

# Trade Liberalisation and Poverty

## The case of Nepal

The benefits of Nepal's trade reforms have been confined to a few manufacturing industries and urban populations and has not helped in the transformation of the agricultural sector.

Shiv Raj Bhatt and Puspa Sharma

Prior to the 1980s, Nepal's trade policies were dominated by inward-looking and state-led development strategies. Protection to domestic industries, import substitution, state-led industrialisation, and government monopolies in major industries/sectors, were the main policy measures. Through the structural adjustment programme, Nepal initiated economic reforms since 1984/85. Liberal and market-oriented trade policy was one of the key components of the reform. The reform process was intensified after the restoration of multi-party democracy in 1990.

The key features of liberalisation included devaluation and introduction of flexibility in the exchange rate, elimination of import license and quotas, rationalisation of the tariff structure, reduction in the average level of tariffs, implementation of full convertibility of the rupee in the current account, liberalisation of foreign investments, privatisation and institutional reform of state-owned enterprises, market-based pricing of agricultural inputs and outputs, and reduction of subsidies on credit and

irrigation.

These reforms targeted high and sustained growth through market-based resource allocation, infusion of competition in the economy, and reduction of state domination and encouragement of private participation in economic activities.

The recent developments in the trade arena – Nepal's accession to the World Trade Organization (WTO) and signing of regional trade agreements - South Asian Free Trade Area (SAFTA) and Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIM-STEAC) – are expected to contribute to further acceleration of the trade liberalisation process.

### Trade performance in the post liberalisation era

After 1990, Nepal's trade liberalisation brought significant changes in the trade sector. During 1990-00, both exports and imports as percentage of gross domestic product (GDP) grew sharply, albeit with a decline after 2000. In 1990, while exports and imports as percentage of GDP were

5 percent and 17.7 percent respectively, the same figures for 2000 were 13.1 percent and 28.6 percent, and for 2005, 11 percent and 25 percent.

Regarding trade deficit, Nepal did not observe any improvement due to trade liberalisation. Trade deficit increased from 12 percent of GDP in 1990 to 21 percent in 1995, and 14 percent in 2005.

Nepal's trade structure also experienced sharp decline in the share of primary goods exports and increase in manufactured goods exports. Share of primary goods decreased from 56.2 percent in 1985 to 17 percent in 1990 and 12.9 percent in 1995. However, due to decline of manufactured exports between 1995-2005 (85.2 percent in 1995 to 70.7 percent in 2005), the share of primary goods exports increased (from 12.9 percent in 1995 to 22.5 percent in 2005).

Growth rates in manufactured exports are largely attributed to carpets and readymade garments industries; the two industries contributing nearly two-third in Nepal's overseas exports.

### Implications of trade liberalisation on poverty

There has been much debate on whether or not trade liberalisation benefits the poor. In fact, the link between trade liberalisation and poverty is extremely complex. However, there is no denying that trade liberalisation affects the poor and poverty. Trade liberalisation can affect poverty through a number of ways.

Table 1: Average GDP growth (at constant prices)

Period	GDP	Agricultural GDP	Non-agricultural GDP
1980 -1985	4.70	5.21	3.77
1986 -1990	5.22	3.57	6.95
1991-1995	4.88	1.85	7.31
1996 - 2000	4.73	3.69	5.47
2001- 2005	2.02	2.85	2.63

Compiled from various Economic Surveys, Ministry of Finance, Government of Nepal

Indirectly, it can affect poverty through its effect on economic growth, and directly through its effect on factor markets (income and employment), product markets (prices and availability of commodities) and government capacities to implement pro-poor policies (government revenue and expenditure). Hence, one option to assess the implications of trade liberalisation on poverty is to analyse the pattern of changes in these variables. However, it should be noted that changes in these indicators depend on many factors, and trade liberalisation is one among such factors.

### **Economic growth**

Nepal is historically a low growth country with GDP growth rates averaging less than 5 percent since the 1980s (see Table 1). There has not also been any significant improvement in per capita GDP. For instance, per capita GDP at constant prices was US\$ 120 in 1980, which reached US\$ 330 in 2006.<sup>1</sup> Average annual growth in per capita GDP was only 2.6 percent during the pre-reform period (1980-85), which reached 4.6 percent during early reform period (1986-90) and 5.2 percent during mid-reform period (1991-95). However, this growth rate could not be sustained after 1996 (4.8 percent during 1996-00 and 3 percent during 2001-05).

The growth pattern of GDP suggests that the reform process complemented by the political change in 1990 – from the party-less Panchayat system to multi-party democracy – led to some positive changes in the economy. However, these changes were mostly confined to the non-agricultural sector, which is evident from Table 1. Whereas the growth of the agricultural sector, in which a majority of Nepal's poor depend for livelihood, was slower than the growth of the non-agricultural sector. Since the reform in the agricultural and non-agricultural sectors did not contribute to sustainable and pro-poor growth but led to sharp increase in rural urban inequalities, the overall impact on poverty reduction cannot be claimed to be positive or pro-poor and broad-based. More-



over, due to low growth in agriculture, living standards in rural areas did not improve as envisaged.

Witnessing the slow growth in the agricultural sector, it can be said that Nepal's trade liberalisation process did not favour the country's overarching goal to use agriculture as a means to poverty reduction. The liberalisation package for the reform in the agricultural sector consisted of withdrawal of state subsidies, opening up of agricultural input markets as well as tariff reduction on both intermediate and final products, among others. The aim was to allow agricultural output prices to rise, which would raise rural incomes. However, small and vulnerable farmers faced higher production costs, once input subsidies were withdrawn, along with competition from imported products. The growth rates of major crops such as paddy, maize, wheat, oil seeds and pulses have witnessed decline while there has been some increase in the growth rate of cash crops such as sugarcane and tea.

Unlike the agricultural sector, as indicated above, the impact of trade liberalisation on Nepal's manufacturing sector has been positive. Manufacturing output grew sharply immediately after the reforms. Growth that averaged around 5 percent per annum during the 1980s rose to 14 percent during 1991-95. However, this high growth rate was mainly because of the growth of readymade garment and carpet industries. This growth decelerated sharply after the phasing out of the quota system in

the garment industry and emergence of standards-related problems in the carpet industry. For instance, the average growth of manufacturing sector declined to 7.6 percent during 1996-00 and to 0.1 percent during 2001-05. In addition to quota phase out and standard related problems, armed conflict and poor supply-side response also affected the growth of the manufacturing sector, ultimately leading to adverse consequences in the performance of the overall economy.

### **Government revenue**

Despite several measures to widen the domestic tax base following trade liberalisation, international trade still accounts for nearly 50 percent of revenue in Nepal. The Nepalese government depends heavily on trade-related taxes for its regular and developmental expenditures. Generally, it is argued that tariff reduction would lower revenue, negatively affecting the government's capacity to finance pro-poor programmes (e.g., related to health, education, drinking water). In the case of Nepal, government revenue in the post-reform period has increased; trade-related taxes alone contributed around 60 percent in total tax revenue during 1996-05. The growth of tax revenue increased from 15.9 percent in the pre-reform period (1981-85) to 18.5 percent in the early reform period (1986-90). However, it declined to around 11.1 percent in the mid-reform period (1996-01) and to 10.4 percent in the recent period (2001-05),

**Table 2: Poverty trends in Nepal**

	MPHBS	NLSS	NLSS
	1985	1995/96	2003/04
Nepal	42.5	41.8	30.9
Urban	19.2	21.6	9.6
Rural	43.2	43.3	34.6
<b>Nominal per capita consumption</b>			
Nepal		6,802	15,848 (133)
Poorest 20 % of population		2,571	4,913 (91)
Richest 20 % of population		15,243	42,236 (177)
<b>Nominal per capita income</b>			
Nepal		7,690	15,162 (97)
Poorest 20 % of population		2,020	4,003 (98)
Richest 20 % of population		19,325	40,486 (110)

Note: Figures in parentheses represents percentage changes.

Derived from Multi Purpose Household Budget Survey (MPHBS), Nepal Rastra Bank, 1985; and Nepal Living Standard Survey (NLSS), Central Bureau of Statistics, 1996 and 2004.

mainly due to low economic growth and poor performance of the export-oriented manufacturing sector in this period. So far, the negative impact of tariff reduction due to trade liberalisation has been offset by higher revenue base created by higher imports, wider income tax base, introduction of value added tax (VAT) system, and upward revision of VAT rate.

### Labour markets

Despite high unemployment and underemployment, there has been some improvement in wage rates during the last two and half decades. However, real wage increased unequally in agriculture (around 1.7 percent) and industrial (around 2.5 percent) sectors during 1981-05. As most of the workers are in the unorganised sector and self-employed (78 percent self-employed and 22 percent wage-workers), trade liberalisation in the labour market has not benefitted the rural poor and only covered a limited and small segments of society, that too in the urban areas, leading to rural urban inequalities.

### Micro level effects: Household income and consumption

At the time Nepal initiated econom-

ic reforms, 42.5 percent of Nepalese were below the poverty line, with a headcount ratio of 19.2 and 43.3 percent in urban and rural areas respectively (Table 2). The results of Nepal Living Standard Survey (NLSS) survey 1995-96 show that there was no marked progress in poverty reduction during 1985-95. The proportion of the urban and rural population living below the poverty line even increased marginally.<sup>2</sup> This shows that initial reform measures did not succeed in reducing poverty during 1985-96. Encouragingly, the headcount ratio declined from 41.8 percent in 1995-96 to 30.9 percent in 2003-04. During this period, urban poverty reduced from 21.6 percent to 9.6 percent (56 percent reduction), whereas rural poverty decreased from 43.3 percent to 34.6 percent (20 percent reduction). Surprisingly, this reduction took place when there were low GDP growth (less than 4 percent, refer to Table 1) and high population growth (around 2.3 percent) rates. Therefore, the achievements cannot be credited to trade liberalisation alone because poverty was reduced when there was low GDP growth. NLSS has credited remittance transfers; rising agricultural and non-

farm wages; enterprise incomes; urbanisation and share of economically active population ratio as the major contributing factors for such reduction.

During 1996-04, nominal per capita household income and consumption also rose annually by 9 and 11 percent respectively. But growth in per capita consumption of poorest 20 percent of population is half than that of the richest 20 percent (see Table 2). Most of the growth in income comes from the non-agricultural sector and non-wage employment, indicating that non-agricultural sector activities facilitated by liberal industrial and trade policies have had an impact on income, employment and poverty.

### Conclusion

Trade liberalisation in Nepal was expected to contribute to high and sustained growth and poverty reduction. But evidences suggest that the benefits of Nepal's trade reforms have been confined to a few manufacturing industries and urban populations. Moreover, trade liberalisation did not help to promote the agricultural sector, including rural farmers and populations. The low supply response of the agricultural sector has resulted in low agricultural growth and hence, slow growth in rural incomes. To conclude, it can be said that Nepal's reform process affected urban and rural households differently and its positive impact increases with income levels. ■

Mr. Bhatt is an economist at SAWTEE and Mr. Sharma is Senior Programme Officer at Forum for Protection of Public Interest (Pro Public), Kathmandu, Nepal.

### NOTES

<sup>1</sup> IMF. 2006. *World Economic Outlook Database 2006*. Washington, D.C.: International Monetary Fund.

<sup>2</sup> This surprising result (decreased overall poverty and increased rural/urban poverty) may be due to the declaration of many village development committees as municipalities.