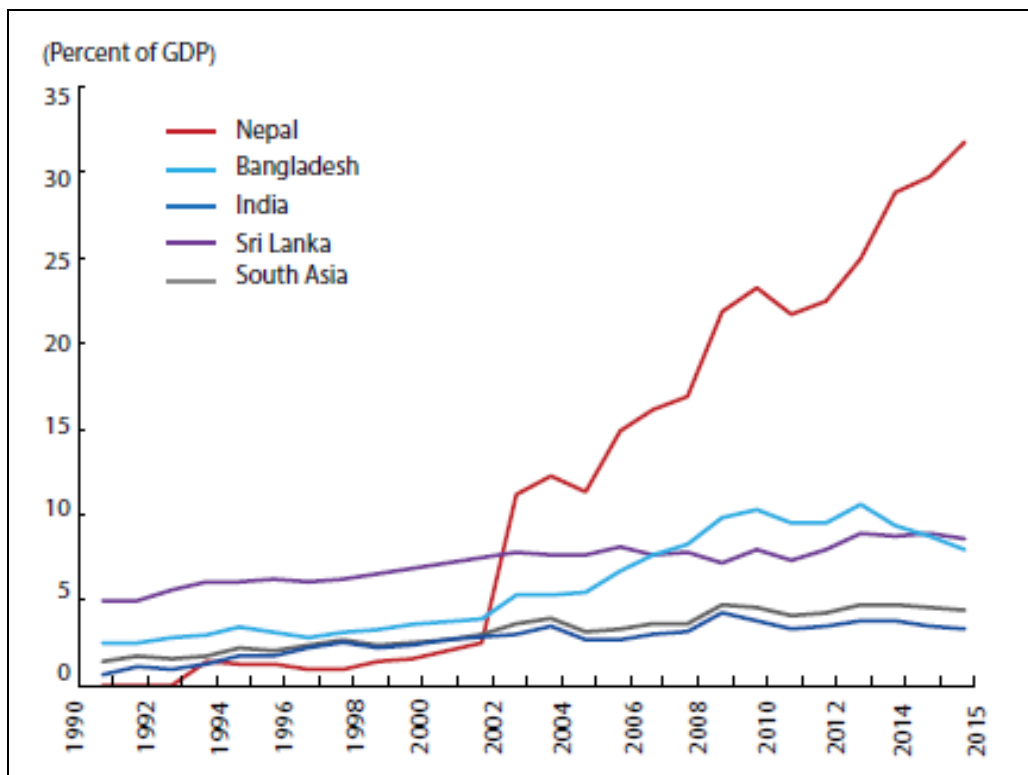
The population census of Nepal in 2011 recorded 123 languages with Nepali being spoken by 44.6 percent of the population. The ethnic composition changes as one moves from East to West as well as North to South. Political institutions and the composition of the ruling coalition ensured the exclusion of most of these social groups from political power and access to rents (S. Jones 2010).

Table 2 shows that Nepal's population can roughly be divided into three segments: a third composed of upper castes including the Newars, a third consisting of various indigenous groups who range from those of Tibetan and Mongol ethnicity in the hills and mountains to other indigenous groups living in the Terai or foothills who are sometimes collectively referred to as Janajatis (though this is an oversimplification of their ethnic complexity). The final third of the population are Madhesis who generally speak dialects of Hindi as their first language and occupy the Terai region. They are not a caste or ethnic grouping but the term Madhesi is used to identify Hindi speaking populations in the Terai who share many cultural similarities with the bordering Indian state of Bihar. Table 2 also shows that Dalits are the poorest group in Nepal, closely followed by Muslims, while Newars and hill Brahmins enjoy the lowest incidence of poverty. This is a policy conundrum because policies supporting growth have to be designed so that they do not exacerbate the already quite serious inequalities across ethnicities, regions and castes.

Nepali politics has been dominated by upper caste Hindus, including a social sub-group called the Newars (Prasai 2007). However a substantial portion of the population including Tharus, other indigenous people, Dalits and Muslims have been and continue to be underrepresented in political organizations (Robinson 2007). In terms of ownership of business organizations, the upper castes once again dominate, but Marwaris, a trading community originally from India who were brought in by the Ranas, also have a significant presence (Shakya 2011). The Madhesis have been agitating, sometimes violently, for more representation and have made significant headway in terms of political participation since the 1950s, but most sections of Madhesi feel more needs to be done (Jha 2017). Before the 1950s the Terai border regions served as a buffer region between British India and Nepal and was occupied by groups like Tharus and some Madhesis. While the Terai was sparsely populated prior to that time due to the presence of thick forests that were malaria infested, deforestation during colonial times to build sleepers for the Indian Railways and a programme to spread DDT, an insecticide that kills mosquitos enabled residents of the hills and others from across the border in India to populate the Terai (International Crisis Group 2007). As a result of the land clearing, the Tharus and lower castes among the Madhesis lost some of their land as ethnicities from other parts of Nepal moved in. Tharus in Dang however lost out much more than Tharus in Chitwan which still has Tharu landlords but this exploitation was nonetheless seen as based on ethnicity (Guneratne 2002).

The two defining characteristics of the contemporary Nepali economy are first, its dependence on remittances by migrant Nepali workers and second, the dominance of India in its trade basket and its relatively open borders with that country. In 1996 it is estimated that one in four Nepali households received some form of income from remittances. By 2004 this figure was one in three and by 2011 it was more than one in two. Around 7.3 percent of its population was abroad (Population Education & Health Research Centre 2016). Figure 3 shows that Nepal’s economy has the highest share of remittances in South Asia and is indeed one of the highest recipient of remittances in the world with remittances accounting for 30 percent of GDP in 2015. Remittances have helped to keep consumption inequality low but exposes Nepal to shocks in the host economies. It has also meant that the Nepali economy has lost a significant portion of its skilled workers. The absolute numbers working abroad have grown dramatically in recent years, as shown in

Table 3. The inward flows also allow the Nepali currency to be consistently pegged to the Indian rupee at an overvalued exchange rate that makes other Nepali exports uncompetitive.



Source: (World Bank 2017: Figure 1.4).

Figure 3 Remittances and the Economy: South Asia

Table 3 Nepali Workers Working Abroad

Year	1991	2001	2011
Number of Workers Aboard	658,290	762,181	1,921,494

Source: (Xu and Hager 2017: Table 13).

Table 4 Minimum Monthly Wages in Current Dollars

Year	Nepal	India	Viet Nam	China
2000	26	26	12	50
2001	26	25	12	53
2002	25	27	14	56
2003	32	28	19	56
2004	33	38	18	66
2005	32	39	22	71
2006	46	38	28	80
2007	52	41	34	96
2008	59	48	32	115
2009	62	54	36	117
2010	64	57	39	142
2011	73	64	40	180
2012	71	56	50	200
2013	81	51	55	226

Source: (Xu and Hager 2017: Table 3)

The scale of migration and therefore the scarcity of domestic workers means that Nepali wages are artificially high given the average productivity of the country. Minimum wages are higher than both India and Vietnam, which have much higher per capita incomes (

Table 4), thereby discouraging formal sector investments in tradable sectors (Xu and Hager 2017). It has also been argued that a large number of working age people being absent from the electorate makes governments less accountable for economic performance (H. Jones and Basnett 2013). The combined effects of all these factors have meant that the growth in the shares of manufacturing and industry in total economic activity have been unusually constrained in Nepal, as we saw in Figure 1. It is not surprising that the World Bank has

described Nepal as an ‘atypical economic transformation’ in its latest Nepal Country Economic Memorandum (World Bank 2017).

The dominance of the trade with India is the other distinguishing feature of the Nepali economy. India is Nepal’s largest trading partner and accounts for 65 percent of its total trade. It is also the major transit point for landlocked Nepal as 85 percent of the goods Nepal imports, irrespective of origin, travel through India into Nepal (World Bank 2017). Though Nepal has borders with both India and China, its historical economic links with India have been deeper because of the accessible terrain on its southern border. However as Indian competitiveness in many sectors has moved ahead of Nepal, the relatively open borders create challenges for Nepali tradable sectors that initially have lower levels of productivity and often also have higher wages. This has made it difficult for Nepal to attract investment into these sectors, and indeed it has been losing out to bordering Indian states on FDI (Unknown 2017).

These factors, together with its overvalued currency pegged to the Indian rupee, can explain why Nepal sucks in Indian imports and runs a huge trade deficit with India (and the rest of the world). India’s share in Nepali imports is 65.9 percent and 66.3 percent of Nepal’s exports go to India (Table 5). But the absolute value of imports greatly exceeds that of exports. The terms of trade are also skewed against Nepal as it mainly exports primary commodities like cardamom, ginger or low value added products like jute goods and GI Pipes. Nepali imports from India are higher-value products like medicines, vehicles and spare parts though commodities like rice, paddy and mild steel billets are also imported. Even though the borders are open and the two countries have signed a preferential trade agreement, Nepali products find it difficult to find markets in India.

Table 5 Nepal's trade with India and China

1. Share in total export (%)	2012/13	2013/14	2014/15
India	66.3	64.8	65.5
China	2.7	3.1	2.6
Other Countries	31.0	32.1	31.9
2. Share in total import (%)	2012/13	2013/14	2014/15
India	65.9	66.9	63.5
China	11.2	10.3	12.9
Other Countries	22.9	22.8	23.6

Source CMES Annual 2014/15

Table 6 shows the scale of the large and growing trade deficit with India, which in 2014/15, was around 63 percent of Nepal’s overall trade deficit. Not only is India more competitive, it has powerful internal lobbies of producers pushing for the protection of its markets. In the

few sectors where Nepal is more competitive, for instance in the manufacture of vegetable ‘ghee’, a cooking medium, or copper wire, India often applies quota-based restrictions in response to its internal pressures to protect its own industries.

Any hope that Nepali manufacturers could upgrade their technologies by moving up the Indian value chain would also come up against the superior lobbying abilities of powerful manufacturing associations in India who would naturally want to reserve the more lucrative parts of the chain for themselves. Under the Gujral Doctrine of the 1990s when India was attempting to exercise leadership in South Asia by offering preferential trade opportunities to its neighbours, India changed 22 tariff lines for Nepal and reduced duties to zero on these lines. But these preferential rates were rapidly withdrawn due to intense lobbying from manufacturers on the Indian side who were threatened by a few Nepali sectors. A combination of effective lobbying by Indian manufacturers to protect its internal markets in a few areas where Nepal was competitive, and the lack of Nepali competitiveness in most sectors, add up to Nepal not being able to use the vast Indian market to its advantage.

Table 6 Nepal's Trade Balance with India, Millions of NPR

2000/01	-28,670.70
2001/02	-28,665.90
2002/03	-44,494.20
2003/04	-47,962.40
2004/05	-49,758.60
2005/06	-66,428.40
2006/07	-74,143.50
2007/08	-103,820.80
2008/09	-121,431.70
2009/10	-177,120.60
2010/11	-218,564.80
2011/12	-249,773.30
2012/13	-316,031.20
2013/14	-418,333.40
2014/15	-435,791.40
2015/16	-139,383.30

Source: Economic Survey Report 2016, mof.gov.np

Interestingly, in a survey published in 2012, trade and transit arrangements with India were identified as the main constraint by larger firms (with over 100 employees) while small and medium sized firms identified this as a much less important constraint. Trade and transit arrangements were also a more important constraint for businesses in the border towns of Biratnagar and Birganj which are dependent on cross border trade with India than for Kathmandu and Pokhara (Margon 2012). While these results are not really surprising, it would have been good to get a more detailed set of responses from the survey about the

nature of these constraints. We would expect Nepali firms that were competitive to prefer freer trade with lower transaction costs. On the other hand, the more typical Nepali large firm facing a competitiveness deficit with India may well prefer more protection as they would probably find it difficult to compete with both legally imported and smuggled Indian products.

3. Political Settlements, Rents and Governance

- *The distribution of organizational power affects the operation of economic and political institutions*
- *Changes in institutions can induce responses by powerful organizations that affect the operation of these institutions*
- *Mapping how particular institutions generate rents (policy induced incomes) is necessary to track the responses of organizations and explain how these institutions work in that context*
- *The political settlements framework connects these dots to identify opportunities for institutional and policy reform that are likely to be effective*

We address the governance challenges facing Nepal using a political settlements approach. This section provides a brief introduction to concepts before we move to an application to Nepal. A political settlement is a description of the distribution of organizational power in a society at various levels appropriate for addressing specific policy problems (Khan 1995, 2010, 2012a). The distribution of power is relevant for understanding the likelihood of a particular organization ‘holding out’ for rents in conflicts ranging from economic competition in price wars, to political competitions to change government policies, and more overt violent conflicts. Powerful organizations have greater ‘holding power’ and can outlast competitors in these costly conflicts. They are therefore more likely to win in market and political competition and get policies and institutions working in their interests because other organizations are more likely to exit or compromise.

From the perspective of institutional change and policy formulation, powerful organizations have a greater likelihood of influencing changes in formal policy through lobbying. This is the common route through which organizational power is exercised in advanced countries through formal and rule-following rent seeking in the form of lobbying, political contributions and so on. In rule-following advanced countries, the relevant governance challenge is to ensure that a wide range of interests can formally influence policy so that sectional rent seeking by some interests does not result in restrictive monopolies and other damaging rents. But powerful organizations are also likely to influence the *implementation* of institutions and policies so that the actual operation of rules gives them the benefits they want. This is particularly important in developing countries, where powerful organizations are likely to *distort* the implementation of formal institutions and policies to capture rents.

One reason for this is that organizational power in developing countries is more likely to be based on the capacity to mobilize informal networks. It is difficult to lobby for formal policies that specifically target rents to an informal network. It is more likely that powerful organizations in developing countries will therefore capture a (large) part of their rents by distorting formal institutions and capturing rents informally for their informal networks.

This is an important reason why there is much greater *informality* in the implementation of formal rules in developing countries, why formal institutions and rules appear to be *difficult to implement*, and why there is so much overt rule-violating behaviour that often manifests itself as *corruption*. All these phenomena are related to a distribution of organizational power that works by distorting the implementation of formal institutions to bring about a distribution of benefits that reflects this informal distribution of power. The governance challenge in these contexts is more complex because a quick transition to a rule-following society is not possible. Here, the challenge is to identify institutions and policies that will achieve socially desirable results despite the types of distortions that powerful organizations can be expected to attempt and to strengthen enforcement capabilities of the state in targeted areas to further improve outcomes (Khan 2017).

The main aim of the political settlements framework is not to try and predict why particular policies or institutions emerge. Policies or institutions do not mechanically reflect the distribution of power in a society. Governments in power represent particular constituencies and are influenced by international pressures and their own ideologies. A variety of policies and institutional strategies can therefore emerge at different times. The dynamic question is whether particular policies *survive* and how they are *implemented* given the evolving distribution of power in a society. In advanced countries, powerful organizations that are adversely affected by particular institutions and policies can be expected to lobby and put pressure on governments to revisit these rules, or compensate them in other ways. In developing countries, the response is likely to include distortions and corruption in the implementation of particular policies to modify their implementation in line with the interests of powerful organizations or networks, many of which are informal. The political settlement framework therefore has to be used in a dynamic way to understand how a social system tends towards an 'equilibrium' between the distribution of rents and the distribution of power, without presuming that it is ever actually in equilibrium, or that the distribution of power across organizations is static. Sometimes institutions and policies change or are modified, sometimes the conflicts unleashed result in changes in the distribution of power. The most important part of the analysis from the policy advisors' perspective is to assess how institutions and policies can be redesigned given our assessment of the current distribution of power and its likely trajectories of change so that better social outcomes are achieved.

An analysis of rents is necessary for looking at this dynamic process. Political and economic organizations are both concerned about institutions and policies because these affect the distribution of incomes and benefits. We describe the incremental changes in benefits associated with particular institutions or policies as 'rents'. Some of the ways in which institutions or policies determine rents are obvious, like subsidies, or the benefits going to particular firms as a result of tariffs, or the incremental incomes of monopolists when policies restrict access to markets. Other rents are subtle, such as incremental gains and losses for organizations as a result of regulations, for instance those that limit the use of dirty technologies or require minimum construction standards.

Organizations affected by particular institutions and policies can be expected to try and change policies that adversely affect them or to informally modify their implementation so that they can capture or retain rents by violating rules. This is one way of explaining why many potentially beneficial interventions may fail to get introduced or be properly implemented in particular contexts. In developing countries, powerful organizations and networks often capture rents by distorting the implementation of formal rules. For instance, tariffs may fail to promote domestic industries if the rents are captured by low productivity firms who then prevent their removal, or by smuggling networks who prevent the emergence of productive enterprises; credit programmes can be distorted through corruption that diverts the new finance to organizations who were not the intended beneficiaries and so on.

The political settlement framework goes further. Its aim is not just to explain why particular institutions may have been distorted or blocked, but also to identify potential opportunities and solutions that have a higher chance of being implemented in that political settlement. There are many different solutions to particular development challenges. If allocating resources through the public school system results in the employment of unqualified teachers who happen to be politically connected (a form of rent capture by informal networks and organizations), the political settlement framework can be used to evaluate whether alternative methods of allocating resources for education using NGOs or other organizations may work *relatively* better in that context. If tariffs to protect infant industries are failing because powerful networks are engaged in smuggling to capture these rents in unproductive ways, the political settlement framework can be used to evaluate whether other forms of delivering support to infant industries may be less likely to be captured given the current configuration of organizational power.

Some rents are captured by, or are deliberately allocated to politically powerful organizations. While this may have economic costs, there may also be a political benefit of maintaining political stability and averting even more costly conflicts. Not all 'wasteful' rents are really wasteful when these political costs are factored in. However, the proper allocation

and management of all rents are important not only for maintaining political stability but also for achieving important development outcomes, like improving skills, developing new entrepreneurial capabilities, improving health and education outcomes, developing green technologies and so on. The misallocation or distortion of rents may have damaging political, economic and developmental consequences. In these cases, the political settlements analysis aims to identify alternative ways of managing these rents so that better development outcomes can be achieved given the distribution of organizational power.

The political settlements framework therefore suggests two parallel lines of analysis. First, it identifies the importance of mapping important rents in an economy to examine how the current configuration of institutions, organizations, and economic opportunities are driving or constraining growth. This analysis provides a map of how institutions and organizations are involved in the creation, management or allocation of particular rents, and the implications for growth and political stability. The second plank examines the characteristics and evolution of the political settlement. This looks at the configuration of organizational power in society and how this has been changing over time. Organizational power depends on social movements and mobilizations and how particular organizations have mobilized these to enhance their organizational power. But it is also affected by other autonomous factors like changes in economic capabilities and opportunities that affect the relative power of firms in different sectors, changes in global economic conditions, technological changes, the discovery of natural resources, international support for or resistance to particular organizations, and so on. All of these processes can change the distribution of organizational power in different parts of a society.

The two parts of the analysis are clearly closely related. Autonomous changes in organizational power can create new challenges and opportunities for managing growth and political stability, while autonomous changes in institutions and policies can result in mobilizations by organizations to support, block or distort these institutions. This two-way relationship is not fully determinate or mechanical and the challenge for policy is to identify the most effective interventions to nudge the evolution of the social system in positive ways, by supporting inclusive growth, political stability and helping to reduce conflicts, depending on what the most important challenges happen to be.

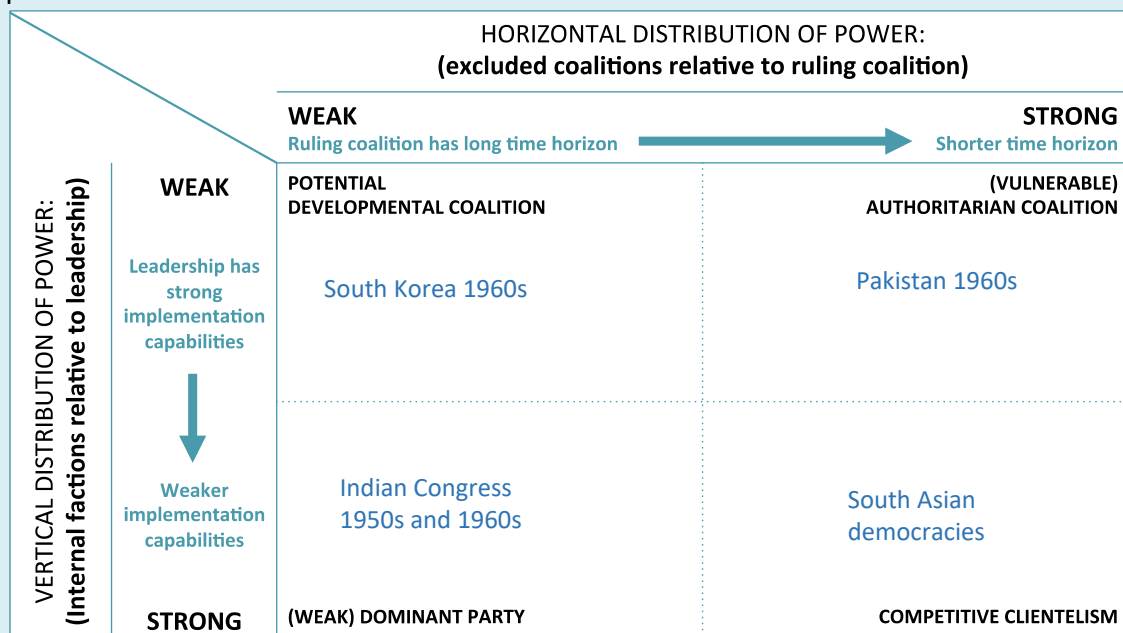
The evolution of political organizations

We will map phases in the configuration of political organizations using a classification developed in Khan (2010) and summarized in Box 1. Changes in the configuration of power across political organizations have important implications for the time horizon of governments and their capabilities of implementation, including the management of different types of rents. We will then look at the capabilities and distribution of power

across economic organizations (firms) to get an overview of the political settlement and the implications for policy.

Box 1 Political Organizations and Political Settlements

The distribution of power *across* political organisations and *within* the ruling coalition are both important. The capabilities of economic organisations and of the bureaucracy (including the military) are also important components of the overall configuration of power. However, the configuration of *political* power is particularly important and we use the framework in Khan (2010) to describe this aspect of the political settlement as shown below.



The configuration of power can vary across two dimensions. The horizontal axis shows the power of political organizations that are currently *not* in the ruling coalition. The vertical axis shows the holding power of higher levels of the ruling coalition relative to lower levels. The top left hand corner of the diagram describes *potential developmental coalitions* where the ruling coalition faces weak opposition from excluded groups and the leadership has effective power over their own organisations. This combination results in long time horizons, as the ruling coalition is not vulnerable and has significant implementation capabilities as its lower levels can be disciplined by higher levels. These coalitions may appear to be authoritarian but rarely have to use violence. In principle, they could also be elected to power. Countries like South Korea in the 1960s would be in this region.

As excluded organisations become more powerful, the ruling coalition may have to use more repression or violence to stay in power. We then have the emergence of *vulnerable authoritarian coalitions* as we move towards the top right. These coalitions can also be developmental for a while but they have a shorter time horizon

and the leadership eventually engages in more unproductive rent capture, even if their control over their followers remains strong. Many authoritarian regimes in developing countries, like Pakistan in the 1960s are of this type.

However, an authoritarian ruling coalition also tends to lose control over its lower levels because it is difficult to control them when powerful excluded organisations can offer them better deals. Parts of the ruling coalition can begin to leave and build new organisations or join the opposition hoping to get better deals. As multiple parties emerge, each party has weaker control over their organisations because disaffected members can leave. When political organizations are of this type we are in the bottom right hand corner described as *competitive clientelism*. This configuration of power typically supports democratic competition in developing countries. South Asian democracies are often of this type. Democracy can be more stable and less repressive than a vulnerable authoritarian coalition if organisational power has actually become fragmented, but democratic parties also have short time horizons and weak implementation capacities. If the competing parties can work out 'live and let live' arrangements for replacing each other in power, institutional and policy stability may emerge with good development outcomes in some contexts.

Finally, a configuration of power where a large political organisation faces limited opposition can result in a *weak dominant party* in the bottom left hand corner. Such a ruling coalition may have limited implementation capability because by including almost everyone the leadership pays the price of not being able to impose discipline on their own organisation. Work dominant parties can be stable but their rent management is not very developmental. The Congress Party in India during the 1950s and 1960s was of this type. These ideal types are simplifications and many examples lie on the boundaries of these configurations: for instance dominant parties with strong organisations can be close to being developmental coalitions, developmental coalitions that face growing resistance can become vulnerable authoritarianisms and so on (Khan 2010).

The configuration of political power in Nepal has changed dramatically since the 1950s. In the Sections 4 and 5, we will map these changes using the framework outlined in Box 1.

Characteristics of business organizations

The implementation of economic policies depends not only on the configuration of political power but also on the configuration of economic power and capabilities. An important reason why policies to support the emergence of competitive firms fails in developing countries is that business-government relationships often result in rents being unproductively captured rather than being used to raise productivity and learning. The role

of productive capabilities of firms and their power relative to political organizations is summarized in Box 2. High capability firms are ones that are already globally competitive or are close to having the capability of achieving competitiveness. Low capability firms are poorly organized and lack effective organizations, and are likely to need rents on a more permanent basis to survive. Firms with high holding power can hold out for rents by mobilizing their own networks of power such as links with individual politicians. Those with low holding power are easier to discipline (if the political coalition is developmental), but also easier to expropriate (if the political coalition has short-term rent capture motives). These interdependencies can make simplistic prognoses about rent management prospects very misleading.

Box 2 Economic Organizations and Political Settlements

		TECHNOLOGICAL-ENTREPRENEURIAL CAPABILITIES OF ECONOMIC ORGANIZATIONS	
		HIGH CAN ADOPT SOPHISTICATED TECHNOLOGIES	LOW CAN ONLY ADOPT SIMPLE TECHNOLOGIES
POLITICAL POWER OF ECONOMIC ORGANIZATIONS	HIGH DIFFICULT TO DISCIPLINE	HIGH CAPABILITY AND POWERFUL Capitalists can drive accumulation but imposing state discipline difficult. Typical scenario with big globalized firms in emerging market economies. Advanced areas of India after 1990s, Thailand 1980s and 90s	LOWER CAPABILITY BUT POWERFUL Political connections can drive 'primitive accumulation' but industrial policy difficult to enforce. Competitive low-tech enterprises possible under market competition. Large firms in India 1950s and 60s, Many areas of Indian subcontinent including Nepal today
	LOW EASIER TO DISCIPLINE	HIGH CAPABILITY AND WEAK Outcomes depend on organization of ruling coalition. With developmental coalition, effective industrial policy and disciplining possible: South Korea 1960s to 80s. But a weak dominant party or authoritarianism can have adverse results: West Bengal 1980s and 1990s, Thailand under Thaksin 2000s	LOWER CAPABILITY AND WEAK Very challenging because outcomes depend on whether ruling coalition can build firm capabilities. Developmental coalition could drive accumulation and disciplined learning but other scenarios may witness adverse effects: Tanzania 1990s and 2000s, SMEs in South Asia including Nepal

Source: Based on Khan (2010), Figure 18

The development states of East Asia not only had a configuration of *political* power that was in the top left corner in Box 1, but also *high-capability firms that were relatively weak* in their bargaining power with the ruling coalition, located in the bottom left in the box above. This political settlement allowed the ruling coalition to allocate rents to high-capability firms and then enforce conditions on them to ensure that productivity and competitiveness increased. A more adverse combination is to have political organizations in a *competitive clientelist configuration* (bottom right hand of Box 1) facing firms that are *low capability but powerful* (top right in box above). Here the probability of rents being captured by powerful but low capability firms is very high and the capability of policy-makers to discipline them is

low. The challenge in countries like Nepal is that the political settlement is close to this configuration and designing policies to drive capability development and inclusive growth are correspondingly more challenging. A more promising group of firms in Nepal are the lower-capability but also politically weak firms in the SME sector (bottom right hand quadrant) where there is a better chance of providing a combination of rents and effective market and state disciplining to raise productivity and achieve sustainable growth.

The configuration of power across businesses in Nepal has not changed quite so dramatically over time. Business in Nepal is dominated by a few large diversified conglomerates and most of them have relatively low productive capabilities compared to their competitors in the region. Apart from the big players, there are many smaller firms with much lower competitive capabilities and with little social and economic power. Over ninety percent of employment is in the informal sector, which roughly corresponds to the smaller firms. The large conglomerates are important because they are active in the modern economy and have the potential capability of increasing modern high-value adding economic activities and employment opportunities. Their limited productive capabilities are indicated by the fact that many of the larger conglomerates are primarily engaged in trading activities or engaged as 'agencies' for foreign firms.

Their manufacturing competitiveness and capabilities are relatively low compared to their regional competitors and this is demonstrated by their low levels of exports. A few, however, are indeed competitive (Lamsal and Sharma 2016). As we saw earlier, the share of the manufacturing sector has declined from around 15 percent in the protected market before liberalization to only around 5 percent now, suggesting that the firms that were being developed with protection and subsidies largely failed to acquire competitiveness.

These observations locate most large firms in Nepal in the top right hand quadrant in Box 2. They had, and continue to have, relatively low productive capabilities but are connected to powerful politicians and have enough holding power to resist disciplining. It is not surprising that they were mainly involved in activities that gave them access to easy rents with little compulsion to raise their competitiveness. Prior to India's liberalization in the 1990s, one of the main business activities was importing products that faced high tariffs in India and re-exporting them to capture easy rents. This was encouraged by the government as a means of revenue generation. These opportunities provided businesses with profits based on rent capture while investments in manufacturing capabilities remained limited (Dhakal and Subedi 2006). The smaller and more numerous firms in Nepal are located in the bottom right hand quadrant in Box 2.

Our analysis of business-government relationships focuses on the capabilities of firms and the distribution of power *rather than the sector they are in*. The sector in which a firm is operating is less important. For instance, a firm could be in the export-oriented garments industry but in our analysis it may not be a ‘magician’ firm as defined by Pritchett and Werker, with sustainable global competitiveness, even if it was actually exporting in competitive markets (Pritchett and Werker 2012). If the firm was politically powerful and located in a competitive clientelist political settlement, it may find it possible to export by capturing unproductive rents, for instance by not repaying bank loans or relying on hidden or explicit subsidies, rather than using these rents to raise its productivity to become truly competitive. This is particularly important in Nepal (and many other developing countries), where many export-oriented firms are actually not competitive and rely on permanent supplies of rents. Many export-oriented garments factories in Nepal that emerged when there were MFA rents in the 1980s and 1990s disappeared quickly when MFA was phased out, demonstrating that their export prowess was based on access to rents.

Equally, if political organizations have high enforcement capabilities and domestic firms have high productive capabilities and are not very powerful, rent allocations to firms in domestic non-tradable sectors, the ‘powerbrokers’ in Pritchett and Werker’s language, could be very efficient and achieve rapid productivity growth. This is often the case with construction companies or public sector providers in developmental states like Taiwan or China. The reality is that firms in all sectors in developing countries need to have access to policy support and therefore to rents (but for different reasons), and the outcomes in every case depend on how these rents are managed. The implication is that policy design to support productivity growth needs to take into account the features of the political settlement outlined in our Box 1 and Box 2, and focus less on the type of sector the firm is operating in, though that can clearly matter as well.

4. Rents and the Challenge of Inclusive Growth in Nepal

- *The configuration of organizational power in Nepal has changed dramatically since the 1990s*
- *The intermediate classes have become stronger, particularly since 2006*
- *Large firms are mostly uncompetitive and share a collusive relationship with political organizations*
- *Opportunities exist to develop an SME-based entrepreneurial class particularly by leveraging opportunities created by the growing strength of the intermediate classes*

The political settlement approach allows us to look at the challenges of effectively managing any policy induced rents. However, we will focus on a particular policy challenge, before turning to how the political settlement and the presence of a range of other rents in Nepal

affect the achievement of this central policy challenge. A necessary requirement for sustaining inclusive growth in Nepal is that the country must be able to develop competitive productive sectors that are able to generate large numbers of jobs. In common with many developing countries, in our assessment the binding constraint in Nepal is the absence of large numbers of potential firms that can rapidly become globally competitive with small changes in prices and opportunities. If this constraint cannot be overcome, attempting to improve other constraints may provide disappointing results.

The openness of Nepal's borders with India and India's greater competitiveness in manufacturing, revealed by the magnitude of the trade imbalance, create a serious challenge for Nepal's policy-makers attempting to develop its own employment-generating economic activities. If its own economic activities in particular sectors are not yet competitive enough (with a high enough productivity and product quality given wage differentials with competing countries) then policy has to assist the development of these competitive capabilities. The policy challenge is to identify and then to provide support for domestic industries to develop competitiveness in potentially feasible sectors. Without the development of a large number of competitive firms in these sectors, particularly those using labour-intensive technologies, it will not be possible to provide extensive employment opportunities in Nepal. Potentially feasible sectors are not particularly difficult to identify. They are sectors where there is already some activity, and where the competitiveness gap defined as the gap between the current productivity and quality levels of Nepali firms and the levels they would have to achieve to become globally competitive is feasible to address using learning-by-doing and skills upgrading strategies (Khan 2013b). We will later discuss some of these potential sectors in Nepal. However, identifying these potential sectors is relatively easy compared to the challenge of devising effective policies to upgrade their competitiveness.

The support that is required for firms to enable them to improve their productivity and product quality to narrow the competitiveness gap generates rents for these firms. These are potentially useful rents, provided they can be managed properly. This means they have to be targeted to the right firms, the performance of the firms has to be monitored, and support has to be withdrawn if performance remains poor. If firms know this will happen they will put in high levels of effort, and the failure rate will be low (Khan 2000a, 2013b). Managing these rents has not been easy in most countries, and Nepal is no exception. Policy-makers will have to devise strategies to support this upgrading that will work in the Nepali context. This policy challenge is further complicated by the presence of other important rents that powerful firms are already capturing. We will discuss these in a later section. These rents also make the management of policy rents for accelerating inclusive growth challenging because they distort the incentives of firms.

Parallel to the evolving story of policy rents in Nepal, there have been rapid changes in the organizational structure of Nepali society, which in turn affects the prospects of effectively managing different types of rents. Despite its enormous diversity, for a long time economic and political power had remained concentrated in a relatively narrow range of organizations and social groups in the Kathmandu region. This is particularly remarkable given the complex social structure of Nepal, its regional and ethnic diversity, and the economic and social differences across its many micro-communities. Indeed, any simplified description of the Nepali political settlement always has to come with the caveat that this diversity needs to be factored in. But we can safely make the generalization that the concentration of organizational power that characterized Nepal till very recently was not very sustainable. The close connections between a relatively small number of powerful economic and political organizations in Kathmandu meant that developmental rents could not be effectively disciplined, and political rents were too narrowly distributed to sustain political stability.

However, the Nepali political settlement went through dramatic changes as a result of successive mobilizations for democracy that eventually led to the ten-year Maoist insurgency from 1996. Even though the insurgency appears to have ended with a return to politics as usual, our assessment is that there has been a significant rupture that cannot be ignored in the longer run. The insurgency mobilized groups that had previously been entirely outside the political mainstream in Nepal, and it thereby demonstrated the potential organizational capabilities of different groups in the country. This is likely to have permanently changed the political dynamics of Nepal. In our assessment, the change in the political settlement is very significant and belies the perception that nothing much has changed in the politics of Nepal. In particular, Nepal is likely to see more significant mobilizations of the intermediate classes in the future and this will force institutions to support a more decentralized pattern of rent allocation, in line with other parts of the Indian subcontinent where intermediate class politics has been dominant for a much longer.

The intermediate classes refer to social groups that are neither surplus-consuming classes, like capitalists and large landlords, whose claim on the economic surplus is their primary source of income, nor groups whose income from labour constitutes their main source of income, like workers and landless peasants. The intermediate classes are in-between these two strata: their incomes come partly from labour, partly from access to capital, including human capital, but significantly, they have potentially important organizational capabilities in the typical developing country context. These groups constitute the middle thirty to forty percent of South Asian societies. It would be wrong to call them 'middle class' because many of their members are quite poor in absolute terms, and they are also distinct from middle classes in advanced countries in that their upward mobility often depends quite significantly on their success in political mobilization and the capture of political rents. The significance of these groups was pointed out by Kalecki, Chatterjee, Washbrook, Khan and

others, in the context of the organization of politics in South Asia (Kalecki 1976; Washbrook 1981; Chatterjee 1997; Khan 2000b).

The deepening of democratic processes in South Asia benefited the intermediate classes because they soon came to achieve a pivotal position in political organizations. Capitalists and landlords were richer but too few in number, and they did not generate enough surplus to dominate the entire national political process. Workers, peasants and other subaltern groups were more numerous than intermediate classes but they were too poor and too busy making a living to be able to effectively organize. In contrast, the intermediate classes, a varying mix of middle peasants, petty bourgeoisie, professionals like village school teachers, urban small-town lawyers, the educated unemployed and others, whose composition would vary from region to region, always played a significant role in the organization of politics. Any investigation of who the dominant players are in most political parties in the Indian subcontinent shows that the bulk of their organizational capacity comes from enterprising members of these classes. They are the most capable in mobilizing large numbers of others through different variants of patron-client politics. In turn, patron-client politics led by the intermediate classes has been a major mechanism for the capture of informal 'political' rents that are then distributed through these networks to satisfy clients and to sustain the organizational power of the network.

An immediate indication of the direction of travel in Nepal has been the evolution of the new constitution and the federal structure. These institutional changes were set in motion by the Maoists but it is clear that the Maoist-led mobilization has now been normalised into a more decentralized pattern of rent allocation, ostensibly in response to the steadily growing mobilization by intermediate class organizers of new groups lower down the social hierarchy. This has been very good for reducing the space for violent mobilizations by excluded poorer layers of society in the future, though other, regional and ethnic fissures like the demands of the Madhesis and the Tharus remain. However, even they are now fighting for their rights and rents through elections contested by parties organized by their own intermediate class political entrepreneurs. The long insurgency thus created the space for a gradual emergence of a relatively more inclusive political rent allocation as the relative power of the intermediate classes within political organizations increased. The sustainability of these institutional changes will depend on whether the rent allocation to new segments of Nepali society can be matched with the creation of new productive capabilities across regions in ways that benefit the upwardly mobile intermediate classes. Otherwise, the growing demand for rents for newly mobilizing groups may not be sustainable and may result in zero-sum conflicts that can eventually become very intense. On the other hand, the mobilization of these new groups also creates opportunities for allocating rents that can be disciplined to achieve developmental objectives. Emerging entrepreneurs from within the intermediate classes may be induced to set up SMEs. Many may initially be relatively weak

in terms of the holding power against national politicians and bureaucrats, creating opportunities to use policies and institutions to allocate capability-enhancing rents to them in ways that can be linked to performance and withdrawn if necessary. If this can be achieved, and the new rent-recipients can be disciplined or incentivized to achieve competitiveness, Nepal may be able to enter a virtuous cycle of growth and political inclusion that would be sustainable over time.

The bureaucracy in Nepal is also an important part of the organizational structure that determines the implementation success of particular institutions and policies. Given the complexities of Nepal, simple generalisations can be misleading, but it is safe to say that senior levels of the bureaucracy are highly politicised and bureaucrats are part of political patronage networks that make reform in critical sectors difficult. Ministers as well as bureaucrats have incentives not to increase efficiency in various government agencies and departments if this affects their own established mechanisms of rent capture, whether through procurement processes or informal kickbacks. The energy sector is an example where this feature of bureaucratic and political collusion is holding up reform in the Nepal Electricity Authority (Rai and Neupane 2017).

While the informal collusion between bureaucrats and politicians is common across developing countries and South Asia, it appears that officials in the Nepali bureaucracy behave in a somewhat more fragmented way relative to many parts of South Asia. Some of our informants suggest that Nepali bureaucrats become part of patronage networks at an early stage of their careers in order to be promoted to senior positions (despite entry being through a competitive exam) and their primary allegiance is to particular political leaders. This reflected to some extent the weak organization of parties in Nepal in the past, and therefore the greater importance of very personalized networks. If the allegiance of the senior bureaucrat is to a particular politician, their freedom of operation can be much more constrained. Deals with businesses are more likely to involve very immediate sharing of damaging short term rents, for instance captured through collusion over inflated contracts or by setting up monopolies rather than potentially more dynamic conditional rent allocations to raise productivity and share benefits over time. High levels of bureaucratic fragmentation can therefore have negative implications for rent management in the same way as the political fragmentation in competitive clientelism creates short time horizons and poor enforcement capabilities.

The configuration of power between political and economic organizations has a bearing on the political settlement. Similarly the configuration of power across political organizations has an important effect on the organization and capabilities of bureaucratic agencies. The evidence shows that there are some agencies that have in recent times performed well under senior bureaucrats like the current head of Nepal Electricity Authority. But good

results are typically based on discretionary actions by strong bureaucratic leaders who have political support rather than as a result of well-working bureaucratic institutions. In most areas of the bureaucracy opposition to increased transparency is high, and even within the electricity sector there is strong opposition to any transfer of responsibility to a proposed regulatory body (Rai and Neupane 2017). There is also anecdotal evidence of a '10 per cent' rule in Nepal in sectors like local development, irrigation and energy where resources are captured and channelled up to ministries with the relevant bureaucracies acting as conduits. This suggests the bureaucracy in Nepal is constrained by the political parties and in effect work with them, and sometimes for them, to capture rents.

Political parties can directly constrain the bureaucracy as was seen in 2015 when the Commission for the Investigation of Abuse of Authority (CIAA) had some of its powers curtailed. Its authority as an ombudsman was taken away and was only allowed prosecuting functions. This was because politicians had earlier been negatively affected by the CIAA's investigations as an ombudsman. One of the specific features of the configuration of power in Nepal is that senior bureaucrats owe allegiance to individual party leaders or at best factions within parties. This makes the bureaucracy highly fragmented as well as curtailing implementation capacity. However this would be a bigger difficulty for more ambitious rule of law reforms (as with the case of the CIAA) while the implementation of smaller sector-specific reforms of the type we propose may not be seriously affected. Finding sectoral 'champions' within bureaucracies could be also one way of ensuring better policy uptake and implementation.

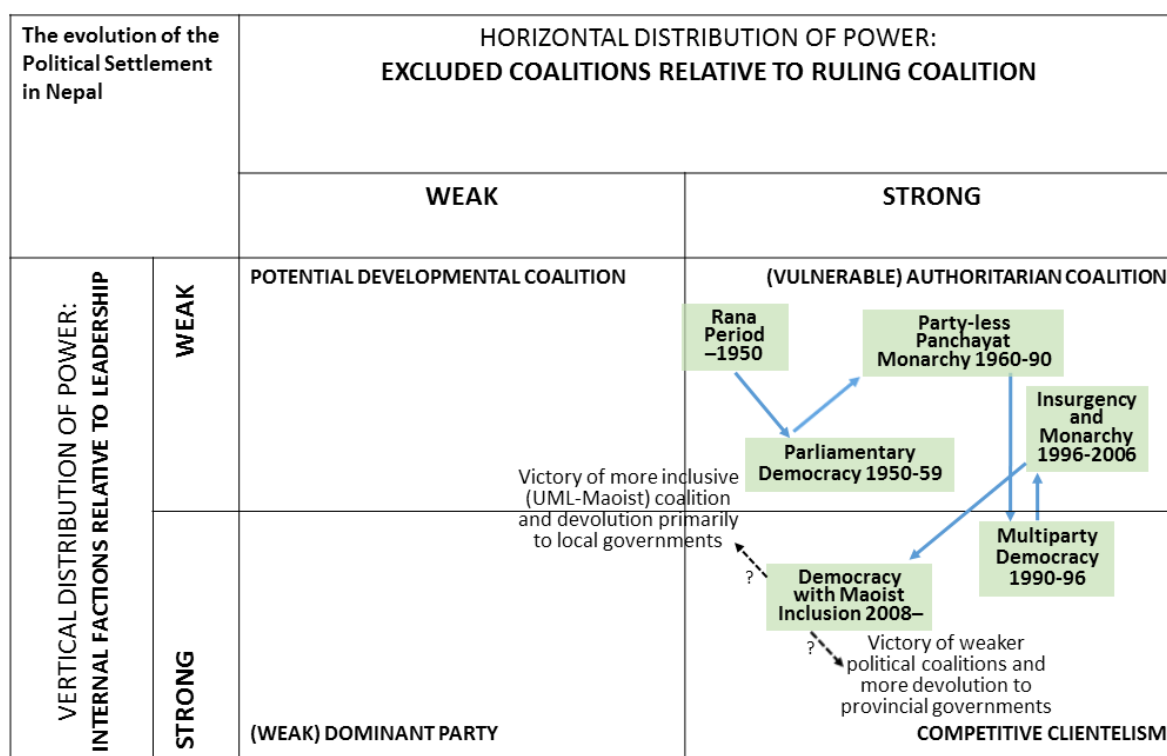
Finally, the factors supporting damaging rent creation in Nepal include the limited development and low capabilities of the Nepali business sector. This is one reason why Nepal achieved low growth even after the Comprehensive Peace Agreement of 2006. The period of democracy that began in the 1990s did provide some economic organisations the political stability to make longer term investments and created some incentives for productivity growth. The insurgency and the negotiations that ended it created stronger political parties. So far, a dynamic pattern of rent creation and allocation between political and economic organizations has not emerged and the challenge for policy is to identify interventions that can nudge rent management in more productive directions that are feasible within the evolving political settlement.

An important message of our analysis is that recent changes in the distribution of organizational power have created both challenges and opportunities for future rent-allocation strategies for sustaining inclusive growth. The challenge for political stability is that political institutions have to evolve to allocate political rents more effectively through decentralized political institutions. This is necessary to provide rents to emergent power groups where intermediate socio-economic classes and a broader range of regions are likely

to play a more prominent role. The economic opportunity is that these classes and regions can also provide potential entrepreneurs who can set up SMEs in low-technology labour-intensive sectors that can achieve competitiveness in sectors like food and beverages, garments and textiles, manufacturing simple components for domestic industries and construction, a diversified tourist industry and so on, which could herald a new inclusive growth strategy. This would require thinking through ways of delivering rents for achieving economic outcomes in ways that are less likely to be wasted or captured. A number of strategies for developing SMEs in new sectors may be feasible, particularly by taking advantage of changes in the political settlement that may allow a broader range of firms to be targeted, and which may be easier to discipline. The experiences of Bangladesh and other countries provide pointers, but like other countries, Nepal will have to experiment and innovate on its own developmental institutions and policies.

5. Phases in the Evolution of Nepal's Political Settlement

In this section we map major changes in the configuration of power in Nepal. While the changes in the organizational capabilities of economic organizations have changed relatively slowly, political change has been rapid and dramatic in Nepal. We argue that the insurgency of 1996 and the peace that subsequently emerged in 2008 represents a significant break with previous political settlements. In particular, some future trajectories are potentially very promising for developmental rent management. Using the framework outlined in Box 1, the narrative that follows is summarized in Figure 4.



Source: Authors

Figure 4 Evolution of the Political Settlement in Nepal

The Rana Period –1950

Our mapping begins with the Rana period that lasted till 1950. The contours of modern Nepal, in terms of its national identity were formed in the latter half of the 18th century during the reign of Prithvi Narayan Shah. Territories were unified and systems of land taxation were introduced. A rigid social structure based on the non-inclusive Hindu caste system was introduced. These patterns intensified under the period of Rana rule that began around a hundred years later and led to the creation of a Nepali consciousness, even though it was exclusionary and absolutist in nature. The caste system was rigidly followed and the upper castes of Brahman and Kshatriya (Bahun and Chettri in Nepal respectively) were the most privileged. While the years under the rule of the Shah dynasty were characterised by wars with the British and even the Chinese, the subsequent period of Rana rule witnessed close co-operation with the British which ensured that Nepal was never colonised unlike the rest of South Asia.

Excluded political organizations were weakly organized and the near feudal state structure had control over lower levels of the ruling coalition. This political settlement had very limited political access to power for excluded groups but the latter were very weakly

organized. Thus, while the state had aspects of authoritarianism, opposition was low, and the political settlement therefore had some characteristics that resembled a developmental state (for instance the Ranas built the first hydel power plant in Nepal in 1911, one of the first in Asia). However, the Rana state achieved weak developmental outcomes because economic organizations (firms) in Nepal prior to the 1950s (and even today) had relatively low capabilities (discussed in Box 2). The few firms that were there in Nepal during the Rana period had low capabilities and were closely connected to political networks and could not be effectively disciplined. The Rana state could not have directed productivity-enhancing rents to such firms to attempt to achieve productivity growth.

The Democratic Period 1950-59

The period of Rana rule came to an end in 1950 when a popular uprising supported by India secured the return of the monarch, King Tribhuvan, and the Nepali Congress (NC), the oldest extant political party in Nepal, while maintaining a diminished Rana representation. This marked the beginning of India's not-so-covert involvement in the domestic politics of Nepal in order to keep the Chinese at bay in the background of the invasion of Tibet. The NC gained a two-thirds majority in parliament in 1959. In Figure 4 we show the change in terms of excluded groups becoming more powerful over time. Repression alone was unable to maintain the Rana political settlement, as the popular uprising demonstrated. The political parties were still very centralized and controlled by upper caste elites, and the opposition was very weak. So the movement to the right was not very great. The control of the ruling coalition over its lower levels was also likely to have been somewhat weaker than under the more cohesive Rana rule. This type of democracy could have been developmental, but once again, the low capabilities and political connections of the nascent Nepali business sector help to explain why developmental outcomes did not accelerate.

The Panchayat Monarchy 1960-90

A coup by Tribhuvan's successor King Mahendra in 1960 led to another significant rupture and the suspension of democracy. In its place came a party-less 'Panchayat' system (the system of micro-devolved local governance prevalent in much of Northern South Asia) but with the monarchy exercising most powers. This was a move towards vulnerable authoritarianism in Figure 4. Ironically, excluded groups had in the meantime become more assertive so this political settlement was further to the right compared to the Rana period, and excluded groups were managed with a combination of limited inclusion through the panchayati system but also repression and restrictions on political activity. The Panchayati system had limited developmental characteristics, but King Mahendra was able to

implement some development programmes including building a road link between East and West Nepal and he attempted some land reforms. But the vulnerable authoritarian political settlement was not used to direct rents for the development of new economic organizations and the King ensured that he was the only power centre.

This system achieved some improvements in indicators like education but economic growth remained poor (Robinson 2007). Mahendra started the civil service and laid the foundations of the modern Nepali state. Mahendra's reign however has been described as 'ethnically hegemonic' because it upheld the primacy of upper caste hill culture in Nepal (Shakya 2011). This partyless Panchayat system was used to cement a Nepali identity based on Hinduism and the Nepali language, ignoring the diversity and complexity of the Nepali nation. A comprehensive outline of this period is available in Baral (Baral 2012). This period is seen by many analysts as having laid the foundations of Nepal's development trajectory because of some of the steps described above.

Multi-Party Democracy 1990-96

The next move was again a significant one. Multi-party democracy was restored in 1990 through a *Jan Andolan* or mass movement. The aspirations of excluded groups had been growing during the Panchayati period despite restrictions and repression. The party-less panchayat system was a cover for monarchical rule that sustained the power of a narrow range of upper castes by enforcing strict restrictions on political activity. The *Jan Andolan* forced King Birendra, Mahendra's successor to hand over power and make Nepal a constitutional monarchy in 1990. The Nepal Congress, NC, emerged victorious in the first parliamentary elections in 1991 and the left-wing CPN-UML formed the government after the mid-term elections in 1994 (despite a hung parliament). The new phase of multi-party democracy lasted from 1990 to 1996. This phase was disrupted by the outbreak of the Maoist-led insurgency that mobilized entirely new groups and regions in Nepal to provide the most significant challenge to the established order.

The new political settlement was more clearly a competitive clientelist one in Figure 4. Parties had gradually become somewhat more inclusive. Their lower-level membership and the constituencies they mobilized were somewhat more assertive than before. This meant that the control exercised by higher levels over lower levels was likely to be diminishing. There were more parties as well by now, and the ones that were excluded from power at any time were now stronger than before. However, the introduction of democracy meant that repression against currently excluded political organizations was much lower level as excluded groups that were represented by or organized in parties could wait for elections instead of directly challenging the ruling coalition. However, as the insurgency demonstrated, not all groups were getting access to power and rents through the

democratic process. Democracy therefore had complex effects. On the one hand it arguably reduced the enforcement capabilities of ruling coalitions but on the other hand, it sustained greater political stability and required less repression. We know from Table 1 that the period from 1990 to 2000 witnessed some of the highest growth rates in Nepal, and the political stability that democracy promised probably contributed to sustain this growth.

Insurgency and Monarchy 1996-2006

This period of democracy was also short-lived. The next shift happened around 1996 as the Maoists began to mobilize some of the very large numbers of people in Nepal who were still excluded from power and rents. The immediate effect was a centralization of power in the monarchy and a return to greater authoritarianism and repression. This was a further move to the right in Figure 4 as excluded groups were now even more powerful, indeed they were engaged in an armed insurgency and repression increased dramatically. However, moves to centralize power also faced more pushback from mainstream parties compared to earlier periods of authoritarianism. While not opposing the monarchy outright, political parties were wary of the growth in royal power. This was clearly not a good period for development, and the major concern for most people was to end the conflict on reasonable terms. The conflict ended with a military stalemate after ten years of fighting. It was clear that a military victory was unlikely for either side. This created the grounds for the signing of the Comprehensive Peace Agreement and in a dramatic turn of events, the Maoists decided to lay down their arms and join mainstream politics by contesting the elections.

Democracy with Maoist Inclusion 2008–

A rupture between the mainstream political parties and the monarchy allowed elections in 2008 that included the Maoists and brought them into the mainstream. The new democracy was therefore much more inclusive than previous variants as new constituencies organized in parties were now in play. The new political settlement was a competitive clientelist one. There was a shift to the left in Figure 4 as excluded groups were now weaker, meaning that a significant number of powerful groups could enter the ruling coalition and those waiting in the wings were not necessarily permanently excluded and had little incentive to revert to violence. Repression could decline dramatically as a result. Parties now mobilized wider constituencies and there was more intense party competition. There was potentially greater stability but parties now included more organizers and responded to wider constituencies, so it was more difficult to discipline themselves and achieve high implementation success. So we also have a movement downwards in Figure 4, making the new political settlement a competitive clientelist one.

While the transitions from forms of democracy to forms of authoritarianism (though less so from the turn of this century) in Nepal appear to be messy and baffling, it is worth pointing out that very few developing countries have been able to make the transition that Nepal has made from authoritarian rule and a violent insurgency to peace-building and constitution-making that has radically shifted the political discourse. The insurgency brought into the mainstream a discourse of political and social inclusion that was substantial and not just formal. The instability that the country has been through is the result of the social churn after years of mobilisations that came to a head in 1990, reaching new peaks during the insurgency years. The insurgency ruptured many established power structures and created a space for the emergence of a relatively more inclusive society. This, along with technological penetration and a young population has ensured real pressures for a redistribution of power and rents despite the complacency created by the remittance economy. Nepal's success in pushing through significant changes like a secular constitution and commitment to a federal structure have reflected changes in the distribution of power. Despite persistent attempts to push back by groups whose dominance is threatened, a return to the *status quo ante* is quite unlikely. The 2015 Constitution promises to further devolve power and decentralize the political institutions through which rents are allocated.

A number of political parties have gradually emerged and consolidated in Nepal, including the right of centre, monarchy-supporting Rashtriya Prajatantra Party (RPP) which had split initially and has since reunited, the regionally based Nepal Worker's and Peasant's Party, an offshoot of the CPN formed in 1949 in India, and the Nepal Sadbhavna Party (NSP) that emerged to represent the interests of the Madhesi community in the Terai region of the country. This was the precursor to the Madhesi parties that now represent the region in elections. To this list was added the CPN-Maoists in 2006 when they laid down arms under the Comprehensive Peace Agreement and agreed to join multi-party politics. After having gained the maximum number of seats in 2008, by 2017 they were reduced to the third largest party after the NC and CPN-UML but they nonetheless remain a formidable force in mainstream Nepali politics and especially in their stronghold of the Western Terai. While there remain three main political parties (the NC, the Maoists and the UML) who together hold close to 90 percent of the seats in the current parliament others like the RPP and ideological descendants of the NSP like the Rashtriya Janata Party and Sanghiya Samajbadi Forum-Nepal have emerged as smaller players who could play an important role in coalition politics. The RPP gained a significant number of seats in the 1990s and has seen somewhat of a resurgence since. The Madhesi parties will also be testing their strength in future provincial and federal elections after having come second and third in the local elections in Province 2, an area of much contestation between the Madhesi movement and the larger political parties, especially the UML.

A significant feature of politics in Nepal after 1990 has been the importance of coalition politics and frequent changes in government. Apart from the Worker's and Peasant's Party, most parties, even those winning a few seats in parliament, have been part of the government at one time or another. This has also meant that parties from across the ideological spectrum have been forced to work together in order to keep governments running, at least for short periods. An understanding of the political settlement and the limited organizational opportunities for parties in the past allows us to understand this better. Parties in Nepal did not have the opportunity to develop their organizational structures over long periods of peaceful political competition. If they had, they would have been driven to mobilize and include intermediate class organizers at lower levels and develop distinct constituencies in the way parties elsewhere in South Asia have done over decades. As a result, even when parties won seats in Nepali elections, their holding power against other elites in other parties was low, and elite bargaining could change governments at the top without much reference to party organizations. As parties become more developed in the emergent political settlement, they are likely to develop their formal and informal organizational structures. In the future, the relative holding power of different parties will be much clearer and bargaining at the top will be less likely to change governments so easily.

In some respects, the fluidity at the top has been fortunate for Nepal in allowing deals to be made between leaders of competing parties at a time of intense conflict. The most effective example of coalition politics was the 12 point agreement between the Seven Party Alliance and the Maoists in 2005. The background to this was that between 2002 and 2005 during the insurgency, the mainstream parties were in favour of a constitutional monarchy (with Gyanendra as the reigning monarch after the assassination of Birendra). The Maoists were fighting the monarchy. However, the mainstream parties were compelled to abandon their position when Gyanendra sought to centralize power in his hands in 2005. This was the start of a second *Jana Andolan* that paved the way for the Maoists to push through their republican agenda and their demand for a constituent assembly in return for accepting a role within parliamentary democracy (Hacchethu 2006). The new discourse on inclusion and secularism that is reflected in the constitution of 2015 is therefore ultimately the result of the decade-long Maoist insurgency, even though there is some way to go for these changes to be institutionalized and fully implemented.

However, the still weak organizational capabilities of the main parties in Nepal can constrain the institutionalization of inclusive politics in Nepal. Most major Nepali political parties started life as underground movements and organizations and hence while being relatively well organised in some respects (the NC is the weakest of the three) they also tend to be heavily centralised (Hacchethu 2006). Like political parties in other developing countries, Nepali parties are primarily coalitions of informal and personalized networks linking

powerful political organizers to their supporters through networks of patronage. But the role of intermediate class organizers within these parties appear to be *relatively* less developed compared to other South Asian neighbours. For instance, the parties still continue to be dominated by Brahmins and Chhetris despite two of the main parties being avowedly Communist. This is also a feature of Left parties in neighbouring India and reflects the fact that the educated traditionally come from higher castes. However, after years of political competition, lower castes play critical roles as powerful organizers in all parties in India and have led many parties and state governments. This is very likely to gradually happen in Nepal. Indeed Nepal has its own history of local collective action and mobilisation, for instance through the Forest User Groups, and more recently benefit sharing in hydel projects. Mobilising disaffected groups has clearly become relatively easier over time (Chapagain and Sanio 2012). The diverse social groups who have gradually become mobilized present challenges to the mainstream political parties if they attempt to restrict their rent allocation strategies to upper caste clients to too great an extent, including the Madhehsi parties (Prasai 2007).

One reason for the extreme political instability that we see is due to the intensely factionalised nature of Nepali political parties. All major political parties have two, or sometimes, even three power centres and the conflict between them is often the reason why governments change so rapidly. This in turn reflects the weak institutionalization of power relationships within parties, and the relatively limited role of organizers within parties in mobilizing supporters, reflecting the fact that parties have largely operated in semi-underground conditions. Factionalism and infighting have been particularly characteristic of Nepali Communist movements. This highly factionalised politics leads to governments, or factions in power, having a short political horizon, affecting their strategies of rent capture. Governments or the factions forming governments have internalised that their tenure is likely to be short as other factions (and opposition parties sensing opportunity to destabilise governments) mobilise.

Till party organizational structures become stronger, intra-party factions in Nepali parties are likely to be more fluid and local rent distribution conflicts within ruling elites can result in coalitions breaking down rapidly (Hacchethu 2006). Instability and contestation are also driven by the fact that the current electoral system uses a combination of first-past-the-post and proportional representation (PR), which gives party leaders considerable leeway in drawing up the list for the PR voting. This can result in candidates being dependent on individual party leaders and serving their narrow political interests rather than representing and responding to their voters (Asian Development Bank 2012).

The weak organizational capabilities of parties in Nepal means that deals between leaders are not based on rent-sharing arrangements between organizations to the same extent as

most of South Asia. Deals can happen quickly, and can be reversed equally quickly. Informal agreements between parties are important in all developing countries but their sustainability depends on whether the leaders actually represent the interests of the underlying organizations. For instance, in the Indian state of Tamil Nadu, informal rent sharing arrangements between competing political parties allowed long-term investments to be made in the 1980s and 1990s as investors knew that rival parties had the organizational structures to make deals stick (and that enough people would benefit within the parties to make this happen). As a result, investors were confident they would not be hurt when power changed (Roy 2013). This is because the Tamil parties have powerful networks of organizers within them, and the deals gave significant benefits to large sections within both parties. However these deep organizational structures appear not to have yet emerged in Nepal. As a result, deals between leaders of current Nepali political parties are less stable because they are not based on agreements both *within* and *between* powerful and relatively structured organizations. Secondly, of course, Nepal does not yet have enough productive firms that could have created pressure on politicians to reach informal agreements to share rents and agree on common policies and institutions to sustain long-run growth.

6. Regional Geo-Politics and Nepal's Political Settlement

- *Nepal's geo-strategic position between China and India more a hindrance than an advantage*
- *Indian intervention has of late been high handed, for instance the blockade*
- *China has stepped up investments and influencing activities*
- *India-China competition will have significant impact on Nepal but the challenge for Nepal is to ensure this is a positive impact*

Nepal occupies a geographical position that is somewhat unique. While there are many landlocked countries few have are in a situation where their immediate and only neighbours are rising competing powers like India and China—one already a superpower, the other a regional power. This puts Nepal in the position of having to navigate two powerful neighbours with diverging and conflicting geo-strategic interests, and this has a direct effect on the Nepali political settlement. Historically India's involvement with Nepal has been closer than China's and the former considers Nepal its bailiwick. Nepalis are allowed to freely work and reside in India and even serve in the Indian army. However the faster rise of China and its obvious dominance globally and India's attempts to micromanage Nepal have changed important elements of this relationship.

China's competition in the region, including in Nepal, elicits reactions from India which are not always predictable. Coupled with this is the fact that just as China under Xi Jinping is

moving towards a more authoritarian strategy of control and a more robust foreign policy, moves in a similar direction are also happening within India under the right wing Bharatiya Janata Party. The BJP's Hindutva ideology has already deeply affected politics in India and has found resonance in small but potentially influential sections of the Nepali upper caste elite, including some leaders in the NC. The UML too would not want to completely alienate this constituency. Only the Maoists have rejected Hindutva openly. Sections of the RPP leadership with their support for the monarchy and a Hindu Nepali state are openly sympathetic to the BJP's ideology. What is new and therefore unpredictable in the Nepali-Indian dynamics now is the role Hindutva can play in Nepali politics. Indian interference in Nepal has always been high but never has an attempt been made by an Indian ruling coalition to frame its involvement using Hindutva ideology. Interestingly it seems the Chinese are also backing the Communist parties in Nepal now as they feel these parties will be more ideologically sympathetic to 'Communist' China.

Nepal has become more important for the two countries because of the threats they perceive from each other. India sees Chinese strategies in the region such as the Belt Road Initiative (BRI) as an overtly economic but covertly political strategy to encircle it on all sides. The Chinese see India's increasing co-operation with the US as a threat to its position in the region though qualitatively and quantitatively US-India co-operation is nowhere close to the BRI in its significance. Nepal itself has tried to weigh these relationships by seeing India as an 'erstwhile strategic protector' and China as a 'new (and far richer) investor' (Basu 2017). Culturally though a sizable portion of the Nepali population shares closer ties with India than with any other country in the region and the open borders between the two have remained despite other borders closing up in South Asia.

Historically, there have been close personal relationships between the political leadership of Nepal and India, many of whom were classmates in universities. Examples include the case of Sitaram Yechury of the Indian Left and Baburam Bhattarai a Nepali Maoist who met as students in Delhi. Or ex-Indian prime minister Chandra Shekhar and one of the pioneers of the NC, BP Koirala, who met in Varanasi. At different times, NC members were in exile in India and senior Maoist leaders got safe passage into India. Shekhar attended the first ever meeting of Nepali political parties after multi party democracy was restored in Nepal in 1990. Yechury along with DP Triptahi, another Indian politician were the interlocutors (not always official) on the Indian side negotiating with the Maoists and the NC at the height of the insurgency. The two even attended the first session of the reinstated parliament in 2006.

Table 7 Effects of the 2015-16 Blockade

Product	Daily requirement	Volume imported during blockade	Share of supply (%)
Petrol (KL)	787.6	278.5	35.4
Diesel (KL)	2,525.24	949.5	37.6
LPG (MT)	707.67	284.3	40.2

Note: KL are Kilotres and MT is a metric ton.

Source: Post Disaster Assessment: Blockade 2015/16, Nepal Economic Forum and Alliance for Social Dialogue: Table 7

This warmth is however firmly in the past now. After 2015, Nepali-Indian ties have slid precipitously after India forced a five-and-a-half month long economic blockade on Nepal to support Madhesi demands for increased representation focusing around the creation of provinces and the demarcation of borders for Province 2. The blockade was costly for Nepal as Table 7 shows, with supply lines disrupted and prices of essentials such as petrol shooting up. Inflation in the period between September 2015 and February 2016 averaged 12 percent. This was the third blockade (there were blockades in 1969 and 1989) of Nepal by India but anti-Indian sentiment this time round is likely to be sustained for longer given growing overtures from China. Nepal’s relationship with India has always been tinged with asymmetry, sometimes exploitative and sometimes perceived to be so, but the timing of this blockade by Indian leaders could not have come at a worse time for India. The main beneficiaries were Indian traders and smugglers, Nepali customs and other officials and even some powerful Madhesi political leaders who captured significant rents from informal and illicit trade during this period.

Historically India has been deeply involved in Nepal’s politics, sometimes playing ostensibly positive roles as in 1950 (ousting Rana rule), 1990 (reinstating multi-party democracy) and 2006 (the signing of the CPA). However, there is also plenty of anecdotal evidence to suggest India has also been covertly involved in interfering in Nepal’s electoral politics and its support for the Madhesi movement has been open. While the blockade laid bare the extent of India’s support for the Madhesis at the time (though since then there have been reports that the Madhesi parties were nudged to participate in the elections by India) it also exposed another weakness in recent Nepali-Indian relations—the lack of pragmatic informal back channels, a cornerstone of most successful diplomatic relationships. In the days of Yechury or Shekhar this was possible. The Indian political leadership and both the Nepali elite as well as leaders in exile had informal contacts that could be called upon to defuse hostile situations. According to quite a few analysts this is no longer the case in the current dispensation. Instead, informal backchannels during the blockade included so-called gurus or ‘godmen’, not seasoned politicians with foreign policy experience.

The changed dynamic in Nepali-Indian relations mirrors the rise of fundamentalist right wing politics in India. The new Chief Minister of Uttar Pradesh (UP), Yogi Adityanath, is a hard-line fundamentalist and former head of a Hindu seminary in Gorakhpur close to the Indian border with central Nepal. He is known to have provided active support to the Madhesis. The seminary is also linked to the Nepali royal family. There were reports in the Indian media that Birendra was a devout follower of Avaidyanath, a mentor of Adityanath and it was at the former's behest that Nepal continued being a Hindu state in the constitution of 1990 (Chaudhury 2017). Right wing Hindu nationalist organizations like the Rashtriya Swayamsevak Sangh (RSS), a powerful organization espousing Hindu militancy, have long been trying to influence politics in the Terai region. While one motivation of this strategy is in keeping with the RSS' incongruous vision of a greater Hindu India beyond its current borders, another is to keep in check the ostensibly growing number of madrasas in the Terai in Nepal. A more recent target seems to be Christian missionaries in Nepal. The RSS, which serves as the ideological fount for the BJP has similar antagonistic relations with the work of missionaries in India. The chief ministership of Adityanath has the full support of the RSS in UP and is close to the deposed king Gyanendra. Gyanendra has recently made statements to the effect that the time has again come for him to provide leadership to Nepal. There has always been a section of the population in Nepal who support the restitution of the monarchy and of Hinduism as the state religion but since the CPA they have found little place in the mainstream. But with ideological Hindutva tailwinds blowing in India, this section could become stronger over time. One factor that may block the progress of this trend is that the cultural strands of Hinduism prevalent in Nepal, especially among indigenous population like the Tharu, are very different from the upper caste version of Hindutva.

The changing dynamic with China is also important as that country is also becoming much more involved in Nepali electoral politics. It is already involved in joint military drills and organising high profile seminars on politics in the region. This level of involvement is new. Recent developments indicate Chinese involvement has gone a step further and moved into political territory India considered its own. According to some observers the coming together of the Communist parties in the country was at the behest of China which was wary of an NC government in the next election. The NC has traditionally been more India-friendly and the UML has leaned towards China. Earlier the Chinese would work with whoever was in power. This signals a shift in China's strategy in aligning Nepal's domestic politics with its geo-political interests.

Nepali politicians are not necessarily passive recipients of external attention. They have used India as a whipping boy to serve populist sentiments during elections. The same politicians have also used Indian support when necessary. After the blockade there is much more credibility to their anti-Indian positions. From China's point of view the electoral

arrangement between the UML and the Maoists helps them consolidate a more friendly government. Calculations based on numbers from local government elections suggest a pact between the UML and the Maoists could work well. And contesting on an anti-blockade/anti-India platform may also be popular, enabling the Chinese to make use of this window. This could make India even warier of encirclement by China and may result in concerted attempts to counter Chinese influence with Hindutva as a means of creating new pro-Indian coalitions in Nepal.

The investments and opaque transfers of funds from these competing powers to influence Nepali politicians and parties are likely to provide important sources of rents for Nepali political organizations over the coming years. Competition based on economic investments is likely to benefit Nepal by reducing the cost of capital and accelerating infrastructure projects, though they may not always be the best projects or be efficiently executed. Their real aim may be to create rent-capture opportunities for political parties in Nepal as a way of gaining influence. But more covert flows of finance directly into the political process cannot be ruled out. These too are also likely to affect the internal distribution of organizational power in Nepal and we are already seeing some indications of this. The concern for Nepal is that India's likely response of pushing Hindutva might have damaging long-term consequences. The Hindutva strategy is unlikely to fully succeed in Nepal for the reasons mentioned earlier and is also likely to be resisted by a section of the Indian bureaucracy that is against aggressive ideological interventions. But nevertheless the China-India competition could end up creating new instabilities in Nepal.

7. Future scenarios

- *The evolution of the political settlement depends on how power is devolved in the coming years*
- *We identify two different trajectories in the evolution of the political settlement, one based primarily on devolution to local governments, and the other primarily to the provinces*
- *The nature of rent management and prospects for inclusive growth is likely to depend on the trajectory that emerges*

The political settlement approach tells us that substantive changes in institutions (and therefore in the rents they allocate) are not possible without matching changes in the distribution of power. If the distribution of rents and the distribution of power are not matched in sustainable ways, either the formal institutions will be pushed back by counter-mobilizations, or the formal institutions will be informally modified through corruption and clientelism to deliver to the powerful. In Nepal, the social movements of the past decades have opened up an opportunity because they challenged the pre-existing distribution of power and brought about a recognition across society that institutions should reflect these

aspirations by delivering some rents and greater opportunities lower down the social pyramid. This opens up the possibility of institutionalizing some of these changes. The challenge is to ensure that institutions evolve in ways that consolidate these changes in *progressive and sustainable* ways instead of creating unsustainable rent distributions that result in counter-mobilizations.

Sustainable in this context means that institutions should not only allocate rents to groups lower down the social pyramid, they should also help them to become more productive, with the capacity to create jobs, so that their claim to rents is soon based on sustainable economic power and not just on the more transient voice and power that mass *andolans* have given excluded social groups and their political representatives. Without such a sustainable institutional consolidation, the potential for inclusive institutional changes may soon be lost, and what is worse, the disappointment that ensues may result in a repetition of strife in the future. The sustainability of institutional outcomes is by no means pre-ordained, as we discuss in the next section. But a reading of Nepal's political settlement does provide evidence that a broader range of socio-political forces are now at play, and if their organizational power and demands for rents can be consolidated with progressive rent allocating institutions, the changes may indeed be sustainable. However it must be stressed that at the time of writing the first phase (provincial) of the two-phase elections have been concluded with the next one due in early December. While some pre-election alliances have been made, new alliances could emerge later and old ones could unravel. Our evaluation of the likelihood of the scenarios is based on alliances that are so far known.

Some of the political parties and leaders that led the mobilizations and the insurgency, including much of the Maoist leadership, have now become 'mainstream'. But the nature of their 'reversion' needs to be understood. There was never a realistic possibility of institutionalizing a Maoist revolution in Nepal along the 1950s Chinese model. But the Maoists have mobilized new groups in society, and many of their leaders realize that totally disregarding these social forces will be counter-productive to their own ambitions. This configuration of organizational and political forces and the opening up that has happened makes us somewhat optimistic that the post-conflict peace is not a return to business as usual, and indeed a good time to push for a broad-based and productive economic agenda.

The direction in which devolution may proceed in Nepal will have important effects on the future direction and consolidation of the Nepali political settlement. There were some moves towards devolution in the Local Self Government Act in 1999 which expanded the mandate of local bodies and devolved substantial powers and budgets to local governments. However this mandate was difficult to institutionalize because institutions and political power were not aligned (Prasai 2012). The transition was impeded by the fact that the tenure of the locally elected representative expired in 2002, after which the central

government that was still very authoritarian simply authorised civil servants who were posted in the local area to run the functions of these local bodies. Their lack of effective power and legitimacy in the regions meant that bureaucrats had to informally work with local political elites. But this informal relationship between bureaucrats and politicians without strong organizations allowed damaging rent capture by the individuals involved and was not very developmental.

In 2009 a mechanism called the All Party Mechanism was formally implemented where local political elites, not just from the political parties, would formulate local policy by consensus. Unfortunately, while this structure intended to provide greater representation of diverse interests, it morphed into new forms of collusive rent capture by local elites. These APMs were disbanded after an investigation by the government but “their presence and influence in one form or another continues unabated” (Prasai 2012).

As the debate over the forms of devolution is by no means over, the evolving institutional structures will have important effects on the level and sustainability of the distribution of rents at local levels. At one extreme, the institutional structure for distributing rents could be decentralized but the distribution of power within party structures could remain centralized. If this happened, the ultimate rent allocation decisions would continue to be made in a centralized way but would be delivered through formally devolved institutions. This arrangement would not satisfy new mobilizations that see devolution as an opportunity to exercise their voice and organizational capabilities. This outcome would very likely be politically unsustainable in the longer term.

At the other extreme, there are various possibilities of effective devolution where the devolution of formal institutions is associated with the greater political power of provincial or local political organizers within political parties. In this case more of the rent allocation decisions will effectively be made in response to local power balances but sustainability will depend on whether the institutions and rents deliver development. When the first constituent assembly failed to come up with a constitution, a second constituent assembly was set up in 2013, and the 2015 constitution recognized the growth in the power of intermediate classes and the socio-cultural differences across Nepal. The assembly proposed a devolution of powers in implicit recognition of the changes in the distribution of power that had come about. Beyond that, much of the detail will depend on ongoing negotiation and experimentation.

We believe there are two broad scenarios of effective devolution, one primarily to local governments and the other primarily to provinces, with different implications for the sustainability of developmental outcomes. They define two different potential trajectories for the Nepali political settlement. In reality there may well be some mix of the two, but it is useful to discuss them separately at this stage. The two trajectories reflect differences in the

evolution of the distribution of power, and are tracked separately in Figure 4. One effect of any pattern of devolution may be that the systems for implementing developmental policies may become more difficult to coordinate and manage. For instance, if local politicians and bureaucrats become more powerful, they may also have a voice in the implementation of health, education, infrastructure and other projects. This *could* mean better accountability and control over projects, but could also mean that additional margins are deducted at local levels from the resources available for policy implementation. Moreover, resource allocation conflicts at the local level may also slow down implementation. However, there are reasons for believing that some forms of devolution can have positive dynamic effects on inclusive growth.

In Scenario 1, where the devolution primarily benefits local governments, it may paradoxically be easier to achieve greater central monitoring and coordination of these rents given that any individual local government is unlikely to have huge holding power. At the same time, as a result of greater inclusion of a variety of interests at the local level, the collective of the excluded will be more diverse and less disruptive. Hence we hypothesize a move of the political settlement towards the upper-left in Figure 4. If institutions can be designed to consolidate this distribution of power by allocating rents that are more inclusive at this level (therefore satisfying political demands) while generating a growth in productive capabilities (achieving economic stability), the institutions of devolution may support inclusive growth and be sustainable.

In Scenario 2, provincial governments become more powerful and outcomes will depend on the relationship between parties in power in the provinces and those at the centre. Identity-based parties are likely to get stronger. In the conditions of Nepal, with the mobilizations in two provinces being identity-based, the central coordination of lower-level rent allocation is likely to be more difficult. In such a context, other groups that perceive they have been excluded are likely to follow suit and demand ethnicity-based devolution. Hence we plausibly hypothesize a move in the lower-right direction in Figure 4, with greater contestation of ruling coalitions by excluded groups as well as reduced coordination and control over lower-level rent allocations in the hands of new clientelist networks at the provincial level. These outcomes for local versus provincial devolution are plausible given our assessment of the current organization of Nepali politics and the links between identity-based parties and demands for provincial rights. We are not saying that provincial autonomy always has this effect. A scenario where the NC and the Maoists come together looks almost impossible now but that could have had more positive outcomes for provincial governments and the growth of province-based entrepreneurship.

As the relevant institutions have not yet been established, the winners of the next election or the next few elections will be critical in determining the direction of travel in Nepal. The

first scenario is fortunately the most likely direction of travel because it aligned with the interests of the UML-Maoist coalition, which currently has a higher chance of winning the elections. If they win, they may push for a devolution primarily to local governments. The Maoists have not done as well as they had expected in the last round of elections but they are still strong in the western Terai, and the UML are strong in the hills. In the first constituent assembly the Left wing parties had close to a two-thirds majority. There is therefore a good likelihood of the combine winning. In this scenario, given that the UML was initially not in favour of strong provincial governments, devolution is likely to primarily benefit local governments, many of whom could be run by the Communist parties in this scenario. Relations with the Madhes, however, might be more problematic if the Madhesi parties win in Province 2. Depending on their margins of victory, the Madhesi parties might feel confident enough to take on Kathmandu and demand more powerful provincial governments. While the Maoists have supported Madhesi demands in the past they might not be willing to oppose the UML right away. The same would be true of identity-based provincial demands by the Tharus for province 5, though their mobilizations have not been as successful as Madhesi ones.

Nevertheless, recasting over 3000 village development councils into 744 local governments is likely to be difficult, but with the UML's support for local government this might be a better-managed process. On the other hand, even if they win, the two left parties may fall out over specific issues leaving the new parliament fractured. History has shown that the Left parties have often not been able to make good their alliances, so this optimistic scenario is by no means assured. One of the three Left parties that joined the coalition has already broken away at the time of writing.

A less likely but also less favourable outcome for Nepal would be devolution primarily to the provinces. This would be a likely scenario if the NC wins with the support of the RPP and Madhesi parties. This scenario too faces political challenges. The NC will have to perform a balancing act as its coalition partners would lean towards India, especially the RPP, while anti-India sentiment is still relatively widespread. It will also have to deal with a more demanding China while meeting Indian demands. This tensions could make Nepali politics more unstable because the NC will not be able to refuse Chinese overtures. The UML and Maoists will also offer a strong opposition and the NC's coalition allies would be in a stronger bargaining position making politics more intensely competitive.

This scenario gets even more pessimistic if under pressure from the RPP, the NC openly embraces right wing and exclusionary Hindu politics. The government would then also have to deal with dissatisfaction and possible unrest among those who oppose a formal Hindu tilt in governance. The RPP has been successful in driving its Hindutva agenda in some Terai districts and this success could make it more ambitious. The NC also has a fairly strong

Hindutva lobby with the backing of some leaders. The sustainability of this direction of travel may depend on the Indian general elections in 2019. The export of Hindu political ideology from across the border will depend on whether and how strongly the BJP comes back to power. Of course, India will still try to be heavily involved in Nepal but a non-BJP government is unlikely to use the divisive Hindutva card.

In both scenarios, the chances of violence breaking out again are fortunately relatively slim. However, pockets of regional unrest are possible, for instance there may be tensions if the Communists win in Kathmandu and the Madhesi parties win soundly in Province 2. The Communists are wary of strong provincial governments because they fear that this can strengthen identity-based politics. The contestation over the demarcation of provincial boundaries that divide Tharu and Madhesi populations is already a strong signal that the majority of the political establishment is wary of identity-based provinces. The success of this evolving federal structure will depend on how well the Nepali political establishment navigates the division of powers between Kathmandu, the provinces, and local governments.

A third, less likely, scenario where the NC and the Maoists come together could imply more positive outcomes for provincial governments and the growth of province-based entrepreneurship. In case of a post-election realignment resulting in an alliance between the Maoists and the NC, a possible outcome could be stronger provincial governments. The NC have been somewhat suspicious of NGOs at the local level perceiving them more as a support base the UML draws on. The Maoists do too, but in case of an alliance the NC might prevail over the Maoists to give more powers to provincial governments. Since the NC sees NGOs playing a key role in local politics it could keep in place the policy currently being planned to regulate NGOs by making it mandatory for them to seek the permission of local bodies for their activities. The NC is strong in urban areas and this could nudge them to develop larger provincial cities as commercial hubs and invest in urban management. This could however, also lead to more mobilizations based on identity than in the case of an UML-Maoist alliance. The instrumentalisation of Hindutva could also follow, depending on how well the RPP fares in the next two rounds of elections. In terms of foreign policy the alliance is likely to lean towards India. The recent rescinding of the agreement signed with the Chinese to develop the Budhi Gandaki hydropower project by the current NC government would seem to point in that direction (though it was Dahal's government which had given the project permission).

8. Rent Management Challenges for Inclusive Growth

We now bring together our analysis from previous sections to revisit a number of important rent management challenges in Nepal. Some of these challenges are imposing significant costs on the Nepali economy and the prospects for inclusive growth, but they are not immediately amenable to policy reform given the characteristics of the political settlement. Others are both important in terms of impact as well as being feasible to address with smarter policy design, particularly by taking advantage of the opportunities opened up by changes in the Nepali political settlement. Our underlying theory of change is that we should begin by focusing on potentially high-impact reforms that are feasible because their success in opening up the development of inclusive growth opportunities will actually make other rent challenges easier to address later.

This section sets up the policy implications of our analysis. We look at some of the important types of rents that we identified earlier and their implications for inclusive growth. These include the rents associated with the remittance economy, the rents associated with trading that are captured by financial, trading, and transportation syndicates, the demands for political rents and the challenges and opportunities this can create, collusive rent capture by powerful politicians and linked bureaucrats and businesses, the rent transfers driven by the intensifying regional competition between India and China, and finally the critically important area of developmental rents, particularly those that aim to support the diversification and extension of productive capabilities. We conclude that the last area of rent management offers the most attractive combination of feasibility and impact, particularly if the evolution of political rents proceeds in the direction of greater devolution to local governments. Other less important sources of rents are not discussed at length. For instance, historically, rents from the exploitation of natural resources like timber were important in Nepal but have declined in significance. Taxing and transferring incomes potentially creates rents but the tax take from internal sources is still low in Nepal. Other sources of rents can be very important at a localized level. For instance, syndicates and cartels, especially transport syndicates, have extracted rents by organizing different types of monopoly, often with direct or indirect political support.

The opportunities and challenges around each type of rent depends on how these rents are being 'managed' given institutions and policies, and the characteristics of the relevant organizations affected by these rents, which are described by the political settlement. Rents are created through particular institutions and policies, and these, together with the contestation of organizations over these rules determine how rents are actually allocated, who gets access to them, how they are used, and the conditions under which they may be lost. These features describe the *rent management system* and determine the economic and political *outcomes* that emerge as a result: whether the organizations receiving the rents deliver the goods, services or capability improvements, or the political stability that may

have justified the rents, or whether the rents are absorbed without any results, or indeed with damaging outcomes, which we describe as unproductive rent capture. Some rents, of course, are not intended to achieve any productive or political stability results, and are more in the nature of extraction from society by powerful groups. In all cases there is an explicit or implicit set of *rent management* institutions and organizations that can explain particular outcomes. Feasible reform strategies need to ask what would need to change in this set of rent management institutions and organizations to achieve better development outcomes, and whether these changes are feasible given the political settlement.

Rents linked to the remittance economy

While remittances have contributed to poverty reduction, they have also distorted aspects of the economy and made industrialization and domestic job creation more difficult. Remittance inflows are not directly rents. But the institutional management of these flows and the conversion of foreign exchange remittances into Nepali Rupees has created massive rents for politicians, the banking system and organizations involved in imports. The simplest way to understand this is as follows: Nepali workers overseas earn incomes in say dollars and send it back to Nepal. The dollars go to the central bank, the Nepal Rashtra Bank, which keeps the dollars, while relatives of foreign workers are given Nepali rupees. But the Nepali rupee is somewhat overvalued, because it is pegged to the stronger Indian rupee at a fixed rate. As a result, importers and businesses who then get access to the dollars from the central bank at the official exchange rate can use it to import products that they can sell at a significant margin in the domestic market. An overvalued official exchange rate implicitly transfers income from those who earn foreign exchange (in this case Nepali expatriate workers) to those who spend or mediate the spending of the foreign exchange (including the financial system, importers, wholesalers, retailers and so on). This is a significant source of rents for all these organizations, even if some of the mediation is quite complex. Arguably, the final consumers of imported products also benefit somewhat from the overvalued currency, but the lion's share of the benefit is captured as rents by different intermediaries because of syndicates and market power, discussed in the next section.

The scale of the easy rents from remittances mean that the damaging policies and institutions that sustain and manage these rents are difficult to reform. These include in particular the overvalued exchange rate and the damaging effects this has on export-oriented industries. It may not be stretching the analysis too far to say that it is not only the middlemen in the labour export business who have an interest in sustaining high rates of Nepali labour migration. A broad range of other powerful interests are implicitly interested in the same thing because of the lucrative nature of the rent intermediation. Moreover,

exporting large numbers of workers reduces political pressure for the difficult tasks of creating domestic employment. The danger, of course, is that a shock in labour importing countries can result in large numbers of Nepali workers suddenly returning, which would be truly destabilizing for the country.

Our assessment is that the rents associated with the remittance economy are very significant in Nepal, given the scale of remittances and even a moderate overvaluation of the Nepali Rupee. The use or misuse of these rents by the organizations that eventually capture them, like traders, political networks, banks, and other intermediaries is actually *not* the main problem. An even more important problem is that these rents are underpinned by institutional and policy arrangements that damage the economy through the persistent overvaluation of the currency and the subordination of policies supporting domestic employment generation. Addressing these underlying problems is likely to face resistance from the beneficiaries of these huge rents. These beneficiaries are very diverse and are likely to be linked to many different political parties in different ways. Reforming the system may therefore be quite difficult given the competitive clientelist political settlement.

This is a difficult problem because a number of things need to happen in parallel for reform to be beneficial. Nepal needs to achieve a combination of lower import dependence, greater domestic production and employment, lower outmigration of labour, all underpinned by a gradually depreciating currency. Trying to achieve the latter without the other components will not work as it will be inflationary and reduce living standards. But the achievement of more domestic production and industrialization also requires moving towards a more competitive currency. If this transition can be achieved, the coalitions capturing rents from remittances and trade (next section) will economically lose out to new coalitions engaged in domestic production. This can be sustained if the latter have growing power and influence as a result of the wealth they generate. They may be able to take on the former, providing the transition happens gradually. Therefore, while it would be wrong to see the policy challenge as one of immediate devaluation, a *gradual* devaluation of the currency may be an important part of a policy package that includes effective strategies of industrialization and domestic job creation. This would require, but only as part of the package, a strategy for loosening the link between the Nepali and Indian currencies, perhaps by moving from a fixed peg to a band-based peg.

Trade-related rents

As a land-locked country with a unique combination of almost open borders with India that are difficult to police, as well as formal tariffs on many goods, Nepal faces particularly difficult problems in collecting customs duties and preventing a major leakage of these potential taxes into informal rents. These conditions create significant opportunities for

trade related taxes to be captured by a variety of informal political, bureaucratic, trading and transportation networks as informal rents. These rents are captured through the collusion of transportation and trade syndicates, public officers involved in border control and customs, and formal and informal political networks. The sharing of a part of these informal rents with political networks contributes to making enforcement difficult. The informal rent capture in trade is not just a loss of formal revenues for government. It creates a problem for domestic industries that are ostensibly supposed to be protected by these tariffs. Smugglers can undercut the tariff protection sufficiently to make emerging domestic industry suffer while also raising their transaction costs in trade because of corrupt practices at border posts and the syndication of trade and transportation networks. The joint effect is adverse for domestic producers *and* consumers.

As we saw earlier, trade with India provided significant rents to Nepal when India was a controlled, protected economy. At that time Nepal had relatively few restrictions on imports and Indian traders could buy goods in Nepal unavailable in India and sell them across the border with high margins by evading Indian customs duties. Nepal is no longer the entrepôt economy that it was before the liberalization of the Indian economy when it benefited from the 'customs arbitrage'. Indian liberalization and the relative strength of the Indian economy have now become a constraint on Nepal's economic growth as it creates perverse incentives to invest in syndicates to maintain oligopolistic trading ventures to control the flow of imports and extract value from Nepali consumers. The overvaluation of the Nepali currency allows trade to be used to extract rents, with trading syndicates importing products that are cheap at the border in terms of Nepali rupees but that can be sold on at higher mark-ups in Nepal to capture rents. The rents that can be captured are even higher if customs duties on the Nepali side are evaded. The combination of oligopolistic trading and transportation syndicates using market power, an overvalued exchange rate and customs evasion adds up to the potential of capturing very substantial rents through trade, at considerable cost to consumers, the government budget and domestic industry.

Some estimates from a decade ago suggest that illegal and informal trade with India could be close to 40 percent of the total trade between the two countries (The Himalayan) and not much has changed since then. A recent report by the South Asia Watch on Trade Economics and Environment (SAWTEE) provides some data illustrating the scale of this issue. The study shows, for instance, that twenty percent of seeds that Nepali farmers use arrive through illegal channels or smuggling. Fertiliser is another item smuggled regularly. Diammonium Phosphate (DAP) costs NR 46-48 at border markets, especially Birganj on the Nepali border, the location of choice for both illegal and formal trading. The same product sells for between NPR 36-38 in Indian markets (Post Report 2017). The difference in price shows that traders were not just capturing the overvaluation rent, and possibly the unpaid customs duties, but also adding a margin based on market power created by syndication.

The difference in the price of some seeds between the formally imported and smuggled markets was NPR 3, high enough for poor farmers to purchase from the informal trade. This difference reflects the fact that smuggled goods have not paid customs duties and some of this 'benefit' is passed on in lower prices and the rest captured by the smugglers, but prices in both the formal and smuggled markets are high because of other factors, including oligopolistic trading syndicates and artificial scarcities created by supply bottlenecks, which we discuss next.

It is interesting to note that there has been a recent concerted push for greater transparency of customs data and automated verification at customs points to reduce customs leakages. However, even if customs evasion can be reduced, this will not reduce prices in Nepal (and may even increase them), but may reduce the leakage of customs duties into informal rents. Apart from the market power of trading syndicates, there are other problems that contribute to create supply bottlenecks in Nepal. The most important is the fact that imports into Nepal are almost entirely dependent on Indian ports, and transportation by Indian trucks and railways to the Nepal border. Imports of DAP, for instance, are entirely reliant on ports in India, usually Kolkata and Haldia, which are notoriously inefficient. Consignments meant for Nepal are held up due to both inefficiencies at ports, but also local political rivalries between parties competing to 'control' ports. Addressing these problems is beyond the capacity of the Nepali state but exposes it to the vagaries of India's trading syndicates and its domestic politics. At the time of researching this paper a large consignment of fertilisers bound for Nepal was stuck in Haldia port at the height of the sowing season. It would not be wrong to assume that illegal channels for fertiliser imports would be the only option for farmers and that they would have to pay a huge premium.

A different and particularly distasteful type of rent associated with cross-border trade involves human trafficking. The illegal nature of this trade provides large rents for the organizers of these types of 'transactions'. Anecdotal evidence suggests that criminal activity in the form of trafficking of underage girls and young women to India and further afield, and the organization of surrogate motherhood, provide large sources of rents for mafia and politicians on both sides of the India-Nepal border. Hard evidence will always be difficult to collate but work done by anti-trafficking NGOs in Nepal like Maiti and others have uncovered evidence of a significant scale of activity. The nature of trafficking has also changed and no longer includes only sex workers but also illegal migrant labour.

Money laundering by criminal 'dons' or 'gundas' on both sides use fake product trading as a way of laundering money from other illicit sources. Margins are paid as rents to bureaucratic and political networks facilitating these activities. An emerging area of concern relates to money laundering on a bigger scale by external players through Nepal. We only

have anecdotal evidence so far, but this involves large foreign ‘investments’ that allegedly provide the cover to legalize and launder external funds that are then shortly afterwards transferred out of Nepal. Again, local intermediaries can skim significant rents by facilitating these processes. These flows are large and obviously unaccounted for but given that these activities involve political corruption on both sides of the border, efforts to curb them are likely to be unsuccessful and this has been the experience in the past. While controlling these damaging rents is likely to be difficult, in some areas public scrutiny and pressure, particularly in the case of trafficking and money laundering, can have an impact.

The Indian border is thus a source of complex rents associated with a number of overlapping policy and institutional arrangements. The latter create conditions that allow well-organized networks to capture informal and sometimes criminal rents. Again, our concern is not so much with how these rents are subsequently used, but rather with the distortionary effects of the institutions and policies creating these rents. These policies and institutions create direct social damage in the form of overpriced consumer goods, undermining of targeted protection for growing industries, the exploitation of women and other vulnerable groups through trafficking and so on. Of course, who captures the rents also matters because the rents reproduce the power of networks and organizations that are responsible for sustaining these policies and institutions. Some of these rents will therefore be difficult to address in the short run. However, some of the more egregious processes such as trafficking and some cross-border trades based on syndicates should be continuously targeted by public mobilization and pressure. The pressure is likely to be even more effective if domestic productive interests in emerging industries can be mobilized against smuggling that affects their businesses.

Political rents and the effects of devolution

The allocation of ‘political’ rents to powerful political organizations and networks is critical for maintaining political stability. Devolution will change the allocation of these rents. In developing countries, a large part of the rents for political stabilization are allocated through informal arrangements (Khan 2005). Getting these mechanisms wrong may result in excessively large rents being captured by political players, and could also fail to achieve political instability. Political arrangements and rent distribution mechanisms in Nepal have repeatedly been found wanting and have resulted in successive ‘*andolans*’ that have changed the distribution of power across political organizations over time. As these changes are still ongoing, the rent management challenges in this area will depend on how institutions evolve over time. In general, demands for political rents in Nepal are likely to increasingly come from lower levels of society and are also likely to become more intense over time. This is in line with patterns in other countries in South Asia. The hope is that

there will be changes in political institutions through forms of devolution that will be able to match these demands with mechanisms for delivering political rents to new constituencies. The longer-term risks and opportunities depend on the pattern of devolution, and in our section on scenarios, we discussed a number of possibilities, summarized in Figure 4.

There are reasons, however, to be optimistic because devolution of some types may allow better management of some types of developmental rent allocations. Devolved political structures may allow the allocation of rents to smaller entrepreneurs who are not politically connected to central political networks and who may therefore be easier to discipline at the local level (see Box 2). If devolution evolves primarily in the direction of local governments, there may be significant opportunities for achieving both a more inclusive allocation of rents with better developmental rent management. Political inclusion would also increase if a broad range of potential entrepreneurs at the local level had access to policy rents in the form of, say, enterprise start-up credits and other forms of support that would allow them to sustainably improve their incomes and create new jobs. If this inclusion strategy was combined with a system for managing these resources to create compulsions for productivity growth and achieving competitiveness (discussed in the last subsection), these rent allocations could achieve *both* political stability and inclusive growth.

Collusive rent capture

Low capability business organizations, networked with politicians with short time horizons engage in collusive behaviour and the extraction of damaging rents. Politicians with short time horizons are more likely to create rents that are quick to capture using strategies like market restrictions, padded contracts and so on for businesses connected to them. These types of rents enrich the beneficiaries and impoverish others. Low capability businesses have no other feasible way of making significant returns and are likely to spend much of their time scouting for these opportunities. In contrast, policies that aim to achieve structural transformations in the country, for instance by creating a broad productive base of entrepreneurs, also require the allocation of rents, but they have to be managed properly over time. A much broader group of beneficiaries are eventually better off, including the politicians and businesses, as the examples of South Korea in the 1960s and China in the 1980s show. Unfortunately, politicians who have limited enforcement capabilities and short time horizons are unlikely to pursue these types of policies very seriously, first because the benefits accrue over time, but secondly because they require intensive management and disciplining of beneficiaries. These politicians may nevertheless have enough clout and personalized links with well-placed bureaucrats, intermediaries and businesses to engage in collusive and damaging rent-creation.

The recent spike in investments in hydel power projects is (a relatively benign) example of how damaging rents can be created and captured by exploiting speculative investment opportunities. In this case the investment opportunities were real enough, but the organization of the process created rent capture opportunities that may have resulted in excessive investments in projects that were not economically efficient. Licences and contracts were granted for everything from conducting feasibility studies to allowing investments in hydro-power projects. But the licenses and contracts were transferred through intermediaries before being allocated to speculative final bidders at a higher price. Intermediaries with connections were able to collectively capture huge rents for projects covering around 30,000 MW of potential power generation, many of which will never materialize. A popular phrase capturing what was going on was 'jhola mein khola', or a little river project in every bag. The projects themselves were not always technically very efficient and sought to generate electricity at a relatively high unit cost. These may not have been the most desirable way of generating more power in Nepal given that the country is attempting to catch up on its manufacturing competitiveness with neighbouring countries. Interestingly, licencing procedures have since been strengthened as a result of public pressure, some of it around the management of the hydel projects.

Of late improvements in the supply of electricity have been the cause for some optimism in Nepal. One reason for the improvement is, however, that India has significantly increased its electricity exports to Nepal. In the last three years India's exports to Nepal have increased 2.5 times and is set to increase more by using two transmission lines in Katiya and Raxual in Bihar, whose construction has recently been completed. This was of course complemented by the work done by the director of the NEA Kul Man Ghising who was able to regulate electricity supply and reduce some of the illegal diversion of electricity. Two factors stand out here. Domestic Nepali electricity generation is still low, and this is of concern since Nepal has the potential to export electricity to regional countries rather than import it from India. Secondly, much of the good work done by Mr Ghising is not institutionalised and risks being reversed once his tenure is over. We will therefore only know after a few years if the combination of factors that have resulted in improvements in power supply are sustainable.

It may not be feasible to simultaneously address all collusive practices between politicians, intermediaries and investors in developing countries. This is why it is important to have a rents analysis that can identify the more damaging instances of collusive behaviour, where the policies creating the rents or the process of capturing the rents are particularly damaging. We also need an analysis of the likely drivers of corruption, to identify whether these can be feasibly addressed in that case, so that we can identify national anti-corruption priorities in terms of feasibility (Khan, et al. 2016). In the case of the collusive behaviour in the hydel power case, the process of rent capture may have resulted in significant resource

misallocation and directed resources into inefficient investments. An analysis of the processes behind the contracting also suggests that it may have been feasible to address some of these problems if there was public pressure for improvements in transparency in the awarding of contracts. Indeed, licencing procedures for hydel projects have been slowly improving.

However, damaging collusion is not always due to a lack of transparency. In more difficult cases, collusion happens because the colluding parties are powerful and those who lose out are unable to prevent it even when they know what is going on. This is often the case in developing countries. For instance, collusion between politicians and investors in the granting of mega projects in infrastructure development are very difficult to address through calls for greater transparency or improved procurement rules alone. These types of corruption and collusion are only likely to be significantly reduced when power in societies becomes more broad-based, and there are a large number of firms that could feasibly supply these services and which stand to lose as a result of collusive behaviour. This in turn requires the creation of a broad range of productive capabilities through inclusive growth, which is why we argue that the most important task for policy is to promote the spread of broad-based productive capabilities.

India-China competition and opaque 'influencing' rents

The intensifying competition for influence between India and China is likely to inject rents that may affect the balance of power between domestic parties. The emergence of China and India, and particularly the former, as partners with the capacity to inject different forms of rents into developing countries has raised new challenges across the developing world. In Nepal in particular, a variety of opaque resource transfers are likely, for instance using the project financing arrangements, or directly providing secretive rents for competing political coalitions and politicians that can tilt the funds available to different parties.

These inflows could take a number of forms and there are indications that some of these are already happening, allowing collusive rent capture by particular politicians or political parties. The most likely ways in which these flows may come in include big 'investments' in areas like hydropower and other infrastructure projects where intermediaries connected to particular political parties are deliberately allowed to make significant margins as intermediaries or business partners, with some of the rents captured then being passed on to political organizations. By its nature, these types of transactions are difficult to track in practice. Our intention in pointing this out is simply to identify a plausible possibility. Apart from the effects that such inflows may have on tilting the relative power of domestic parties and organizations, and thereby influencing or disrupting the political settlement, there is

also the possibility that the selection of the investments may not be determined on calculations of long-term efficiency or social benefit.

While rent inflows from India and China play a special role in Nepal, in the context of Overseas Development Assistance (ODA) China and India are still smaller players. Aid from western countries is relatively tightly controlled by the donors. They do occasionally have distorting effects on the domestic economy but development partners have become gradually better at mitigating these risks. The World Bank was the top multilateral donor and the UK was the leading bilateral donor in 2012-13, though the Bank's disbursements had declined from the previous year (IECCD 2014). Nepal also received a large influx of aid after the earthquake in 2015. Even in 2011 long before the earthquake, aid accounted for 22 per cent of the government budget (Banyan 2011). ODA can be a double-edged sword in Nepal, as in other LMICs that receive large sums of aid. Some donor interventions in health, education and communitisation of forestry in Nepal have been held up as success stories. However aid 'rents', 'NGO-isation' and interference in local affairs have also been a criticism of ODA-driven policies in the country. For instance in the 1990s donors in Nepal started pumping large sums of money into networks around community user groups. The leaders of these user groups and the NGOs in the local area soon became recipients of large sums which were captured by them. In 2011 the Economist reported that 60 to 90 per cent of aid in the Terai was 'misused' and captured by politically connected networks. The article goes on to state that any effort at curbing this by officials actually leads to protests by locals who depend on these incomes they accrue through their political affiliations (Banyan 2011). The latest increase in the inflow of aid has been due to reconstruction activities after the earthquake. These efforts have also come in for some criticism for their opacity and non-implementation. One reason for aid rents having a distorting effect in poor countries is that even small margins of capture provide political parties and powerful networks with resources they need to maintain their local patron-client structures. The implementation gets distorted (as we would expect from the political settlements framework) the more divergent the aid spending is from the interests of powerful local interests. It is important to remember that powerful local organizations could include organizations of poor people. Any attempt at ensuring transparency in the use of aid therefore has to be carefully designed, for instance by spending aid in ways that at least some sufficiently powerful local interests support as being aligned with their own interest.

Developmental rents and organizational capabilities

Developmental policies, whether delivering skills, health, education or addressing market failures create rents for different organizations and they have to be carefully designed if good results are to be achieved. Here we look at a specific type of intervention that we

argue is of great importance for accelerating the emergence of a broad-based inclusive economy. One of the most binding of all constraints limiting inclusive growth is that developing countries do not have a large number of organizations (firms, farms and so on) with the capabilities to organize production using modern technologies and large workforces. Countries that fail to crack the problem of creating broad-based organizational capabilities in its business sector cannot sustain inclusive growth.

When firms lack *organizational capabilities* they fail to achieve competitiveness even when they have access to finance to buy the appropriate machines and have access to skilled workers. The organization of competitive production systems requires a lot of ‘tacit knowledge’ (knowledge that has to be learned in practice) about how to organize factories, manage inventories, control quality, manage the value chain and so on. Organizations are not born with this tacit knowledge, they have to acquire it through difficult processes of learning-by-doing under continuous pressure to achieve competitiveness. Learning-by-doing has to be financed because a firm that is not yet competitive will effectively be making a loss by engaging in production. The extra finance required to operate at this time is not likely to be provided by banks or external investors because this investment does not create collateral that can back the investment (unlike buying a machine or a piece of land). Investments in learning are therefore subject to serious market failures.

The importance of supportive policies to accelerate the emergence of new firms in these contexts has been historically recognized by policy-makers. Strategies of supporting emerging enterprises have included protection using tariffs on imports, duty drawbacks, cash subsidies, and so on. Unfortunately this is an area where rent management often fails, and too many firms take advantage of protection to continue producing in inefficient ways failing to raise their productivity by putting in the requisite effort in learning. Emerging firms do need to have access to policy support, but the rents have to be conditional, and have to be *either* withdrawn rapidly if there is poor performance *or* only granted *ex post* to reward investments once performance has been established (Khan 2013b, 2013c).

Not surprisingly, traditional methods of support (tariffs, subsidies and so on) appear to have performed very poorly in Nepal. Each of these forms of support require the enforcement of specific monitoring and withdrawal rules to create effective compulsions to raise productivity and competitiveness. These rules are generally difficult or impossible to enforce in configurations of power where businesses are powerful but have low capabilities, and enforcement agencies are weak. These are exactly the configurations of power in the political settlement that we identified in Box 2 and Figure 4 in Nepal and so the poor results of these conventional strategies are not surprising.

Larger firms and conglomerates in Nepal are linked into political networks that make them hard to discipline. Moreover, policy support is delivered by bureaucrats who are also hard to

discipline and many of the incentives require the payment of bribes and much wasting of time, which significantly reduces their usefulness. As the enforcement capacity of the ruling coalition is weak and not likely to be significantly improved in the near future, it may be necessary to look for potentially promising SMEs in likely growth sectors as targets of industrial policy. The advantage of SMEs is that they generally use more labour-intensive technologies (and therefore are better for inclusive growth anyway) and are less likely to have the holding power to block rent withdrawal if they are underperforming. This is not always the case, and some SME firms in some sectors may be difficult to discipline. But as a general proposition, a shift towards SME sectors in areas like food and beverage production, garments and textiles, components production for the construction industry, service sector supply chains servicing a medium to high-budget tourism sector, and some niche IT sectors, may result in better rent management outcomes given the political settlement. The IT sector in Nepal lacks the scale required to be globally competitive, though it can still provide some meaningful employment if it attempts to serve the domestic market.

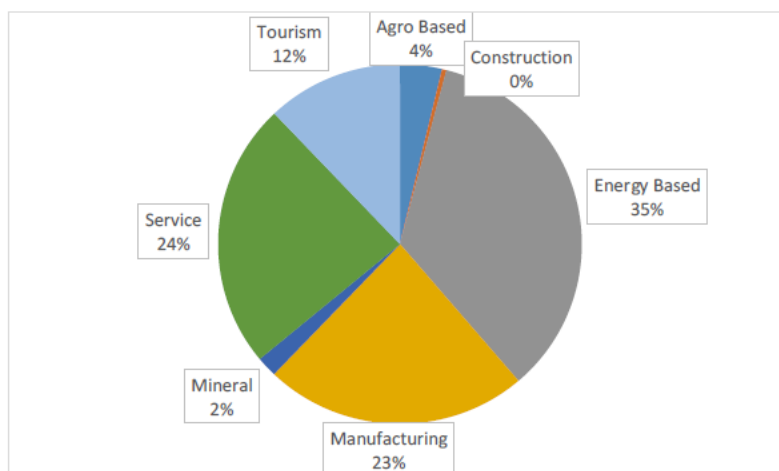
The low likelihood of disciplining the bureaucracy in delivering and enforcing conventional support strategies also means that we also need to look for other policy mechanisms. The experience of other successful learning strategies in South Asia suggests some possibilities. For instance, some remarkable successes have been achieved in Bangladesh and India based on partnerships with foreign companies to develop local capabilities, with the partners being rewarded *ex post*. Examples include the Bangladesh garments industry and the Indian automobile industry (discussed later) (Khan 2013b, 2013d; Black, et al. 2018). Because of the targeted nature of these support policies, significant bureaucratic capabilities were not required, though some specific capabilities may need to be developed for relevant bureaucratic agencies. These successes suggest that in South Asian political settlements, mechanisms of providing incentives to foreign investors to transfer capabilities to raise the productivity of domestic firms can work a lot better for capability development than financing domestic firms and trying to discipline them to force productivity improvements.

The selection of promising sectors where enterprise can be promoted also needs to be addressed. We believe this should be based on a pragmatic assessment of likely points of entry into global value chains, given current competitive capabilities, and domestic market opportunities in areas like tourism. We have not conducted a formal study of such opportunities for Nepal, but it seems plausible to us that the types of SME sectors referred to earlier would figure prominently. We do not believe it is possible to identify potentially promising sectors in Nepal using an arithmetic analysis of Revealed Comparative Advantage based on the export shares of particular sectors in Nepal relative to the world average (Balassa 1964)³. This is because in developing countries, particularly in countries like Nepal

³ This approach was recently used in an unpublished work on Nepal by Whiteshield Partners.

which do not yet have significant volumes of exports, small differences in the export performances of sectors are more likely to reflect differences in their rent capture abilities rather than revealing their underlying global comparative advantage.

The foreign interest in investing in Nepal offers opportunities of converting at least some of the FDI into this type of capability transferring investment. As Figure 5 shows, manufacturing seems to have been getting a fair share of overseas investment and a closer look at the sectors receiving FDI provides some direction for policy. Two of the more popular FDI destinations are cement and food processing. In the latter India is already a big player and Bangladesh has made an entry. This sector could have more employment potential than cement. Indian joint ventures, especially in food processing seem to do well in Nepal despite the sometimes fraught relationship between the two countries. More investments to serve the Nepali market would be an attractive option for Indian investors, and some of these investments could be structured to be capability transfers to Nepali firms for which the Indian or other foreign partner would be heavily rewarded. Indian investors are unlikely to use Nepal as a manufacturing base to supply the Indian market with food products because of higher wages and transport costs. But it is possible for Nepali manufactures to provide agro-industry products to India, Bangladesh and other regional markets based on product differentiation, cheaper agricultural inputs and so on.



Source: Xu and Hager 2017, Figure 4, Pg 19

Figure 5 Global FDI by Sector in Nepal: 2009-2014

China is another country that is making inroads in Nepali manufacturing, especially through its investments in the cement, energy and tourism sector. Tourism is also a sector with great potential in Nepal but little is done to actively promote it. The development of tourism requires the development of a coherent national strategy for the sector as high-value and backpack tourism cannot be simultaneously organized in the same venues. There is considerable potential for Nepal in both segments of the tourism market provided a coherent strategy and planning can emerge, and if domestic firms can be assisted to

develop high quality services in particular market segments. Here too, capability development strategies are required for spread effects in employment generation on a broad scale, but also combined with a plan for the sector as a whole so that developments in one segment do not hurt the development of another segment.

Vignettes of successful Nepali firm development

We looked at a number of vignettes of successful firm development in Nepal to get a better understanding of the processes through which successful firms emerged in sectors as diverse as garments, tea, and steel. These experiences of successful enterprise development in Nepal show that when competitive enterprises emerged, they did so without much assistance from policy. Moreover, overall there has been disappointing development of capabilities in modern industry and manufacturing. An interesting feature in a number of firm development vignettes that we developed for this study show that in all these cases much of the capability development happened through the participation of foreign firms, often Indian, who were paid to transfer capabilities to Nepali counterparts. This is exactly what happened in the Bangladeshi garments industry, referred to earlier, with capabilities transferred by a South Korean firm, and in the Indian automobile case, where capabilities were transferred by a Japanese firm and later the Koreans. However, in these cases, the capability transfers were more significant because they were assisted by policy rents while in the Nepali case the transfers were internally financed by particular companies with limited spillovers to other firms. The challenge for Nepal is to devise policy instruments that are based on a knowledge of what works so that broader swathes of firms can benefit from learning and capability development.

As part of our research we investigated a number of successful firms in sectors we identified as some of the promising ones where broad based manufacturing capabilities could be developed in Nepal.⁴ Our selected firms were a leading garments exporter, one of the country's largest tea plantations and processing units successfully exporting organic tea to western destinations, and a steel company which has grown to be a large firm in the construction materials sector. Our respondents spoke freely because we agreed to anonymize the results so we will report general findings rather than specific details. The three sectors were also chosen for their employment potential, their existing capabilities and their export potential. Nepal's merchandise exports are still very limited (USD 740mn) again underlining the importance of prioritizing labour-intensive export capabilities. Tea (along with spices and coffee) accounts for 7.9 percent of Nepal's exports, garments (excluding knits) 7.3 percent and iron and steel 3.8 percent. Tracing the evolution of these firms from their inception to their current successful status provided us with a micro-level

⁴ We acknowledge the invaluable assistance of Avinash Gupta for providing the material for these vignettes.

view of the constraints they faced and overcame. This 'descriptive understanding' is robust enough to confirm our findings because they are largely consistent with our theoretical expectations based on the experiences of other South Asian countries with similar political settlements.

In all our firms, the support provided to the firms by formal policies played almost no role in their subsequent success. Some policy rents were received without making any impact on learning but a large part also did not reach the firms at all because of corruption by bureaucrats. In all our firms, initial management and organizational capabilities were low and the firms struggled for a long time to acquire enough competitiveness in price and quality to begin to export. The corruption that distorted the implementation of a variety of support policies is the policy-distorting variant of corruption discussed in Khan (Khan 2006, 2014). In these variants of corruption the appropriate response is to pursue the policy objectives with a differently designed intervention to reduce the distortions caused by the corruption (as opposed to eliminating the rents, which is the appropriate response in other types of corruption). None of our three companies were politically connected to the extent that this allowed them to access significant rents. But political connections were frequently important for overcoming obstacles and corruption demands coming from the bureaucratic system. All our respondents reported they had trouble accessing sectoral incentives because of corruption, but they also did not appear to benefit from the incentives that they did receive, perhaps because the rents were not associated with any conditions that encouraged them to raise their productivity.

The three sectors that we looked at are all subject to specific problems faced by manufacturing sectors in Nepal. They are competing with Bangladeshi, Cambodian and Indian workers who generally have lower wages and work in firms that achieve higher productivity and product quality. Competitiveness is a function of productivity, wages and quality. A country can overcome the disadvantage of slightly higher wages if it can compensate for this with higher productivity or higher quality. Both are functions of the organizational capabilities of the firms in the sector, which may allow them to use technologies more effectively and achieve better quality control, inventory management and so on, to achieve a competitive edge. As wages cannot, and should not, be lowered as a way of achieving competitiveness, the binding constraint is usually the lack of sufficiently sophisticated organizational capabilities based on the tacit knowledge that can be acquired through learning-by-doing.

The firms we studied in all three sectors acquired competitiveness and export success through a long and tortuous process of capability development that they mostly financed themselves. A common strategy was to hire technically competent staff from India, Sri Lanka and Bangladesh to help in the learning process and to transfer critical missing

capabilities to the firms. In the case of the garments exporter the company hired a supervisor from India who oversaw the business while they also brought in trainers from Bangladesh. The firm began as a job-working subcontractor but now exports independently. It is also supplying to one of Nepal's few internationally successful clothing brands. The irony is that while the international company still has some production facilities in Nepal it is moving out a large share of its production to more competitive production sites like Vietnam.

The Nepali garments industry achieved rapid growth during the period of the Multi-Fibre Arrangement (MFA) when Indian companies set up garments units in Nepal to make use of the quota-free access to the USA that Nepal enjoyed. However once the MFA came to an end, the Indian units folded up and the sector went into decline. The share of the garments sector had reached 40 percent of total manufacturing output in 2000. But by 2003 there were only 35 firms left and the sector had virtually disappeared, with the insurgency also having a negative effect. The few remaining firms that are now successful in the sector, including our respondent, have been able to use some of the learning from those years to develop their capability. The Nepali garments sector thus had a very different trajectory from the Bangladeshi one, which acquired competitive capabilities during the MFA period, and therefore continued unaffected when MFA ended.

The Bangladeshi garment industry was different because there was capability transfer from a South Korean firm to a Bangladeshi one a time when the South Koreans were trying to set up new manufacturing units in territories that were not quota constrained under the MFA (Khan 2013a). But in contrast to Nepal, the South Koreans did not directly invest in the garments industry to any significant extent. The organizations that emerged were largely Bangladeshi from the outset and a broad-based learning commenced across the sector. When MFA ended, there were thousands of Bangladeshi firms that were now competitive enough in terms of their organizational capabilities to survive without MFA, and growth continued at a high pace. In Nepal, local firms entered the market too late to develop sufficient capabilities to survive the end of MFA, and the Indian firms clearly had no long run interest in staying in Nepal as their prime interest was in exploiting the MFA opportunities. Without that, they preferred to be located in India.

The garments sector in Nepal thus has to work very hard to come back into prominence as it has been left behind by growth in Bangladesh, Vietnam, Cambodia and India. However, there are opportunities in higher-value niche sectors that our vignette firm was focused on. As Nepal has somewhat higher wages, it should focus on higher-value garments for the tourist and export market. But producing competitively in this segment requires high organizational capabilities, including maintaining networks with international design and quality control networks, maintaining quality control and efficient inventories and squeezing

higher productivity out of better production process management. These capabilities need to be learnt, as our successful firm did, but we cannot expect broad-based growth if this learning is left to the devices of individual entrepreneurs with the deep pockets and perseverance to pursue these competitiveness goals.

In the case of the tea company, the owner hired a Darjeeling-based engineer to design his factory. Major functions like withering and rolling are still run by experts from the Darjeeling tea industry and a Sri Lankan tea industry expert helped run the CTC (crush, tear and curl) factory initially. Only ten percent of senior executives in the Nepali tea industry are Nepali, with Indians and Sri Lankans still helping to run the large processing units. The owner of the tea company is politically connected through personal networks and he used these connections to overcome instances of policy-distorting corruption demands.

The tea sector in Nepal was a public sector monopoly till the 1990s and there were no policy-based learning rents for the private sector at that time. However the tea sector is now a successful export-oriented sector and has high small-holder participation. Export growth will therefore have a positive impact on poverty reduction across the sector (SAWTEE 2006). This is in contrast to neighboring India which is a very successful tea exporter and where large tea plantations are the norm. But in India, poverty is high among tea workers in the estates in eastern and north-eastern India. The tea plants in most of Darjeeling's tea estates are also very old and Nepal has a significant advantage here. The tea sector in Nepal is therefore potentially important for inclusive growth. Though most of the tea acreage is for lower value CTC and not orthodox (whole leaf) teas, Nepal has been making progress in organic orthodox teas for which a large premium overseas market exists. More can be done with proper policy design that focuses on branding and marketing and expanding access to overseas markets. The other opportunity here is that big buyers of Darjeeling tea like Germany might want to expand supply sources after the Gorkhaland agitation in tea growing areas of Darjeeling hit supplies.

The steel maker's experiences, both of policy-distorting corruption and his use of external organizational assistance for technological upgradation, mirrors the experience of the firms in the other two sectors. The operations of the company's steel and pipe making units were overseen by a consultant from India. While the workers in all our three firms were eventually mostly Nepali, the garments exporter and steel maker had initially started out with some Indian workers. In the case of the steel company some of the skilled workers are still Indian. This company also hired semi-skilled Nepali workers who were already working in steel units in India.

The construction sector that our respondent services accounts for close to eleven percent of Nepal's GDP. Owing to the vast number of Nepali migrants who work in the construction sector in the Middle East, the sector also has ready access to skilled labour. A particular type

of flat rolled steel products is one of Nepal's biggest exports. The sector had taken a hit after the blockade of 2015 but is seeing some signs of recovery on the back of work related to earthquake reconstruction. Given its export potential, India is the biggest importer for this sector. Improving the capabilities of firms in the sector and supporting their technical upgradation can yield significant benefits for inclusive growth.

These vignettes support the importance of targeted capability developments that allowed a small number of firms to achieve competitiveness in particular sectors. Like Bangladesh and other South Asian countries, competitiveness and growth did not have to await the achievement of horizontal 'doing business' conditions. Corruption demands and bureaucratic obstacles were important, but entrepreneurs could work their way around these problems provided they could develop their organizational and technological capabilities. Clearly, if overall good governance could somehow be achieved, the acquisition of capabilities would become easier as many types of market contracts for investment in learning would become more feasible. However, achieving significant improvements in 'good governance' conditions is not very likely in developing countries. The South Asian experience, including that coming from our three vignettes, shows that significant progress is possible by targeting soluble problems like capability development. As a broad-based economy develops, there is likely to be stronger and more effective demand for a rule-following society. But a rule-following society cannot be wished into existence before a distribution of power within society supports it.

The Nepali firm vignettes and the experiences of neighbouring countries show that foreign partnerships were an important mechanism for capability transfers. It is important not to confuse this with all types of foreign direct investments (FDI). Most FDI does not transfer capabilities to domestic firms, and have limited spillover effects. The policy challenge is to design incentives for foreign investors to transfer capabilities to domestic firms. In the Indian and Bangladeshi case this took the form of policy instruments that incentivized foreign partners to invest in the transfer of capabilities to domestic firms, and when success was achieved in the form of a high valued product, the foreign partner was rewarded with significant rents. The details in the Bangladeshi garments and Indian automobile cases (see references above) cannot be exactly replicated because the policy design depends on local conditions and the sector. However, the general features of a successful policy instrument supporting learning is likely to be similar.

Moreover, political support for and the economic and political benefits of such a strategy are likely to be maximized if these types of capability transfer strategies were focused on SMEs and the conduit of any policy rents for local companies were local or provincial governments. Our discussion of the political settlement suggests that these policies would

be easier to police and would be aligned with political demands if such a combination can be achieved.

9. Policy Implications

The political settlement is evolving rapidly in Nepal and institutional and policy reforms have to be cognizant of what is feasible and the promoting opportunities opening up. Our political settlement analysis suggests that an approach to reform that focuses on creating a level playing field based on excellent ‘doing business’ conditions and improving ‘good governance’ in the form of a strengthened rule of law and general anti-corruption measures is not likely to deliver good results in an early-stage developer like Nepal. Improvements along those lines will be very difficult to achieve given the distribution of political power and organizational capabilities in the country. Policy makers can sometimes encourage private-public dialogue in order to promote economic growth and in some contexts this may well work. We suggest, however, that this will be difficult in Nepal. The mainstream private sector in Nepal is still at relatively low levels of productivity but are nonetheless powerfully connected (upper right had quadrant in box 2). Their sources of revenue are therefore not productivity-oriented but depend on their political contacts for supplies of rents. The political establishment also often uses its business links for activities like informal financing. Given this collusive relationship between business and politics it is highly unlikely that a private-public dialogue will be a driver for productivity growth. Moreover, the political settlements analysis points out that the priority is not to indiscriminately try and remove all types of rents or even the informal ones. Many formal and informal rents play a potentially critical role in maintaining political stability, enhancing organizational capabilities of firms, or addressing other market failures, while some rents are indeed very damaging and should be targeted where feasible.

The most feasible and potentially high-impacts reform would be to seize the opportunity of the current discourse on institutional and political devolution to support the development of broader productive and organizational capabilities at the SME level across regions and sectors in Nepal. Nepal does have emerging pockets of productivity that could usefully be targeted by feasible policies to achieve global competitiveness. Our sectoral policy recommendations are likely to be feasible because none of these emerging sectors provide large sources of rents for powerful Nepali organizations (except tourism to some extent). As a result, policy changes affecting rents to these sectors are less likely to elicit powerful resistance from established interests. Government may also support some of these policies because they do not have very large resource implications, do not affect politically connected big business interests, and are potentially employment-generating in a context where inclusive growth is an important part of the political discourse. Our focus is

also on manufacturing where we believe the maximum potential for both employment and productivity development lies. However service sectors like tourism, which in Nepal's case possesses high employment potential, can also be a driver of inclusive growth in the country.

The challenge is to address one of the key constraints on competitiveness, the missing or weak organizational capabilities of business organizations. The usual response to the observation of uncompetitive companies is to suggest technical and vocational training for the workforce. This is important but not sufficient. Nepal has a national vocational training policy but comparative evidence from South Asia and beyond suggests that firms and sectors that rapidly developed their competitiveness in global export sectors did so largely because they solved problems of organizational capability development through partnerships with competitive firms in more advanced countries. Once employment starts to grow rapidly in a sector, specific skills shortages are revealed and have to be addressed by skills training programmes. But providing skills training without linking this to the needs of firms that are already competitive can be very wasteful. It is very likely to result either in the transmission of skills that are actually not likely to be required, poor quality training as employers themselves do not have the capability to validate quality, or the outmigration of skilled people who cannot then find a local job.

One of our important policy recommendations is that small politically-unconnected firms in sectors like garments and assembly industries would need to be supported for capability development for managing the production process, backed up if necessary with skills development programmes targeting the workforce. In many cases, particularly in the labour-intensive industries that we are focusing on, the latter is less of a priority and may not even be needed at the initial stages because there may be enough unemployed skills of different types already available in the labour market. We saw that all three of our successful companies used trainers from more competitive countries to learn how to organise production better as well as train workers where necessary. However, investments in firms' organizational capabilities create rents for firms and the policy has to be well-designed in the context of the specific political settlement if resources are not to be wasted. One strategy that may work, building on the experiences of India and Bangladesh, is to devise policies that incentivize strategic partnerships with successful foreign companies that are moving out of particular technologies or are themselves looking for joint ventures to transfer capabilities, technology and training to domestic Nepali companies.

The instrument that is least likely to be distorted or captured given the political settlement is one that provides a large *ex post* reward to the foreign investor once success in exporting has been established. The creation of competitive *domestic* companies is particularly important because foreign companies are much more footloose (as the Nepali garments

industry experienced) and it is psychologically and organizationally much easier for domestic entrepreneurs to imitate and replicate successful domestic companies than successful foreign-owned ones. This is because the domestic company will be accessing sources of finance, value chains, and operating through institutional rules and policies that other domestic companies can easily replicate, while foreign companies have many specific arrangements that domestic companies may find hard to copy without much extra effort.

Most ex-post rents are in the form tax incentives and these might end up attracting FDI only for reasons of tax arbitrage and not facilitate technology transfer. One method of designing ex-post rents could be to design a form of build-operate-transfer (BOT) financing where the foreign firm in the targeted sectors are assured full ownership and perhaps even profit repatriation (though this might face political resistance) for a certain period after which it has to transfer some ownership to a private firm in the country. Of course the remit of this paper is not to provide an exact design of such a financing arrangement and any such instrument will need careful thought, but this could be a direction of movement. Most BOT models used in the infrastructure sectors require strong enforcement capabilities and profit realisation is long term in nature making the incentive structure more amenable to distortion. The options we are suggesting for capability development investments do not necessarily have these problems.

We deliberately focused on sectors that were low to medium technology because replicability is an important criterion for sustaining inclusive growth. We also made a pragmatic selection of sectors like tea, tourism, iron and steel and garments, because these types of sectors satisfy the criteria for replicability, generate lots of jobs and can earn the foreign exchange that Nepal needs to fund its imports. Some allowance will have to be made for the fact that manufacturing in Nepal faces other constraints that we have referred to: higher wages, incentives for skilled workers to migrate, exchange rate and transportation cost disadvantages and so on. Immediate improvements in the exchange rate regime or the removal of other disincentives are not likely. We identified quite difficult rent interests sustaining those policies. Early stage policy will have to work within those constraints and realize that quite substantial productivity improvements have to be achieved through capability development if domestic Nepali firms are to become competitive. We believe this is possible, and our vignettes showing the successful operation of a small number of Nepali firms in these sectors validates our assessment. Given that most migrants are men, an important idea to test would be to see if offering training and capability development opportunities in sectors that can employ women helps retention and generates inclusive growth more rapidly. This would also help to further gender inclusion.

As Nepal's remittance economy is likely to remain dominant for some time, a further possibility is to use some of these remittances more productively. Bonds and other

investment vehicles could be set up to encourage workers remitting funds to put some of this directly into foreign exchange bonds that could be used to finance investments in growth sectors. This could help to increase the savings rate in the economy and also provide investors in new sectors with lower cost capital to import machinery. The feasibility of this would depend on the capacity of the banking system to do this intermediation, and even more so, on their willingness to do this, as it will divert funds from the lending that banks do to more lucrative trading activities where more rents are captured. A similar instrument was implemented in the hydro-power sector. Though they were not very effective, addressing some of the design flaws could ensure they could be developed for more broad-based investments. One reason for the failure of the bonds seems to have been higher transaction costs in administering them as they required separate bank accounts. This suggests that a fully self-financing bond may not survive because of market failures. Limited state or donor co-financing support may be necessary. The other reasons for their under-subscription were that migrant workers could find higher returns in commercial banks, the bonds were not marketed effectively enough and Nepali migrants to India and OECD countries were not allowed to buy them. Addressing each of these reasons for failure could be a positive step towards creating such bonds that are more popular among diaspora.

There could also be a fund for overseas workers to invest in that could operate like a mini sovereign wealth fund that could invest in inclusive growth sectors within Nepal, for instance in more mature SMEs with clear potential. These funds have significant management and governance requirements to protect investors, but we are suggesting possibilities that could potentially be technically addressed, perhaps with small pilots given that these funds will be investing incomes of fairly vulnerable sections of society.

Tourism is an established service sector that can also be developed using the capability development approach. One of our respondents who has long been associated with and is successful in Nepal's tourism sector suggested that one way of strengthening tourism in Nepal would be to highlight what he described as its 'endemic' nature (though the word can have a negative connotation). What he meant is that if people want to see Mount Everest up close they can only do so in Nepal. Or if birdwatchers want to track the spiny babbler they have to come to Nepal. He argues there are many more such examples and the Nepali tourism sector can develop this as a marketing strategy. While building a completely separate infrastructure for this type of tourism will be costly, a well-designed campaign on social media (rather than expensive international electronic media advertising) could target 'dedicated' tourists and upgrade identified facilities to cater to these tourists. Here too, the development of a broad range of hotels and possibly even home-stays of a high enough quality to deal with this non-luxury segment of tourism could create broad employment opportunities if appropriate levels of capability can be developed.

Tea, especially orthodox and organic orthodox varieties, is another potential growth sector. This is already gathering momentum in Nepal but the country remains a small exporter. Both of these variants command a premium in international markets relative to CTC tea. The cultivation of organic tea is costly but commands more market value. More needs to be done for the sector with policy design that focuses on branding and marketing as well as helping to develop agro-extension services required for organic tea (for instance cattle rearing for manure) that can actually be self-sustaining. Given that this sector is largely supplied by farmers with small-holdings the scope for inclusive employment and developing community oriented backward linkages is high. Some headway has already been made as some organic tea growers have shown, but the investments have been made by individual firms, and this is where targeted policy for the sector could accelerate growth. The planned auction house in Jhapa which has reportedly been stalled by the Ministry of Finance could also help Nepali tea garner global markets. Most Nepali tea is sold through the Kolkata auctions in India but an auction house in Nepal for its own teas will allow it to attract more international buyers. This could be an area of policy focus too. Auction houses have sometimes been criticised for introducing a layer of middlemen into the tea market but given its global nature brokers at auctions act as aggregators with better market information than a local producer.

As Nepal is a land-locked country, transportation is a major issue for developing domestic industries. Air freight could make sense for higher valued products, those for rapid replenishments and for emergencies. Nepal mainly uses one Indian port (Kolkata) which is also one of India's least efficient. Nepal has recently been given sporadic access to a more efficient southern port but it is located much further from the Nepali border. Another option is to use Haldia port, close to Kolkata which is more efficient. However the average export time for Nepal is 42 days adding pressure to its already low competitiveness. In order to ease some of the constraints around transportation feasibility studies could be conducted for air freight facilities for high-value exporters in Nepal. If Nepali consignments were cleared fast enough at Kolkata Port air freighting would not be necessary as an alternative because it costs 12-16 times as much as ocean transport (World Bank 2009). But as it now stands Nepali policy makers will have to think out of the box. Connectivity with China will certainly also help through the proposed new dry port but that will not solve the problem of supplying lucrative markets in the West.

While space at Kathmandu airport is limited there are plans for expansion and passenger flight services could be used instead of chartered ones to lower costs. Kathmandu is well connected to Middle Eastern cities with some of the world's biggest logistics hubs. There are precedents for using air services in Africa (in the case of Kenya and Tanzania) and with successful results (World Bank 2009). There could be learnings for Nepal here that allow it to circumvent some of the transport bottlenecks it faces.

These are examples where developmental rent management can be feasibly improved without a significant likelihood of being blocked by powerful rent-capturing interests. However, this does not mean that other areas of rent management need not be addressed. In our previous section we identified specific cases where improvements in rent management in each of these more challenging areas may be feasible.

Most importantly, there is a need to adequately prepare for any institutional devolution that may happen as a result of power being devolved to provinces and local governments.

The most feasible strategies at the local government level here would be ones that require some form of co-ordination and collective action, for instance in organising skill development programmes based on the targeted sectors in tandem with the training that takes place for developing organizational capability. Effective capability development for homestays in Nepal could prove to be most beneficial in such a context. This would be in line with our recommendation of 'endemic' tourism.

We believe that the sustainability of devolution will depend on matching the resource allocation decisions that are devolved with developmental policies of the types discussed here, so that the devolution becomes sustainable. Sustainability requires that the resource allocations at the local level create dispersed but sustainable sources of power, ideally based on new productive and employment generation capabilities at the local level. This is essential to create effective power at the local level to sustain devolved institutions over time. This is an exciting and important challenge but how best to do this can only be discussed in detail as we learn more about how devolution will actually occur. Development partners and Nepali policy think tanks can, however, already start thinking in a joined-up way about these rent management challenges to achieve sustainable improvements in inclusive growth and inclusive politics in Nepal.

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