STUDY ON EXPORT POTENTIAL

An Analysis of Selected Sub-Sectors of Nepal:
(Coffee, Cut-Flower and Handmade Nepali Paper)

Compiled and Analyzed By:

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In Coordination with 15 Direct Beneficiaries

Enhancing the Capacity of Intermediary Business Organizations in Nepal
(ECIBON PROJECT)

Funded by the European Union
Implemented by European Economic Chamber (EEC) – Nepal

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August 2008

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ECIBON PROJECT: An Introduction

ECIBON Project was established to enhance the capacity of the Intermediate Business Organizations (IBOs) in order to help the small and medium enterprises (SMEs) from Nepal by undertaking certain activities.

Aim

To make Nepalese IBOs better equipped to service local SMEs and European intermediary counterparts to facilitate trade between Europe and Asia (Nepal).

Overall objectives:

In Nepal, the business development services provided by the government institutions are found to be supply-driven. Even government service providers are not aware about the present business needs and reality. They follow traditional approaches and methods and their services are more theoretical than practical. Furthermore, lengthy procedure and bureaucratic hassles create a negative impression of their business development services. Therefore, recently some of the IBOs started to provide business development services, which found to be effective compared to services provided by the government institutions. However, this is a new role for IBOs and their capacity needs to be developed in this respect. They need to be furnished with additional expertise on trade with foreign markets, exposure within and outside Nepal, strengthened networks within and outside Nepal and information provision.

This has resulted in the following overall objectives: ‘Enhancing the capacity of Intermediary Business Organizations within the private sector of Nepal and reinforce new business development opportunities between Nepal and Europe’

Project purpose:

To make Nepalese Intermediary Business Organizations better equipped to service local businesses as well as their European intermediary counterparts in order to facilitate trade between Europe and Asia by:

1) Capacity-building
2) Policy analyses & information provision
3) The development of new business opportunities through networking.

Target group

At least 15 Nepalese business IBOs whose capacity can be strengthened through training, information provision and a strengthened and broadened network.

Activities

Courses / seminars on different subjects related to trade between Nepal and Europe of which 6 in Nepal and one in London; an assessment of opportunities for potential trade and trade-related procedures and requirements with reference to trade between Nepal and the EU. The establishment of a Nepalese and international IBO-network.

- Capacity-building:

  SMEs in LDCs, producing products and services with applying -to great extent- outdated technologies, have been facing tough competition due to imported products. The situation may further be worsened in the days to come because they have to compete with international competitors due to further globalization, the widening free trade and phasing out of tariff barriers. The changes that have been taking place in the international economic scenario have definitely brought challenges for the SMEs in LDCs. The problems faced by these SMEs are more or less similar in nature. The major constraints faced by them are in the fields of trade promotion / marketing services; opportunities and legislation as well as procedures related to foreign markets; international networking & match-making, management & administration and technology.

  However, the changes that have taken place, have also opened up tremendous business and market opportunities for the SME-sector of LDCs. Therefore, institutional capacity building is key to the sustainable development of SMEs. To meet the challenges of the contemporary global economy SMEs should be strengthened in the fields as mentioned above. IBOs play a crucial role in facilitating a sustainable manner of capacity building of these SMEs.

- Policy analyses & information provision:

Situated in between the world's two largest growing economies of India and China, Nepal offers good economic prospects especially in the field of manufacturing and export, mining, tourism, IT and service industries. Hence, Nepal offers an attractive economy with favourable conditions for the global trade arena. However, due to the rather limited information flow to Nepal over the decades as well as the lack of financial resources to promote Nepal's market opportunities on a global scale, Nepal has not been able to take advantage of its strategic location and its available resources. Due to the developments in IT over the last decade, such as the availability of internet and e-mail, these two restrictions have clearly become opportunities for Nepal. Through the use of e-mail and internet information between Nepal and other countries in the world can be exchanged easily, rapidly and without major financial impacts. It has now become important to use new technologies to make existing knowledge on foreign trade easily available in Nepal and to make Europe aware of the trade opportunities that Nepal offers and vice versa. This task is one of the major current challenges of Nepalese IBOs.

- The development of new business opportunities through networking:

Over the past decade the economies of South Asia, particularly, India and China, have been opening up their markets and in the process have achieved significant gains in exports and economic growth. In conjunction with this increased economic integration there has been increased recognition by regional governments of the potential for a substantial increase in the participation of SMEs in the generation of regional income, employment, exports, investment and economic growth. In addition, developing economies are especially seeing SMEs as potential instruments for the alleviation of poverty.

As the world is becoming a global economy there has been a growing recognition of the need for the Asian economies to engage in comprehensive restructuring of their corporate sectors, with the objective of developing transparent and globally competitive enterprises. The SME-sector of Nepal can play a key role in the attainment of this objective since it is one of the most important sectors of Nepal that contributes significantly to the gross domestic product (GDP), creates employment and earns foreign currency through export. As representatives of Nepalese SMEs the IBOs are excellent representatives of the numerous Nepalese SMEs at the international stage.

The partnership composition

1. European Economic Chamber of Trade, Commerce and Industry (EEC)-Nepal
2. Federation of National Cottage and Small Industries Nepal (FNCSIN), Nepal
3. Chamber of Commerce and Industry of Southern Sweden (CCISS), Sweden
4. London Chamber of Commerce and Industry (LCCI), Great Britain
5. The Danish Federation of Small and Medium-Sized Enterprises (DFSME), Denmark

The duration of the project

This Project would be implemented within the duration of 30 months (including 6 months wind up)

Direct Project Beneficiaries

Executive Summary

Preamble:

The aim of this assessment is to produce, a study on selected target sub-sectors of trade between Nepal and the EU. This assessment will be carried out in Nepal, Scandinavia and the United Kingdom. It seeks to assess the opportunities in selected sub-sectors for potential trade with the EU market.

This study seeks to conduct an analytical review and assess the business opportunities with respect to the following areas:

- Overview of Nepalese trade economy,
- Overview of Nepalese manufacturing sector,
- Overview of Nepalese SMEs export attitude and practices,
- Overview of Nepalese SMEs import attitude and practices,
- Overview on Nepalese enterprise sector and their opportunities for potential trade withEU market,
- Identify three sub-sectors that have good opportunities for potential trade with EU market.
- Identify three sub-sectors which have comparative advantages over other sector for potential trade.

Based on their past experiences in the Small and Medium Enterprise (SME) sub-sectors, the Intermediate Business Organizations (IBOs) have identified the following sectors that that require an increase in exports (for sector that are already exporting) or have relatively higher export potential as compared to other products:

- Tea
- Coffee
- Honey
- Carpets
- Nepali Paper
- Precious Jewellery (Costume)
- Certain Herbs
- Flowers
- Leather
- Water
- Quartz
- Glassware
- Bamboo
- Ginger
- Garments

Furthermore, the Intermediate Business Organizations (IBOs) have narrowed the list to products that maybe deemed as export-oriented. They have stated that the following products are being exported from Nepal and may have the potential for export.

- Yarsa Gumba
- Water
- Coffee
- Flowers
- Handicrafts
- Leather shoes/goods (soles come from Italy/leather goods do not have the capacity to be made here)
- Ceramics (Vases and Pots)
- Carpets

Other products that have high export potential would also include:

- Silk
- Cardamom
- Wooden Handicraft
- Mandarin oranges

While the above-mentioned products produced by Nepali SMEs are being exported to selected countries including the EU market, there was an urgency to further select a few products from these lists that would have higher export potential. The products that have been identified for further sub-sectoral analysis are as follows:

- Coffee
- Cut Flower and

- Nepali Handmade Paper

The status of the SMEs that are manufacturing/producing these products would also be studied. It is hoped that information thus obtained, would assist in determining how these SMEs would be able to cater to the export market, especially to the EU market.

The most binding constraints faced by private sector firms in Nepal are

(i) poor business environment, characterized by distorted policies and regulations, and poor implementation, economic depression, and inadequate infrastructure;
(ii) limited access to capital;
(iii) weak links to markets outside the small domestic market;
(iv) a high level of political instability. Information technology (IT) development needs a regulatory framework, training standards in computer training, and rationalized tariff regime for computer hardware and software.

Under several programmes rural microfinance projects have been implemented, where rural women have been trained in group formation, and occupational skills.

Furthermore technical assistance loans have been received to improve corporate and financial governance to address the problem of high transaction cost of business and poor financial intermediation.

Chapter One

Overview of Nepalese Trade Economy

Introduction

The general environment of the Nepalese trade economy

Brief Statistics of Nepal

Country	Nepal
Capital City	Kathmandu
National Flag	
Government type:	Democratic Republic of Nepal
Total Area	147,181 sq km
Bordering countries	China and India
Topography	Geographically, the country is divided in three regions; Mountain, Hill and Terai region.
Currency (code)	Nepalese Rupee (NPR) (Euro 1.00= NPR 107.00)
Major language	Nepali
Major Religions	Hinduism, Buddhism
Climate	Varies from cool summers and severe winters in north to subtropical summers and mild winters in south
Population	Total: 28,901,790 (July 200 est.)
Population Growth Rate	2.17% (2006 est.)
Population Below Poverty	31% (2003-04)
HDI Rank 2005	136
Life expectancy	60.18 years 60.43 years (men), 59.91 years (women) (2006)
Literacy Rate	For population that are 15 years or older Total Literate population: 48.6% Male Literate population: 62.7% Female Literate population: 34.9% (2004)
GDP - per capita	Purchasing power parity - $1,500 (2005)
GDP	Purchasing power parity - $39.9 billion (2005)
GDP – real growth rate	2.7% (2005)
GDP – Composition by Sector	Agriculture: 38% Industry: 21% Service: 41%
Industrial production growth rate	3.8% (2004-05)
Inflation rate	7.8% (October 2005)
Labour force	10.4 million – Severe lack of skilled labour (2004)
Labour force-By occupation	Agriculture:76% Industry:6% Service:18%
Unemployment rate	42% (2004)

Introduction

In 1951, the Nepalese monarch ended the century-old system of rule by hereditary premiers and instituted a cabinet system of government. Reforms in 1990 established a multiparty democracy within the framework of a constitutional monarchy. A Maoist insurgency, launched in 1996, gained traction and threatened to bring down the regime, especially after a negotiated cease-fire between the Maoists and government forces broke down in August 2003. In 2001, the crown prince massacred ten members of the royal family, including the king and queen, and then took his own life. In October 2002, the new king dismissed the prime minister and his cabinet for "incompetence" after they dissolved the parliament and were subsequently unable to hold elections because of the ongoing insurgency.

While stopping short of reestablishing parliament, the king in June 2004 reinstated the most recently elected prime minister who formed a four-party coalition government. Citing dissatisfaction with the government's lack of progress in addressing the Maoist insurgency and corruption, the king in February 2005 dissolved the government, declared a state of emergency, imprisoned party leaders, and assumed power. The king's government subsequently released party leaders and officially ended the state of emergency in May 2005, but the monarch retained absolute power until April 2006. After nearly three weeks of mass protests organized by the seven-party opposition including the Maoists, the king allowed parliament to reconvene on 28 April 2006. Following the November 2006 peace accord between the government and the Maoists, an interim constitution was promulgated and the Maoists were allowed to enter parliament in mid-January 2007. Constituent elections were held in April 2008. The newly elected Constituent Assembly overwhelmingly voted to abolish the monarchy from Nepal and established a Federal Democratic Republic of Nepal in June 2008.

The Economy

Nepal ranks among the world's poorest countries, with a per capita income of around $322. Based on national calorie/GNP criteria, an estimated 31% of the population is below the poverty line. An isolated, agrarian society until the mid-20th century, Nepal entered the modern era in 1951 without schools, hospitals, roads, telecommunications, electric power, industry, or a civil service. The country has, however, made progress toward sustainable economic growth since the 1950s and is committed to a program of economic liberalization.

It has been estimated that while only one fifth of the land is arable, agriculture accounts for about 38.15 per cent as per 2006 ADB report. The industrial base is underdeveloped and trade imbalances are a persistent feature of the economy. According to the available information, the trade and commerce of Nepal account for 10.60 per cent of GDP as per trade accounts. Similarly the manufacturing sector contributes approximately 7.49 per cent as per the 2006 ADB report. A heavy dependence on imports and a weak export base have resulted in a widening trade deficit, from 5.6 per cent of GDP in 1975 to 22.8 per cent in 1996 and to 25.5% of GDP in 2006.

Due to consistently low levels of revenue generation, the Nepali economy is highly dependent on foreign aid, both bilateral and multilateral. Although the Government has adopted more open and market-oriented policies with private-sector-led policies being given due importance, this has not had the desired effects on the overall economic development of the country. Consequently, wide-ranging trade liberalization and substantial reforms in industrial policy were initiated through the Trade Policy and the Industrial Enterprises Act of 1992. These reforms have given priorities to critical issues like privatization, deregulation, de-licensing, export and import liberalization and evolution towards full currency convertibility. The Foreign Investment, One Window Policy and the Foreign Investment and Technology Transfer Act were also initiated in 1992 with the general belief that incentives for foreign investment, considered vital for the effectiveness of these policy measures.

Against the backdrop of these reforms, economic policy aims at encouraging the development of entrepreneurship in order to achieve higher economic growth. The vast majority of entrepreneurs have informal micro and small enterprises. There are few enterprises that have been successful in progressing to formal medium-sized or large enterprises, which could make a significant contribution to national productive capacity in terms of positive impact on the GDP and employment. Large enterprises, on the other hand, are typically constrained by a small domestic market and high operating costs and are characterized by chronic underutilization of capacity.

Nepal launched its tenth five-year economic development plan in 2002; its currency has been made convertible; and fourteen state enterprises have been privatized, seven liquidated and two dissolved. Foreign aid accounts for more than half the development budget. The Government of Nepal has shown an increasing commitment to fiscal transparency, good governance, and accountability. Also in 2002, the government began to prioritize development projects and eliminate wasteful spending. In consultation with civil society and donors, the government cut 160 development projects that were driven by political patronage.

Agriculture remains Nepal's principal economic activity, employing over 71% of the population and providing 38% of GDP. Only about 25% of the total area is cultivable; another 33% is forested; most of the rest is mountainous. Rice and wheat are the main food crops. The lowland Terai region produces an agricultural surplus, part of which supplies the food-deficient hill areas. Because of Nepal's dependence on agriculture, the annual monsoon rain, or lack of it, strongly influences economic growth.

Nepal's exports increased 2.8% in FY 2005/2006 compared to an increase of 8.3% in FY 2004/2005. Imports grew by 9.8% in FY 2005/2006 compared with 9.2% in FY 2004/2005. Exports were constrained by a prolonged phase of general strikes, industrial closures, and political turmoil during the second half of FY 2005/2006 and also by a significant drop in Nepal's main export, ready-made textile products. The trade deficit for FY 2004/2005 was $1.2 billion, which widened to $1.4 billion in FY 2005/2006. Real GDP growth during 1996-2002 averaged less than 5%. Real growth experienced a one-time jump in 1999, rising to 6%, before slipping back below 5%. In 2002, GDP recorded a negative growth rate of 0.33%, largely because of the Maoist insurgency. GDP grew 3.1% in FY 2002/2003 and 3.6% in FY 2003/2004, and again slipped to 2.4% in 2004/2005 and to 2.4% in FY 2005/2006, according to the Central Bureau of Statistics.

Despite its growing trade deficit, Nepal traditionally has a balance of payments (BOP) surplus due to remittances from Nepalese working abroad. In FY 2005/2006, Nepal recorded a balance of payments surplus of $355 million, as compared to $79 million in FY 2004/2005. The lower BOP surplus in FY 2004/2005 was mainly attributed to the lower inflow of net government loans, and the higher surplus in FY 2005/2006 was due to resumption of foreign loans and assistance after the April 2006 People's Movement. Both the current account and the capital account registered significant growth in FY 2005/2006. Nepal receives substantial amounts of external assistance from India, the United Kingdom, the United States, Japan, Germany, and the Scandinavian countries. Several multilateral organizations--including the World Bank, the Asian Development Bank, and the UN Development Program--also provide assistance. Such assistance decreased substantially in FY 2004/2005 after the royal takeover of February 1, 2005 and also because of the Maoist conflict, which undermined development activities throughout most of Nepal. On April 23, 2004, Nepal became the 147th member of the World Trade Organization (WTO).

With eight of the world's ten highest mountain peaks--including Mt. Everest at 8,848 mt. (29,000 ft)--Nepal is a tourist destination for hikers and mountain climbers. However, the decade-long insurgency and a global economic slowdown threatened the tourism industry. Figures from the Department of Immigration showed a 4% increase in arrivals in 2006, but these remained well below numbers during 1999, the peak tourism year. Recent tourist arrivals have given relief to the tourism-based hotel, trekking, mountaineering, and aviation industries. Since the political parties and Maoists brokered a comprehensive peace agreement in November 2006, the tourism industry hoped that guest arrivals in Nepal would bounce quickly back to 1999 levels and higher.

Swift rivers flowing south through the Himalayas have massive hydroelectric potential to service domestic power needs and growing demand from India. Only about 1% of Nepal's hydroelectric potential is currently tapped. Several hydroelectric projects, at Kulekhani and Marsyangdi, were completed in the early to late 1980s. In the early 1990s, one large public-sector project, the Kali Gandaki A (144 megawatts--MW), and a number of private projects were planned; some have been completed. Kali Gandaki A started commercial operation in August 2002. The most significant privately financed hydroelectric projects currently in operation are the Khimti Khola (60 MW) and Bhote Koshi (36 MW) projects.

The environmental impact of Nepal's hydroelectric projects has been limited by the fact that most are "run-of-river," with only one storage project undertaken to date. The planned private-sector West Seti (750 MW) storage project is dedicated to electricity exports. An Australian company signed a power purchase agreement with the Indian Power Trading Corporation in September 2002 and has the lead on the project. Negotiations with India for a power purchase agreement have been underway for several years, but agreement on pricing and capital financing remains a problem. The Government of Nepal has taken up the issue of project financing for the West Seti project with the EXIM Bank of China. The Department of Electricity Development recently obtained proposals from 14 foreign companies for survey licenses of three projects--

600 MW Budhi Gandaki, 402 MW Arun III, and 300 MW Upper Karnali. The Ministry of Water Resources is currently evaluating the proposals and has not awarded the survey licenses. Currently, domestic demand for electricity is increasing at 8%-10% a year.

Population pressure on natural resources is increasing. Overpopulation is already straining the "carrying capacity" of the middle hill areas, particularly the Kathmandu Valley, resulting in the depletion of forest cover for crops, fuel and fodder, and contributing to erosion and flooding. Additionally, water supplies within the Kathmandu Valley are not considered safe for consumption, and disease outbreaks are not uncommon. Although steep mountain terrain makes exploitation difficult, mineral surveys have found small deposits of limestone, magnesite, zinc, copper, iron, mica, lead, and cobalt.

Progress has been achieved in education, health, and infrastructure. A countrywide primary education system is under development, and Tribhuvan University has several campuses. Although eradication efforts continue, malaria has been controlled in the fertile but previously uninhabitable Terai region in the south. Kathmandu is linked to India and nearby hill regions by an expanding highway network.

The Nepalese economy remains largely traditional, underdeveloped and backward with over three fourths of the population dependent on agricultural for employment.

Policies of the Government

Policy environment

Chaired by the Prime Minister, the National Planning Commission (NPC) has overall responsibility for setting national development priorities, formulating policy and monitoring the progress of stated plans/programmes. Various ministries are responsible for developing strategies and executing national policies in their spheres of operation. The Ministry of Supply, Commerce and Industry is the key ministry related to enterprise development as it is primarily responsible for enforcing regulations and disseminating information about trade and industry. However, the Ministry of Finance, in coordination with the line ministries, has overall responsibility for all matters relating to fiscal revenue. This means that the Ministry of Finance has to be consulted and consent taken prior to providing any trade and industrial incentives, such as tax rebates, and exemptions that may be offered to domestic or foreign investors. In light of the heavy dependence on trade and indirect taxes, conflicts between the objectives of trade and industrial reform and the need to balance the budget have arisen and have frequently resulted in the reversal of reforms. Consequently, although the Government is committed to policy reforms as stated in its five-year development plans, practical problems hinder the proper implementation of these policies.

Furthermore, in the absence of an alternative source of income, the Government has sometimes gone back on certain policy commitments. There are examples of reversals from its commitments in trade and industrial reforms, some of which have had far reaching implications. In addition, policy implementation has, to some extent, been influenced by political instability in general and the internal insurgency in particular. Unstable governments has led to political turmoil leading to frequent changes of key decision- makers in ministries and/or departments, contributing to interruptions, delays and at certain times reversal of reforms. Although the private sector and investor confidence was low it is envisaged that there would be additional investment especially after the successful conclusion of the recently held Constituent Assembly elections. At this stage, the Government, in association with the private sector, may need to develop, promote and implement certain confidence building measures that would assist in creating a conducive business environment enabling additional investment.

Regulatory environment

The Government initiated tax reforms in 1997 which included modifications to income tax, customs duties, indirect tax (sales tax) and tax administration. Specific examples of the reforms comprise a self-assessment system introduced with respect to income tax, a reduction in the number of bands and the level of customs duties, and the introduction of a value added tax (VAT) in place of sales tax on imports and manufactures. There have been accusations that inconsistencies and an inherent bias in favor of tax officials exists when disputes arise. Delays in the annual renewal of income tax certificates and complicated tax forms also increase compliance costs and adversely affect industrial growth.

Another source of uncertainty is a lack of transparency and reversals in tax policy and procedures which are normally not made public. There exists a complicated system of valuation and exemptions when determining import duties. Although the introduction of VAT appears to have been effected without adequate canvassing of the business sector, tax officers have engaged in educating the taxpayer, and the majority of those registered for VAT are being motivated to comply with the new tax regime. Enterprises with a turnover of less than 3 million Nepalese rupees are VAT exempt. Despite the periodic reforms, the tax system remains complicated for the industries, with more improvements needed in the areas of tax administration and tax law. In this context, efforts are under way to make the tax system more effective in achieving the primary goals of creating an enabling business environment and reducing tax evasion.

Trade and Industrial Policy

With a view to making the trade environment more conducive to enabling more private sector investment and with the additional aim of attracting foreign direct investment, the Government introduced the following reforms in 1992 as an effort to make the trade policy more relevant:

- All goods (except for some banned items) can be imported without license (de-licensing);
- Any importer may obtain a letter of credit for any amount from any bank;
- The Nepalese currency to be made fully convertible;
- Exchange rate controls have been abolished;
- The maximum import tariff now stands at 110 per cent (down from 140 per cent);
- Export duty drawback schemes for the refund of import duty paid on imported raw materials and intermediate goods have been introduced;
- Exports are exempt from all duties except for a 0.5 per cent service charge;
- An export promotion zone (EPZ) has been established;
- Exporters may retain export earnings in personal foreign currency accounts with the requirement that a certain percentage of this amount be spent on trade promotion activities; and
- Income from exports is exempt from income tax, as is income earned from exports to India, on the basis of a letter of credit.

However, a number of practices negate these reforms. Although a letter of credit can be obtained for any amount, small businesses often cannot meet these additional requirements. Since the Nepalese currency is fixed at par with the Indian currency, Nepalese entrepreneurs exporting to India gain no benefit from devaluation. Frequent changes in trade taxation through annual budgets and confidential departmental circulars have also been counterproductive as these tend to bring uncertainties in the business environment and complicate business planning.

The initial surge in exports following trade liberalization has not been sustained. Exports from Nepal during the first eight months of FY 2005/06 increased by 14.6% totaling NRs. 43.32 billion as compared to 4.6% growth in the corresponding period of FY 2004/05. Exports to India rose notably and the exports to other third countries has also improved indicating encouraging growth rates for exports. During the period mentioned (FY 2005/06), the exports to India were 69.1% of the total exports while exports to other countries were the remaining 30.9%.

Total imports during the first eight months of FY 2005/06 increased by 27.9% totaling NRs. 117.48 billion in comparison to 6.2% increase in the corresponding period of the previous FY. Imports from India were 63.3% of the total imports, while imports from third countries were the remaining 36.7%.

As per the available data, the volume of imports has remained quite high as compared to the exports. The trade deficit has sharply increased by 37.1% during the first eight months of FY 2005/06 totaling NRs. 74.17 billion. The increase in trade deficit with India was much higher as compared to other third countries.

Liberalization has failed to induce export diversification and reduce the trade deficit. Frequent changes in trade policy have, no doubt, contributed to this poor response. The changes brought about by the industrial policy reforms through the Industrial Enterprise Act of 1992 include:

- Abolition of the requirement for a license for the establishment, expansion and modernization of a business (except in the areas of defense, public health and environment);
- A generous income tax holiday (5 to 15 years);

- Creation of a one-stop shop for investors (One Window Policy);
- Incentives for reinvestment of earnings;
- A reservation policy for cottage and small industries (i.e. foreigners may not engage in activities designated as reserved for cottage and small entrepreneurs);
- Exemption from income tax on exports for export-oriented industries;
- Total repatriation permissible of proceeds from the sale of shares or dividends earned by a foreign investor; and
- Foreign experts or technicians permitted to repatriate 75 per cent of their remuneration.

Unfortunately, these reforms have had little impact. One reason for the poor response maybe due to the fact that while trading activities account for 52 per for more than half of all economic activities, the share of manufacturing activities is approximately 30 per cent. The major constraints to increased domestic and foreign investment are grossly inadequate infrastructure, such as roads, electricity and telecommunications. Other bottlenecks include lack of skilled manpower and potable water, among other aspects, is also hindering growth. In terms of attracting foreign investors the large Indian market is more attractive as compared to the small Nepalese market. Encouraging entrepreneurship development through the growth of SMEs, often viewed as a prime mover for the economic development for a country like Nepal, is still constrained. Multiple factors like the Nepal being a land locked country, low incomes coupled with lack of capital and access to technology have resulted in the slow pace of development of growth-oriented SMEs. Other constraints include problems of availability of inputs and marketing. While the limited resource needs of the micro-enterprises (often referred to as cottage industries) can be met locally, SMEs largely depend on raw materials from India, China and in some cases, third countries.

Domestic firms have been doubly affected by increased competition from foreign goods and by rising costs of production. Most Nepalese entrepreneurs thus find it difficult to compete with products from India where the costs of production are lower. Hence goods produced in Nepal utilizing Indian raw materials are seldom able to compete with similar goods imported from India. The entry of unauthorized goods through the porous and open border with India further exacerbates the problem by discouraging the establishment of small industries and the diversification of production.

Nepalese exports destined for the Indian market have also suffered as a result of trade liberalization in India. Freer access of raw materials and finished goods from abroad has resulted in the closure of many industries in Nepal. Failure to meet environmental and labour standards (i.e. the use of azo dye and child labour) in importing countries has resulted in the restriction on the sales of Nepalese carpets on the international market. As a result the fall in demand for Nepalese carpets has also led to a shortage of raw material imports for the carpet industry as a whole. Bulk importers of wool (on which SMEs in the industry also depend) have reduced their imports; hence, many Nepalese carpet producers that still have international markets are faced with raw material shortages in the local market. Moreover, India exports cheaper Nepalese-style carpets.

While the Government of Nepal as a facilitator should take all policy and procedural measures to reduce the cost of export, the Government and the private sector have responsibility of creating and maintaining infrastructural facilities which are vital for the smooth flow of exports. Moreover, the institutional role of Government Ministries, Departments and Agencies in supporting product development and market promotion are critical in the export promotion drive. The Ministry of Foreign Affairs, the Nepalese Diplomatic Missions abroad and the Trade Promotion Centre are important players in the promotion of external market and product development to suit the need of international markets. Their efforts should be further enhanced and consolidated with continuity and sustainability ensured.

The recently introduced export promotion and development measures comprises of a policy and procedural measures to reduce the cost of production, increase competitiveness and expedite the flow of exportable products. Additionally it deals with the creation and maintenance of infrastructural and institutional facilities required for the development of export such as production centres, warehouses, transport and transit networks, insurance, information services, packaging units, etc. and export promotion activities including product development and market promotion.

Present Context of Foreign Trade

TOTAL FOREIGN TRADE BALANCE OF NEPAL							
NRs. In Million							
Fiscal Year	Exports	% in Total	Imports	% in Total	Total Trade	Total %	Trade Balance
1999/00	49822.70		108504.90		158327.60	100.0	(58682.20)
2000/01	55654.10		115687.20		171341.30	100.0	(60033.10)
2001/02	46944.80		107389.00		154333.80	100.0	(60444.20)
2002/03	49930.60		124352.10		174282.70	100.0	(74421.50)
2003/04	53910.70		136277.10		190187.80	100.0	(82366.40)
2004/05	58705.70		149473.60		208179.30	100.0	(90767.90)

Source:- Trade and Export Promotion Centre & Nepal Rastra Bank.

Export Performance (NRs in Million)

	TOTAL	INDIA	OVERSEAS
1999/00	49822.7	12530.7	23145.6
2004/05	58705.7	38916.9	19788.8

Major Export Products 2005/06

S.No	Commodities	Unit	Quantity	Value (NRs in Million)
1	Woollen Carpet	Sq. m	2,167,247.0	5,897.63
2	Ready-to-wear garment	Pcs	25,207,303.0	5,430.98
3	Hides and skins	Sq. ft	6,493,273.0	292.34
4	Pulses (Lentil)	M.T.	4,680.0	191.72
5	Tea	M.T.	833.5	98.74
6	Cardamom (Large)	M.T.	677.0	114.33
7	Handicrafts	M.T.		598.17
8	Silverware & jewellery			298.87
9	Woolen & Pashmina Goods			1,665.95
10	Towel			107.26
11	Nepalese Paper & Paper Product			378.43
12	Wooden Goods			37.00
13	Incense Sticks			22.47
14	Cotton sacks & Bags			49.82
15	Micro Transformer			59.71
16	Others			2,744.30

Export Partners (in %) (2005 data)

India	53.7
USA	17.3
Germany	7.1
Others	21.9

Import Performance (NRs in Million)

	TOTAL	INDIA	OVERSEAS
1999/00	108504.9	39660.1	68844.8
2004/05	149473.6	88675.5	60798.1

Major Import Products in Nepal

- Machinery & Parts, Electrical Goods
- Textile
- Chemicals
- Fertilizers
- Raw Wool
- Transport Equipment
- Petroleum Products
- Medicine & Medical Equipment
- Telecommunication Equipment & Parts
- Computer & Parts

Import Partners (in %) (2005 data)

India	47.2
UAE	11.3
China	10.9
Saudi Arabia	5.0
Kuwait	4.2
Others	21.4

Trade Deficits (NRs in Million)

	TOTAL	INDIA	OVERSEAS
1999/00	58682.2	18439.4	40242.8
2004/05	90767.9	49758.6	41009.3

SWOT Analysis

Strength, Weakness, Opportunity and Threat analysis on the state of the trade economy

Strength:	Weakness:
* Possibility of high value addition in the country. * Realization that Pro business policies is important for growth * Availability of investors * Availability of low cost manpower. * Suitable climate, place and location. * History of SME entrepreneurs * Use of appropriate technology. * Commitment of quality production. * Stable market linkage and their relationship. * Availability of adequate organization and labor. * Well developed business community	* Lack of adequate technical manpower for scientific production. * Inadequate financial resource and technology for Hi-Tech quality exportable products. * Low levels of IT base * High cost of overseas market promotion. * Lack of information on world markets and trading systems. * Limited capacity of production. * Missing market linkages with buyers. * Under-developed infrastructure base * Absence of government commitment and support. * Frequent changes in the economic, trading and import-export policies.
Opportunity:	**Threat:**
* Creation of new employment opportunities that helps to alleviation poverty. * Favorable geo-climatic condition and rich bio-diversity. * ncreasing world market demand for Nepali products * Favorable market access condition with preferential tariffs under multilateral, regional and bilateral trading arrangements. * Means of women empowerment by involving them in women oriented SMEs. * Positive affect on development. * Preferential trade with countries as Nepal is a LDC * Ability to attract foreign direct investment (FDI) form foreign based institutional and individual investors * New areas where industries can invest (e.g. herbs, software etc)	* Non-tariff barriers with trading countries * Competition from other nations where cost of production is similar or lower * Inability to comply with the import regulation of trading countries. * Composition of tariffs and complicated regulatory procedure in imports of raw materials required by industries. * Militant trade union activities in certain existing enterprises * Unstable political environment discouraging investment * Unstable marketing policy due to change in business ownership regulations.

Chapter Two

Overview of Nepalese Manufacturing Sector

Introduction

Nepal is a least developed country (LDC) and one of the poorest countries in Asia, with a per capita GDP of US$228 in 2000 (presently US$ 325), compared with US$479 for India, US$ 432 for Pakistan and US$ 368 for Bangladesh. Although an estimated 31 per cent of the population of 28 million lives below the poverty line, there has been reduction in the percentage of people living below poverty. With a large percentage of the total workforce employed in the primary sector, the main cause of poverty can be traced in low agricultural productivity. However, a significant contributing factor is the relatively underdeveloped state of the country's manufacturing sector. The manufacturing sector employed just 6 per cent of the total workforce, according to a recent survey. Its contribution to GDP was also relatively small, below 10 per cent, much lower than in neighboring countries. Nepal's per capita manufacturing output was lower than that of Bangladesh, a third of that of Pakistan, a fourth of that of its large neighbor India, and a sixth of that of Sri Lanka. Nepal's level of industrialization was in fact one of the lowest in the world, on par with Tanzania and Nigeria.

Labour productivity in Nepali manufacturing was one of the lowest in Asia and the world, at just $2,000 per employee compared with $4,000 in Sri Lanka and $6,000 in India in 1996-97, according to the 2001 UNIDO industrial statistics database. This was due to two main factors.

First, the technological level of Nepal's manufacturing production was one of the lowest in the world, with three quarters of its manufacturing production consisting of low-technology labour-intensive industries such as textiles, garments and carpets. Second, the majority of manufacturing workers were employed in labour-intensive small-scale and household enterprises, where value-added per worker was much lower than in larger establishments. Small-scale (10-49 workers per establishments) and very small or micro-enterprises (less than 10 workers) accounted for 12 and 51 per cent respectively of total manufacturing employment, but together produced 28 per cent of total manufacturing value-addition. Incomes were particularly low in the latter segment, comparable to those for agricultural workers. On the other hand, medium and large-scale establishments (employing more than 50 workers) accounted for 37 per cent of total manufacturing employment, but produced 72 per cent of total manufacturing value-addition.

Nevertheless, Nepal's manufacturing sector recorded a respectable growth of 6 per cent per annum over the past 15 years, on average (although growth was uneven over the period, with declining trends but looking more upbeat now). It grew more rapidly than other economic sectors, thereby increasing its share in overall GDP. In the future, a rapidly expanding Nepalese manufacturing sector, both in terms of increasing its relative size in the domestic economy, and in terms of raising its productivity level, is crucial to reducing poverty and generating well-paid jobs, and ultimately to the country's prosperity. Experience in other South and Southeast Asian countries show that, with appropriate policies and strategies in place, the manufacturing sector can be turned into a driving force of economic progress. Given its relatively small manufacturing base and low labour costs, this is certainly achievable provided the countries restores law and order, and provide a stable macroeconomic and political environment, and a conducive regulatory and business environment to attract and retain domestic and foreign investment.

Classification of Industries

Industries in Nepal have been classified across different categories as per the Industrial Enterprise Act, 1992. These are mentioned as follows:

1. Manufacturing Industries
   - § Industries which produce goods by utilizing or processing raw materials, semi-processed materials, by-products or waste products or any other goods
   - § Production and packing of photographic film roll by cutting, slitting, confecting, perforating, spooling and capping from jumbo roll, production of cinematographic film, medical and x-ray film, graphic art film, photographic paper by cutting, slitting processes from imported jumbo roll and pan cake industry

2. Energy-based Industries

3. Agro and Forest based Industries

4. Mineral Industries

5. Tourism Industries

6. Service Industries

7. Construction Industries

Similarly, this Act has categorized various industries as per the scale of investment. These are:

1. Cottage Industries – The traditional industries utilizing specific skill or local raw materials and resources. These are usually labor intensive and related with national tradition, art and culture.

2. Small Industries – Industries with fixed assets of upto Nepali Rupees thirty million.

3. Medium Industries – Industries with fixed assets between Nepali Rupees thirty million and one hundred million.

4. Large Industries – Industries with a fixed asset of more than Nepali Rupees one hundred million.

In addition there are other classes of industries. There are special types of industries that require additional permission prior to commencing. These would be industries that produce explosives, including arms, ammunition and gun powder, security printing, bank notes and coin industries. Other industries that fall under this category would be cigarettes, bidi (tobacco in rolled leaf), cigar, chewing tobacco, khaini (similar to chewing tobacco) and industries utilizing tobacco as the raw materials and alcohol or beer industries. The Government has also classified certain industries as National Priority Industries.

Company Registration

S. No.	Particulars	Fiscal Year		
		2004/05	2005/06	2006/07
1	Private Company Registration	6,481	3,608	6,598
2	Public Company Registration	37	29	36
3	Non Profit Making Company	-	25	49
4	Contact Office of Foreign Companies	-	7	10
	Total Companies Registered as of June 2008	6,518	3,669	6,693

Source: Government of Nepal -Company Registrar Office Record Desk-2008

Global competition and trade liberalization with respect to the Nepali manufacturing sector

Due to rapid globalization and trade liberalization, the Nepali manufacturing sector faces the following challenges and constraints:

- Increasingly stiff competition, in the export markets, from other countries whose international competitiveness has improved;
- Increasing inflows of imported consumer goods due to rapid liberalization;
- Additional pressure on balance of payments due to increasing inflows of imported products;
- Aggressive competition from equally reform-oriented countries for foreign direct investment (FDI); Abolition of guaranteed export quota markets from trading countries;
- Increasing pressure to forego tariff measures to promote and protect domestic industries from foreign competition.

Nepal experienced a widening gap between manufacturing imports and exports over the past fifteen years, rising from US$240 to $913 million between 1985 and 1997. Due to a subsequent drop in manufactured imports, the deficit in manufactured goods narrowed to US$460-480 million in 1999 and 2000. Manufacturing trade deficits are not unusual in developing countries, particularly those industrializing rapidly (and importing large amounts of capital equipment, raw materials and components), or those diversifying their economies (and importing capital equipment and consumer goods to support tourism and other foreign exchange earning sectors). In Nepal's case, the gap between manufactured exports and imports was widest in the 1994-1998 period, when manufactured exports stagnated while manufactured imports accelerated, due to the import requirements of the rapidly growing tourism sector and expanded foreign aid grants and loans. Tourism and transfers (remittances and official grants) were the main foreign exchange earners in recent years. The recent security situation has reduced tourist arrivals and corresponding foreign exchange earnings drastically. The challenge is therefore to rapidly increase manufacturing exports to compensate for the loss of tourism foreign exchange earnings. While the country's exports consisted almost entirely of manufacturing products in 2000, manufacturing export per capita remained one of the lowest in Asia. Due to its low labour costs, abundant hydropower and comparative advantage in the production of tourism related exotic products; the manufacturing sector has the potential to generate additional foreign exchange, and to lessen the country's dependence on tourism, remittances and official grants.

Declining share of Nepali exports

According to data collected by the WTO/UNCTAD International Trade Centre, Nepali exports (excluding to India) grew by some 14 per cent per annum compared with 4 per cent for total world trade in the period 1996-2000. Nevertheless, the market positioning of these exports was relatively weak. Half of Nepal's export earnings came from product categories which gained world market share, but for which the world demand stagnated or increased less than on average, the so-called 'achievers in adversity' (figure 3). Shawls, scarves, and most garment products fell in this category. A further 38 per cent of Nepali exports, including carpets and men's shirts, belonged to the declining markets category, losing world market share in products for which world demand stagnated or declined relative to average. Only 11 per cent of export revenues came from products which gained world market share and for which world trade itself grew by more than average. Finally, other products that were losing market shares constituted the remaining one per cent of export revenues.

The strategic challenge for Nepal is therefore to increase the manufacturing and export of products that are in demand and dynamic in world trade.

Low technology level of exports

Nepal's exports, like those from many South Asian countries, were almost entirely all manufactured goods. However, most of these exports were labour-intensive products including carpets, textiles and garments for Nepal (92-95 per cent), while technology intensive and human capital-intensive products accounted for around 5-6 per cent of total exports in 1999. In contrast, labour-intensive exports formed only 40-50 per cent of total exports in India and China while it was less than 10 per cent in Malaysia and Singapore.

Southeast Asian countries' orientation and emphasis towards electric and electronic exports offered the added advantage that the demand for such products was growing in the world market. In contrast the world market for Nepali products like textiles, carpets and garments was either stagnant or falling.

Reliance on limited number of export products and markets

Nepali exports were limited to a few product categories, consisting mainly of carpets, textiles and garments, and which moreover were sold in a limited number of countries. They were thus quite vulnerable to changes in demand in such countries, as the recent trends in the world demand for woollen carpets and pashmina products clearly illustrates. According to the Carpet and Wool Board, carpet export declined by 25 per cent between 2001 and 2002, while corresponding earnings declined by 30 per cent. This was due to the slump in demand in its largest market Germany, which alone accounted for 60 per cent of total carpet export. Exports to its second and third largest markets USA and Belgium also declined by respectively 8 and 19 per cent. The challenge for the Nepali manufacturing sector is therefore to raise the innovative capacity of domestic firms and diversify markets by identifying future market niches.

Industrial Structure Increasingly at Odds with Nepal's Comparative Advantage

Although considerable capacity has been built up in the overall manufacturing sub-sectors or products these are not in line with the country's future comparative advantage. Trade liberalization has exacerbated the already precarious position of these industries. The current industrial structure evolved mainly in the 1970s and 1980s by imposing high protective trade barriers, other government incentives and the establishment of numerous state-owned enterprises. Explicitly or implicitly, a 'basic industries strategy' was pursued, a strategy which was not successful in many developing countries at their early stages of development.

Learning from its mistakes, the government, in the late 1980s and early 1990s, took measures to liberalize trade, phase out certain sub-sector specific incentives and privatize or liquidate state-owned enterprises. Nevertheless, the overall industrial structure remains insufficiently aligned with the country's comparative advantage, preserved by high import duties and the continued presence of large state-owned enterprises. Te lack of comparative advantage was due to one or more of the following factors:

- Nepal being a landlocked country;
- As the demand was high, some products required large-scale production which was beyond the reach of Nepali industries;
- Some products required significantly large investments;
- Some products was not labour-intensive in which Nepal has a comparative advantage;
- Lack of critical mass of sufficiently educated staff or skilled workers;
- Inadequate and underdeveloped infrastructure; and
- Unavailability or access to raw materials at internationally competitive prices.

Some product categories like sugar, textiles (excluding Pashmina and carpets), cement, chemicals, plastic products, mechanical engineering and the electrical/electronics were considered to lack comparative advantage at present or in the foreseeable future. However Nepal may have a comparative advantage in certain niche products of particular sub-sectors. Rampant smuggling has further eroded the efficiency of certain products.

These are also sub-sectors and product categories characterized by deteriorating technology, low capacity utilization, low productivity and low value-added to output ratios. Aggravating the situation is the fact that production of some goods in Nepal is based entirely on tariff differentials between Nepal and India. The challenge to the government and the industry itself is to restructure the entire manufacturing sector so as to reduce activities from the less competitive industries, and make available financial and human resources that could be diverted to those industries which are more in line with Nepal's comparative advantage and have brighter commercial prospects. This restructuring will be no doubt be associated with significant financial costs, both to the industry and the Government, but the longer-term financial and economic benefits to the industry and the society will outweigh these short to medium term financial costs.

Unfavorable Business Environment

Due Nepal's land-locked situation, limited resource endowments, inadequate physical infrastructure, rugged terrain, small and poor population, and the increasing competition from neighboring India and China, the country suffers from a difficult business environment for additional manufacturing investment. Some of these problems are beyond the purview of the country's control, are however compounded by deteriorating law and order situation, persistent political instability, government red tape, and restrictive legislation in the key areas of labour, tax and investment. Together they present formidable challenges to rapid industrialization. Nepal must take urgent steps to improve the business climate in areas under its control.

Political instability and deteriorating law and order

After a brief period of relative stability following the transition to a democratic government in 1991, Nepal has entered into a prolonged period of political instability, witnessing many governments (including a number of coalitions) between 1994 and 2001. This was compounded by weakening of public administration and institutions due to political interference and delayed policy announcements followed by conflicting implementation of these policies. Other issues were increased governance problems and a marked deterioration of law and order. The latter has culminated in the Maoist uprising, with obvious implications for domestic and foreign investment flows. It can be now hoped that, with the Maoists joining the mainstream politics, the general investment climate for the manufacturing sector would be more upbeat.

Tariff structure

Starting in the early 1990s, Nepal began a process of simplifying its import and export tariff regime to open its economy to foreign competition and to promote exports. Nevertheless a number of anomalies remain. Nepal maintained a generally lower tariff structure than India, while there is free movement of goods, labour and capital along the 500 mile-long open border between the two countries. This has provided opportunities for some importers to route their imports destined for

India via Nepal, draining its foreign exchange reserves, while exporters of Indian products can take advantage of export incentives intended for Nepali goods. Another important side-effect of the differential tax structure has been the encouragement of transitory types of industries in Nepal but with the implementation of the certificate of origin and value addition components this is being increasingly difficult.

The import license system was completely abolished by 1993. The import tariff rate has been reduced. Imported machinery and basic metals benefit from the low tariffs. In addition, Nepal provides preferential treatment to imports of India, other SAARC countries, and the Tibet Autonomous Region of China. Nevertheless, some discrepancies remain.

Export duties and export licenses have been abolished except for a few selected commodities. The bonded warehouse system for imported inputs and raw materials, successfully introduced for the garment industry in the late 1980s, was extended to other exports. On the other hand the duty drawback system, also introduced at around the same time, was not as effective, due to lack of established procedures and guidelines, administration by different tax departments, and inadequate funds for its implementation. In July 2001, the government introduced new measures to improve the duty drawback system. Nevertheless, some important export restrictions remain which constrain export expansion.

Bureaucratic government

Excessive government delays in the provision of government services, and poor management and administration of the tax laws impose unnecessary burden on manufacturing firms. Some problems include the poor delegation of authority, inadequate dissemination of information, lack in clarity, consistency and simplicity of laws and regulations, overly rigid application of rules, and absence of accountability. Such shortcomings have often led to opportunities for arbitrary decisions. The government should reduce its role as a regulator and instead be a facilitator for manufacturing investment, and to be supportive of industrial firms.

Tax administration suffers from tax officials having too much discretion on tax assessments, and the absence of workable system for resolving tax disputes. The VAT system has not been accompanied by adequate training of tax officers.

Customs administration suffers from endemic key problems: procedural delays and complicated documentation (too many documents for export), inaccurate classification of goods (leading to arbitrary decisions and delays), inaccurate valuation of goods (due in part to the use of reference value rather than invoice value), delays in the duty drawback scheme and VAT refunds (six-month delays are common), lack of enforcement and smuggling (especially due to price differentials with India). All these increase the transaction costs of doing business, and adversely affect the competitiveness of manufacturing firms.

Government policies and regulations suffer from frequent changes without prior and adequate consultation with business, including changes in tariff rates and currency regulations, introduction of a five-year income tax holidays for new industries in 1992 followed by its removal, and absence of action on the establishment of export processing zones and export promotion houses.

Restrictive labour legislation and administration

A labour law stipulates that permanent workers cannot be dismissed without prior approval of the Department of Labour, a process which can take months or even years. As a result, many older firms are over-staffed, while other firms have cut down on recruitment of new workers, at least on a permanent basis, as well as encouraging some firms to adopt more equipment intensive production methods. More often, firms have switched to recruiting temporary and contract workers. Labour regulations have achieved neither their aim of protecting labour, nor attracting investors. In addition, trade unions with political affiliations have caused industrial disputes.

Several institutions are responsible for labour regulations and administration, including the Department of Labour under the Ministry of Labour, the Central Labour Advisory Committee, the Minimum Remuneration Fixation Committee, the Labour Advisory Board, the Labour Relations Committee and labour courts. Some of these, such as the Labour Advisory Committee, are inactive, while others, such as the Department of Labour, are more involved in skills development programmes. The challenge is therefore to establish a legal environment that does not hamper the employment of labour in the manufacturing sector, and which is supported by clearly defined institutions for dealing with labour relations.

Lack of coordination among government agencies

Industrial policies consist of all policies that have an impact on the manufacturing sector. Rapid and environmentally sustainable industrial development require that various government policies are well coordinated and effectively implemented by the ministries involved, including the Ministry of Finance, the Ministry of Industry, Commerce, Supplies, the Central Bank, The National Planning Commission and other Ministries responsible for infrastructural development.

A number of coordinating mechanisms have been established to provide efficient services to manufacturing firms and investors, including the One-Window Committee (chaired by DOI and with high-level representation from MOICS, MOF and NRB), the Investment Promotion Board, and the Nepal Trade Promotion Board. However, the desired coordination has not materialized. It is important for the government and the private sector to jointly identify and resolve the constraints faced by these institutions. In particular, the One-Window Committee must be strengthened with representations from land and infrastructural agencies, because the availability of land, power and other infrastructural needs are major bottlenecks for investors. Another important need is to coordinate tax agencies under Ministry of Finance and DOI, so that tax policies, which are primarily designed to raise revenues, do not discourage manufacturing investment and activity, and so that tax regulations are simplified.

Several other institutions have been established to provide support to industrial development. The Industrial Enterprise Development Institute (IEDI) was established in 1996 to enhance human resources through enterprise, entrepreneurship and managerial training. Its Entrepreneurship Development Centre provides business development services. The National Productivity and Economic Development Centre (NEPDC), affiliated to MOICS, provide the secretariat for the national productivity council. The Industrial Districts Management Company manages the nine industrial estates in different parts of the country, including three in Kathmandu. The Nepal Trade Promotion Board (NTPB), and the Trade Promotion Centre (TPC), was established to promote the expansion and diversification of exports, but the national and sectoral business associations have now overtaken this role.

In addition to duplication, many Committees and Councils carry representations from different ministries and agencies at very senior levels, often the same ones, thus making it difficult for them to schedule meetings regularly. Some of these institutions have clearly outlived their original purpose, and need to be phased out or merged with others.

Inadequate Physical Infrastructure

A survey undertaken by the Nepali Federation of Chambers of Commerce and Industry (FNCCI) and the World Bank in 2000 revealed the extent of inadequacy of the physical infrastructure in Nepal. Many firms experienced problems with electricity, the road network, water supply, telecommunications and water disposal. These issues in turn are discussed below.

Electricity

Electricity availability from the grid is the most significant infrastructural problem faced by industrial firms. As a result, many industries supplied their own electricity using diesel generating sets. Larger firms were relatively more likely to spend their resources on electricity generating equipment, particularly in the chemical, pharmaceutical and metal sub-sectors.

Firms experienced cuts and erratic electricity supply during the dry season. Electricity is accessible to approximately 35 per cent of the population, while the remaining of rural dwellers do not have access to it, and rely on traditional fuels such as wood, agricultural waste and animal dung. Rural electrification, virtually non-existent at present, would provide the largest impetus to rural industrialization and rural poverty reduction. The major portion of the electricity is supplied by the Nepal Electricity Authority hydroelectric plants while foreign, Indian and Nepali private hydropower producers provide electricity to NEA through Power Purchase Agreements (PPA). A small per cent comes from diesel plants and India.

While the potential demand for electricity for industrial use and domestic consumption far exceeds supply, less than one per cent of potential hydroelectricity capacity has been exploited so far, and this for a number of reasons. First, power planning has been aimed at satisfying domestic consumption, and insufficient consideration given to the needs of industrial users or the potential for power export to India. Neither has it considered the potentially large captive market of new electricity-using industries such as fertilizer plants. Second, due to poor energy pricing policies, traditional fuels, as well as coal and petroleum, were cheaper than hydroelectricity. But with the very high spike in the petroleum prices worldwide, there will be increased pressure on NEA to produce more electricity. Additionally the currently energy pricing policy and the large investments required have combined to limit private investor interest in hydropower. Moreover, NEC is the only agency allowed in electricity generation, transmission and distribution in Nepal. The private sector involvement is only limited to hydropower development. Finally the existence of several government agencies dealing with hydropower development, including the Ministry of Water Resources, the Water and Energy Commission and the Department of Electricity Development has created confusion and slowed down the implementation of energy plans.

Road and air transport

Road transport services constituted the second most important infrastructural problem in the country after electricity supply, according to a FNCCI-World Bank survey. In the absence of a railway system in this mountainous country (except for a 52 km stretch from Janakpur and Jayanagar in India), most goods are shipped around the country and exported using roads and airfreight. The existing road network, though relatively extensive, is generally inadequate to support a modern manufacturing sector. For the most part it consists of narrow, fair-weather roads and only a third of the total length is asphalted, while another quarter is graveled. The government lacks the resources to expand and maintain a modern road network, yet it has been passive in promoting private investment in this area. Recently some private sector companies have shown keen interest in building a fast track highway linking Kathmandu and the Terai region in Southern Nepal.

Some firms experienced problems in the existing airfreight services, especially related to exports. This is not considered a luxury in Nepal, since around 90 per of carpet firms and 85 per cent of garment and pharmaceutical firms used them to meet shipment deadlines. A substantial per cent of textile and metal fabrication firms also used airfreight services, usually through Kathmandu. In a land-locked country with a rugged terrain, airfreight services are very important, yet many firms experienced problems with the services.

Telecommunications

One fifth of the firms in FNCCI-World Bank survey experienced problems with the prevailing telecommunication services. The demand for telephone lines remains very high. The National Telecommunications (NT) has approximately 2.5 million lines in operation, but has substantial applications waiting for connection, especially outside Kathmandu. This consists of approximately 0.5 million fixed land lines, 1.6 million GSM cellular lines, 0.4 million CDMA lines and others. Cellular and satellite communications were introduced a few years ago and were expensive. With the rates substantially reduced, cellular phones are quite popular. Private sector participation in the telecommunication area has been allowed following liberalization by the Government. Besides NT, two private sector firms are involved in this sector at a national level while regional private operators are also operating.

Water supply

One third of the firms surveyed by FNCCI-World Bank reported problems with regular water supply. This percentage was 58 per cent in Kathmandu. As a result, 71 per cent of firms owned their own water supply which was usually through deep bore wells. Carpet, garments and textile firms require large volumes of water in their washing and dyeing processes.

Industrial estates

There are nine industrial estates in the country, including three in Kathmandu. Despite the availability of transport, power, telecommunications and water, many manufacturing firms set up facilities outside these estates for three main reasons. First, land cannot be bought but only leased, and cannot therefore be used a collateral for bank financing. Second, estates have been prone to labour disputes, since problems in one establishment tend to spread to the operation of the whole estate. And third, the physical infrastructure provided in the industrial estates is inadequate, forcing many firms have to deal directly with the service providers.

Finally, Nepal’s physical infrastructure, especially electricity supply, roads, telecommunications and water supply, is inadequate to support a modern manufacturing sector, which is capable of quickly responding to trends in world market demands for manufactured products. The Inland Container Depots (ICD) or ‘dry port’ currently being built in Birgunj, in combination with the railway link between Raxaul and Birgunj, will ease the movement of goods between Nepal’s border and Calcutta seaport. However, the necessary agreement with India to allow this movement has not been signed yet.

Low Productivity and Weak Human Resources

Labour productivity

Manufacturing value-added per employee in Nepal is one of the lowest in the world. The primary reason for this appears to be the low technology, labour-intensive pattern of industrialization in Nepal, especially in small and medium industries, which employed the majority of manufacturing workers.

There has been healthy growth in the manufacturing employment in Nepal where household and cottage industries accounted for half of total manufacturing employment, but produced just 12 per cent of manufacturing value-added. Small-scale establishments (10-49 workers) accounted for about 12 per cent of employment and produced 16 per cent of value addition. Medium scale establishments (50-199 workers) employed 19 per cent of the total employment and produced 32 per cent of value addition. Large-scale establishments (above 200 workers) accounted for the remaining 19 per cent of total manufacturing employment, but produced 40 per cent of value addition.

Education quality

Due to its relatively small size, the quantitative needs of the manufacturing sector for educated manpower are likely to be satisfied by the current output of education and training system. For example, engineers and scientists form typically less than one per cent of the manufacturing workforce even in the modern sector. Medium and large firms (above 50 workers) employed a total of 150,000 workers, out of which perhaps 1,500 were engineers and scientists. A 10 per cent annual growth rate of such firms would translate into an additional demand of 150 technical graduates. Similarly, science and engineering technicians form typically less than 2 per cent of the modern manufacturing work force, so their additional demand would be perhaps 300 per annum.

The issue of weak human resources for the manufacturing sector is therefore not so much one of quantity but quality. The primary education system produces relatively poor primary school leavers due to, among others, insufficient numbers of teachers, who are moreover poorly motivated and paid, and inadequately trained in modern teaching methodologies, insufficient and poor quality textbooks and other teaching materials, and a weak quality control and supervisory system to ensure that minimum standards are being met. In addition, secondary education and tertiary education quality has deteriorated because it has expanded rapidly in recent years, and because of the poor quality of its intake.

Enabling Business Environment

Manufacturing firms operating in land-locked Nepal are already facing serious competitive pressures due to inadequate physical infrastructure, limited natural and human resource endowments, a relatively narrow and poor domestic market, and increased competition from neighboring countries. The government and the private sector must work together and urgently take steps to improve the business climate in areas over which they have control. Some of the steps are briefly outlined:

Restoring political stability and law and order

Restoring political stability and law and order must rank at the top of Nepal's list of priorities. Political instability is one of the worst outcomes of a dysfunctional democracy. It encourages a short-term outlook and corruption, and may have contributed to the present serious law and order situation in the country. In the present context, absence of the internal insurgency, though a very positive sign, does not necessarily translate to enabling a positive business environment.

Supportive macroeconomic policies

The government must pursue appropriate macroeconomic policies to promote manufacturing competitiveness, including a stable competitive exchange rate and competitive interest rates.

Trade policy reform

- Accelerate efforts to introduce more reforms;
- Establish time table to reduce import duties;
- Harmonize tariff rates with those of India to the extent possible. Because they differ, they encourage transitory

types of industries in Nepal, while some businessmen abuse the system by importing through Nepal goods destined for India, while exporting Indian goods via Nepal;

- Abolish export taxes on commodities prone to re-export to India. Their imposition unnecessarily complicates and burdens the tax system;
- Rationalize the existing import tariffs to avoid discriminating against domestic firms, such as higher taxes on some intermediate inputs relative to finished products;
- Improve rules of origin and certificates of origin system;

Public-private-union consultation mechanism

Several new institutions and agencies have been established to facilitate coordination and provide efficient services to manufacturing firms and investors. Unfortunately, the desired coordination has not materialized, while their proliferation and competing mandates have become a new and serious problem. In many cases, donors have contributed to this problem by requesting the government to establish new institutions to service their projects. While the government will face considerable opposition from vested interests inside and outside government, concrete progress is required in the following areas:

- Improve the formal institution(s) responsible for consultation between government, business and trade unions.
- Manufacturing support agencies: A number of agencies are responsible for developing and supporting the manufacturing sector, but their functions and mandates overlap and create confusion. Steps need to be undertaken to review the operation of the various agencies and recommend streamlining and merging arrangements, so that remaining industrial support agencies have a clear mandate to look after the interest of manufacturing firms.
- Labour relation agencies: Several agencies exist to implement labour policies, but their functions and mandates overlap and create confusion. There is a need to review their operation and to recommend streamlining and merging arrangements, so that remaining labour agencies have a clear mandate to look after the interest of investors and workers.
- Tax forum: Establish consultation forum between tax authorities, the Department of Industry and business, when formulating new tax generating schemes designed to raise revenues, to avoid discouraging manufacturing investment and activity.

Efficient government

In order for the government to change its role from regulator to facilitator of business, it must act promptly to reduce bureaucracy, red tape and corruption. Action is required to improve the efficiency of tax and custom administration, investment promotion and licensing, and government agencies. Legislation reforms are also required in certain areas.

The Labour Law should be amended to facilitate recruitment and dismissal of regular workers; the Company Law should be amended to facilitate liquidation and abolish the need to require approval for loan transactions; the Contract Act should be amended to address compensation for breach of contract; the Land Law should be amended to provide more secure land tenure; other laws to encourage investment are required, including bankruptcy, anti-dumping, intellectual property rights and antitrust laws.

Pursuing financial sector reform is the appropriate response to address the problem of insufficient availability of credits and high interest rates. Some possible reforms might include a credit guarantee scheme with shared risks between HMG, the banks and the enterprises; an export credit guarantee scheme - possibly assorted with a subsidized export insurance scheme - would alleviate the cash-flow constraint and mitigate the risk
associated with international trade.