

# *Nepal*

## **Trade and Competitiveness Study**

*A Study conducted as part of the Integrated Framework for Trade-Related Technical Assistance*

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**ACRONYMS AND ABBREVIATIONS**

ACAP	Annapurna Conservation Area Project	MW	Megawatts
ADB	Asian Development Bank	NEA	Nepal Electricity Authority
APP	Agricultural Perspective Plan	NGO	Non-Governmental Organization
ASEAN	Association of South East Asian Nations	NLSS	Nepal Living Standards Survey
ASYCUDA	Automated Systems for Customs Data	NPC	National Planning Commission
AOTA	Advisory and Operational Technical Assistance	NRB	Nepal Rastra Bank
ATC	Agreement on Trade and Clothing	NRs	Nepali Rupees
BOI	Board of Investment	NTB	Nepal Tourism Board
BOOT	Build-own-operate-transfer	NTPC	National Thermal Power Corporation (India)
BOT	Build-operate-transfer	NTSC	Nepal Trade and Competitiveness Study
BPC	Butwal Power Company	ODC	Other Duties and Charges
CAAN	Civil Aviation Authority of Nepal	OECD	Organization for Economic Cooperation and Development
DDC	District Development Committee	OPEC	Organization of Petroleum Exporting Countries
DFID	Department of International Development, U.K	OWC	One Window Committee
DOC	Department of Customs	PATA	Pacific Asia Travel Association
DOED	Department of Electricity Development	PEA	Post Entry Audit
DOLIDAR	Department of Local Infrastructure Development and Agricultural Roads	PEV	Post Entry Verification
DOR	Department of Roads	PRC	People's Republic of China
EDIFACT	Electronic Data Interchange for Administration, Commerce and Transport (UN System)	PSI	Pre-shipment Inspection
EPB	Export Promotion Bureau	PTC	Power Trading Corporation (India)
ERR	Economic Rate of Return	RMRP	Road Maintenance and Rehabilitation Project
FDI	Foreign Direct Investment	RNAC	Royal Nepal Airlines Corporation
FNCCI	Federation of Nepalese Chambers of Commerce & Industry	RUPP	Rural Urban Partnership Program
FNCSI	Federation of Nepal Cottage and Small Industry	SAARC	South Asian Association for Regional Cooperation
FY	Fiscal year ending 15 July of the year specified	SARIE	South Asian Regional Initiative for Energy Cooperation and Development
GDP	Gross Domestic Product	SASEC	South Asian Sub-regional Economic Cooperation
GEFONT	General Federation of Nepal's Trade Unions	SEB	State Electricity Boards (India)
GWhr	Gigawatt hours	SME	Small and Medium Sized Enterprises
HDP	Hydropower Development Policy	SPS	Sanitary and Phytosanitary Measures
HMGN	His Majesty's Government of Nepal	SNV	Netherlands Development Organization
HMIS	Highway Management Information System Unit	TA	Technical Assistance
ICD	Inland Container Depot	TANN	Trekking Association of Nepal
IDA	International Development Association	TBT	Technical Barriers to Trade
IF	Integrated Framework	TC	Transit Country
IMF	International Monetary Fund	TPC	Trade Promotion Centre
IPP	Independent Power Producer	TRIPS	Trade-related Intellectual Property Rights
ITC	International Trading Centre	TRPAP	Tourism for Rural Poverty Alleviation Program
kV	Kilovolts	UNCHS	United Nations Center for Human Settlements
LC	Letter of Credit	UNCTAD	United Nations Conference on Trade and Development
LLC	Landlocked Country	UNDP	United Nations Development Program
MFA	Multifibre Arrangement	VDC	Village Development Committee
MFN	Most Favored Nations	WECS	Water and Energy Commission Secretariat
MOT	Ministry of Transport	WCO	World Customs Organization
MPPW	Ministry of Physical Planning and Works	WTO	World Trade Organization
MTEF	Medium-Term Expenditure Framework	WB	World Bank

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## PREFACE

Following a request from His Majesty's Government of Nepal (HMGN) in 2002, the Integrated Framework Working Group agreed to conduct a diagnostic trade integration study of Nepal as the first step in the Integrated Framework (IF) process of assisting Nepal with trade integration. The World Bank subsequently carried out this diagnostic Nepal Trade and Competitiveness Study on behalf of the IF Working Group, which consists of six agencies, (IMF, ITC, UNCTAD, UNDP, WTO and the World Bank), two donor representatives, an OECD-DAC observer and two LDC representatives. The World Bank also thanks the Department for International Development, U.K., the Lead Donor for the IF Work in Nepal, for providing assistance for this study.

This study is intended to aid policy makers, researchers, civil society stakeholders, and Nepal's development partners to identify policy and technical assistance requirements for making the Nepalese economy more competitive and enabling it to get greater benefits from world trade.

Diagnostic trade integration studies balance the benefits of new research to support findings with the equally important task of systematically uncovering policy and capacity building requirements. Other goals are to stimulate debate and discussion on policy issues and identify policy areas that may require more in-depth work. This report contains a blend of detailed recommendations where these have been made possible by focusing on a particular bottleneck to trade where existing reforms need to be built upon (e.g. Customs reform) and broader suggestions designed to initiate further work required for policy development (e.g. labor market changes). As a diagnostic study aimed at assisting HMGN to produce practical, time bound policy initiatives with identified technical assistance needs to support them, this work has built on a series of relevant and recent studies undertaken in Nepal, often through support of other development partners.

The groundwork for this study was laid through a preliminary mission conducted in September 2002 and a full field mission in October 2002, during which consultants gathered data and conducted extensive interviews, including a small survey to supplement the larger FNCCI/World Bank survey of firms carried out in 1999.

The report was prepared by a team of international and national consultants, and by IMF and World Bank staff (see next page). Ahmad Ahsan was the Task Manager from the World Bank and Ross Chapman (from the Center for International Economics, Australia) led the team of consultants. This work was carried under the guidance of the Steering Committee for the Nepal Trade and Competitiveness Study (NTCS) appointed by HMGN. Comments were received from the Ministry of Industry, Commerce and Supply, Ministry of Finance, the National Planning Commission, Ministry of Labor and Transport Management, Department of Customs, Nepal Bureau of Standards and Metrology. The Steering Committee also included representatives from private sector bodies such as the Federation of Nepal Chamber Commerce and Industry (FNCCI), the Federation of Nepalese Cottage and Small Industries (FNCSI), Nepal Chamber of Commerce (NCC) and the Confederation of Nepalese Industries (CNI). Valuable discussions were held with donor representatives such as ADB, DfID, the IMF, UNDP, and the USAID. The report has benefited from comments by peer reviewers (H. Shishido, IMF; and Kathie Krumm, World Bank), DfID staff, World Bank staff and management.

This report was discussed in the Nepal Trade and Competitiveness Study Conference held in Kathmandu on June 27, 2003 under the chairmanship of Dr. Shankar Sharma, Vice Chairman, National Planning Commission. The prioritized recommendations contained in the report and presented in the Policy and Technical Assistance matrix of the executive summary, reflect the comments made by the National

Steering Committee and other participants in that conference. A separate Volume on the Background Papers of the Nepal Trade and Competitiveness Study is also being prepared.

### **National Steering Committee**

Chairman: Dinesh Chandra Pyakurel, Secretary, MOICS (Previous Chairmen and Secretaries: Bhanu Acharya, Lava K. Devacota). Members: Purushottam Ojha, Prachanda Man Shrestha (MOICS), Bidya Dhar Mallik (MoFinance), Ram Kumar Shrestha (NPC), Deependra Chhetri (NRB), Rajendra Khetan, Badri Ojha (FNCCI), Satish Moor (CNI) Basu Giri, Subarna Shrestha (FNCSI), Bala Ram Rajbhandari (NCC). Member-Secretary: Kailash Bajimaya, (MOICS). Advisor: Pushkar Bajracharya (Professor, Tribhuban University).

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## EXECUTIVE SUMMARY

1. With a trade<sup>1</sup> to GDP ratio of about 50%, an average tariff rate of 14%, and virtually no quantitative restrictions, Nepal is among South Asia's most open and trade-dependent economies. Despite its significant geographical constraints and policy and institutional weaknesses, Nepal has comparative advantage in a number of labor-intensive manufacturing and agricultural products. During the 1990s, these manufacturing exports grew (in U.S. dollar terms) at an average annual rate of 20%, compared to 15% overall export growth, though with considerable volatility.<sup>2</sup> The share of certain products in world markets increased 2-10 times, reaching 7% in the case of carpets and 0.12% in the case of garments, while overall share in global exports doubled. The country's potential for further trade growth remains high, as its share of exports in world markets is less than 0.02%. Also, while Nepal's trade to GDP ratio is high by South Asian standards, the ratio in similarly sized economies is about 80%,<sup>3</sup> indicating further potential for the country's trade growth. Nepal's proximity to large economies such as China and India also offers opportunities for trade.

### *Challenges to Trade Potential*

2. Nepal's geography is a major constraint to realizing its trade potential. It is a landlocked country of 23 million people, nestled in the southern slopes of the Himalayas, bordering China to the North and India in all other directions. Most of the country's terrain is mountainous or hilly, with only 20% arable land. Nepal's per capita income of US\$250 in nominal terms or US\$1,450 in purchasing power parity (PPP) terms makes the country one of the world's poorest outside Sub-Saharan Africa, further constraining the development of domestic trade networks. Distance to the nearest port, located in India, is 660 miles. All of these factors make transport costs high, hinder the development of markets, raise the costs of expanding agriculture, and create near-complete dependence on India for transit routes.

3. As the sharp 18% decline in exports in the last fiscal year (FY 2002) suggests, Nepal faces numerous other challenges to realizing its export potential. The first set relates to the external economic environment. Nepal's narrow export basket and a concentration of exports to only a few countries makes it susceptible to global economic volatility. A further challenge is posed by the forthcoming phasing out of the Multi-Fibre Arrangement (MFA) in 2005, whose quotas enabled significant growth of ready-made garments exports (28% of all exports in 2000). The second set relates to the Nepal's close economic and trading relationship with India. Here, the new and more restrictive Nepal-India Trade Treaty of 2002 will slowdown Nepal's manufacturing exports to India. In addition, uneven implementation and interpretation of the trade treaty measures by State Governments in India are imposing additional barriers to Nepal's exports. Nepal will now need to focus more on exports to the large Indian market where it has true comparative advantage, including textiles and a variety of agricultural products. Third, Nepal also faces the challenge of its forthcoming integration into the World Trade Organization (WTO), which has to be met in a way that promotes its economic competitiveness. Finally, Nepal has to address its significant domestic or "behind-the-border" constraints of ineffective implementation and still pending regulatory constraints that lowers its productivity, makes its investment climate unfriendly and reduces its competitiveness.

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<sup>1</sup> Trade includes merchandise and non-factor services.

<sup>2</sup> While exports fell steeply in FY 2001 and FY 2002 due to the global economic slowdown and domestic uncertainty and the more restrictive Indian trade treaty, exports to third countries have increased again in the current year. Garments exports, for instance are expected to increase by about 50%.

<sup>3</sup> That is, countries with GDP of US\$ 4-6 billion; examples include Azerbaijan, Estonia, Gabon, Honduras, and Yemen.



## ***Study Goals and Findings***

4. This study seeks to help Nepal address these challenges by analyzing its trade policies and performance, identifying constraints to increasing trade competitiveness, and recommending policy changes and technical assistance to remove these constraints. The study is timely, as Nepal's draft Poverty Reduction Strategy Paper of 2003 assigns a key role to trade and exports as drivers of broad-based economic growth—one of the four main pillars of its strategy.

5. Key conclusions are that Nepal's trade policies are generally sound, and the country is competitive in a variety of products. More than one-third of its export basket consists of "rising-star" goods (ready-made garments, textiles, and jewelry), share in world trade and in Nepal's exports are increasing. Minor reallocation of resources within Nepal's garment and carpet sectors could bring more than 50% of its exports into this dynamic category.

6. These positive findings are tempered by constraints that make Nepal's productivity among the lowest in the region, create an inhospitable business climate, and discourage foreign direct investment—a key conduit for export-market access and technology transfer. The most critical constraints are: i) delays in customs and transshipment to India's Kolkata port; ii) high infrastructure costs, especially transport and power; iii) a rigid, formal labor market; and iv) weak policy and institutions in the areas of taxation, investment and trade promotion.

7. The Matrix at the end of this summary lists prioritized and sequenced policy recommendations and technical assistance requirements for overcoming these constraints. Case studies are also included in this report to show how Nepal can boost its trade competitiveness in six areas of comparative advantage.

## ***Role of Trade in Nepal***

8. Despite significant structural changes in its merchandise exports over the last two decades, Nepal, like other low-income countries, remains dependent on relatively few exports, making it more vulnerable to external shocks. The share of primary goods declined from nearly 70% in the early 1980s to 17% in 2000, whereas export of manufactured goods increased from 30% to 66% over the same period. However, Nepal's exports (totaling US\$ 709 million<sup>4</sup>, excluding re-exports) were heavily concentrated in a few manufactured items—mainly ready-made garments and carpets—which accounted for nearly 60% of all export earnings. Nepal's main imports include machinery and transport equipment (18%), followed by chemicals (17%) and food products (13%).

9. The destination of Nepal's exports and the sources of its imports are limited to a few countries. Exports directed to North America (clothing to the U.S.) and Europe (knotted carpets, mainly to Germany) comprised more than 50% of all exports in 2000. Indian markets—consisting mainly of textiles, food items, and chemicals—accounted for another 45%, although this share will fall now that the more restrictive Nepal-India Trade Treaty has been signed. The two main sources of imports are India (38%) and the East Asia region (33%). Estimates of informal trade with India show it to be significant, especially in agriculture (one-third formal volumes) and roughly balanced in each direction. Tariff differences between India and Nepal, versus other countries, offer one explanation for informal trade, but so do the high transaction costs of formal trade, suggesting the need for reforms.

10. Notwithstanding its narrow base, Nepal's growth in trade has been a driver behind accelerating per-capita economic growth to 2.4% per year in the 1990s, compared to the less than 1% growth rate for

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<sup>4</sup> The data is for the year FY 2000, the last year for which detailed breakdown of trade data is available from UN COMTRADE statistics.

most of the country's prior economic history. Following trade liberalization in the early 1990s, Nepal's exports grew at an average annual rate of 15% throughout the decade, while the net exports of key items such as garments increased steadily, contributing to overall growth. Trade has stimulated demand-side growth by enabling Nepalese producers to access global markets instead of relying on weak domestic markets and stagnant agricultural incomes. On the supply side, liberalization of machinery, equipment, and raw materials imports helped to boost growth. Imports of machinery and transport equipment grew at about 10% annually during the 1990s, enabling the growth of private investment.

11. The importance of trade for growth and the nature of Nepal's exports (labor-intensive manufacturing and diversified agriculture) mean that trade is critical for poverty reduction. As analysis of the 1995–1996 data suggests, if the 5% average growth rate of the 1990s could be restored in the next five years, and if inequality does not worsen and consumption grows at the same rate as income, then the share of population living below the poverty line would be expected to fall below 30% by the end of FY 2007. A simulation exercise carried out for this study shows that trade and its associated improvement in transportation can raise the income of the poor (especially the urban poor) through employment and by encouraging farmers to switch to higher-value crops.

12. While Nepal has comparative advantage for a number of products and a significant potential for increasing its trade, medium-term prospects are challenging. The global economic slowdown and disruptions related to the Maoist conflicts have shown the downside risks by the collapse of exports and tourism in FY 2002. The forthcoming phasing out of the MFA, increasing competition from new WTO members and the recent new Nepal-India Trade Treaty all pose significant challenges for realizing Nepal's export potential in the medium term. Overcoming them will require Nepal to undertake significant reforms and institutional development to increase its competitiveness.

### *Macroeconomic and Trade Policy*

13. Nepal's prudent macroeconomic stance throughout most of the 1990s has helped to increase its competitiveness. Low levels of domestic borrowing by the public sector, the nominal anchor of an exchange-rate peg with India, and a large jump in remittances by expatriate Nepalese labor have enabled Nepal to maintain macroeconomic stability. Sustaining this position, which keeps inflation low and avoids crowding out the private sector and real exchange rate appreciation, is fundamental to maintaining export competitiveness. The current exchange-rate peg served Nepal reasonably well in the 1990s by keeping the real effective exchange rate (REER) stable in the face of large inflows of labor remittances.<sup>5</sup> However, the challenges noted above will increase competition in world markets. In that light, the current pegging arrangement and its level will require ongoing review to ensure that Nepal's competitiveness does not erode.

14. Along with Sri Lanka, Nepal has the most liberalized trade policy in South Asia—comparable to those of the most liberalized developing countries. Since 1990, the average tariff has been reduced from 40% to only 14% (2001). Current policy aims for a further simplification and reduction of tariff bands. As trade-related taxes account for about one-third of all tax revenue, the rationalization of tariffs will need compensating measures by enhancing the tax collection from other trade-neutral taxes.

15. Nepal's tariff structure follows the basic pattern found in other developing countries, with cascading tariffs aimed at giving higher protection to producers of consumer goods and lower levels of protection on intermediate inputs. Given the reduction in tariff dispersion over the years, effective protection rates have also declined. Recently imposed additional duties and charges, levied on top of the

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<sup>5</sup> Initial research suggests that, on average, Nepal's real exchange rate has tracked the equilibrium in the 1990s.

basic tariff structure, are around 3 to 4% on average and can be as high as 14.5%. However, most of these do not discriminate against imports and are non-protectionist in nature.

16. The tariff regime also accommodates the preferential treaty for India and regional trade agreements, including the South Asian Preferential Trade Agreement (SAPTA). Preferences are given to Indian imports through rebates on ad-valorem customs duties. However, the effectiveness of these preferences, and those for SAPTA nations and the Tibet Autonomous Region of the People's Republic of China, as well as the costs of trade diversion, have eroded with the steady decline in Nepal's tariff levels. In the event, trade with countries in the region, other than India, is negligible.

17. While the Nepal-India Trade Treaty of 2002 continues Nepal's customs duty-free access to India in principle, it is more restrictive than the previous treaty. Under the new treaty, India has imposed quantitative restrictions on four items to restrict a "surge" in exports from Nepal to India. In addition both countries have the right to impose safeguard measures to protect their domestic industries and domestic value added requirements for trade have been increased. While exports to India have dropped due to these new restrictive measures on rules of origin, quota allocation and other non-tariff barriers, the proximity of the large Indian market continues to present Nepal with important opportunities to expand trade in goods and services where it has comparative advantage, which are identified in this report

18. Coordination of Nepal's trade policies present major problems, as policies are developed and implemented by many agencies with multiple objectives. Given the importance of trade for the Nepali economy, the Government needs to make investment in trade policy capacity building a high priority. It needs to consider building an apex body with specific responsibility for trade policy development in line with its poverty reduction strategy, evaluation of these policies, and trade negotiation. Nepal needs technical assistance in all these areas. Trade promotion needs to be rationalized and separated from this body, based on public-private partnerships and cost-sharing.

#### ***Accession to the World Trade Organization***

19. The forthcoming WTO accession, which will take place after Nepal's ratification of the WTO agreement, holds important benefits and challenges for Nepal—one of the two least developed South Asian countries that are not yet WTO members. The benefits are threefold: i) discipline of Nepalese policymakers and policy credibility resulting from WTO commitments; ii) discipline of trading partners to give Nepal access to their markets and trans-shipment rights; and iii) WTO-required institutional improvements. The costs of accession stem from potential revenue loss and competitive challenges brought about by further tariff reductions and the need to strengthen institutional capacity.

20. A key issue during the negotiations was the level of tariff bindings. In its final goods offer, Nepal succeeded in preserving flexibility on the margin between bound and applied rates. Nepal should now rationalize the current tariff structure and adjust rates (possibly both up and down) within the confines of its tariff bindings to promote efficient development of domestic industries through appropriate levels of protection. But this can be done only if the analytical capacity for trade analysis within His Majesty's Government of Nepal (HMGN) is increased with technical assistance.

21. WTO compliance can impose costs in various ways. Standards compliance involves real resource costs and new testing facilities. The private sector stands to gain from such changes and should be persuaded to share these costs. Nepal has negotiated to phase out "other duties and charges". Consequently, Nepal will need to find other revenue instruments to compensate for possible revenue losses.

22. Having negotiated liberalization offers on trade in 11 service sectors (including many business support services, engineering and consulting), Nepal has to make best use of service sector liberalization

to promote its economic development. Nepal has submitted a lengthy legislative action plan; however, it requires substantial drafting and other technical assistance in such areas as Trade-related Intellectual Property Rights, Sanitary and Phytosanitary Measures, and Technical Barriers to Trade (see chapter 3.3 for a glossary). The United Nations Development Program (UNDP)'s assistance in these areas needs to continue. Nepal is considering using anti-dumping provisions and competition policy legislation open to members as safeguards against unfair trade practices. Technical assistance will be required for implementation in either case.

23. In the critical area of agriculture, subsidies are not an issue, given that Nepal has eliminated most of them. Current policies are generally appropriate. However, the Government's view is some irrigation and agricultural subsidies may need to be reviewed, and which can be accommodated under aggregate measures of support to agriculture under WTO rules. Similarly, the treaty with India and regional agreement like SAPTA does not appear to be inconsistent with WTO rules.

24. In the area of intellectual property rights, implementation will be demanding. Existing patent protection falls short in several areas, and resources of the Department of Industry, the responsible agency, are inadequate to ensure compliance with existing requirements, even in such basic areas as storage for seized goods. Such capacity must be added as a priority. Gains from the enhanced property rights requirements of TRIPS will come only in the longer term for Nepal and will depend on being able to connect investors to capital markets and exploit property rights in traditional knowledge. Nepal needs assistance in the areas of trade negotiation and commercial diplomacy, support for this through adequate trade policy analysis and assistance in preparing and enforcing legal provisions, and overall implementation of WTO rules.

#### ***Competitiveness and Productivity: Constraints and Potential***

25. Despite liberalization and growth of trade in the 1990s, the study shows that competitiveness of Nepal's economy is low, as measured by firm-level surveys in manufacturing, farm yields, and aggregate productivity estimates. Labor productivity in manufacturing and agriculture are among the lowest in the region, while manufacturing unit labor costs are among the highest even though Nepal has comparative advantage in a range of agriculture and manufacturing products. While unit labor costs declined in the 1990s, this could not be sustained, partly because of the appreciation in the REER at the end of the 1990s.

26. This study shows how three key factors contribute to low price competitiveness and productivity in Nepal's economy: i) inadequate mechanisms and incentives for firms to acquire new technology, ii) weak infrastructure, and iii) an unfavorable business climate. Rigid labor legislations in the formal sector, with strict anti-dismissal rules, prevent incentive-based wages, constrain investment in labor training, and decrease labor productivity. Inadequate bankruptcy and foreclosure provisions raise the costs of reallocation of factors to more productive uses, leading to an economy that tolerates a broader range of inefficient firms, compared to other developing countries. Price competitiveness is further diminished by a comparatively weak infrastructure and one of the highest charges for electricity in the region. Transport and transaction delays lead to exceptionally high inventory costs. An inadequate regulatory framework, unpredictable implementation, the Maoist conflict, and related uncertainty further add to costs.

27. Despite these constraints, Nepal's economy has shown potential to be competitive in many areas. This is evidenced by analysis of domestic resource costs, price differentials, and revealed comparative advantage. While growth has been rapid in these areas of comparative advantage, global market share is still low, suggesting significant potential for growth. However, given the increasing volatility and competition of global markets, Nepal must make significant efforts to improve trade facilitation and remove "behind-the-border" constraints to realize this potential.

### ***Trade Facilitation and Behind-the-Border Constraints***

28. Improving customs performance in governance, procedural and infrastructure areas to make it a facilitator of trade is a priority and is necessary for WTO accession. Customs processing delays at the border and Kolkata port add 3-5 days to the 8-day travel time between Kathmandu and Kolkata. Customs and trans-shipment delays can account for as much as 55% of the logistics costs of sending certain types of goods from Kathmandu to Kolkata, instead of the typical 25% for other international routes.

29. On the governance side, the Customs Department needs greater service orientation in trade facilitation, instead of focusing exclusively on revenue collection. Encouraging more voluntary compliance and transparency in customs clearance, developing a new code of conduct for the Department, and strengthening investment capacity are critical. The role of the Customs Officer and organization need to be reviewed and changed, in line with introduction of new post-entry audit and valuation and Automated Systems for Customs Data (ASYCUDA) rules. The Customs Department needs greater authority and support on budgetary, personnel, and management issues. In the medium term, Government needs to reconsider the concept of a Revenue Authority to improve coordination between the Customs and the Inland Revenue Departments. Overall, the Customs Act and Rules need reforming to be made consistent with WTO requirements. Other requirements are to simplify and harmonize trade documents and procedures with India and other neighboring countries and organizing systematic meetings with traders and training them in new procedures. Finally, sufficient resources need to be made available to open major customs posts on a 24-hour basis—a measure that will require Indian cooperation.

30. On the infrastructure side, there are four priorities: i) developing internal audit and investigative capabilities on such Customs clearance issues as valuation, classification, and origin (which need to be more selectively conducted, based on clearly defined risk-assessment criteria); ii) creating post-entry valuation capacity; iii) strengthening facilities to provide training in these new procedures; and iv) building up Customs infrastructure in such key facilities as Birgunj and the Tribhuban airport, which lack weighbridges, X-ray machines, testing, quarantine and refrigeration facilities and are clearly unable to handle the traffic.

31. **Transport and Logistics:** Pre-shipment transport costs account for 7-8% of the prices received by exporters (more than twice that in Bangladesh or Vietnam). Thus, reducing transport and logistic costs is critical for increasing competitiveness and there is significant scope to do so. For example, it is estimated that the current 8-day travel time between Nepal and Kolkata can be reduced to 3-5 days by using containerized rail transport from the Birgunj Inland Container Depot (ICD), thereby reducing transport costs by about 30%.

32. The logistics requirements of Nepali traders, however, remain heavily dependent on internal road freight. To this end, there is scope for significantly improving management of the roads system through more effective and timely maintenance and strategic expansion of the national road system. While the Government has recognized the importance of maintaining strategic roads, expenditure on rural agricultural roads has been slightly more than 25% of the budget, lowering agricultural competitiveness. The Priority Investment Plan (PIP), which underpins the development of the roads infrastructure until 2007, needs to be more effectively implemented, especially at the district and village levels.

33. The recently created National Roads Board presents an opportunity for taking an integrated, national logistics system approach to road transport, rather than the project approach taken in the past. However, this body needs technical strengthening, as well as an assured source of funding from a fuel levy. In addition, more information is needed on road use and evaluation of alternative transport corridors, including the one to Mumbai port, which is one of the more efficient ports in the region.

34. While telecommunications development in Nepal has surpassed that of certain neighboring countries, the power sector (with a current 522-MW capacity) suffers from high costs, resulting from piecemeal development. Despite a doubling of generating capacity, supply and demand remain unbalanced, both regionally and seasonally. Past pricing has not been supportive of expansion. Evidence suggests that license agreements with independent power producers (IPPs) have been costly, though they have resulted in rapid expansion of electricity generation in recent years. Future licensing arrangements need to be better linked to the least cost expansion path of the national grid. Unbundling the generation, transmission, and distribution of Nepal's power utility can increase efficiency and private sector participation. Despite much discussion, large-scale power exports to India have yet to occur because of the weak financial position of potential buyers, the large capital investments required for these projects and the still inadequate regulatory framework for private sector participation.

35. **Labor Markets:** Growth and poverty alleviation in Nepal are constrained by one of the most rigid regulatory frameworks for labor markets in the developing world and a poor-quality education system. Available evidence suggests Nepal has high labor-force participation, low unemployment, and underemployment.<sup>6</sup> This study suggests that the key issue is low productivity of the labor force caused mainly by the effect of labor market regulations and the low quality of the education.

36. While labor market regulations directly affect about 2%<sup>7</sup> of the labor force, the adverse implications extend much farther. These regulations lower labor productivity by creating disincentives for labor to be efficient and for firms to invest in training, restrict growth of firms, encourage more capital-intensive production, and generally discourage investment and employment in the formal sector. In extreme cases, firms have the incentive to employ Indian labor in highly skilled positions rather than train Nepali workers. These regulations include the Labor Act of 1992, which prohibits, with the exception of criminal behavior, the dismissal of "permanent" employees (i.e., all employees with more than 240 days of employment). One result is that firms face great difficulties in closing down or changing their business. In addition, minimum wage regulations cover skills categories in firms with more than 10 employees, the mandatory payment of 10% of profits to a workers' benefit fund (under the 1973 Bonus Act), and Trade Union resistance to providing incentive or performance-related pay.

37. Without labor market improvements, Nepal will find it impossible to increase competitiveness and formal sector employment significantly. This study suggests the following options for improvement: drafting a labor law consistent with an Employment Contracts Law, which would allow unrestricted agreements between workers and employers of firms; amending the existing code to allow firms the flexibility of retrenching workers, along with compensation; amending the Bonus Act of 1973 to remove mandatory payments; and revisiting the Income Tax Law of 2002 to consider providing tax credits for companies that can document the costs of providing training for their workers

38. The long tradition of Nepalese seeking employment opportunities abroad has accelerated and diversified, with some 10-15% of the labor force now working as expatriate labor. Their annual remittances are estimated at US\$800 million in the current year, four times the flow of official aid. A key issue is whether the recent surge in labor remittances is a lasting or a transitory phenomenon, and the conditions that can enable it to continue. Government has requested technical assistance for this purpose.

39. **Investment Climate:** With its considerable natural barriers, Nepal must make an extra effort to improve its investment climate relative to its competitors. At present, this is far from the case. The Heritage Foundation's Index of Economic Freedom (based on relatively transparent and objective

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<sup>6</sup> These data have to be treated cautiously as labor market data is extremely weak (see Chapter 6).

<sup>7</sup> Estimates by trade unions are that these regulations cover 8% of the labor force, while other estimate suggest it to be around 5%.

indicators), for example, ranks Nepal 119 out of 250 countries—lower than half of Sub-Saharan countries and much lower than competitor economies of East Asia, such as Cambodia. A telling indicator of investment-climate problems is that foreign direct investment (FDI) is the lowest in Nepal, even among landlocked countries. More analysis is needed on why foreign investment has avoided Nepal.

40. While improvements in the 1990s brought about by the Foreign Investment and Technology Act of 1992 and rapid growth of private sector credit have facilitated market entry and increased investment over the past decade, the legislative policy and institutional framework governing investment in Nepal still need considerable improvement. Regulatory laws need more clarity and removal of inconsistencies. The overriding 2002 Income Tax Act has not been accompanied by published amendments to the 1992 legislation where this has been overridden; this has created uncertainty with respect to investment incentives, most of which have been withdrawn. Business approval procedures, which are, in principle, business friendly, are implemented unevenly and unpredictably. The One Window Committee, whose nominal role is to expedite approval and granting of available facilities, is preoccupied with an ineffective duty-drawback scheme for exporters. Coordination between the line ministries relevant to approvals is weak. The separation between business and tax registrations introduces additional transactions costs.

41. These problems largely result from having too many entities responsible for areas of investment approval, investment concessions and facilitation, and trade and investment promotion. These bodies include the Investment Promotion Board, Board of Investment, Foreign Investment Promotion Section of the Ministry of Industry, Commerce, and Supplies (MOICS), Fast Track Committee, One Window Committee, and Trade Promotion Center. The number of bodies should be reduced to perhaps three that handle well-defined areas of approval, facilitation, and promotion.

42. The Government also needs to address private sector concerns about policy opacity and unpredictability, as well as lack of consultation on policy changes. Firms have cited the arbitrariness of tax administration and the opacity and inconsistency of tax laws as one of the main constraints to their business. Previous recommendations, dating back to 1997, to create a Revenue Authority and remove the constraints that civil-service rules impose on creating a well-motivated, facilitative revenue administration is currently being reviewed by the Government. The Government needs to take other intermediate steps to improve revenue administration and accountability and promote trade facilitation. For instance, arrangements to introduce on the spot resolution of the issues at the border will greatly help in minimizing transactions costs with customs.

43. Inefficiencies in factor markets (i.e., markets for land, finance, and labor) raise costs significantly, though trade finance per se does not appear to be a constraint. Inadequate specification of property rights indicated by delayed processing of contractual disputes by a weak judiciary, weak bankruptcy and foreclosure procedures, and the inability of financial institutions to recover bad loans all hinder reallocation of resources from less productive to more productive uses. Currently, the Government is reviewing the Insolvency Bill, Secure Transaction Bill, and Companies Act amendments to address these issues. Restructuring the balance sheets of state-owned banks is another priority and a prerequisite for addressing the critical issue of agricultural lending by the Agricultural Development Bank (ADB) and extending credit guarantees on longer-term lending to exporters.

44. Rules governing foreign investment are liberal in principle but ambiguous and less friendly in practice. There are no restrictions on ownership or repatriation of investment and profits. The Negative List, which excludes certain activities from foreign investment, is relatively short. However, some excluded activities are ones in which foreign investment could help to lift efficiency and quality of local businesses, marketing, consulting and accounting services (i.e., critical support services for business). Vaguely defined terms, such as *cottage industry*, create further investor uncertainty. The HMGN should

address this issue immediately by redrafting the relevant part of the Foreign Investment and Technology Act.

45. This study makes specific recommendations for improving the investment climate. Key measures include: i) opening up business support services (e.g., accounting, consulting, marketing) to foreign investment; ii) rationalizing and reducing the number of organizations that handle investment and trade-related issues from more than 10 to about 3; iii) removing constraints on exporters by easing access to duty drawback; and iv) introducing a bankruptcy law and its implementation.

### *Case Studies*

46. ***Carpets:*** The hand-knotted carpet/rug industry is a major source of foreign exchange (US\$145 million in 2000) and employer of more than 50,000 workers, contributing significantly to rural and urban household incomes and poverty reduction. Carpet exports grew by 65% annually during the 1990s and increased their share of global market tenfold, even after the share fell towards the end of the 1990s. Recently, however, the industry has stagnated in the face of static global demand, more intense international competition from machine-made carpets, inadequate marketing networks and design capacity and regulatory restrictions on product variety, lack of FDI, and price regulations, including minimum price restrictions. These regulations, intended to ensure product quality, need to be liberalized and replaced by other credible, quality-assurance arrangements.

47. ***Garments:*** During the 1990s, the ready-made garment (RMG) sector was a leading source of growth in manufacturing output, exports, and employment. Last year, exports slumped, but this year they are expected to increase by 50%, suggesting both the pitfalls and the potential of this sector. The external environment for garment exporters will change radically when the quotas on all suppliers in the European Union (EU) and U.S. are eliminated at the end of 2004 under the Agreement of Textiles and Clothing. At that time, competition from such countries as China and India will intensify. In the U.S. market, Nepalese suppliers now face competition from the preferences granted to selected African and Caribbean countries. On the other hand, Nepal has not been able to exploit its duty- and quota-free access to the EU. This again suggests that Nepal needs the beneficial presence of foreign investors (as in Cambodia and Sri Lanka) to increase market access. The new trading environment will offer opportunities to efficient suppliers of garments. Nepalese garment exporters have advantages, particularly low-labor costs, which may enable them to exploit existing and emerging market opportunities. But current garments quota allocation rules need to be changed to support efficient producers. The case study in the report shows how policy reforms that increase labor productivity, increase competition, reduce transaction and transport costs can help to lower prices by more than 15%, enabling exporters to expand exports and output.

48. ***Agriculture:*** In a break with past performance, agricultural exports grew rapidly in the late 1990s. Food and feed exports (e.g., beans, peas, lentils, other legumes, cardamom, and nutmeg) grew 15% per year in the second half of the 1990s, directed almost entirely to India. Nepal's comparative advantage extends to a variety of forest products, including medicinal herbs and aromatics.<sup>8</sup> Yet, value added in this sector currently accounts for only 1.5% of agricultural GDP. Comparative advantage extends to a range of other areas: honey, horticulture products, livestock, fisheries products, fiber, and off-season vegetables. Trade policy distortions are not widely evident. But poor factor markets lower competitiveness. The sustainability of agricultural credit, which doubled in the 1990s, is an issue. Large-scale subsidization of agriculture in neighboring Indian states affect border prices of produce adversely. Several acts (e.g., Forest Act, Lands Act, and Cooperatives Act) hinder large-scale private commercial or contract farming and cause land fragmentation. Nepal's higher agricultural processing costs compared to those of India (e.g., rice milling in Nepal is twice as expensive as in Uttar Pradesh) tax agriculture. To

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<sup>8</sup> Nepal is richly endowed with forest resources, which supply timber, fuelwood, and medicinal plants and herbs. The country has more than 700 species of medicinal and aromatic plants, of which 250 species are endemic.



address these constraints, strategic investments are needed in the following areas: i) capacity building in agriculture-related agencies, ii) facilitation of border transactions, iii) infrastructure improvements to promote commercialization, and iv) enforcement of quality standards and SPS requirements at both farm and processing stages.

49. **Tourism:** With foreign exchange earnings of about \$US167 million in FY 2000 (13% of current account earnings) and a high value-added component, tourism is a key service export for Nepal. The Himalayan landscape, a wide diversity of flora and fauna, and a rich heritage of cultural and religious sites give Nepal inherent advantages. In the 1990s, tourism grew rapidly before being interrupted by a series of shocks (e.g., Indian airlines hijacking, escalating Maoist conflict, etc.). In the last two years, the sector has experienced a severe downturn due to these factors, though more recently tourism from the Far East and India has been growing and shows promise. Improving transport will be key for this sector's prospects. Eighty percent of tourists arrive by air. But the uncertain prospects of the Royal Nepal Airlines and the high landing costs of Tribhuban Airport can restrict air access. Inadequate road transport raises costs for tourists to pilgrimage sites like Mount Kailash (in Tibet) and to scenic, trekking and rafting destinations. Road-transport master planning needs to incorporate tourism's needs along with freight. Cooperation between the agencies involved in this sector needs improving. Important segments of the industry are not well represented in the National Tourism Board (NTB) and there is political interference, leading to low performance. The funding of the NTB is volatile, depending on levying businesses on a billable, tourist-numbers basis. This funding volatility restricts tourism promotion exactly at the time it is most needed.

50. **Tea:** The tea processing industry, though currently small, is seen as a potential growth industry and an important channel for reducing poverty due to strong linkages to rural communities. The case study for tea also serves as an illustration of the issues facing commercial and estate farming. Large areas of Nepal are suitable for tea plantations, and global demand for niche teas, such as orthodox tea, continues to grow. Export quantities are small (less than 1,000 tons compared to more than 1.3 million tons of total world exports). As the Nepal industry is relatively young, the quality of tea trees is regarded as high, compared to those in India leading many to consider tea to be a potentially important export. However, significant obstacles to investment and expansion remain. These relate to weak capacity of the Tea Board resulting from lack of clarity of its role, inadequate funding, staffing, and in adequate participation of the private sector, cumbersome investment processes, and land fragmentation. The limited transport infrastructure and underdeveloped marketing channels further constrain tea's potential. The Government is addressing some of the constraints that are hindering growth of the sector through its tea sector policy.

51. **Hydropower:** The potential market for selling power from Nepal to India—and particularly the Northern Grid Region that lies to Nepal's west—is large. The Indian Central Electricity Authority (CEA) has estimated a shortage of roughly 10,000 MW in the Northern Region at the end of the Tenth Five-Year Plan (2007). At the same time, Nepal has a significant hydro resource base. By 2020, Nepal's total domestic power demand is estimated at around 1,650 MW, compared to a hydro potential of about 43,000 MW. But the present level of exchange between Nepal and India is limited in capacity to 50 MW per annum, indicating the large constraints in this sector. Attaining Nepal's hydropower export potential will require increasing system efficiency to lower its power production costs, and improving the financial viability of potential purchasers in India – the public state electricity boards or private purchasers. Recent reforms in India suggest increasing opportunities for power exports. However, exports are likely to take place in small to medium sized projects (200 to 300 MWs) or through incremental expansion of present arrangements, rather than through large multi-purpose projects. Two important institutional reforms are required. First, the Power Exchange Committee between India and Nepal, which has been defunct for some time, has to be reactivated. Second, the Government will need to facilitate the private sector of both countries to directly negotiate power development and trading arrangements.

**POLICY AND TECHNICAL ASSISTANCE MATRIX (A)**  
**TOP PRIORITY MEASURES RECOMMENDED FOR IMMEDIATE IMPLEMENTATION**

\* Immediate = next 6 months

Objectives	Action recommended	Requirements			Time frame and agencies
		Implement existing policy	Policy/legislation change	Technical assistance	
Strengthen trade policy capacity; rationalize institutions and practices	<ul style="list-style-type: none"> <li>▪ Continue activities of the National Steering Committee with the ToR to monitor implementation.</li> <li>▪ Appoint national and international advisors to set up an apex trade policy evaluation, promotion and negotiations unit based on audit of existing trade policy expertise.</li> <li>▪ As an interim measure, strengthen capacity in two trade divisions of the MOICS.</li> </ul>	Yes	Yes	No Yes Yes	HMGN HMGN, Development Partners (DP) MOICS, DP/WTO MOICS/FNCCI/DP
Move toward WTO compliance	<ul style="list-style-type: none"> <li>▪ Identify service-related bottlenecks that increase costs, and liberalize these sectors.</li> </ul>		Yes	Yes	HMGN, DP
Reduce transaction costs and improve market integration	<ul style="list-style-type: none"> <li>▪ Complete legal review of Draft Nepal India Rail Agreement; finalize and implement.</li> <li>▪ Appoint a terminal management operating company for Birgunj through competitive tender.</li> <li>▪ Operationalize and fund Roads Board activities and expenditures, including fuel levy transfer; implement APP budget for rural roads.</li> <li>▪ Fund customs and ASYCUDA training.</li> <li>▪ Review passbook scheme for duty drawback; implement or replace by exemption.</li> <li>▪ Introduce One Spot Export Clearance Arrangement in major customs points.</li> <li>▪ Review constraints to market access, especially in EU.</li> <li>▪ Introduce on the spot resolution of issues.</li> </ul>	Yes Yes Yes Yes Yes Yes Yes	Yes Yes Yes Yes Yes Yes	No No No No No No Yes	HMGN MOICS MOF, Roads Board MOF DOC, DP MOF, DOC MOICS, DOC, MOF, DP MOICS, Export related agencies, DP, Private Sector MOF/MOICS/FNCCI
Reform labor market mechanisms	<ul style="list-style-type: none"> <li>▪ Review the Income Tax Act 2002, with a view to clarifying tax credits for accredited training to employees.</li> </ul>		Yes	No	MOF MOLTM
Reform institutions and regulations, targeting investment	<ul style="list-style-type: none"> <li>▪ Review functions of BOI, IPB, OWC, Fast Track Committee, and TPC, with a view to rationalization to three bodies dealing with approvals, concessions, and facilitation.</li> </ul>		Yes	Yes	HMGN, DP

Note: DP = Development Partners

**POLICY AND TECHNICAL ASSISTANCE MATRIX (B)  
SUPPORTING MEASURES**

Short term= within 12 months, Medium term = within 2 years, Longer term = 2 to 5 years

Objectives	Action recommended	Requirements			Time frame and agencies
		Implement existing policy	Policy/legislation change	Technical assistance	
<b>TRADE POLICY AND WTO ACCESSION</b>					
Institutional rationalization	<ul style="list-style-type: none"> <li>▪ Set up public-private funded Trade Promotion Agency to replace TPC/EPB.</li> <li>▪ TRIPS: finish drafting laws to bring Nepal into formal compliance; initiate extension services to educate SMEs on commercial benefits of trademarks and branding; construct facilities to hold confiscated counterfeit goods.</li> <li>▪ TRIPS: Establish inquiry point (for non-agro. Products); build capacity in judicial system to handle IP disputes; conduct public-education campaign on commercial benefits of patents, geographical indications, and commercial value of traditional knowledge; promote the private provision of intellectual property legal services to SMEs.</li> <li>▪ SPS/TBT: Introduce legislation to base domestic regulations on international standards; accept, on reciprocal basis where needed, any goods bearing certificates of conformity assessment issued by other WTO members (e.g., the EU's "CE" mark); establish an inquiry point for SPS measures.</li> <li>▪ Establish infrastructure and strengthen organization for implementing TRIPS/SPS/TBT legislation.</li> </ul>		Yes	Yes	Medium term HMGN, FNCCI
WTO accession			Yes	Yes	Medium Term HMGN, MOICS, DP
			Yes	Yes (extend TA)	Medium Term HMGN, MOICS, DP
			Yes	Yes	Medium Term HMGN, MOICS, DP
			Yes	Yes	Medium term MOICS DP
Tariff and duty drawback and tax reforms		<ul style="list-style-type: none"> <li>▪ Analyze impact of moving to a reduced tariff bands on effective protection, trade flows and revenue impact.</li> <li>▪ Broaden tax base to compensate for selective phasing out of ODCs and reduction of customs duties through removing exemptions, and extending VAT base.</li> </ul>	No	Yes	Medium term MOICS, MoF DP
			Yes	Yes	Long Term MOF, DOC

Objectives	Action recommended	Requirements			Time frame and agencies
		Implement existing policy	Policy/legislation change	Technical assistance	
<b>TRADE FACILITATION THROUGH CUSTOMS AND LOGISTICS REFORM</b>		Implement existing policy	Policy/legislation change	Technical assistance	
Customs procedure	<ul style="list-style-type: none"> <li>▪ Amend Customs Act and Rules to accommodate valuation compliance and other WTO compliance requirements.</li> <li>▪ Develop selectivity criteria for risk-based management of Post Entry Valuation and Audit; implement ASYCUDA selectivity module and train staff. Introduce Direct Traders Input Module into system.</li> <li>▪ Simplification and Harmonization of Trade and Transport Related Procedures and Documents.</li> <li>▪ Align transit documentation with EDIFACT System.</li> </ul>	Yes	Yes	Yes	Medium Term DOC, WCO.
Customs Governance and Institutional reform	<ul style="list-style-type: none"> <li>▪ Introduce voluntary customs compliance and clearance facilitation. Develop Code of Conduct specific to DOC employees.</li> <li>▪ Develop customs clearance, non-compliance audit and investigation capability within DOC. Provide training in Post Entry Audit, Investigations and Intelligence.</li> <li>▪ Create a Post Entry Valuation section.</li> </ul>	Yes	Yes	Yes	Medium Term DOC/DP
Customs infrastructure	<ul style="list-style-type: none"> <li>▪ Study benefits of amalgamating DOC into a revenue authority.</li> <li>▪ Correct weighbridge, X-Ray, laboratory testing, quarantine and refrigeration facility deficiencies at major border points.</li> <li>▪ Extend computerization and wide area network to major customs points</li> <li>▪ Undertake benefit cost appraisal of a dry port/Container Freight Station at Kathmandu, Tatopani, and Kakarbhitta.</li> </ul>	Yes	Yes	Yes	Medium Term DOC/MOF, DP
					Medium term DOC, DP
					Medium term MOF, DP
					Medium term DOC, DP
					Medium Term DOC, DP
					Medium Term MOICS, DOC, DP
					Medium Term MOICS, DOC, DP

Objectives	Action recommended	Requirements			Time frame and agencies
		Implement existing policy	Policy/legislation change	Technical assistance	
<b>Improving transport and logistics</b>					
	<ul style="list-style-type: none"> <li>▪ Pass Carriage of Goods by Rail, Carriage of Goods by Road, Multimodal Transport Acts, and Marine Insurance Act or promulgate through Ordinances.</li> <li>▪ Improve physical infrastructure to operationalize Kakarvitta-Phulbari-Banglabandh corridor.</li> <li>▪ Conduct evaluation of other transit corridors, especially those accessing Mumbai port, and Singhabad-Rohanpur with a view to communicating and negotiating these with the Government of India and Bangladesh.</li> </ul>	Yes		No	Short Term MOICS
		Yes		No	MOICS
			Yes	Yes	Medium Term MOICS, MOLTM, DP
<b>Ease labor market rigidities</b>					
	<ul style="list-style-type: none"> <li>▪ Legislate labor law consistent with a contracts-based legal framework for the labor market; alternatively, consider amending laws to allow dismissal with compensation.</li> </ul>		Yes	Yes	Medium term HMGN, MOLTM, Private Sector, Trade Unions, and DP
<b>Regulatory framework and FDI</b>					
Rationalize institutions	<ul style="list-style-type: none"> <li>▪ Create a maximum of three bodies with representation from MOICS, MOF/Department of Revenue to deal with investment approval, concessions, and trade/investment promotion.</li> </ul>		Yes	No	Medium term MOICS, MOF, Private Sector
Enhance Implementation	<ul style="list-style-type: none"> <li>▪ Clarify and refine <i>cottage industry</i> and other broad category definitions that cause confusion among investors.</li> </ul>		Yes	No	Medium term, MOICS, FNCSI, Private Sector
Improve business/government relations	<ul style="list-style-type: none"> <li>▪ Legislate Insolvency Bill and new Companies Bill and proceed with implementation.</li> <li>▪ Consider alternative to current assessment of tax liabilities, including self-assessment and greater selectivity.</li> </ul>	Yes	Yes	No	Short Term MOICS, NRB FNCCI
			Yes	No	Medium term MOF, FNCCI

Objectives	Action recommended	Requirements			Time frame and agencies
		Implement existing policy	Policy/legislation change	Technical assistance	
<b>EFFICIENCY IN KEY MANUFACTURING EXPORTS – GARMENTS AND CARPETS</b>					
<p>Carpets: rationalizing regulations</p> <p>Garments: reducing finance and transactions costs</p>	<ul style="list-style-type: none"> <li>▪ Review purpose and costs of floor price scheme for carpets, with a view to its abolition.</li> <li>▪ Introduce quality certification and labeling.</li> <li>▪ Conduct benefit/cost assessment of restrictions on importation of various wools, use of machine-spun yarn and foreign investment.</li> <li>▪ Review and Accept alternatives to Letters of Credit.</li> <li>▪ Rationalize quota allocation system to promote efficient firms</li> <li>▪ Eliminate requirement for business credibility license and two separate certificates of origins.</li> <li>▪ Prepare carpets and garment development action plans and implement these</li> </ul>		<p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p> <p>Yes</p>	<p>No</p> <p>Yes</p> <p>Yes</p> <p>No</p> <p>No</p> <p>No</p> <p>Yes</p>	<p>Short term MOICS</p> <p>Short Term MOICS, DP</p> <p>Short Term MOICS/DP</p> <p>Short term NRB, MOICS</p> <p>Short Term MOICS, GAN</p> <p>Short Term, MOICS, NCC, GAN,</p> <p>Short and Medium Term MOICS, Private Sector</p>
<b>EFFICIENCY IN A POTENTIAL GROWTH INDUSTRY - TEA</b>					
Institutional strengthening and rationalizing regulations	<ul style="list-style-type: none"> <li>▪ Involve private sector participation and funding of Tea Board. Strengthen professional capacity and clarify terms of reference of the Tea Board.</li> <li>▪ Allow large-scale contract farming, including by FDI.</li> </ul>		<p>Yes</p> <p>Yes</p>	<p>No</p> <p>No</p>	<p>Medium term MoAC, MOICS, Ag Ent. Centre, NTCB</p> <p>Short Term MoAC, MOICS, NTCB</p>

Objectives	Action recommended	Requirements			Time frame and agencies
		Implement existing policy	Policy/legislation change	Technical assistance	
<b>EFFICIENCY IN A POTENTIAL GROWTH SECTOR - AGRICULTURE</b>					
Improve productivity and market access	<ul style="list-style-type: none"> <li>▪ Build agriculture extension services, with a view to SPS and TRIPS application in agriculture.</li> <li>▪ Support agriculture market development and commercialization with APP roads funding and improved PIP implementation at village/district levels.</li> <li>▪ Promote large scale contract farming.</li> </ul>	Yes		Yes  No  Yes	Long term MOAC, AEC, DP  Medium Term, MOAC Roads Board, DP  MOAC, MOland Refroms
Address credit market imperfections	<ul style="list-style-type: none"> <li>▪ Sustain agricultural credit growth by restructuring of ADBN and other related institutions.</li> </ul>		Yes	No	Medium Term NRB, MOF, NPC
<b>EFFICIENCY IN KEY SECTORS -TOURISM</b>					
	<ul style="list-style-type: none"> <li>▪ Create stabilization fund for the NTB with its own revenues and private sector support.</li> <li>▪ Improve industry's ownership of the NTB and make NTB more independent from Government.</li> <li>▪ Conduct independent review of finances, and management of RNAC before privatization with a view to promoting tourism.</li> </ul>	Yes	Yes Yes	No No Yes	Medium term MOCTCA Short term MOCTCA MOCTCA Short term DP
<b>EFFICIENCY IN KEY SECTORS – HYDROPOWER</b>					
	<ul style="list-style-type: none"> <li>• Activate and strengthen Power Exchange Committee to conduct discussions with India.</li> <li>• Facilitate Nepal-India direct private sector agreements on power trade.</li> <li>• Remove inefficiencies in transmission and distribution, and rationalize generating capacity through internal unbundling.</li> <li>▪ Establish independent licensing authority.</li> <li>▪ Open competitive bidding for IPPs. New agreements need to be coordinated with NEA's expansion plans, with early consideration given to licensing agreements for transmission and grid operations.</li> </ul>	Yes  Yes	Yes  Yes  Yes	No No No No Yes	Short Term MOWR, NEA Short Term MOWR, NEA, private sector Short Term MOWR, NEA Medium term HMGN, DP

## 1. COUNTRY BACKGROUND

### 1.1 Economic Structure and Performance

Nepal is a landlocked country of 23 million people and 147,181 square kilometers (sq km.), lying in the southern slopes of the Himalayas, bordering China to the North, and India in all other directions. Nepal's per capita income is US\$250 in nominal terms or US\$1,450 in purchasing power parity (PPP) terms. Nepal's PPP per capita income—similar to that of Cambodia, Lao PDR, Senegal, and Uganda—makes the country one of the world's poorest outside Sub-Saharan Africa. Nepal's geography presents formidable challenges to economic growth and development. Kolkata, the nearest port in India, is located 660 miles away in India. Most of Nepal's terrain is mountainous or hilly, and only 20% of its land is arable. These factors contribute to the country's high transport costs, thereby hindering market development, raising the costs of expanding cereal-based agriculture, and creating a near-complete dependence on India for trading routes.

**Table 1.1 Economic Performance Indicators ( Averages in % unless stated otherwise)**

	1971-1980	1981-1990	1991-2000	2001-2002
Per capita Income Growth	0.4	2.0	2.4	-1.5
GDP Growth	2.4	4.3	4.9	0.8
Share of Agriculture	62.7	52.8	41.8	38.8
Share of Industry	12.7	15.0	19.5	20.2
Share of Services	24.6	32.2	38.8	41.0
Investment as % GDP	13.1	19.4	23.5	24.1
Public Investment	3.9	7.9	7.0	6.1
Private Investment	9.2	11.5	16.5	18.0
Revenue to GDP	6.5	8.5	9.8	11.6
Expenditures to GDP	11.0	17.6	16.8	16.8
Deficit to GDP (after grants)	4.4	6.5	4.9	4.4
o/w Domestic Financing	1.1	2.8	1.8	2.8
Export to GDP	12.1	12.0	22.8	20.7
Import to GDP	17.3	22.0	34.1	31.1
M2 to GDP	17.1	28.5	39.9	53.2
Domestic Credit to Government (net)	2.7	12.3	10.8	11.6
Domestic Credit to Parastatals (net)	1.8	2.7	0.7	0.5
Domestic Credit to Private Sector (net)	5.1	10.3	21.9	31.8
Inflation (CPI Average)	7.8	10.2	8.3	2.8
Lending Interest Rates	13.5	15.6	11.6	7.7
Exchange Rate (NRS/US\$)	11.4	19.6	58.6	76.5

*Source:* World Bank staff estimates from IMF and HMG Nepal data.

Nepal's economy and society have seen significant changes and improvements over the last two decades. The economy has diversified (Table 1.1). The share of agriculture has decreased from 62% of the



economy 20 years ago to less than 40% now, while the share of industry has increased from 13% in the 1970s to 20%. Gross school enrollment has increased from 78% in 1980 to 113% today, and longevity from 48 years in 1980 to 59 years. Acceleration of per-capita economic growth to 2.5% since the mid-1980s, compared to a growth of less than 1% before then, has helped to underpin these changes. In addition, the economy has become more integrated, as the share of trade in goods and non-factor services has nearly doubled over the past decade to about 50% of GDP, the second highest ratio in South Asia (after Sri Lanka).

Despite these improvements, as its per capita income indicates, Nepal still has a highly underdeveloped, predominantly agrarian economy, with agriculture accounting for around 40% of GDP and 76% of employment. Manufacturing accounts for a mere 9% of GDP. Even after the progress of recent decades in developing physical infrastructure and human capital, Nepal is the least developed of South Asian countries in these areas. For example, the average years of schooling is less than 2 years, compared to over 4 years in India, and road density is 0.1 km per sq km, compared to 0.7 km in India.

## **1.2 Poverty and Its Determinants**

Poverty is deep and pervasive in Nepal, with wide disparity across regions. According to the 1995–1996 Nepal Living Standards Survey (NLSS), 42% of Nepali households are poor, using a nutrition based poverty line of US\$75.91 per person per year.<sup>9</sup> Using the international dollar-a-day measure of poverty, the poverty incidence rate is computed as 37%, while 76% live on less than two dollars per day—that is, no matter how one defines poverty, its incidence is high in Nepal, even when compared to other South Asian countries.

There is significant disparity in the incidence of poverty, and its spatial dimensions are marked. First, poverty is predominantly rural; rural poverty rates of 44% are nearly twice those of urban areas (23%), and more than 90% of the poor live in rural areas. The disparity is also large across regions. As Table 1.2 shows, 4% of people living in the urban Kathmandu Valley are poor, in contrast to 56% living in the mountains. The eastern region has much less poverty than the mountain or hill regions or the mid-Western region generally. Not coincidentally, especially poor regions are those where transport infrastructure is poor, resulting in inadequate development of markets and commerce and poor government services.

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<sup>9</sup> If one uses economic growth data from 1996, and assumes that inequality has not grown and consumption has grown at the same rate as income, current poverty rates should be at about 37%.

**Table 1.2 Poverty Incidence by Region, 1995–1996**

<b>Region</b>	<b>Poverty Incidence</b>	<b>Poverty Gap</b>	<b>Illiteracy (% pop.)</b>
Nepal	42	0.121	64
Urban	23	0.070	37
Rural	44	0.125	67
Urban Kathmandu Valley	4	0.004	24
Other Urban	34	0.109	45
Terai	42	0.099	69
Hills	41	0.136	58
Mountains	56	0.185	75

*Source:* Prenzushi, 1999.

Household survey data suggest that poverty in Nepal is correlated with such factors as family size, dependency ratio, size of landholdings and use of irrigation in agriculture, level of education of the head of the household, in addition to distance from markets and degree of commercialization. Typically a poor rural family has a large family size with a high dependency ratio, low landholdings with mostly non-irrigated land, is relatively less educated, lives farther from markets, and depends on its own production or wage labor. Poor households also depend on labor remittances, but these come from family members working in Nepal, as opposed to other better-off households, whose remittances come from earnings outside the country.

Social indicators confirm the severity of poverty. Only 71% of the population has access to safe water, infant mortality is 72%, and 52% of the population is illiterate (64% for women). While there were marked improvements in the 1990s, progress remains mixed. The evidence of changes in social indicators presents a mixed picture. Data from the 1996 and the 2001 Nepal Demographic and Health Survey indicate that the infant mortality rate has fallen from 79 per 1,000 in 1996 to 64 in 2001 and child mortality from 43 to 29 per 1000. Total fertility has declined from 4.6 to 4.1 births per woman, and life expectancy has increased from 56 years to 59 years over this five-year period. On the other hand, there was little improvement in the nutritional status of children, with 50% of children under five years of age stunted, 48% underweight, and 10% wasted. The gender gap in education has not narrowed, with a 13 percentage-point difference at the primary level and an 8 percentage-point difference at the secondary level.

### **1.3 Macroeconomic Performance and Reforms**

After anemic growth until the mid-1980s and fiscal instability, Nepal implemented stabilization policies around 1985 and further stabilization and liberalization in the early 1990s. In the first reform episode, public savings was increased through expenditure and tax policies, and a 15% step devaluation occurred. Structural reforms liberalized the import regime, introduced duty drawback and bonded warehouses, and eased import and industrial licensing. In the second reform episode, the tax base was broadened, revenue administration improved, trade and industrial policies liberalized, the foreign exchange system unified, and the role of the private sector expanded through privatization and easing of business licensing. Since 2000, the Government has improved tax policy and administration, introduced a medium-term

expenditure framework, and strengthened the management of Nepal's two main commercial banks and Central Bank.

As seen in Table 1.1 above, the economy responded well to these reforms. Per capita growth rates accelerated significantly, along with private investment and trade. Export earnings, in terms of U.S. dollars, grew at 15% annually—three times the rate of GDP in the 1990s. This export performance was an important engine of growth in Nepal's small open economy by stimulating demand through exports and facilitating imports of capital goods and equipment and raw materials.

However, as the sharp declines in exports (-20%) and manufacturing (-10%) in FY02 suggest, Nepal faces major challenges in sustaining its growth of trade, given current global economic volatility, the pending implementation of WTO commitments, and the phasing out of the Multi-Fibre Arrangement (MFA). Overcoming these challenges critically depends on Nepal's ability to improve its productivity and competitiveness, and to manage the WTO accession in a manner that promotes these objectives.

#### **1.4 Current Macroeconomic Environment and Recent Developments**

Nepal's economy is characterized by its close ties with India, its prudent macroeconomic management, and the pegging of its currency to the Indian Rupee. Long and porous borders with India facilitate the cross-border flow of goods and reduce the effect of Nepalese policies on prices, which closely follow those of India. Excess demand, caused by, for example, expansionary macroeconomic policy in Nepal tends to lead directly to increased net imports, both formal and informal, and can be reflected quickly in changes in international reserves, rather than in changes in inflationary pressures.

Nepal's macroeconomic stance is largely determined by its fiscal management, which was conservative in the second half of the 1990s, as indicated by steady albeit modest public savings and low levels of domestic financing. Actual development expenditures have been limited to levels that can be financed mostly by the country's foreign savings and large foreign aid flows.<sup>10</sup> However, fiscal management has become more challenging since 2000/01 due to weak revenue growth (4%), rising security expenditures to deal with the Maoist insurgency, and increased reliance on domestic borrowing (2.9% of GDP).

Nepal's current account position has been comfortable thanks to significant external aid inflows, and, more recently, because of sizeable remittance flows from Nepalese working abroad. Budgetary grants and loans were nearly 5% of GDP annually during 1970/71–1999/00. Of this percentage, grants represented about 2.2% of GDP per year, and the bulk of loans were on concessional terms. More recently, while aid disbursements have slowed, remittances from Nepalese abroad have increased significantly and now exceed merchandise exports.

##### ***Recent Macroeconomic Developments***

Real GDP declined in 2001–2002 by 0.5%, after having grown by an average of about 5% during the 1990s. Manufacturing and tourism were particularly hard hit by the deteriorating security situation and the global economic slowdown. Irregular rainfall adversely affected agricultural production. Economic weakness continues in 2002–2003 and the economy is expected to grow by about 2% over this year. Prices rose only moderately (3%) in 2001–2002, primarily because of a weak economy and low Indian

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<sup>10</sup> Nepalese authorities use the concept “regular expenditure” instead of “current spending.” The former includes debt amortization.

inflation, but more sharply in 2002–2003 (5%) due to agricultural shortages and an increase in administered prices.

Total exports (excluding re-exports) declined by almost 20% in 2001–2002 and are projected to decline 1.6% further in 2002–2003. Exports to countries outside India declined more than 40% in FY 2001–2002 due to slow growth in Europe and the U.S.—exacerbated by increased international competition, supply (garments) disruptions caused by the insurgency situation, market saturation (carpets), and insufficient product improvements (carpets and pashmina). However, exports of garments increased by more than 50% in the first nine months of the current FY, partly because of special conditions (e.g., spillover of Indian orders as Indian manufacturers approach MFA quota limits) but also indicating a possible rebound if peace and global demand are sustained.

The new trade treaty with India (revised in March 2002) placed a sudden brake on exports to India by introducing non-tariff barriers. Tourism receipts were down by 29% in FY 2002 (after declining 10% a year earlier) due to internal and international security concerns. Despite these adverse developments, the current account surplus continued because of a decline in imports (resulting from a weak economy) and continued high growth of remittances from Nepalese working abroad (estimated at about US\$800 million in 2001–2002), which exceeded merchandise exports. Gross official reserves remained at slightly more than US\$1 billion, covering 6.5 months of imports at the end of 2001–2002. Traditionally, the external debt service ratio has been low—about 5–6% of current receipts—because of the highly concessional nature of external borrowing, but with the decline in exports and tourism receipts, the ratio has increased during the last two years, exceeding 7% in 2001–2002.

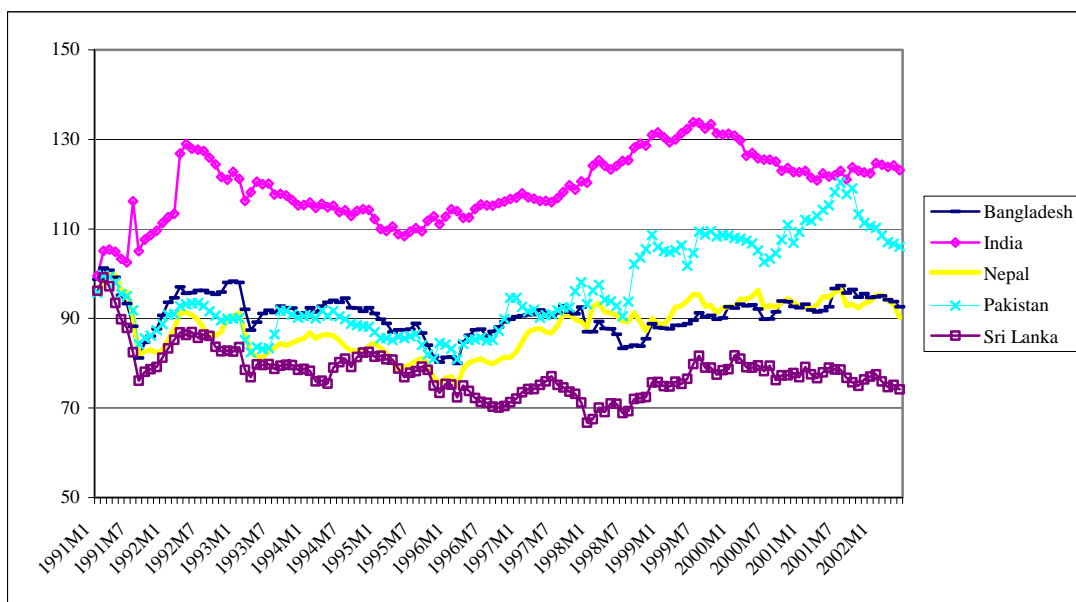
Fiscal management has become challenging. The current surplus disappeared in 2000–2001, and has since turned to deficit, as the insurgency situation and weak economy contributed to a revenue shortfall and higher spending. Revenues in 2001–2002 were below the budget target by 1.2% of GDP, despite the Government's serious collection efforts, including imposing special security revenue measures (e.g., special fees on imports and a surcharge on petroleum products). Current spending rose, with security spending reaching 3% of GDP in the same year—an increase of nearly 1% above the budget. The difficulties continue in 2002–2003, with projected revenue shortfalls and further increase in demand for security spending. At the same time, foreign aid disbursements have declined to 2.8% of GDP because civil disturbances have made project implementation difficult in certain areas. To maintain fiscal sustainability, the Government reduced development spending; however, a significant increase in domestic borrowing of nearly 3% of GDP could not be avoided last year. As a result, the public debt rose to nearly 66% of GDP, of which 17% was domestic debt. Domestic borrowing in 2002–2003 is projected to decline but still remain at around 2% of GDP.

The weak economy also reduced growth of monetary aggregates (6% in FY 02), even though monetary policy has accommodated fiscal needs and authorities' desire to stimulate a weak economy. Lending to government rose by 24% in 2001–2002 and has continued to increase at a similar rate during the first six months of 2002–2003. A weak economy reduced private demand for new credit (demand for additional credit was largely for refinancing loans to troubled borrowers) and, as a result, private sector credit grew slowly—by 8% in 2001–2002, compared with 16% the year before. Broad money grew in FY 2001–2002 by 4.4 %, compared with 15% the previous year. In the first nine months of the FY 2003, broad money growth and private sector credit growth appears to have revived to 7% and 9% respectively.

The Nepalese Rupee (NR) has been pegged to the Indian Rupee at 1.6 NRs/IC. The peg has provided a suitable nominal anchor, enabling Nepal to benefit from the close economic ties with India. Furthermore, with the current rate of peg, Nepalese exports increased rapidly during the period when free trade was largely permitted between the two countries, indicating that a concern that the peg rate needs to be

adjusted in the near future may not be justified. The current decline in exports is due largely to the more stringent Nepal-India Trade Treaty of 2002, which has restricted duty free exports from Nepal.

**Figure 1.1 Real Effective Exchange Rates (REER), Nepal and South Asia**



Note: These series reflect the ratio of Nepal's REER index and that of the respective country (1990 = 100).

Source: IMF Information Notice System.

With the peg and low inflation, the real effective exchange rate (REER) has been stable throughout the 1990s (although it has appreciated by 14% since 1996). To determine whether Nepal has lost competitiveness relative to other South Asian countries, Figure 1.1 also compares Nepal's REER index to those of other countries. Nepal's REER has appreciated relative to that of Pakistan, but for the other four countries, the REER ratios are relatively stable over the course of the decade. Still, the issue of REER appreciation in the second half of the 1990s and the appreciation of Nepali Rupee in recent months against the dollar points to the need for continued review of exchange rate policy to ensure no significant loss of competitiveness.

While the stable REERs throughout the 1990s suggest that there is no strong evidence of loss of competitiveness, the issue, given its importance, needs careful analysis. Formal estimation of equilibrium REERs is hampered by inadequate availability of data on factors that affect the equilibrium level, including trade protection, capital flows, terms of trade government expenditure on non-tradables, and productivity growth.<sup>11</sup> However, given the importance of this issue for Nepal's trade and competitiveness, it needs further examination, especially in light of potentially significant adjustments

<sup>11</sup> For a detailed discussion, see Edwards, Sebastian (1994), "Real and Monetary Determinants of Real Exchange Rate behavior: Theory and Evidence from Developing Countries", published in Williamson, John ed. (1994) Estimating Equilibrium Exchange Rates (Washington: Institute for International Economics), Ch. 4 and Elbadawi, Ibrahim A. (1994), "Estimating Long-run Equilibrium Real Exchange Rates", published in Williamson, John ed. (1994), Ch. 5.

posed by the lapse of the MFA and the possible decline in Nepal's garments exports.<sup>12</sup> At this point, structural constraints posed by costly customs transactions, inefficient labor markets, and high transportation costs are more significant issues affecting Nepal's competitiveness, and these topics are addressed later in this report.

### **1.5 Outlook for Macroeconomic Management**

The Government needs to continue efforts to maintain sound macroeconomic management by limiting domestic borrowing to finance the fiscal deficit and avoiding inflationary pressures that would cause the REER to appreciate. In addition to continuing efforts to achieve peace, the Government needs to implement more revenue generation efforts, curtail non-priority expenditures, and maintain overall macroeconomic balance. While outstanding domestic borrowing now appears low (about 20% of GDP), a combination of low growth and high domestic debt accumulation continued into the medium term could quickly increase the domestic debt-to-GDP ratio. In addition, the Government needs to take into account its high contingent liabilities associated with losses of the banking sector and public enterprises. One important trade-related fiscal issue for Nepal is its high dependence on tariffs and other duties and charges (ODCs) for revenue (international trade taxes account for 33% of all tax revenues). As WTO obligations for further tariff rationalization and the phasing out of ODCs can lead to revenue losses, it is important to further rationalize the tax policy and administration so that more trade-neutral taxes can compensate for these revenue losses.

The exchange rate peg has served Nepal well. The country should maintain fiscal balance and conduct monetary policy consistent with moderate inflation projected in India to protect the peg and its rate. This assumes that India will continue to pursue a policy of stable and competitive exchange rates vis-à-vis its trade partners. However, the rate needs to be reviewed continuously in view of changing fiscal conditions and export prospects brought about by the phasing out of the MFA in 2005 and accession to the WTO. The potential effect of high inward remittances, as well as anticipated increases in aid disbursements (as the security situation is expected to improve) on the real exchange rate, should be monitored continuously.

### **1.6 Organization of this Study**

Chapter 2 reviews Nepal's trade performance and policies, which is followed, in Chapter 3, by a review of issues related to the pending WTO-accession. Chapter 4 analyzes trends in Nepal's competitiveness and productivity, using various indicators and factors that have affected it. Chapter 5 discusses trade facilitation issues, while Chapter 6 covers labor market performance and rigidities. Chapter 7 then discusses broader investment climate and regulatory issues. Case studies of goods and sectors key to Nepal's exports are the focus of Chapter 8. Finally, Chapter 9 analyzes the impact of trade on poverty, using a simulation model.

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<sup>12</sup> An initial exercise at estimating the equilibrium real REER and possible misalignment (De Soto, Raimudo, "Estimating the Equilibrium Real Effective Exchange Rate in Nepal", April 2003, mimeo, The World Bank) suggests that the REER has, on average, broadly tracked the equilibrium rate. During the 1990s, as Nepal rapidly lowered its trade protection and established a more liberal one than its South Asian neighbors, the equilibrium REER depreciated, but the actual REER depreciated even more and thus avoided overvaluation. In the second half of the 1990s, the situation reversed as higher aid flows, remittances, and export earnings appreciated the equilibrium exchange rate, but the actual REER appreciated even more, leading to a slight overvaluation (about 6%).

## **2. NEPAL'S TRADE REGIME AND PERFORMANCE**

### **2.1 Performance and Structure of International Trade**

With a trade-to-GDP ratio of more than 50%, an average tariff rate of about 14%, and virtually no quantitative restrictions, Nepal is one of South Asia's most open and trade dependent economies. Despite its significant geographical constraints and policy and institutional weaknesses, Nepal has comparative advantage in a number of labor-intensive manufacturing and agricultural products. Exports of these manufacturing products grew, in U.S. dollar terms, at an annual rate of 20% on average in the 1990s (overall export growth was 15%), amid great volatility, and the share of these products in world markets increased by two to four times. For the same period, Nepal's overall share in global exports doubled. However, Nepal's exports share in world markets, including products where Nepal has comparative advantage, is still less than 0.02%, suggesting a significant potential for growth.

However, Nepal's trade performance over recent years has been highly variable, reflecting the formidable constraints to realizing this potential. Even with structural change in its merchandise exports, Nepal remains dependent on a relatively small basket of exports and a few destination markets. A significant share of its exports face dwindling world demand, making the continuing restructuring of its export basket urgent. With regard to trade policy, Nepal has significantly opened up trade in the past decade, a trend that is likely to be reinforced by the implementation of its WTO commitments. However, further effort is required to ensure that the resulting pattern of incentives does not adversely affect potential exporters. In addition, the high transaction costs associated with formal cross-border trade with India lead to a significant share of that trade occurring through informal channels. Reducing these costs at the border will be an important part of facilitating trade between the two countries. More generally, while market access barriers are important for a number of goods exported to India, these goods are not the most important in Nepal's export basket. Subsequent chapters on competitiveness and case studies (Chapters 4 and 8) suggest that the limiting constraints to integration into the world economy exist mainly at and behind the border. Strengthening Nepal's capacity to conduct and implement trade policy will require institutional strengthening across a range of public and private agencies and equal emphasis on improving the process of trade policy formulation.

#### **Exports: Determinant of Trends**

Following market-oriented economic reforms undertaken in early 1990s, Nepal substantially increased its integration into the world economy. Major reforms included liberalization of trade and industrial policies and rationalization of the foreign exchange regime, including a substantial depreciation vis-à-vis the US dollar. Nepal's trade-to-GDP ratio increased over the last two decades, from 23% during the 1980s to more than 50% by the end of 1990s, although this fell markedly in 2001–2001, due to the global economic slowdown and escalating violence of the Maoist-related insurgency. The improved business environment greatly assisted rapid exports growth (by 30% annually from 1991 to 1995), driven mainly by manufacturing exports, especially carpets and garments, which together rose by 77% (in U.S. dollar terms) during the early 1990s. In the case of garments, export growth came initially from the spillover of Indian exports, due to quota limitations on India. Additionally, improved profitability and increased willingness of domestic producers to enter the industry also stimulated the growth of Nepalese garments exports.

Weak demand, quality problems, and concern in importing countries over child labor in certain factories adversely affected one of Nepal's major export items (carpets), causing export growth to decelerate in the second half of the 1990s. Although many problems have been resolved, carpet exports have not recovered. Exports of ready-made garments (RMG), which benefited from preferential treatment under

the Multifibre Arrangement (MFA), suffered as international trade regulations changed. The fall in garment exports is probably due to supply bottlenecks and the industry's inability to compete with exporters from other South Asian countries. (Other chapters of this report, especially chapters 4 and 8, discuss determinants of Nepal's competitiveness in more detail.)

Merchandise exports rebounded during 1999–2000, partly owing to increased exports of RMGs to third countries and, more importantly, due to increased exports to India.<sup>13</sup> Furthermore, some of these increased exports were transitory. In RMGs, Nepal benefited from unsettled political conditions in Bangladesh and consequent diversion of export orders to Nepalese manufacturers (World Bank 2000). Nepalese manufacturers have also taken advantage of prevailing tariff differentials between Nepal and India in order to increase exports to neighboring Indian states.<sup>14</sup> This is true especially in the case of vegetable ghee, where exports to India have increased rapidly (accounting for about 25% of Nepal's India-bound exports). Other such exports include acrylic yarn, copper wire, zinc oxide, and mild steel pipes. In response to the substantial growth of Nepal's exports to India, access of recorded exports to the Indian market continues to be subject to difficulties that might be described as non-tariff barriers (Karmacharya 2000c).<sup>15</sup> India considers the above five export items as sensitive to their domestic industry. Overall, however, there is little question that Nepal's export performance in the 1990s was impressive, having doubled its share of world markets.

Recent deterioration of export performance in 2001–2002 can be attributed to both external and internal factors. External factors include weaker world demand and adverse policy shift in countries that import Nepalese goods. Domestic factors, including faltering competitiveness (see Chapter 8), higher transport costs, and the Maoist insurgency may have deepened the impact of negative external shocks.

Weak external demand seems to have affected Nepal's exports to third countries, particularly those from the U.S. and Germany. Imports from developing countries into these markets declined in 2001 by 5% and 1%, respectively, compared with respective increases of 24% and 14% the previous year. In particular, U.S. apparel imports declined by 1% in 2001, compared with an increase of 13% in previous years. Similarly, growth of imports from developing countries into India has also slowed to less than 2% in 2001 from 13% in 2000.

Regarding internal factors, Nepal's export performance is also affected by its limited competitiveness, which is not a recent development. This arises from various barriers related to geography, policy, and institutions (Karmacharya 2000). Nevertheless, after improving through most of the 1990s Nepal's competitiveness has shown recent signs of deterioration in recent year, the causes of which are discussed in depth in subsequent chapters.

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<sup>13</sup> The renewal of the Nepal-India Trade Treaty of 1996 provided improved access of Nepalese exports to the large Indian market by removing the domestic content requirements. Under Treaty terms, either country can export goods to the other, without respect to the origin of raw material inputs in the product process, as long as there is local value added in manufacturing.

<sup>14</sup> Nepalese manufacturers are also genuinely exploring opportunities in the Indian market through joint ventures and collaborative marketing arrangements.

<sup>15</sup> Four key restrictions are as follows: i) India's suggestion of voluntary export restraint of vegetable ghee to its market, which Nepal accommodated by imposing a tax of 5% on such exports; ii) India's enforcement of the Food Adulteration Act; accordingly, Nepalese food exports, including vegetable ghee, are subject to mandatory laboratory tests (initially in Kolkata, which now can be done in Patna); iii) India's imposition of special additional duty (SAD) on all its imports from Nepal which was later abolished; and iv) India's quarantine fees imposed on Nepalese agricultural products.



**Table 2.1 Market Position of Nepal's Exports, 1995--1999**

Share of Country's Export in World Trade	Share of Product in World Trade	
	Dynamic (↑)	Stagnant (↓)
Competitive (↑)	Optimal <b>Rising stars</b> 35.3%	Vulnerable <b>Falling stars</b> 6.3%
Not competitive (↓)	Weak <b>Lost opportunity</b> 5.2%	Restructuring <b>Retreat</b> 53.2%

*Source:* Derived from Karmacharya, Binod K., (2003). "Performance of Foreign Trade", Background Study for this Report.

Another way to understand the challenges facing merchandise exports is the unfavorable market positioning of Nepal's exports. In 1999, the largest share of Nepal's export products, 53%, fell in the "retreat" category.<sup>16</sup> That is to say, Nepalese exports in this category not only lost world market share, but also the world demand for such products declined between 1995 and 1999 (Table 2.1).<sup>17</sup> This category was led by carpets, but also included men's cotton shirts and women's dresses.<sup>18</sup> The optimal position is in the "rising stars" quadrant, where a country is gaining market share in products for which demand is growing worldwide. This category accounted for 35% of Nepal's exports (low by East Asian standards), and included men and women's trousers, shawls and scarves of fine animal hair, and other textile and garment products.<sup>19</sup> A close look at products in the retreat category (unknitted cotton apparel and carpets) suggests that, in the case of the former, Nepal could change technique and continue moving into knitted apparel. The prospect for carpets, in the face of declining world demand (discussed in Chapter 8), can also change if Nepal changes policies that are restricting the industry from becoming more competitive. The remaining two market position categories consisted of 6% of "falling stars" and 5% of "lost opportunity" exports.<sup>20</sup>

<sup>16</sup> In market positioning terminology, products sold in the world market are classified in four categories: i) competitive, ii) non-competitive, iii) dynamic, and iv) non-dynamic. A product is competitive when the country's share of this product in the world market increases. A dynamic product is one whose share in world trade increases faster than the average for all products. This classification produces a matrix consisting of "rising stars" (competitive, dynamic), "falling stars" (competitive and non-dynamic), "lost opportunity" (non-competitive, dynamic), and "retreat" (non-competitive, non-dynamic). Ideally, the highest share of exports should be rising stars, whereby the country is gaining market share in fast-growing products. Lost opportunity is the least desirable outcome since products in this category lose market share in dynamic products. See I. Nabi and M. Luthria (eds.), "Building Competitive Firms," The World Bank, 2002.

<sup>17</sup> Nepal seems to have the highest share of "retreat" among Asian countries. South Asian countries like India and Pakistan share this category at only 8-9%, while ASEAN and East Asian countries share in the range of 2-11%.

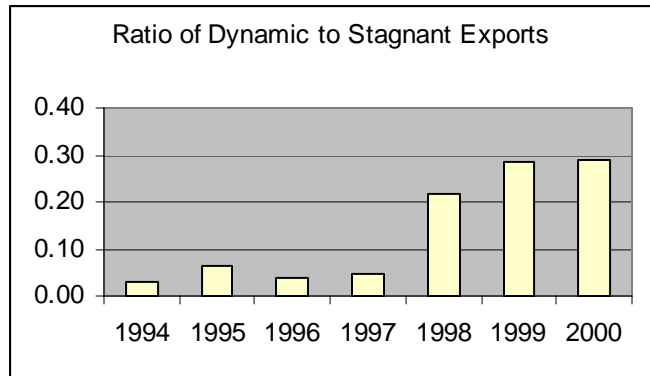
<sup>18</sup> All of these export products have a revealed comparative advantage (RCA) value, a measure of relative market share and success in world trade, greater than one. For a particular product and a country, RCA is the ratio of the share of the export of this product in the country's total export to the share of world exports of this product in total world exports (Balassa 1965). A ratio of one is considered the dividing line between comparative advantage and disadvantage. To the extent that this ratio is greater than one, this is expected to reveal a comparative advantage that this country has in the export of this particular product.

<sup>19</sup> By contrast, Malaysia, Singapore, and Thailand's exports were mostly rising stars (73, 69, and 55%, respectively, of the total). This was better market positioning than even Korea and Taiwan (42 and 51%, respectively).

<sup>20</sup> Only 3% of Thailand's exports were in the "lost opportunity" category, a performance comparable to China and Malaysia (less than 1%). Exports from Taiwan and Indonesia had the highest share of lost opportunity (losing market share in dynamic products). A large proportion of Thailand's exports (38%) was in the "falling star"

**Figure 2.1 Growth of Nepal's Dynamic Exports**

This analysis above suggests that the Nepalese export industry needs to restructure away from the retreat category. Indeed, Figure 2.1 shows that this is already happening to an extent, as evidenced by the steady increase of Nepal's dynamic-category exports (i.e. exports whose world share is increasing) in total exports, over the past decade. Figure 2.1 also shows that Nepal's adaptability index – i.e. ratio of Nepal's dynamic exports (i.e., exports whose share in world trade is increasing) to stagnant exports (i.e., exports whose share is falling), based on its top 50 export products, accounted for 76% of all exports in 2000. While this ratio is low compared to many other countries and reconfirms the need for Nepal to change its export basket, the rising trend shows that the basket of Nepal's exports are becoming more competitive.



### Composition and Concentration of Trade

Despite significant structural changes in Nepal's merchandise exports over the last two decades, like other South Asian countries, Nepal remains dependent on a few markets and relatively few exports. This has made it vulnerable to external shocks arising from demand and policy changes in destinations. However, manufacturing now dominates Nepal's exports, though, in a welcome development, growth of agricultural products has occurred in recent years (Table 2.2). The share of primary goods declined from nearly 70% in the 1980s to 17% in 2001, while export of manufacturing goods increased from 30% to 75% during the same period.

Within manufacturing, Nepal's export basket is narrowly concentrated in a few products: garments, carpets, and pashmina. These accounted for more than 50% of total exports in the late 1990s. Furthermore, they depend on limited external markets. Carpets are exported primarily to Germany and garments to the U.S.<sup>21</sup> Following the signing of a renewed bilateral Trade Treaty in 1996, Nepal has been exporting new manufacturing products, all destined for India. These include vegetable ghee, toothpaste, toilet soap, acrylic yarn, copper rod, zinc oxide, MS pipe, *Hazmola*, *Chyawanprash*, noodles and biscuits.<sup>22</sup> Other exports comprise a basket of about 20 agricultural products and consumer goods, which go primarily to India.

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category (gaining market share in stagnant products). Thailand shared this less desirable outcome with China, Indonesia, India, and Pakistan (47-71%).

<sup>21</sup> Germany buys about 80% of Nepal's total carpet exports, while the U.S. buys more than 80% of Nepal's garment exports.

<sup>22</sup> Some of these products, however, are transitory in nature since Nepalese manufacturers have been taken advantage of prevailing tariff differentials between Nepal and India on their imports from third countries (Karmacharya 2000; 2001a, b).

**Table 2.2 Nepal's Structure of Merchandise Imports and Exports**

Product	Imports	(\$ '000)	Share (%)	Share (%)	Growth (%)
	1990	2000	1990	2000	1990–2000
All goods	610,674	1,557,926	100.0	100.0	9.8
Food and Feeds	80,079	162,254	13.1	10.4	7.3
Agricultural Raw Materials	40,401	55,029	6.6	3.5	3.1
Ores and Metals	43,076	68,164	7.1	4.4	4.7
Fuels	50,402	236,161	8.3	15.2	16.7
All Manufactures	386,970	709,756	63.4	45.6	6.3
Of which:					
Chemicals	102,688	165,877	16.8	10.6	4.9
Textiles and Clothing	48,691	146,002	8.0	9.4	11.6
Other Manufactures	58,035	61,292	9.5	3.9	0.5
Machinery and Transport Eq.	109,984	267,901	18.0	17.2	9.3
Misc. Manufactures	36,154	43,864	5.9	2.8	2.0
<b>Export Value (\$ '000)</b>					
Product	1990	2000	1990	2000	1990–2000
All goods	180,366	708,775	100.0	100.0	14.7
Food and Feeds	23,341	68,937	12.9	9.7	11.4
Agricultural Raw Materials	5,423	3,223	3.0	0.5	-5.1
Ores and Metals	494	1,766	0.3	0.2	13.6
Fuels	0	0	0.0	0.0	
All Manufactures	150,177	473,061	83.3	66.7	12.2
Of which:					
Chemicals	849	60,540	0.5	8.5	53.2
Textiles and Clothing	132,043	391,614	73.2	55.3	11.5
Other Manufactures	11,096	6,842	6.2	1.0	-4.7
Machinery and Transport Eq.	7	3,362	0.0	0.5	84.2
Misc. Manufactures	6,178	10,598	3.4	1.5	5.5

Note : The product groups are classified by SITC product in Revision 2 as Foods and Feeds (0+1+22+4), . Agricultural Raw Materials (2-22-27-28), Ores and Metals (27+28+67+68), Fuels (3), All Manufactures (5+6+7+8-68), Chemicals (5), Textiles and Clothing (65+84), Other Manufactures (6-65-67-68), Machinery and Transport Equipment (7) and Misc. Manufactures (8-84). All nine SITC 9 items are excluded.

Source: United Nations ComTrade Statistics.

In the last decade, Nepal's dependence on the same few markets has also increased. At present, 90% of its total exports go to India, Germany, and the U.S.; of the three, India is the most important. Long porous borders, free movement of people and capital, and the special regime of trade and payments between the two countries are the major factors responsible. Despite a concerted effort by Nepal in the 1970s to diversify its foreign trade partners, the share of Nepal's total imports from India is about 42%. After a long decline in relative importance, Nepal's dependence on exports to India has recently increased sharply (more than 50%) due to the preferential trade treaty (signed in December 1996), a slowdown in

exports to other key markets and limited success in penetrating other regional markets, despite Nepal's membership of the South Asian Association for Regional Cooperation (SAARC) (Box 2.1).

Excessive concentration makes Nepalese exports vulnerable to import policy changes and international competition in destination countries. In 2001, two treaties came into effect in the U.S., which can be considered as negative policy shocks for Nepal. These two treaties, the Africa Growth and Opportunity Act (AGOA) and the Caribbean Basin Trade Partnership (CBTPA), which grant producers in Sub-Saharan Africa and the Caribbean preferential access to the U. S. market, may have negatively affected Nepal's garment exports.

Nepal's increased dependence on India has elevated risks arising from Indian policy shifts. The renewed Nepal-India Trade Treaty is more restrictive than its 1996 predecessor (see Box 2.1). It imposes the following: i) more stringent Rules of Origin (ROO), ii) Tariff Rate Quotas (TRQs), iii) clear specification of safeguard clauses,<sup>23</sup> and iv) submission of information regarding the basis of calculating ROO to the Indian government by Nepal on an annual basis. The Nepal-India Treaty also designates 22 border crossings that may occur through preferential trade. This change in policy, from virtual free trade to one with a number of restrictions, has had an immediate negative effect on Nepal's export performance with India.<sup>24</sup>

Nepal's exports are also subjected to a high degree of volatility. The IMF (2002) made three observations in this regard: (i) compared to other South Asian countries, Nepal's exports are least correlated with overall changes in imports by the U.S.; (ii) unlike others, Nepal's market share varies with its yearly export performance; and (iii) Nepal's exports are more volatile, compared with other South Asian countries. That is, while exports from other South Asian countries to the U.S. generally follow the fluctuations in U.S. demand, Nepal faces larger gyrations, making its market share sensitive to export performance.

No significant changes have occurred in Nepal's import structure over time. Manufacturing constitutes the largest share of Nepal's total imports, with machinery and transport equipment the most important product. These imports underpin much of Nepal's manufacturing export capacity. Intermediate goods constitute the second largest share of Nepal's total imports, followed by food and then fuels. The almost stagnant structure of imports reflects the slow and narrow growth of manufacturing activities during these periods. If industrial deepening had occurred, marked increase in imports of capital goods would have been evident. On the import front, markets are relatively more diversified. More than 10 countries supply 90% of Nepal's imports.

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<sup>23</sup> Renewed Trade clearly defines "injury" as significant damages to the domestic procedures of like or similar products, resulting from a substantial increase of imports under the Treaty in situations that cause substantial losses in terms of earnings, production, or employment unsustainable in short term. The safeguard measure was specified in the original 1996 Nepal-India Trade Treaty in terms of a broad clause of "export surge."

<sup>24</sup> Under the new treaty, India permitted freer movement of capital to Nepal to establish joint ventures. Similarly, the new Nepal-India transit treaty signed between the two countries in January 1999 opened up vital transport corridors and established a lifeline to the outside world with which Nepal seeks to interact commercially.

### **Box 2.1 Nepal India Trade Agreement and the South Asian Association For Regional Cooperation (SAARC)**

Trade relations between Nepal and India are governed by bilateral treaties on trade and an agreement for cooperation to control unauthorized trade. Nepal signed its first trade treaty and transit with India in 1950. They were subsequently renewed in 1960, 1971, 1978 (when trade was de-linked from transit), 1991, 1996, and 2002. Key features of the treaties were:

- Exemption from basic customs duties and quantitative restrictions on imports of primary products on a reciprocal basis;
- Access for selected Nepalese manufacturing exports (except for those on the Negative List) to the Indian market free of basic customs duties and quantitative restrictions on the basis of non-reciprocity;
- Preferential entry on manufacturing goods imported from India to Nepal, without any quantitative restrictions.

Preferential access for Nepalese manufacturing exports to the Indian market is subject to Rules of Origin (ROO) conditions that have changed over time. The 90% value-added condition (from materials originating in India or Nepal) of the 1960 trade treaty was reduced to 50% in the 1992 treaty, removed under the 1996 treaty, and replaced by a requirement for a certificate of origin issued by the FNCCI. The 1996 treaty substantially reduced the negative list (i.e., goods excluded from preferential treatment) to include only such items as alcoholic liquors/beverages and their concentrates (with the exception of industrial spirits), perfumes and cosmetics with non-Nepalese/non-Indian brand names, cigarettes and tobacco.

The **Nepal-India Trade Treaty renewed in March 2002**, however, introduced several new restrictions: (i) more stringent ROOs, (ii) TRQs, (iii) clear specification of safeguard clauses, and (iv) submission of information regarding the basis of calculating ROO to the Indian government by Nepal on an annual basis.

The new ROO provisions include: (i) value addition (domestic content) requirements of 30% of ex-factory prices (from March 2003) and (ii) changes in tariff heading (CTH) at four-digit level of the harmonized system code. For Nepalese manufacturing exports, which cannot fulfil CTH criteria, the new ROO provision requires that these products have undergone a “sufficient manufacturing process within Nepal,” determined on a case-by-case basis.

TRQs have been imposed on Nepal’s exports of vegetable ghee, acrylic yarn, copper, and zinc oxide. If Nepal’s exports of these products exceed the quotas, which are lower than recent export levels, they are subject to MFN treatment. According to the amended clause of the renewed Trade Treaty, India has provided Nepal a fixed annual quota for the export of these products at 100,000 tons for vegetable ghee; 10,000 tons for acrylic yarn; 10,000 tons for copper; and 2,500 tons for zinc oxide. India has canalised its import of vegetable ghee from Nepal through a state trading company. Nepalese exporters must pay service charge to the state trading company for doing this. The new treaty provides “safeguards” against significant damages to the domestic producers, from an “export surge”. Nepalese exports to Indian market are subjected to Indian countervailing duty. Such duty is charged to make price of Nepalese products comparable with its Indian counterparts. Trade transactions are in local currencies. However, Nepal permits imports of few intermediate inputs and machineries required for local industry from India against payment in convertible currency. Such imports enjoy normal Indian export benefits.

The commitment of South Asian governments to accelerate the process of regional economic integration within a framework of **South Asian Association of Regional Cooperation (SAARC)** is now over a decade old. It began with the intention of establishing South Asian Preferential Trading Arrangements (SAPTA) through continuous negotiations to eventually lead to the formation of South Asian Free Trade Area (SAFTA). However, SAPTA, in operation since December 1995, has proved to be an arduous tool to negotiate. Until now, four rounds of trade negotiations have been concluded.

The progress achieved in the first four rounds of the negotiations is meager for various reasons (Karmacharya 1999b). First, SAPTA has inherent limitations. The negotiations held to date have been on a product-by-product basis, which is time-consuming. As a result, around 7,000 items have been covered for preferential tariff concession thus far. Furthermore, regional liberalization does not reflect patterns of regional trade; i.e., many concessions are on products not widely imported from within the region. Second, barring some offers made in favor of the least developed member states, the preferential margins are small. Finally, only tariff cuts have been made until now. Finally, SAFTA, initially proposed to come into force in 2001, is unlikely to do so before 2008. Given the strained ties between the two largest economies in South Asia, the political constraints to freeing trade within the framework of a regional arrangement has been formidable.

## Exports and Growth

Table 2.3 shows that exports<sup>25</sup> have played a positive role since the 1986–1990 period, during which time their contribution to economic growth increased to 10%, from -2% for the previous period (1976–1985). Exports were an engine of economic growth (36%) during the 1990s, particularly during the period after economic reforms (1991–1995). However, the fall of exports by 20% contributed negatively to economic growth in 2002.

**Table 2.3 Demand-Side Sources of Economic Growth**

	Contributions to Growth (%)						
	1976-85 I	1986-1990 II	1991-1995 IIIa	1996-2001 IIIb	1991-2001 III	2002 IV	1976-2002
Private Consumption	104.2	86.8	68.0	74.9	71.7	98.4	87.5
Government Consumption	10.0	9.0	10.9	11.5	11.1	25.5	10.8
Investment	13.3	16.4	33.1	23.8	28.0	9.4	19.7
Private	3.3	6.4	22.2	7.4	14.1	33.1	9.4
Government	6.7	8.5	6.1	9.3	7.9	2.4	7.3
Net Export	-27.5	-12.2	-12.0	-10.1	-10.9	-33.4	-18.1
Export	-1.6	10.3	34.5	17.0	24.9	-81.1	8.5
Import	25.9	22.5	46.5	27.0	35.9	-47.8	26.6

*Source:* Karmacharya, Binod K. (2002). "Explaining Nepal's Economic Growth Performances", Report presented to the World Bank.

## 2.2 Unrecorded (Informal) Trade

Unrecorded or informal trade is an important feature of Nepal's trade with India. It operates both through and outside official channels. Informal trade through legal channels is carried out via false invoicing of documents. It partially evades export/import tariffs, domestic taxes and non-tariff barriers. Informal trade through unofficial channels totally evades export/import tariffs, domestic taxes, and non-tariff barriers. Such informal trade takes place along Nepal's border with India and the Tibet Autonomous Region of China. This section limits discussion to the extent of the border crossings of goods between Nepal and India, based on estimates obtained from both Indian and Nepalese territories (Karmacharya (2002); Taneja and Pohit (2002)).

### Estimates of India-Nepal Informal Trade

Contrary to earlier belief that informal trade between India and Nepal takes place largely in one direction, from Nepal to India (Muni 1992), recent studies<sup>26</sup> show that informal trade is two-way. In fact, the data suggests that the average informal exports from India to Nepal is US\$180 million, while that from Nepal to India is US\$157 million, implying Nepal has a slight deficit on the informal trade account. Total two-

<sup>25</sup> The discussion is mainly limited to formal exports.

<sup>26</sup> Karmacharya (2002), and Taneja and Pohit (2002).

way informal trade ranges between US\$368 million (Nepalese study estimates) and US\$408 million (Indian study estimates). Interestingly, the informal trade estimates of the two countries lie within a small range, whereas there is a large discrepancy in recorded formal trade, as indicated in their national trade statistics.

The Indian study estimate shows the four largest items traded informally from India to Nepal are textiles, processed food, unprocessed food, and cement, which account for 59% of total informal trade from India to Nepal. The Nepalese study estimate shows that the four largest items account for 58% of total informal trade from India to Nepal. Most of the items traded informally from Nepal to India are of third-country origin. (The survey also shows that, despite liberalization and the FTA, there has been little or no increase in informal trade flows from India to Nepal, but there has been an increase in informal trade from Nepal to India).

**Table 2.4 Summary Estimates of Formal and Informal Trade Balance, 2000–2001**  
Current Prices (US \$ million)

Trade Balance	Indian Territory			
	Exports (X)	Imports (M)	X+M	X-M
Formal	141	255	396	-114
Informal	180	228	408	-48
Informal/Formal*100	128	89	103	54
	Nepalese Territory			
	Imports (M)	Exports (X)	X+M	X-M
Formal	614	359	973	-255
Informal	211	157	368	-54
Informal/Formal*100	34	44	38	21

Note:(i) The reference period for Nepal's formal trade is June/July 2000-May/June 2001; (ii) for Nepal's informal trade the reference period is April/May 2000-March/April 2001; and (iii) the reference period for both formal and informal trade for India is April 2000 to March 2001.

Source: Karmacharya, Binod K. (2002). Nepal's Informal Trade with India. Report prepared for South Asia Network Economic Institutes.

### Reasons for Informal Trade: - Policy Distortions and Transactions Costs

The conventional argument says that informal trade takes place due to the trade and domestic policy distortions. This is true to a larger extent in the case of informal exports to India from Nepal of the goods originating in third countries. The difference in tariffs with the rest of the world prevailing between Nepal and India in these goods is wide ranging (5-30%). Furthermore, Nepal's trade regime is relatively more liberal in the sense of having hardly any non-tariff barriers. In the context of bilateral agreement between two countries, third countries do not meet the ROO requirement and are therefore traded informally from Nepal to India. In the case of informal imports from India, the tariff difference may not necessarily be a strong influencing factor. This is evidenced by the incidence of informal imports from India of primary products, such as rice and other unprocessed food products, which face no tariff or non-tariff barriers in Nepal.

However, factors other than trade policy-related distortions are apparently more important in influencing informal trade. A survey carried out by Taneja and Pohit (2000) revealed that institutional factors—quick realization of payments, no paper work, no procedural delays, and lower transportation costs—were all instrumental in driving the traders toward informal channels. The study highlighted that trade policy barriers, like tariffs and quantitative restrictions between the two countries, were not considered as important as institutional factors.

Pohit and Taneja (2000) have also shown that informal traders bear relatively low transaction costs<sup>27</sup> in comparison to the formal trade. The majority of informal traders bear transaction costs of less than 10% of their turnover. Few informal traders bear transaction costs of more than 20%. None bear transaction costs of more than 30% of their turnover. On the other hand, total transaction costs faced by formal traders can be more than 30% of their turnover (Table 2.5).

**Table 2.5 Percent of Respondents (%) of Formal and Informal Traders Facing Varying Magnitude of Transaction Costs in Nepal-India Trade**

Transaction cost as percent of their turnover in the range of	Formal traders		Informal traders	
	India	Nepal	India	Nepal
Less than 10%	33	18	72	61
10-% to 20%	13	42	10	36
20-% to 30%	18	24	3	3
More than 30%	36	16	0	0

Source: Pohit and Taneja (2000).

Note: Transaction cost here includes total payment as bribes to officials at various stages plus transportation cost plus cost of credit.

## 2.3 Trade Reforms and Current Trade Regime

### Determinants of The Trade Policy Regime

Nepal relies on its trade policy to achieve economic, social, and political objectives including, inter alia, significant government revenues and as a key instrument in the pursuit of broader industrial and development policies. Geography has had a much larger impact on economic development in Nepal than in most other countries and will continue to define the options available in the future. Trade policies have also played an important part in defining Nepal's relationship with its South Asian neighbors, particularly India.

It would be difficult to overestimate the influence of India on Nepal's economy in general and its trade regime in particular. The virtually free movement of labor and capital between these two countries makes this an unusual and highly sensitive economic relationship. In addition, at least three key factors must be considered in Nepal's trade regime:

- **Border:** A long and relatively porous border in the south separates the Terai and northern India. The eastern Terai is one of the more industrialized areas in Nepal, largely in response to the commercial opportunities provided by access to the Indian market.
- **Preferential market access:** The longstanding preferential trading relationship between the two countries, which permits most exports to enter India duty free and allows imports from India to enjoy significantly reduced duties.

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<sup>27</sup> These arise from time constraints and/or in the form of money resources they spend in the process, including bribes that the trader has to pay to avoid unlawful harassment or procedural delays. At the same time, the risk for exporters of going through informal channels is apparently quite low. They are due to delay in delivery of goods, default in payment, and due to seizure while that for importers arise due to goods not conforming to specifications, default in delivery of goods and delay of goods was very low. Informal traders have developed several mechanisms to mitigate risk including non-anonymous transacting, as an important mechanism for risk mitigation.



- **Exchange rate:** The free convertibility between the Nepalese and Indian Rupees at a fixed, nominal exchange rate.

Given their relative sizes and the overriding impact of the existing ties between Nepal and India, it would be difficult for Nepal to pursue a trade and development strategy that deviated significantly from that followed by India. Experience has shown that when this has happened, opportunities to exploit artificial rents emerge and there is inevitably some form of retaliation. Nevertheless, there are clearly considerable economic benefits and costs for Nepal arising from the close economic relationship with India, and policymakers must weigh the overall impact, not any one dimension in isolation.

Cost-benefit assessment of the economic relationship with India depends on expectations of the future course of reform and liberalization. India has implemented significant trade reforms in recent years and is officially committed to a program that would greatly reduce trade barriers. For example, virtually all import-licensing requirements have been removed, and there is a stated goal of adopting, by 2005, a two-tier tariff rate structure (10 and 20%). However, there are also concerns about whether these additional reforms would be feasible financially (i.e., India also relies greatly on import duties as a source of revenue, and alternative taxes may be difficult to implement).<sup>28</sup>

The commercial importance of Nepal's preferential access is relative. At this time, Nepal has greater (less restricted) trade access to the Indian market than any other country in the region or elsewhere. However, the trade agreements between India and Sri Lanka may eventually come close to granting equal preferences. In addition, if India enters into other similar preferential agreements and/or is able to introduce substantially more liberal policies generally, Nepal's relative advantage would be reduced. Producers in Nepal would have to compete on an essentially equal footing with producers in other countries.

### **The Trade Policy Regime**

Nepal's widespread economic reforms during the early 1990s aimed at increasing economic growth and social development. The strategy was based on greater integration with the global economy. Key measures included:

- Reduction and restructuring of import duties,
- Elimination of most quantitative restrictions and import licensing requirements, and
- Introduction of full convertibility for current account transactions.

The *1992 Industrial Policy* emphasized deregulation, competition, and increased reliance on market forces. Direct export promotion measures included:

- Reduction of export service fees,
- Allowing exporters to retain export earnings in convertible currency accounts,
- Improved duty drawback and bonded warehousing arrangements, and
- Income tax concessions on income from exports.

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<sup>28</sup> See WTO, 2001.

The reforms of the early 1990s appear to have substantially reduced the level and variation in rates. The unweighted average tariff rate fell from nearly 40% to 14% (Table 2.6). Most rates now fall at 5-25% while more than 70% of rates exceeded 25% in 1990.<sup>29</sup> The current MFN tariff rate structure (applying to countries other than India and China) falls mainly into five tariff rate bands (ranging between 5% and 40%), albeit complicated somewhat by the preferential trade arrangements with India. Relatively few rates fall outside this framework, primarily high rates that are set for revenue reasons. For example, the Government replaced an excise tax on vehicles in 2000 with two additional tariff bands (80% and 130%). Since there is no manufacture or assembly of vehicles in Nepal, the tariff and excise rates are essentially equivalent. There are few trade-related, non-tariff barriers (NTBs).

The Government has indicated its intention to further reduce the number of tariff bands. This will, however, largely depend on India's progress in this direction, which aims to have a two-band tariff rate structure in place by 2005.<sup>30</sup> In addition, Nepal is in the process of acceding to the WTO and, as a result, is reviewing and addressing a number of trade-related policy issues, (e.g., customs valuation).

**Table 2.6 Distribution of Tariff Rates**

<b>Tariff Rates</b>	<b>No. of tariff items 2002</b>	<b>1990 (% in each category)</b>	<b>2002 (% in each category)</b>
0-5	1,228	7.4	0.8
5-10	1,731	8.4	22.1
10-15	1,729	2.8	32.2
15-25	1,582	2.7	29.4
25-40	543	37.1	10.1
40-50		0.0	4.4
50-80		38.8	0.5
80 plus	52	2.9	0.04
Total	5,374	100	100
Average		39.8	13.8

*Source:* Data file provided by the Department of Customs, HMG Nepal, October 2002. 1990 data from Second Industrial Sector Study, Maxwell Stamp, 1991.

In addition to the MFN rates, Nepal imposes a series of “additional duties.” The result is a cascading tariff rate structure, where the highest rates are applied to final goods, lower rates to intermediate goods, and the lowest rates to raw materials. Cascading tariff rate structures have been implemented largely to provide protection for import-competing activities, as part of a development strategy based on import substitution. (The implications of a cascading tariff rate system for incentives arising from effective protection are examined below.) Box 2.2 describes the items falling in various rate bands.

<sup>29</sup> One should be cautious in interpreting these averages, as there were only 2,281 rates in 1990 while there were 5,374 in 2002.

<sup>30</sup> The tariff rate structure in Nepal generally follows the pattern of protection embodied in Indian MFN import substitution policies. The average tariff rates in both countries in the early 1990s were comparable (30-40%). India's average rate has remained at 32.3%, while Nepal's has fallen considerably to 13.8%.

### Box 2.2 Commodities by Tariff Band

Very generally, the types of goods that fitting into the existing MFN tariff rate structure can be characterized generally as follows:

- 1 **80 percent and above:** Includes mainly excisable goods, such as petroleum products, vehicles, tobacco, beer, and weapons. Cement and cement clinker are also included here. (Note that a number of goods included in this group are subject to specific duties; i.e., a Rupee amount per unit rather than a percentage of value. Additional research would be needed to determine the ad valorem equivalent of these specific duties.)
- 2 **40 percent:** Includes a wide variety of final and import competing goods, such as processed food, sugar, juices, coffee, Portland cement, building stone and materials, soaps, matches, plastic goods, footwear, iron and steel products, furniture, batteries, and furniture.
- 3 **25 percent:** Includes processed foods, such as coffee and tea, confectionery, fruits and vegetables, fertilizer, industrial chemicals, plastics and acrylics, garments, jewelry, pots and pans, household appliances and some commercial vehicles.
- 4 **15 percent:** Includes some consumer goods, such as milk and dairy products, preserved fruit, canned fish, medicines, toiletries, some metal cookware; as well as – and many industrial goods, such as industrial chemicals, polishes, plastic materials, tubes and pipes, leather and skins, wood and lumber, iron and steel components, machinery and equipment, and electronic components.
- 5 **10 percent:** This, the largest category, contains some consumer goods, but primarily intermediate goods, including live animals, meat and fish, milk and dairy, rice, wheat and other grains and flours, chemicals, industrial materials, yarns, thread, metal components, and machinery parts.
- 6 **5 percent:** This group consists mainly of raw materials, machinery and equipment including, for example, industrial chemicals, dyes and pigments, rubber, raw skins and hides, wood pulp, fiber and yarn, and industrial machinery and equipment, including machine tools.

The analysis above reflects only MFN tariff rates. Several adjustments should be taken into account. Additional duties and taxes are levied primarily for revenue purposes and can amount to as much as 14.5% additional duty on some types of imports. They currently include the following:

Agriculture Development Fee	5 percent (10 percent for rice and paddy)
Local Development Fee	1.5 percent
Special Fee	1 percent for items with Customs Duties of less than 5 percent 3 percent for products with Customs Duties of more than 10 percent, except for petrol, diesel and kerosene, Rs. 1/- per liter on petrol, diesel, and kerosene 10 percent for products of HS 87 with Customs Duties of more than 25 percent

An export service fee of 0.5% of fob value is being imposed on all exports. It is intended to cover the costs of services provided by customs and other trade facilitation agencies. As such, it should not be a major disincentive to exporters. There are also limited export restrictions on raw hides and unprocessed wool. These are intended to constrain options and lower domestic prices for these goods so that greater domestic value addition will occur.

## Tariff Preferences for Regional Neighbors

Imports from India currently receive a rebate on ad valorem customs duties, 7% of the tariff rate up to 40%, and 10% on rates of more than 40%. (No rebates apply for specific duties). This represents a reduction since 1990 in the preference for Indian imports.

The unweighted average tariff rate in 1990 for imports from India was substantially less than half of the MFN rate, 14.1% as compared with 39.8%. A 10% rebate of the customs duty applies to imports from China that enter Nepal through Tibet. This also does not include goods for which specific duties apply. There are evidently preferential rates currently available for qualifying imports from SAARC member states.<sup>31</sup>

## 2.4 Pattern of Incentives in Nepal

As noted above, in a cascading tariff system, several rates or bands exist and the relative rates are intended to correspond to the stages of production or the degree of fabrication. This usually means that the highest rates are levied on final goods, lower rates applied to intermediate goods and the lowest rates to raw materials and capital goods. Although this approach might seem to be straightforward and sensible, it leads to serious difficulties in practice and represents a major impediment to achieving an effective policy environment conducive to rapid and efficient economic growth. While there are a number of exceptions to this pattern in most developing countries, this has often been the basic structure of the tariff system for many years.<sup>32</sup>

Officials in many countries find themselves laboring to maintain a cascading tariff system for reasons that may not be clearly understood. Indeed, this approach has been widespread for so long that it is often no longer questioned. Both India and Nepal have followed this approach.

### Implications and Unintended Consequences of Cascading Rates

A cascading tariff rate structure has important implications for economic incentives, which policymakers should well understand. The measure used here to reflect economic incentives is the effective rate of protection (EPR). The EPR rate for each good depends on a combination of its nominal tariff, the tariffs on its inputs and the ratio of value added in productions to the border value of the commodity.

To get a better idea of the potential impacts of a cascading tariff rate system across types of productive activities, it is important to keep in mind that different types of productive activities are generally characterized by different value added ratios. These reflect the underlying technology and are not something that can be readily influenced by producers or policymakers. Broadly speaking and based on considerable field experience, the following relationships are generally representative:

- **Simple assembly activities** are often characterized by quite low value-added ratios (e.g., 1% or 2% are not unusual and negative value added is common);

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<sup>31</sup> It has not been possible to obtain information on whether these preferences are available or to what extent they are being used. In 1990, SAARC preferences amounted to a 5% reduction in the additional tariffs for countries other than India.

<sup>32</sup> See, for example, Papageorgiou, Michaely and Choksi, *Liberalizing Foreign Trade*, Basil Blackwell, Oxford, 1990 and 1991.

- **Most manufacturing of consumer goods** typically exhibits value-added ratios in the range of 5-30%;
- **Manufacture of intermediate goods and processing of raw materials** usually have somewhat higher value added ratios, commonly 20-60%; and
- **Agricultural production** is usually characterized by high value-added ratios of more than 80%.

As an illustration, if such levels were combined with tariffs of 25% on outputs and 10% on inputs in Nepal, effective rates of protection would vary from 28% in agriculture up to 927% in some assembly activities.

These results suggest that, even if all domestic activities were subject to the same cascading tariffs, there would still be a strong bias in the structure of incentives. Although this analysis is only broadly indicative, the results correspond reasonably well with experience in Nepal and elsewhere (see, for example, the 1991 Stamp report). Furthermore, it can be shown that similar results would be obtained with rather different output and input tariffs.

The bias inherent in this type of cascading tariff structure works in favor of low value-added activities, whether they are assembly industries or producing intermediate goods. However, in principle, a system biased in the other direction, in favor of high value-added industries would be no more desirable for promoting efficient industrial development. If an economy can undertake low value-added activities efficiently, (e.g., post-war Japan), these industries may provide a firmer basis for rapid industrialization than inducing investment in high value-added industries. Thus, the major drawback of this type of bias in incentives is not so much that it disproportionately rewards low-value activities, but that it distorts investment decisions in a way that does not correspond to economic efficiency and comparative advantage. Because cascading tariffs can award very high effective rates of protection to some industries that receive only modest nominal protection through their own tariff, they can hurt Nepal by providing protection-based incentives to industries that policy suggests should be open to robust competition.

The above analysis illustrates the possibly unintended consequences in conferring different levels of effective protection on goods in different categories, even though the Nepali tariff structure has significantly lowered average nominal tariffs in recent years. Pursuit of further reform in the form of a simple two-tier structure should be accompanied by a thorough analysis of the final, effective rate structure.

## **2.5 Implications of the Tariff Structure of WTO Bindings**

One of the questions that has arisen as part of Nepal's accession to the WTO concerns the levels of tariff bindings. (A country may not increase a tariff rate above its bound level except in unusual circumstances.) One objective of the Uruguay Round that led to the establishment of the WTO in 1995 was for Member States to bind their tariff rates at or near to the rates applied. Developed countries are expected to have 100% of their tariff rates bound at the rates applied. However, there had been a tendency among some developing countries to leave bound rates well above the applied rates in order to preserve flexibility to easily raise rates when it was desired. In effect, the bound rates were ceilings.

India, for example, has bound 72.4% of its tariff lines (WTO 2002, See Table 2.7). These amounted to an increase in coverage, up from 67%. However, India has been among those countries that have tended to maintain bound rates (note that bound rates are based on commitments to implement by 2005) well above applied rates in some areas. For most agricultural products, the bound rate is 100% and for edible oils it is 300%.

**Table 2.7 India – Bound Rates and Applied Rates**

<b>India</b>	<b>Bound Rate (2005) (%)</b>	<b>Applied Rate (%)</b>
Agriculture	115.7	40.7
Non-agriculture	37.7	31.1
Total	50.6	32.3

Source: WTO, 2002.

There are widespread concerns of the numbers of developing countries that have been unsuccessful in completing trade liberalization programs and have tended to slide back into protectionism. This is in stark contrast to the economic and social advances that have been realized by developing countries that have, in fact, successfully liberalized their trade regimes. During its accession process, however, Nepal has been able to retain a certain amount of flexibility by binding its tariffs above currently applied levels, though the differential is not relatively large.

## **2.6 Export Incentives and Administration**

### **Duty Drawback Facility**

Many countries provide various import-duty exemption schemes to exporters, since sourcing materials at international prices is considered essential for exporters to remain internationally competitive. Duty exemption schemes may include duty-drawback facilities or duty suspension schemes or a straight duty exemption to exporters. All schemes have strengths and weaknesses.

As in many other countries, Nepal's duty drawback scheme has performed poorly and has turned out to be costly for many exporters. This has happened for three reasons. First, the procedures to obtain duty rebates are cumbersome. They require substantial amount of documentation and involve several departments and ministries.<sup>33</sup> Second, exporters complain of lengthy delays in rebates and some have not received their entitlements for almost four years. Currently, the government is processing several hundred applications for duty rebates that have been pending since well before July 2001. The bond swap has not yet happened. As a result of these problems, many exporters prefer to avoid claiming duty rebates, especially on low-value, low-tariff items. One carpet producer mentioned that because of these problems, s/he does not request duty rebates on the importation of dyes, which are levied at 5-10% of the tariff rate and comprise about 7% of total cost of production. The Government is considering ways of revamping

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<sup>33</sup> To obtain the duty rebate, the exporter must deal with several government agencies. First, the exporter must provide the duty drawback committee at the Department of Industry with several documents. These documents include, but are not limited to, the purchase agreement, export invoice, Letters of Credit and other bank documents, and proof that export earnings have been received by the exporter's bank. The duty drawback committee, consisting of officials from the Department of Industry, Customs, and the Nepal National Chamber of Commerce or FNCCI, meet every month to calculate the amount of duty payable to the export, based on a pre-determined matrix of input-output coefficients. The committee writes a letter of recommendation to the One Window Center (OWC), which is chaired by the Director General of the Department of industry. The OWC issues a letter to the Ministry of Finance to refund the duty amount. The Ministry of Finance then reimburses the exporter. Based on international experience, this process is complicated and involves too many government agencies. Exporters must spend a substantial amount of time following up on their refund application at the various agencies involved in the process. Exporters complain that they never receive the full entitlement from the Ministry of Finance and often the amount received is a negotiated one.

the duty drawback facility. One proposal is to introduce a passbook system whereby the importer will be able to receive the duty rebate, within one month, directly from a designated customs office at the border. The system is not yet functioning, and many exporters are not aware that this system is or will be available.

The advantage of the duty exemption or duty suspension schemes over the duty drawback facility is that they avoid tying up exporters' working capital in the scheme, as they do not have to pre-pay duties, which they would have to do in the drawback facility. Duty suspension and exemption schemes are not without their difficulties, including problems created through abuse. However, given the many cost disadvantages faced by exporters in Nepal, a duty exemption scheme for exporters should be considered seriously, after a review of the strengths and weaknesses of the alternatives. Meanwhile the passbook scheme should be reviewed and implemented without delay or replaced.

### **Bonded Warehouse Facility**

In Nepal, the bonded warehouse facility was initially limited to garment producers exporting to third countries (i.e., non-India markets) and only for fabrics, not accessories. The facility was recently extended to other producers exporting to third countries, although few non-garment exporters currently use this scheme. The bonded warehouse facility is not available to producers exporting goods to India, so these exporters must use the duty drawback facility. Investors entitled to import duty exemptions must provide Customs with a bank guarantee up to the amount of the value of duties for each shipment of imports. The bank guarantee is released upon evidence of export receipts within 12 months from the date of importing the raw materials. The Government is considering ways to extend the bonded warehouse facility to garment producers exporting their goods to India. However, this is complicated by Nepal's trade relationship with India under their trade treaty as India is concerned that bonded warehouses will be used as conduits for smuggling to India those goods that have substantial differential tariff rates between the two countries.

## **2.7 Strategy for Technical Assistance**

### **Improving Trade Policy Advice and Implementation**

Nepal's trade policies are developed and implemented by different agencies, including, inter alia, the Ministry of Industry, Commerce, and Supplies (MOICS), Ministry of Finance, and National Planning Commission. Other agencies also play a role, usually indirect, such as the ministries responsible for foreign affairs and agriculture. The multiplicity of objectives and participants inevitably results in a degree of contradictory signals and, at times, a lack of direction. In addition, it should be recognized that there will always be competing interests and pressures seeking to influence trade policies. A number of common elements exist among the countries that have had relatively effective trade policy regimes. Chief among these is a close alignment of national economic objectives and strategies with trade policy.

Equally important is having in place an institutional structure that adopts an economy-wide perspective and, to some extent, government-wide perspective. This usually takes the form of an apex body within the Government that can assess and balance competing objectives while ensuring consistency with national economic objectives and strategies. Examples of such bodies include Australia's Productivity Commission, EU DG for Trade, and U.S. Office of the Trade Representative.

Many countries have adequate technical skills and understanding to design appropriate trade policies, but lack the capacity necessary to implement these policies effectively. This can only be done if there is a

clear and consistent trade policy framework and sufficient technical understanding and managerial capability throughout the Government. The implementation of trade policy inevitably encompasses virtually every government office or agency concerned with the economy—from customs to environmental and consumer regulation, agriculture and industry, and tourism.

Technical assistance for Nepal to build increased capacity for trade should take place in the general context of developing and strengthening the institutional structure, infrastructure, as well as the technical and policy management skills needed for effectively understanding and implementing trade policies.

Design and implementation of more effective trade policies fall into three broad areas:

- **Trade policy evaluation:** This entails the analysis and assessment of the economic implications of existing and alternative trade policies and is usually the responsibility of economists with strong backgrounds in international trade.
- **Trade promotion:** The success or failure of trade policies is usually measured in terms of the levels of trade that ensues. The commercial opportunities provided through liberalization programs must be sold both in markets at home and abroad. Typically, this role falls to officers based in foreign missions and/or export development agencies.
- **Trade negotiation:** With the proliferation of bilateral and regional trade agreements, this has become an increasingly important function. It usually falls to trade negotiators to translate trade policies into policy parameters, such as tariff rates, rules of origin, and negative lists. Unfortunately, trade negotiators too often operate in ways that are inconsistent with the underlying objectives of countries with larger trade policies. Therefore, it is important that the people that represent Nepal in trade negotiations fully understand national trade policies and receive adequate technical support.

Technical assistance should be designed to assist the HMGN in these three broad functional areas and within an appropriate overall institutional structure.

### **Institutional Structure to Support Strategy**

The National Planning Commission (NPC) in Nepal already holds an “apex” position in the development of economic policies and has the responsibility of balancing competing interests and ensuring consistency between policies and national economic objectives. An early step in developing a comprehensive technical assistance strategy for trade should be a detailed audit of the process of trade policy formulation and implementation in the NPC and the other responsible agencies, principally MOICS. The audit should document not only the existing process for arriving at trade policy decisions but also the available expertise drawn on in this process and its location within the bureaucracy.

Consideration should be given to building an apex body that assumes primary responsibility for trade policy development and evaluation and trade negotiation functions. Primary responsibility for trade promotion functions may be brought within this body or be established in another institution, such as the MOICS or Ministry of Foreign Affairs. It is essential to establish strong linkages between the apex body responsible for trade policy and other government agencies with an interest in trade, as well as with the private sector. Technical assistance by national and international advisors can be useful in this regard by providing opportunities to increase understanding and awareness of Nepal’s trade policy objectives and strategies. Building up such a program of technical assistance is high priority. In the interim, the two trade divisions of the MOICS need to be strengthened with technical training and advisory support. The continuity of staff, that have gained expertise on trade negotiation matters also need to be ensured by the Government. Otherwise, Nepal’s trade negotiations ability will be seriously weakened.



Nepal needs to strengthen its economic diplomacy capacity through providing specialized training to MOICS and foreign service officials and making them accountable for trade promotion. The neighboring Indian states of Uttar Pradesh, Bihar, and West Bengal figure prominent in the Nepal-India trade and wield considerable power in practice in affecting trade. Given this, the Government should appoint trade representatives for promotion and trade facilitation in these capitals.

Finally, the National Steering Committee for the Nepal Trade and Competitiveness Study should continue with the terms of reference to finalize the policy and action plan, obtain Cabinet approval, and monitor implementation.

### **Technical Capacity for Design and Implementation**

A program of technical assistance for the development and implementation of more effective trade policies should reflect the three key functions discussed above. Suggestions follow for areas where support may be usefully directed.

#### Trade Policy Evaluation

A strong, ongoing capability to analyze trade policies is usually the foundation on which effective policies are built. Nepal has a number of capable trade economists inside and outside of government. However, consistent financial and institutional support necessary to develop a trade policy evaluation unit has been lacking. An audit of capacity and feasibility study of creating such a unit is urgently required.

Support for implementation is critical but is usually more difficult to provide. Most donors' technical assistance programs are structured in ways that emphasize short-term exercises with tangible deliverables. Technical assistance to support implementation usually entails providing long-term advisors that work closely with government officials. If steps were taken to establish a dedicated Trade Policy Unit, this would necessarily involve the appointment of a long-term advisor to simultaneously assist in the design and establishment of the unit and advise on the mechanism for taking on board and implementing the policy advice emerging from the unit. A possible model for establishing formal links between trade policy advice and implementation is one where a specific ministry is given responsibility for referring particular trade policy issues to the specialist unit for analysis and advice. The responsible minister then tables the reports from the unit in Parliament, for further consideration of the recommendations.

#### Trade Promotion

Over the years, there has been much financial and technical assistance to export promotion agencies in developing countries, with mixed results. One model that has not worked well has been Government-dominated or -led export promotion activities. Direct support to private sector groups or to joint public-private initiatives has been more effective. For example, such countries as Sri Lanka have made good use of demand-driven, matching-grant facilities to support export development. Others, however, including Indonesia, have not done as well using this approach. There will inevitably be a role for Government officials in Kathmandu and posted abroad to promote trade in various ways. While these should not be the "front line" in these efforts, this is an area where limited assistance may yield significant results.

#### Trade Negotiation

Strengthening capacity in trade negotiations has two dimensions: i) increasing capacity in the mechanics of the process and ii) improving understanding of the country's trade policies among those conducting and directing the negotiations. It is important to see how often trade negotiators that are operating more or less independently of policymakers frustrate the core objectives of trade policies. The institutional

reforms indicated above form at least part of the first step in addressing shortcomings in this area. Integrating the trade negotiators into the policy analysis functions may be part of the answer. Building negotiating capacity through training is another important aspect. Numerous short courses aim at “commercial diplomacy,” and integrating trade negotiation with policy analysis. These courses would be useful in Nepal’s context.

## **2.8 Recommendations**

### Immediate Actions (next 6 months)

- Continue activities of the National Steering Committee with the ToR to monitor implementation.
- Appoint national and international advisors to set up an apex trade policy evaluation, promotion and negotiations unit based on audit of existing trade policy expertise (HMGN/TA)
- As an interim measure, strengthen capacity in two trade divisions of the MOICS (MOICS/TA)
- Review replacing duty drawback system for exporters with a duty exemption system.

### Short to Medium Term Actions (1-2 years)

- Appoint trade economist to analyze impact of reducing number of tariff bands on effective protection, trade flows and revenue impact. (HMGN/TA)
- Broaden tax base to compensate for removal of ODCs on selected products and reduction in customs duties through removing exemptions, extending VAT base. (HMGN/TA)
- Establish trade promotion agency using matching Government and private sector funds to replace existing TPC and other trade promotion units within the Government. TA will be required to advise on the most effective structure. (HMGN/TA)

### 3. NEPAL'S ACCESSION TO THE WORLD TRADE ORGANIZATION

Nepal and Bhutan are the two least developed countries in South Asia still outside the World Trade Organization (WTO). After accession negotiations lasting more than a decade, Nepal's membership in the World Trade Organization (WTO) was approved in September 2003 at the WTO ministerial meetings in Cancun, Mexico. Chapter 2 noted that Nepal has reduced formal trade barriers well below those of its neighbors in the region.<sup>34</sup> This chapter argues how WTO membership can help Nepal achieve benefits from even greater integration into the world economy, primarily by enhancing discipline on policymakers and through access to the WTO's dispute-resolution facility.<sup>35</sup> In addition, the accession timetable can help the Government focus attention and generate support for a sound trade policy and the strengthening of trade-supporting institutions. This chapter notes, however, how the benefits of accession come with costs and emphasizes the need for technical assistance (TA).

This chapter reviews the demands made on Nepal for membership in WTO by current members, and identifies the need for TA to support institution-building and administrative reform in such areas as customs modernization, standards, and intellectual property rights (See Box 3.1 for key WTO related terminology). Accession negotiations should not distract His Majesty's Government of Nepal (HMGN) from opportunities to improve market access through bilateral arrangements or from domestic reforms that can improve the competitiveness of the Nepali economy—issues addressed throughout this study.

#### Box 3.1 Glossary of WTO Terms

**GATT:** The General Agreement on Tariffs and Trade, a multilateral trade agreement was signed in 1947. From 1947 to 1994, the GATT was the forum for negotiating lower customs duty rates and other trade barriers; the text of the General Agreement spelt out important rules, particularly non-discrimination. The GATT is the WTO's principal rule-book for trade in goods.

**GATS:** The General Agreement on Trade in Services, an agreement developed in the Uruguay Round of the GATT. The GATS spells out principles for liberalizing international trade in services. WTO members make individual commitments under GATS stating which of their services sectors (e.g., business services and telecommunications) they are willing to open to foreign competition, and how open those markets are.

**SPS:** The Agreement on Sanitary and Phytosanitary Measures. This agreement requires WTO members to apply their domestic regulations on food, plant and animal sanitation fairly and transparently to imported products. Members are encouraged to base domestic regulations on international standards and principles of "sound science." They are required to notify others when developing new SPS measures that may affect another WTO member's exports.

**TBT:** The Agreement on Technical Barriers to Trade. This agreement requires WTO members to apply technical regulations affecting industrial products fairly and transparently. Technical regulations should embody international standards and should be designed to restrict trade as little as possible. Members are required to notify others when developing new technical regulations that may affect another WTO member's exports.

**TRIPS:** The Agreement on Trade-related Intellectual Property Rights. The rules in the TRIPS Agreement state how copyrights, patents, trademarks, geographical names used to identify products, industrial designs, integrated circuit layout-designs and undisclosed information such as trade secrets — "intellectual property" — should be protected when international trade is involved.

<sup>34</sup> The exception to this rule is Sri Lanka, where liberalization began in the late 1970s and early 1980s.

<sup>35</sup> In addition, one would usually point to the benefits that trade liberalization brings new WTO members. In Nepal's case, however, there seems to be little pressure to reduce existing tariffs.

### 3.1 What Does WTO Membership Offer Nepal?

#### Membership Benefits

*Discipline on trading partners.* Nepal's major trading partners currently grant Nepali exporters better than most-favored nation (MFN) access to their markets. But nothing prevents them from withdrawing such access at any time, as long as Nepal remains outside the WTO, or from imposing barriers that would otherwise violate WTO rules. The same holds for transit rights through India and Bangladesh. Membership in the WTO will provide Nepal the protection of international rules, which Nepal's trading partners cannot violate without costs. In addition, membership will also give Nepal access to the WTO's dispute-settlement procedures and legal recourse to contest capricious trade policies imposed on its exporters. For example, many in Nepal question the legitimacy of Indian trade restrictions on vegetable ghee and a number of other goods.<sup>36</sup> As a WTO member, Nepal would have the right to present its case before an impartial panel, though this process is not without cost. Nepal would need to devote considerable resources to preparing and presenting its case to the WTO. But an approach to the WTO might generate sufficient negative publicity for the trading partner that it would agree to bring its policies in line with WTO rules.

*Discipline on policymakers.* WTO membership benefits Nepal by imposing discipline on its own government, helping to lock in the liberalization it started a decade ago, and increase the credibility of Nepal's policies with investors. As a member, it will need to keep tariff rates below "bound" rates, refrain from using quotas or export subsidies, and make any changes to trade-related regulations in a transparent manner. WTO membership therefore benefits Nepal by keeping the government's feet on the path of economic reforms initiated in the early 1990s and strengthening its hand in resisting protectionist pressures from special interest groups.

*Increased transparency and reduced uncertainty for traders.* By introducing a regime of rule-guided trade policy, WTO membership increases transparency and reduces the uncertainty facing traders. Not knowing what tariff will be applied when a product crosses the border may in itself discourage that trade from occurring. The same is true for rules that may or may not be applied, depending on the official considering the case. One of the most important benefits of WTO membership may be to reinforce the rule of law in the application of trade policy.

*Participation in multilateral trade negotiations.* Finally, as a WTO member, Nepal will be able to participate in future negotiating rounds. The resulting trade liberalization will benefit Nepali consumers and export industries in particular.

#### Challenges

One must bear in mind that challenges accompany membership. The Government will face the fiscal-adjustment cost of finding new sources of revenue to replace the several new import surcharges introduced since 2000, which WTO members have asked Nepal to eliminate as a condition of accession.<sup>37</sup> As a member, Nepal will be expected to liberalize its markets, especially in services, over the course of

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<sup>36</sup> These include various quantitative restrictions and testing requirements. Chapter 2 of this volume and the manufacturing sector study in the Background Papers Volume both discuss these restrictions in greater detail.

<sup>37</sup> These include the Local Development Fee, Agricultural Development Fee, and the Special Fees introduced to fund security operations (see Chapter 2 for details). It is in Nepal's long-term economic interest to replace trade taxes—characteristically high rates imposed on a narrow tax base—with more broadly based taxes.

future multilateral trade negotiations, and any trade liberalization generates adjustment costs for the private sector by altering relative prices, exposing firms to world competition. Other chapters in this study propose measures that can help Nepali firms increase productivity and respond to changing international conditions.

In addition to these adjustment costs, the Government of Nepal will bear the burden of implementing trade-related regulatory rules once it joins the WTO. This will require significant investments in administrative capacity, legal reforms, and institution building, which, in turn, will require TA. This issue is discussed in greater detail in Section 3.3 below.

### **WTO Membership, Agriculture, and Poverty**

The effect of WTO membership on agriculture and poverty reduction merits special attention. WTO rules require members to convert import quotas into bound tariffs, reduce export subsidies and levels of domestic support for agricultural products, and base plant- and food-safety rules on sound science. Following these rules should not have a large effect on current Government policy. First of all, much of Nepal's agricultural trade is conducted with India on a reciprocal, duty-free basis, and would be unaffected by WTO membership. Furthermore, Nepal uses no quotas and does not provide significant agricultural subsidies.<sup>38</sup> In 1998, when it submitted its Memorandum of the Foreign Trade Regime to the WTO), Nepal imposed phytosanitary measures on only four agricultural products.<sup>39</sup> MFN tariffs on agricultural products are relatively low, and there is no pressure on Nepal to reduce many applied tariff rates on agriculture at the present time, only to commit to not raising them in the future beyond bound levels.<sup>40</sup> However, Nepal can count on pressure to reduce these further in the course of future trade rounds once it joins the WTO.

### **Nepal's Future Role in the WTO**

How can Nepal best participate in the WTO? Given its limited resources, Nepal needs to participate selectively in WTO proceedings, working in coalition with members that share Nepal's economic interests and engaging only in those issues that have the greatest effect on the country, both positive or negative. Among the issues currently being debated in the Doha trade round, Nepal has the greatest interest in:

- Reducing tariff peaks (though not in all cases);

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<sup>38</sup> Nepal falls well within the 10% de minimis level of domestic support that developing countries are permitted under the Agreement on Agriculture (government support as a share of total agricultural production). Nepal reported to the WTO working party that its total aggregate measure of support in agriculture was NRs. 548.7 million in 1998 (WT/ACC/SPEC/NPL/1, Table DS:4). Published statistics put value added in agriculture at NRs. 112,495 million the same year (see World Development Indicators, 2002).

<sup>39</sup> Nepal informed the WTO that it restricted imports of citrus saplings, breadfruit plants, potato tubers, and grass peas to prevent spread of plant diseases. DDT is restricted on environmental grounds and beef imports are restricted for religious reasons. In addition to these import restrictions, the Food Standardization Board has developed 84 mandatory food standards for goods in the domestic market (Karki 2002).

<sup>40</sup> Currently, the applied tariff rate on agricultural products averages around 14%, while those for manufacturing goods are slightly less. Under the terms of its accession to the WTO Nepal has agreed to bind average tariffs rates on agricultural products at 43% and industrial goods at 24%.

- “Mode 4” services liberalization (easing rules related to the flow of natural persons), given the importance of labor remittances to the Nepali economy;
- Placing limits on contingent protectionism, such as anti-dumping actions; and
- Preserving the maximum flexibility to import generic drugs under compulsory licensing.

Since Nepal competes with many other developing countries for access to U.S. and European garment markets, it is better off pursuing better preferential access for its own exports, rather than better MFN access for all developing countries’ garments. Nepal should therefore not neglect opportunities to strike bilateral trade agreements. Derogations from current rules of origin are one issue Nepal might raise bilaterally. The EU presently allows Nepal to count inputs from ASEAN, SAARC, and African Caribbean Pacific Group of States (ACP) countries as meeting its rules of origin requirements for garments. This is temporary; Nepal might push for permanent derogation.<sup>41</sup> Likewise, it might lobby Washington to grant the relaxed rules of origin requirements it presently offers African LDCs under the AGOA.

The precondition for more effective participation in the WTO is building the capacity to conduct commercial diplomacy, regardless of whether this occurs in Geneva, Brussels, or New Delhi (see Chapter 2). Here it is noted only that, due to the complexities of modern trade agreements, Nepal’s future representatives in Geneva must work closely with officials from a wide range of ministries who previously did not participate in trade policymaking.

### **Maximizing Membership Benefits**

This section has outlined some of the challenges and opportunities Nepal will face as a member of the WTO. The benefits come mainly from an improved trade policy environment. Membership gives Nepal a seat at the negotiating table, allowing it to contribute to the debate on the future shape of the world trading system. Nepal must make significant investments in implementing trade-related regulatory reforms, for which its Government will require considerable TA. The prerequisite for effective participation in trade negotiations—whether multilateral, regional or bilateral—is improved trade policy capacity.

## **3.2 WTO Accession Negotiations and the Implications of WTO Commitments**

This section discusses the course of negotiations on Nepal’s WTO accessions. It then reviews the commitments made by Nepal for accession and technical assistance that the United Nations Development Program (UNDP) has provided to HMGN during negotiations and the next steps in that process.

### **Timeline of Events**

Nepal first applied to the GATT in 1989, during a dispute with India over transit rights, but interest in membership waned after the Nepal-India Trade Treaty was successfully renegotiated in 1991. The Government renewed its commitment to membership after the economic reform program was

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<sup>41</sup> The initial derogation in European Commission Regulation No. 1615/2000 (July 24, 2000), which was renewed until the end of 2004 in EC Regulation No. 293/2002 (February 15, 2002).

launched and an accession working party was formed;<sup>42</sup> Nepal gained observer status in 1993; it participated in the final meetings of the Uruguay Round; and, in December 1995, HMGN presented its formal application to accede to the newly created WTO. It submitted its Memorandum of the Foreign Trade Regime in 1998. The negotiating team delivered revised offers on goods market access and services in 2002. Two meetings of its working party were held in May 2000 and September 2002. After three informal meetings and a formal meeting on August 15, 2003, Nepal has now finalized its terms of accession. This agreement will now have to be ratified by Nepal before the accession is completed.

Information provided by officials and parties close to the negotiations suggests that Nepal's efforts towards accession were favorably received. WTO members reportedly have voiced sensitivity to the general challenges facing LDCs in the accession process, as well as the specific difficulties confronting Nepal at this time. Below are the specific commitments that Nepal has made for its accession:

## **Nepal's Commitments and Their Implications**

### **Market Access**

*Tariffs Bindings:* During the course of multilateral trade negotiations, WTO members commit to "bind" their tariffs at certain levels. Governments are free to apply their statutory rates below these bound levels, but imposing duties above those levels risks retaliation by other WTO members. Committing to tariff bindings helps insulate the government from protectionist pressures at home, thereby increasing policy transparency and reducing market uncertainty faced by traders. Nepal negotiated an average tariff binding of 42 percent on agricultural products and around 24 percent on industrial goods. The majority of the import items fall in the customs duty range of 10–20 percent. The maximum tariff rate of 130 percent applied to cars and jeeps will be reduced as specified in the goods schedule. A minimum tariff rate up to 5 percent will be applied on daily consumption items.

*Other Duties and Charges:* One key issue during later stages of accession negotiations involved what the WTO refers to as "other duties and charges," which are simply trade taxes specified outside the schedule of ordinary customs duties. Nepal had no ODCs in 1998, when it submitted its Memorandum on the Foreign Trade Regime. In the last two years HMGN introduced a number of new import surcharges (documented in Chapter 2 of this volume) to finance domestic security and local development programs. The emerging practice in WTO accession negotiations is for acceding countries to bind ODCs at zero, i.e., to commit to not applying any ODCs at all.<sup>43</sup> In its final goods offer, Nepal agreed to eliminate its ODCs over a period lasting from two to ten years, depending on the tariff line. The country also pledged not to introduce new ODCs. Replacing existing import surcharges with more broadly based taxes will increase economic welfare in the long run. HMGN must now integrate this WTO commitment into its broader fiscal policy. A number of donors, including the IMF, are actively working with the government on fiscal reform. The task now is to ensure close coordination between those working on WTO accession and those working on tax policies.

*Services:* As a result of the negotiation, Nepal agreed broad commitments in 11 services sectors, revealing its clear belief in the benefits of liberalization as an engine for future growth and prosperity. These sectors include business, communication, construction, education, environmental, and certain categories of

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<sup>42</sup> The working party is formed to consider a candidate country's policies in detail and draft the terms under which the country will be allowed to join the WTO. A working party typically consists of the larger WTO members and the candidate country's principal trading partners. As of April 2002, there were 25 members in Nepal's working party.

<sup>43</sup> A recent WTO Secretariat report on members' bound rates indicates that *all* new WTO members have bound ODCs at zero (TN/MA/S/4/Rev. 1, November 1, 2002).

financial services, health, tourism, and transport. Most of Nepal's commitments relate to liberalization in cross-border supply of services (called Mode 1), consumption of services abroad (Mode 2) and, with some restrictions, on foreign commercial presence (Mode 3) in these categories. Greater access to foreign providers of business services will help Nepali firms reduce costs and identify new foreign markets. On the other hand, practical, political, and economic considerations make liberalizing services trade considerably more complicated than goods trade liberalization. Trade negotiators must now work with domestic regulators to ensure that service trade liberalization commitments are carefully integrated with balance of payments considerations and overall regulatory policy.<sup>44</sup>

### **Nepal's Legislative Plan of Action for Regulatory Reforms**

Nepal has also committed to a timetable of legislative reforms required to comply with WTO rules on trade-related domestic regulations, such as the Agreements on Trade-related Intellectual Property Rights (TRIPs), Customs Valuation, Sanitary and Phytosanitary Measures (SPS) and Technical Barriers to Trade (TBT). Nepal has agreed to the following legislative plan of Actions.

*Customs:* Legislation on the valuation of imports for customs and taxation purposes conforming to the requirements of the Agreement on Customs Valuation would be enacted by 1 July 2004. Nepal would progressively implement the Agreement on Customs Valuation in accordance with the action plan and full implementation will start from 1 January 2007.

*Sanitary and Phytosanitary Measures:* Nepal will implement fully the provisions of the Agreement on Sanitary and Phytosanitary Measures by 1 January 2007 following an action plan in different stages which started with the adoption of the Food Act and the implementation of Codex Alimentarius, and will continue with the establishment and operation of a single enquiry point.

*Technical Barriers to Trade:* Nepal will progressively implement the Agreement on Technical Barriers to Trade in accordance with the Action Plan submitted during the negotiations and would implement fully the provisions of the Agreement on Technical Barriers to Trade by 1 January 2007.

*Trade-Related Intellectual Property Rights:* As a least-developed country, Nepal is preparing the new Industrial Property (Protection) Act, which would incorporate all the substantive provisions of the TRIPS Agreement. It would cover all categories of industrial property and would incorporate the basis for an adequate enforcement and be promulgated no later than 1 January 2006.

Implementing commitments under these agreements will require careful planning, technical assistance, and time. Implications are discussed in detail below in Section 3.3.

*Other Negotiating Issues:* Various other issues have emerged in the accession negotiations; while important, they have not generated much controversy. These include Nepal's membership in preferential trade agreements, the Government's plans for safeguards laws and competition policies, and possible membership in plurilateral agreements.<sup>45</sup> It is worth noting that the economics of these issues can be

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<sup>44</sup> The optimal sequence of domestic reform and external liberalization varies with the sector. In telecommunications reform, opening market access works best when it occurs simultaneously with privatization (Rathindran, et al., 2002). A lesson many economists draw from the currency crises of the late 1990s is that domestic banking reform should precede capital account liberalization.

<sup>45</sup> They include the Government Procurement Agreement and the Information Technology Agreement. Since only a subset of GATT signatories agreed to these codes, they were termed "plurilateral" to distinguish them from the multilateral commitments of the GATT itself, which are binding on all GATT signatories.



complicated, and that TA may be useful to conducting cost-benefit analyses and in helping to write implementing legislation.

**UNDP/UNCTAD Technical Assistance:** One important factor in Nepal's accession process is a TA package provided by UNDP. This project, entitled Nepal's Accession to the WTO (NEP/96/10), started in 1999, was originally scheduled to terminate in June 2001, but was extended later. UNDP's contribution is US\$915,000. The United Nations Conference on Trade and Development (UNCTAD) is the executing agency, and MOICS is the implementing agency. Activities to date include:

- Preparing technical documents for submission to the WTO, including the Memorandum on Foreign Trade Regime, Questions and Answers on the MTR, Legislative Action Plan, and numerous other documents in the prescribed WTO format;
- Commissioning background papers, including reports assessing the conformity of Nepal's laws to WTO obligations, evaluating the effect on bilateral and regional trade agreements, and reviewing options for Nepal's service sector offer;
- Conducting seminars for MOICS staff; and
- Promoting public awareness about WTO membership.

**What happens after accession?** Nepal has now successfully concluded an agreement on the terms of its accession to the WTO. After this agreement is ratified, Nepal will have formally acceded. Ahead lies the major challenge of implementing its commitments to comply with the agreement and mobilizing technical assistance to help with compliance. The UNDP assistance program has concentrated on helping the government work through the accession negotiations, addressing the challenging tasks of responding to both WTO reporting requirements as well as substantive requests from members of the working party. One expects that the capacity built during the past several years will enable the country to participate effectively as a WTO member in future rounds of multilateral trade negotiations, which is, after all, the original inspiration for creating the Integrated Framework. Moving beyond immediate support for negotiations, there is a pressing need for technical assistance with future implementation of WTO agreements. Successful implementation of WTO regulatory rules (such as those required by the SPS or TRIPS Agreements, for example) will require building different types of capacity than what is needed to conduct negotiations. There is clear need of technical assistance in this area. But the terms of reference of the technical assistance should explicitly identify the need to implement WTO rules in ways that will benefit the Nepali economy. We pick up these issues in the following section.

### **3.3 Implementation of Trade-related Regulatory Reforms**

This section reviews four areas of regulatory reform where technical assistance (TA) is needed to help Nepal maximize the benefits of WTO membership. These four areas are i) customs administration; ii) intellectual property-rights protection; iii) food and plant sanitary measures; and iv) technical standards.

#### **Overview**

During the first several decades of the GATT trade regime, negotiators concentrated on the liberalization of trade barriers that are applied at the border (e.g., tariffs or quotas). Starting with the Tokyo Round and reaching full flower in the Uruguay Round, GATT disciplines have been extended to domestic regulations. Many of the new agreements (including TRIPS, SPS, TBT, and Agreement on Customs Valuation) attempt to harmonize domestic regulations in an effort to minimize adverse effects on trade

flows. For industrial countries, the primary challenge of implementing these agreements is to ensure that existing regulations are applied transparently and fairly, as many of these agreements essentially codify their existing regulations as the default to be accepted in cases of WTO disputes. For developing countries, on the other hand, compliance with the new agreements requires substantial investment in legal, administrative, and judicial reforms. Furthermore, they may receive few economic benefits from compliance until complementary market institutions evolve to allow individuals to make commercial use of new laws.

This suggests two important points. First, the Nepali government must plan carefully how to implement new trade-related regulatory reforms to generate economic benefits, since many reforms are premised on the institutional conditions that exist in developed countries, but not in Nepal. Second, reforms cost money and time; significant TA will be needed to implement the reforms.

### **Food and Plant Sanitation**

WTO agreements require countries to apply sanitary and phytosanitary measures fairly, openly, and based on sound science. Importing countries' SPS measures typically require exporters to guarantee that their products are free of pests, disease, and pesticide residues. These measures are often stringent for more processed (and higher value-added) agricultural products than for bulk commodities. If Nepal is to meet world demand for various niche agricultural and horticultural products, as many propose, Nepali producers must meet the SPS measures imposed by importing countries. The implementation challenge for the Government is to put in place risk assessment mechanisms, pest detection and eradication campaigns, and strict quarantine procedures. Furthermore, the Government should help Nepali exporters to meet the standards and regulatory requirements used in importing countries. This will require extensive efforts to raise awareness of foreign standards, improved laboratory and testing facilities in Nepal, and international agreements to grant foreign recognition to the results of tests conducted in Nepal.

The Department of Food Technology and Quality Control in the Ministry of Agriculture operates five regional laboratories and is responsible for regulating SPS measures. The Food Standardization Board has formulated 84 mandatory standards (Karki 2002). Government agencies have received TA to improve domestic SPS measures, including an FAO/WHO project to introduce international standards in the dairy industry, FAO support for food control systems, and regional training workshops on the SPS agreement.

The Government's action plan for improving SPS measures is highly detailed, identifying the financial and technical assistance needed to meet each provision of the SPS agreement, specifying the time frame for implementation, and breaking all of this down by the office within the Ministry of Agriculture that is responsible for implementation. Indeed, the plan should be used as a model for developing implementation programs in other areas. HMGN has identified several pieces of legislation that must be introduced to comply with the SPS agreement, for which it also needs legal assistance. A recent review of Nepali SPS measures argues that implementation of the SPS Agreement will require extensive harmonization of Nepali standards with international standards, a general upgrading of laboratory facilities, and expansion of staff capable of conducting risk analysis (Karki 2002). The Government will also need technical and financial assistance for training, supplies, and laboratory facilities.

The action plan estimates it will cost US\$12.5 million to introduce an improved SPS regime (this estimate may be low). World Bank projects devoted to improving food, plant, and animal sanitation standards often involved much larger sums of money (Finger and Schuler 2000).

## Industrial Product Standards

The Nepal Bureau of Standards and Metrology (NBSM) manages industrial product standards in Nepal, developing standards, conducting tests, and accrediting private laboratories. Since Nepal has only a handful of mandatory technical regulations currently, WTO rules would not appear to impose a heavy administrative burden on the Government. On the other hand, many accuse India of imposing greatly restrictive testing requirements on Nepali products. Nepali exporters must either meet or challenge them; either decision requires improving Nepal's domestic standards regime.<sup>46</sup>

Nepal received assistance from UNIDO to construct existing laboratory facilities during the early 1990s. More recently, the Finnish government funded a US\$863,000 program to help Nepali carpet makers meet European eco-labeling requirements (UNDP 2000).

HMGN's May 2003 WTO legislative action plan calls for amending the Nepal Standards (Certification Mark) Act of 1980 and related regulations. It plans to accomplish this by December 2005, contingent on receiving TA. MOICS has produced a brief description of the TA required to comply with the TBT. The Government anticipates needing US\$12 million over a five-year period. This would cover procuring equipment (including \$10 million for calibration equipment), training staff, and purchasing consulting services. Receiving this assistance would:

- Develop the capacity of NBSM to provide quality control, testing, and metrology services;
- Support the negotiation of mutual recognition agreements;<sup>47</sup> and
- Allow NBSM to participate in international standards bodies (Box 3.2).

One issue to consider is whether NBSM may be trying to assume too many responsibilities, thus taxing its capacity. Rather than aiming to provide all standardization services on its own, it should facilitate the development of private sector organizations or companies capable of standards development, testing, and accreditation. Moreover, Nepal should not avoid relying on foreign standards service providers. Finally, NBSM should, generally accept foreign conformity assessment certificates without requiring additional testing. Where appropriate, this can be done on the basis of reciprocity.

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<sup>46</sup> It should be stressed that the private sector bears the burden of meeting legitimate foreign testing requirements. This is not the state's responsibility, nor should governments assume the exclusive (or even primary) responsibility for providing conformity assessment services. There is a role for TA to private-sector organizations to enhance firms' own capacity to satisfy those requirements.

<sup>47</sup> NBSM has signed a memorandum of understanding with New Zealand recognizing tests conducted there on wool bound for Nepal. It is also working on a mutual recognition agreement with India. The TBT agreement discourages WTO members from relying exclusively on such formal, intergovernmental agreements.

### **Box 3.2 ISO-9000 Certification: Provided by State or Market?**

Certification of compliance with ISO-9000 quality management standards has become popular with firms around the world, including Nepali firms that operate in international markets, which can be costly.\* A few Nepali firms believed that the extra profits generated by having the certification exceeded the costs. For most of those who remain without certification, the costs of developing a certified quality management system still exceed the benefits.

At present, no Nepali organization is licensed to certify ISO-9000 compliance; local firms depend on foreign consulting firms to provide this service. A recent newspaper column decried this dependence on “hiring costly foreign expertise” and called for developing indigenous capacity to provide this service.\* This sentiment is supported by senior officials interviewed at NBSM, who outlined an objective of training and licensing NBSM staff to become ISO-9000 registrars. NBSM officials noted that the limited local demand for ISO-9000 certification created an unexpected complication: ISO-9000 auditors must conduct 3-6 audits annually over a three-year period to maintain their registrar certification, and there are not many audits to perform in Nepal.

No compelling reason for state intervention exists in this case. There is no shortage of service providers in world markets. If local firms are willing to pay the price for private services, there is no need for the Government to enter the market.

\* Kulprasad S. Sapkota, “Implementing ISO-9000 Standard: Sequential Approach is a Must,” *Rising Nepal* (November 27, 2000).

## **Intellectual Property Rights**

Nepal’s Department of Industry is responsible for issuing patents and trademarks and copyrights are managed by the Ministry of Culture. The present regime falls short of conformity with TRIPS in several areas. Current patent law grants protection for only seven years (TRIPS requires 20-year patent terms), and Nepali law has no provisions for protection of integrated circuit topographies, geographical indications,<sup>48</sup> and several other provisions required in the TRIPS agreement. Enforcement is hampered by inadequate administrative capacity, in addition to such mundane matters as lack of space to store seized counterfeit goods. Understandably, the police are unable to respond to infringement cases due to the current security situation. Clearly, much work is needed simply to achieve compliance.

The legislative action plan submitted to the WTO working party in May 2003 anticipates that the Parliament should be able to pass TRIPS-related laws on copyright and plant protection by the end of 2005.<sup>49</sup> In addition, the Department of Industry will prepare a new Industrial Property Act. Subject to receiving TA, this new law should be approved by Parliament in December 2005.

MOICS has outlined a TA package that will enable it to implement the TRIPS agreement over a three-year period. Assistance is needed to:

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<sup>48</sup> Geographical indications identify a good as originating in a particular territory, where the good’s quality or reputation is essentially attributable to that geographical origin. The TRIPS Agreement explicitly provides for protection of geographical indications in wine and spirits only (e.g., champagne). India recently passed a law codifying Darjeeling tea as a geographical indication.

<sup>49</sup> These include the instruments of ratification of the Berne Convention and the International Plant Protection Convention, the Plant Resources Act, and the Access to Genetic Resources Act. A new Copyright Act went into force in 2002.

- Fully evaluate the existing regime and draft new legislation;
- Develop the administrative capacity to review patent, trademark, and copyright applications (automation systems, training, etc.);
- Introduce more effective enforcement by police, customs officials, and the judicial system; and
- Establish an IPR information center to help educate the public on IPR issues.

The MOICS outline does not project the expected cost of such assistance; however, the cost of expanding current IPR offices could range from US\$4 to \$32 million, based on experiences in other countries.<sup>49</sup>

The Government must take great care in writing new laws to comply with the TRIPS Agreement. First, studies suggest that international IPR harmonization will, in the near term, lead to large transfers of rents from poor to rich countries.<sup>50</sup> The challenge for Nepal is to develop an intellectual property rights regime that balances such transfers by facilitating the rapid adoption of foreign technologies and commercialization of its existing intellectual property.

Second, while legislation establishing property rights over new inventions and literary works is fairly well understood, formal legal regimes that establish intellectual property rights over ethno-botanical knowledge, traditional cultural expressions, and genetic resources are in their infancy. Developing such a regime in Nepal can help the country commercialize the knowledge and creativity that it currently possesses. Thus, HMGN should explore the applicability of new legal models that are being developed around the world.<sup>51</sup> HMGN should approach these new models, as well as more conventional intellectual property rights laws, with the objective of clarifying property rights to facilitate commercialization of existing intellectual property in ways that generate economic benefits for the poor, that respect cultural sensitivities and minimize environmental harm.<sup>52</sup>

Finally, technical assistance in this area must look beyond the narrow issue of legal conformity toward broader commercial issues. For TRIPS compliance to yield benefits to Nepal, there must be capital markets connecting inventors to entrepreneurs, such institutions as collection societies to channel payments from copyright users to copyright owners, and legal institutions that allow inventors and creators to defend their property rights. Increasing access to foreign providers of IP-related business and legal services can help Nepali companies make use of intellectual property rights. The terms of reference for TA must focus explicitly on this commercial dimension of IP.

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<sup>50</sup> The World Bank estimates that TRIPS will lead to an annual transfer of \$35 billion in patent licensing fees and higher prices for the six largest, patent-holding countries (World Bank 2002). The International Intellectual Property Alliance estimates that U.S. copyright holders would earn an additional \$20 billion annually from stronger copyright protection around the world (IIPA 2003).

<sup>51</sup> Initial research suggests that IPR laws may be less significant than the commercial problems of repackaging traditional knowledge into a new product and then bringing it to market. See Finger and Schuler (eds.), *Poor People's Knowledge: Helping Poor People to Earn More from Their Knowledge* (Oxford University Press, forthcoming in 2003).

<sup>52</sup> The latter is particularly important in the area of medicinal herbs, many of which are gathered from the commons. Solving an intellectual property rights problem may, in turn, aggravate a physical property rights problem.

## **Customs Administration**

Article VII of the GATT requires WTO members to apply customs duties on the value of an imported article, which, in turn, is based on the price paid or payable in the market (known as “transaction values”). This blocks members from using minimum or reference prices that are set artificially; i.e., in a government ministry rather than the market. The rationale is to increase transparency and predictability in the customs house. This also gives trade negotiators confidence that a tariff reduction will not simply be undone by subsequently raising the reference price on which the tariff is ultimately applied.

Some assert that Nepal already complies with WTO customs valuation requirements since the Customs Act of 1962 provides for transaction values.<sup>53</sup> However, closer inspection of current practices reveals that WTO valuation methods are not being applied at present, and they cannot be applied effectively until current laws are revised. Furthermore, adopting WTO methods will be beneficial only after customs inspectors have received training in valuation methods and have access to databases with pricing information. Otherwise, using transaction values simply opens the door to fraudulent invoicing. Adopting WTO customs valuation methods is simply the last link in the chain of customs modernization (see Chapter 6).

## **3.4 Conclusions and Recommendations**

This chapter argues that Nepal can use WTO membership to lock in past trade reforms, improve the domestic trade policymaking process, help exporters contest foreign trade barriers, and supplement the preferential market access it enjoys in key foreign markets. These benefits will help the country better integrate itself into the world economy. Membership also requires the Government to undertake investments in domestic institutions to take advantage of WTO rules.

### **Immediate Actions (next 6 months)**

The following are priority areas for policy changes in the short run:

- Conduct follow-up economic analysis to identify sectors where service-related bottlenecks most severely reduce cost competitiveness of Nepali businesses, especially SMEs (MOICS/Technical Assistance required (TA)).

### **Medium Term (in the next two years)**

- Customs Reform—Begin implementing, as a matter of urgency, comprehensive customs reform so that implementation of GATT (Article VII) valuation requirements are practical and beneficial to Nepal. (DoC/MoICS/TA)
- Amend Customs Act and Rules to Accommodate Valuation compliance and other WTO compliance requirements. (DOC/MoF/TA)
- TRIPS: finish drafting laws to bring Nepal into formal compliance; initiate extension services to educate SMEs on commercial benefits of trademarks and branding; construct facilities to hold confiscated counterfeit goods. (MOICS/HMGN/TA).

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<sup>53</sup> Pant (2002) makes this point explicitly; Tongzong (2000) implies that the law needs to be revised only to give clearer guidance to officials and traders.

- TRIPS: Establish inquiry point (for non-agriculture products); build capacity in judicial system to handle IP disputes; conduct public-education campaign on commercial benefits of patents, geographical indications, and commercial value of traditional knowledge; promote the private provision of intellectual property legal services to SMEs.(MOICS/HMGN/TA).
- SPS/TBT: SPS/TBT: Introduce legislation to base domestic regulations on international standards; accept, on reciprocal basis, any goods bearing certificates of conformity assessment issued by other WTO members (e.g., the EU’s “CE” mark); pass legislation to establish an inquiry point for SPS measures.
- Establish infrastructure to implement TRIPS/SPS/TBT legislation. (MOICS/HMGN/TA).

### **Technical Assistance Needs**

Substantial technical assistance will be needed in at least the following three areas.

- *Continued support for multilateral trade negotiations*—The key issues are assessing optimal tariff levels and choosing the service sectors where liberalization commitments will be most economically beneficial.
- *Capacity building in trade policymaking*—including improvements in analytical capacity, coordination across agencies, setting up an apex trade organization, and public communication.
- *Support for implementation of WTO rules*—In customs reform, standards, and IP rights protection.

## 4. PRICE COMPETITIVENESS AND PRODUCTIVITY

### 4.1 Introduction

The gains from trade and global integration of a country depend largely on the competitiveness of that country's economy, i.e. how efficiently it can produce goods and services. This chapter addresses key questions about Nepal's competitiveness: How price competitive is Nepal in world markets? In the future, will Nepal be competitive enough to sustain, diversify, and expand its markets in the face of increasing global competition? These questions are answered using both aggregate and survey-based data.<sup>54</sup>

The chapter suggests, first, that while Nepal's lower wage costs provide an important competitive advantage, this is offset by the country's significantly lower labor productivity. Second, aggregate productivity is also low in the economy, and performance varies widely among firms, indicating that the economy tolerates high levels of inefficiency. Third, while Nepal's productivity and competitiveness increased over the 1990s, these improvements could not be sustained by the end of the decade.

The chapter then outlines the other deeper factors that make productivity low: lack of technology transfer mechanisms and labor market rigidities, which reduce incentives for training labor, or investments by firms in raising productivity; low interest of foreign direct investment, often the key transmitter of new technology and productivity; high costs of infrastructure; high transaction costs; and an unpredictable business climate. Finally, the chapter previews competitive price margins in certain representative products where Nepal currently has a comparative advantage.

### 4.2 Defining Competitiveness and Comparative Advantage

There is no agreed upon definition of *national competitiveness*; the term means different things to different people. A country is always competitive in global markets in that it always has a *comparative advantage* (it is comparatively more efficient) in producing something that it can then export to other countries, even if the country has lower productivity in producing that good. In this chapter, the term *competitiveness* is defined more narrowly as cost efficiency, i.e., how cheaply and reliably a country can produce the goods and services in which it competes. Three indicators are used to measure the competitiveness of Nepal and its firms:

- Relative unit labor costs in the manufacturing sector, expressed as a common currency: total labor costs of producing one unit of output, measured in a comparable currency. Labor productivity, wage costs, and exchange rates are all taken into account in this measure, which is sometimes defined as the *real exchange rate*;
- The *Real effective exchange rate* (REER), which measures the overall competitiveness of the country by taking into account movements in its exchange rates and inflation relative to those of its trading partners;
- *Total factor productivity* (TFP), the growth in productivity of all productive factors taken together. In the long run, competitiveness is measured by growth in total factor productivity, as the exchange rate settles into its equilibrium value and wage rates also increase as productivity increases. TFP growth

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<sup>54</sup> A small, focused survey of exporters was conducted for this chapter to update and add to the information gathered in a large, countrywide World Bank/FNCCI survey of manufacturing in 2000. The questionnaire and a brief synopsis of the responses are included in the Background Papers volume.



allows a country to support higher wages, a stronger currency, and attractive returns on capital—and with them higher standards of living. Productivity depends on the value of a country's products and services, measured by the prices they can command in world markets, and the efficiency with which they can be produced.

### Short-run Productivity

The authors of this study compare Nepal's unit labor costs, as defined above, with nine Asian countries (Table 4.1).<sup>55</sup> While Nepal clearly has an advantage of lower wages (column A), this is more than offset by low labor productivity (column B). As a result, unit labor costs are among the highest among its competitor countries. This points to the need for a competitive exchange rate and for higher labor productivity in order to keep unit labor costs low.

Encouragingly, Nepal's unit labor costs declined over the 1990s. As Table 4.2 shows, Nepal's unit labor cost declined at an annual rate of more than 3% during the 1990s, 1% per year faster than India's. Nepal, in fact, made substantial gains in competitiveness, compared with the Asian countries listed in Table 4.3. Compared to Sri Lanka, Indonesia, and Malaysia, Nepal's competitive gains were quite substantial (about 8% per year compared with Sri Lanka and 3.6% against both Indonesia and Malaysia). Even in the case of China, Nepal was able to improve its price competitiveness by 2.6% per year over the period.

**Table 4.1 Index of Cost Competitiveness Indicators of Nine Asian Countries, 1999**

Country	Labor Cost per Worker (A)	Value Added per Worker (B)	Unit Labor Cost (C)
Nepal	100	100	100
India	130	205	81
China	180	271	72
Bangladesh	110	130	90
Indonesia	120	276	87
Thailand	480	390	94
Sri Lanka	160	195	105
Malaysia	960	909	93
Philippines	600	742	93

Note: A = average labor cost per worker manufacturing, B = value added per unit of labor, C = labor cost per unit of output manufacturing according to the internationally accepted definition of the U.S. Department of Commerce.

Source: UNIDO Yearbook of Industrial Statistics, 2001; ILO Yearbook of Labor Statistics, 2001 (India's labor cost index is 260 according to ILO data; the lower number here is based on discussions with the private sector in Nepal); World Bank/FNCCI Industrial Survey, 2000.

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<sup>55</sup> It should be noted that comparisons of unit costs across countries have serious methodological problems. See Nabi and Anjuria, 2002.

**Table 4.2 Nepal's Annual Rate of Improvement in Unit Labor Cost , 1990-99**

Country	Annual % Change	Relative Improvement in Competitiveness % per annum
Nepal	- 3.7	
India	- 2.3	1.4
China	- 1.1	2.6
Indonesia	- .1	3.6
Thailand	- 2.3	1.4
Sri Lanka	+ 4.5	8.2
Malaysia	- .1	3.6
Philippines	- 2.7	1.0

Sources: UNIDO, 2001; ILO, 2001.

What accounted for the improvement in Nepal's price competitiveness over the decade? Table 4.3 suggests that slow growth in Nepal's wages kept costs low. Thus, even when Nepal's productivity growth was the slowest among these countries, wages grew at an even slower pace, which lowered unit labor costs, compared to other countries. As the data in Table 4.3 illustrate, wage costs grew four times faster per year in India than in Nepal during the 1990s, while the annual rate of labor productivity improvement in India was only slightly higher (.2%). Thus, while both countries improved their price competitiveness (as measured by unit labor costs) over the period, Nepal's rate of decline in unit labor cost was more than 1.4 percent faster per year than India's, due mostly to India's higher growth of wage costs.

**Table 4.3 Annual Percentage Change of Labor Costs and Labor Productivity of Eight Asian Countries**

Country	Labor costs	Labor productivity
Nepal	.5	4.2
India	2.1	4.4
China	9.0	10.1
Indonesia	8.1	8.2
Thailand	8.4	10.7
Sri Lanka	5.3	.8
Malaysia	9.1	9.2
Philippines	7.4	10.1

Source: UNIDO, 2001; ILO, 2001

### Real Effective Exchange Rates

Another indicator of competitiveness is the REER, a trade-weighted average sum of the real effective exchange rates of all of Nepal's trading partners. In this case, a depreciation of 9% in the index over the decade has increased Nepal's competitiveness. However, like the unit labor costs in manufacturing, this index also suggests that Nepal's improvement in competitiveness was largely a phenomenon of the early

1990s following Government policy reforms. Toward the end of the decade, the REER appreciated significantly, signifying deterioration in the country's competitive position.

### **4.3 Nepal's Long-Term Competitiveness: Total Factor Productivity Trends and Determinants**

As discussed above, TFP growth provides the index for long-term productivity, as it measures the combined effect of all factors of production on firm efficiency. Based on data gathered from a countrywide World Bank/FNCCI survey of 225 manufacturing enterprises, this chapter uses the TFP index to examine the average level of productivity of Nepal's manufacturing firms, compare it with productivity studies from other developing countries, and analyze the trend of TFP growth in Nepal.

The results suggest that the Nepali economy tolerates large inefficiencies of many inefficient firms. The average level of firm productivity in Nepal is 53% (productivity is measured as a percentage of the most efficient benchmark). This compares with a mean level of productivity found in other studies in both developed and developing countries of 60-70%.<sup>56</sup> The variance in average productivity is quite large between large and small enterprises—large firms, on average, are about 25% more productive than smaller enterprises—and between sectors—the mean productivity gap between the two most productive sectors and the two least productive sectors is 26%.

These figures indicate that the factor markets are not efficient in reallocating capital and labor from less efficient to more efficient firms and sectors. Rigidities in labor markets, inadequate provisions for bankruptcy and foreclosure and the exit of inefficient firms, and an inefficient financial sector contribute to keeping inefficient firms active while constraining the growth of efficient firms, thereby keeping overall productivity low.

Turning to growth of productivity over time, both economy-wide and firm-level estimates indicate that, at least since the early 1970s, manufacturing total factor productivity has not improved.<sup>57</sup> In manufacturing, the annual rate of output growth picked up in the post-reform period after 1987–1988 from about 2% per year to more than 8%. However, most of this increased growth resulted from factor accumulation rather than productivity improvement. In fact, total factor productivity growth in manufacturing contributed negatively to output growth over the period (-1.4%).<sup>58</sup> Even in highly labor-intensive industries, such as carpets, garments, and other textiles, capital is estimated to have contributed significantly more than labor to output growth in the post-reform years. In short, measured by the trend growth in total factor productivity and comparative levels of efficiency, Nepal has not made many strides in improving its long-term competitiveness over the last 20 years.<sup>59</sup>

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<sup>56</sup> See, for example, Rataswamy (1994) and Bhavani (1991) for India; Hill and Kalieajan (1993) for Indonesia; Biggs et al. (1995) for Africa; Tyler and Lee (1979) for Columbia; and Corbo and de Melo (1986) for Chile.

<sup>57</sup> Kishor Sharma, 1999.

<sup>58</sup> In the 1990s, the annual rate of total factor productivity growth was negative (estimated at -0.11% per year). This was a substantial improvement over the pre-reform period, however, when the annual rate of productivity decline was -0.96% per year.

<sup>59</sup> As indicated earlier, short-term competitiveness improved because of declining unit labor costs in Nepal (growth in output and substitution of capital for labor over the period resulted in labor productivity growth, while wages remained stagnant) and relatively faster growing labor costs than labor productivity in other countries.

**Table 4.4 Average Productivity in Manufacturing: Size and Sectors (Relative Unit)**

Manufacturing Industry	2000–01		
	Average	Large Firms	Small Firms
Garments and Textiles	53	56	42
Wood and Furniture	53	58	52
Food Processing	52	55	51
Chemicals	46	50	36
Non-metal Fabrication	53	63	49
Metal Processing	44	53	41
Pharmaceuticals	60	67	55
Carpets	56	58	41

*Source:* World Bank and FNCCI survey, 2000.

Three reasons help explain such performance: i) inability of firms to acquire new technology that could improve productivity, ii) poor infrastructure that lowers the productivity of both labor and capital, and iii) an unfriendly business climate. The first reason is discussed below, while the other two issues are also discussed in greater detail in Chapter 7.

### **Absence of Technology Transfer Mechanisms**

Firms do not have the ability or incentives to acquire and use new technology because of the absence of strong technology-transfer mechanisms (in-firm training, business support, and foreign direct investment [FDI]), which is key to raising productivity. Research on the determinants of productivity in Nepal has confirmed this. For example, the World Bank/FNCCI 2000 survey of firms found that, after accounting for such factors as enterprise size, capacity utilization, and employee skill ratios, the availability of technology transfer mechanisms explained most of the productivity gaps between firms (World Bank and FNCCI 2000).

Technology transfer mechanisms are weak for three broad reasons. First, in-firm training programs are limited. The World Bank/FNCCI survey and the survey of firms for this study both found that 84% of firms in the sample invested little or nothing in training. Where training investments were made, only about 10% of the workforce in the company received formal training. This is about one-third of what is found in Western Europe and East Asia, where the average percentage of workers trained is 25-36%, and more than 65% of firms provide some type of formal training. As Chapter 6 suggests, labor market rigidities provide little incentives for firms to invest in training.

Second, lack of business support services for training, technical assistance, and market information is a major handicap in raising firms' technical capabilities (30% of the firms surveyed identified this as a major constraint). By contrast, all successful East Asian exporters had programs to build up such business support services, by way of both government efforts and private sector activities. The absence of these services could help explain why, despite being price competitive in exporting wearing apparel to the U.S. market, Nepal has been unable to make any significant entry into the EU market (see Chapter 8).

Third, Nepal needs more access to FDI—a key conduit for transferring technology. The survey of firms in Nepal found that those that had significantly higher levels of productivity had access to foreign technical assistance and licensing agreements, engaged in worker training, and had more extensive and

sustained interactions with foreign buyers and suppliers by way of exporting, importing, and visiting abroad. In addition, Sharma (1999) found that firms with higher-skilled employees had much higher TFP growth rates.

Fourth, the problem of lack of training is compounded by poor human capital in Nepal. Nepal's adult illiteracy rate is one of the highest in the world, and the average years of schooling of the adult population is extremely low. The proportionate number of students in science, mathematics, and engineering is about half what it is in the rest of South Asia, and the number of scientists and engineers involved in research and development (R&D) per million population is paltry. Such low skill-development indicators are reflected in the number of foreign workers brought in to fill skill-intensive jobs in Nepal. More than 15% of technical jobs in manufacturing are filled by foreign nationals; this percentage is probably understated because it is often difficult to discriminate between locals and foreigners along the border with India. Finally, the Government's contribution to R&D expenditures is also low by regional standards. As a percentage of GDP, India's R&D expenditure is two times that of Nepal.

### Poor Infrastructure

Nepal's cost of infrastructure is high compared with other Asian countries. Table 4.5 show that, except for telecommunications, Nepal lags significantly in infrastructure development. Electricity costs much more in Nepal than in most other Asian countries, particularly when one considers that firms must supplement public services with own-generation in many cases (Table 4.6). Inefficiencies of the excessively centralized Nepal Electricity Authority (NEA), piecemeal expansion of the distribution grid, and the high prices agreed to under power purchase agreements (PPAs), which currently provide about 25% of all power, have all served to raise power costs. In the case of water, Nepalese companies also operate at a cost disadvantage; for example, industrial water costs in India are 50% lower.

**Table 4.5 Comparative Infrastructure Indicators**

Indicator	Year	Nepal	Bangladesh	India	Pakistan	Sri Lanka
Paved roads (% of total)	1999	30.8	9.5	45.7	43.0	95.0
Internet users (thousands)	2000	50.0	100.0	5000.0	133.9	121.5
Electricity consumption, (kWh per capita)	1999	47.1	89.0	379.2	321.2	255.3
Telephones mainlines (per employee)*	1997	37.2	14.7	33.7	48.3	30.4
Radios (per 1,000 people)	1997	39.2	49.4	120.5	105.1	207.5
Road density (km per sq. km of land)	1999	0.1	1.4	1.0	0.3	1.5
GDP per unit energy use (PPP \$ per kg oil equivalent)	1999	3.5	10.8	4.7	4.2	8.1

\* Data for Bangladesh and India are 1995 and 1996, respectively.

Sources: World Development Indicators (for paved roads, internet users, electricity consumption, road density, and GDP per unit energy use); Social Indicators and Fixed Factors database (for telephone mainlines and radios).

**Table 4.6 Comparative Infrastructure Costs**

Country	Electricity Tariffs \$/kWh (2000)		Water Industrial use \$/Cu Meter
	Avg. Overall Tariff	Industrial Tariff	
Nepal	0.093	0.084	0.331 to 0.357
India	0.043	0.064	0.14 to 0.224 <sup>a</sup>
Sri Lanka	0.079	-	0.14
Thailand	0.077	-	-
Indonesia	0.074	-	-
Pakistan	0.065	-	0.074 to 0.191
Malaysia	0.111	-	-
Philippines	0.114	-	-
Bangladesh	0.041	0.068	0.246

<sup>a</sup> 0-50 to above 100 cu meters.

In the case of electricity, the survey completed for this study and that of the World Bank/FNCCI indicate that power fluctuations and power outages add substantially to production costs. In fact, companies note that infrastructure in general, and electricity in particular, constitute one of their biggest business problems (Table 4.7).

**Table 4.7 Problems with Infrastructure Services**

Service	Firms with Problems (%)	Firms with Severe Problems (%)	Firms Providing own services (%)
Electricity	71	42	57
Water	31	19	71
Roads	35	20	12
Telecom	17	8	-

Sources: World Bank FNCCI (2000) and this study.

Transport is another key constraint for Nepal. Distance from the sea, poor road conditions, relatively small volumes of cargo, and intermediate handling costs all conspire to raise Nepal's transport costs. A journey of 1,160 km require 8 days due to poor roads, border delays, and intermediate handling costs. More than road transport costs per se, loading costs, and trans-shipment of cargo at border crossings, bulk breaking, and other handling of cargo in ports can account for 60% of transport costs, instead of the usual 25-40%. The survey for this study found that Nepalese firms pay, on average, 50% more for export freight costs than do developing countries.

Firms complained about the low frequency of air cargo flights, inadequacy of container trucks from Kathmandu to Kolkata, time delays, loading and unloading expenses along the road at checkpoints, and theft and pilferage from the border to Kolkata. Exporters who participated in the survey also complained about lack of specialized facilities, like warehousing, cold storage, and customs facilities, to assist exporters of such products as foods and cut flowers—items in which Nepal has a clear comparative advantage in world markets.

Problems of transport cost and inadequate services directly affect exporters' inventory costs. At a time when a major component of international competition in many industries is just-in-time inventory control, high transactions costs lead to much high inventory costs for Nepal's companies. The survey for this study indicates that, in most cases, Nepalese firms need to keep three-to-four months of inventory on hand while in India, for example, firms generally carry inventories for only 10-to-15 days, resulting in a minimum of 15-25% higher inventory costs.

Finally, to improve productivity and become world-class exporters, firms surveyed for this study, particularly those in agriculture and food-related industries, noted the need for a standards testing institution with facilities to certify product standards. Currently, obtaining certification for products in India and the EU is time-consuming and costly. Exporters suggest a joint India/Nepal facility somewhere near the border for products going to India. Such services are generally widely available in other Asian exporting countries. The Government could take the initiative in facilitating negotiations of a joint Nepal-India facility but, as argued in Chapter 3, with the private sector bearing most of the costs.

### **Business Climate**

Productivity improvement requires a stable and supportive business climate. Investments in physical and human capital needed to upgrade firm capabilities will not occur in a high-cost, uncertain, and high-risk business climate. Today, political uncertainty creates significant problems for business investment in Nepal. However, beyond this issue, a host of problems associated with government policy and poor policy implementation give rise to a poor business climate.

Many problems are caused by lack of clarity in laws and regulations and unpredictability and inconsistency in their implementation. Sometimes policies and regulations are made without the advice and knowledge of the private sector. Firms also complained about excessive government red tape, public-services delays, and corruption. Implementation of the import regime (problems with customs and duty drawbacks), the tax regime (inappropriate revenue targets and poor tax administration), and the labor law (inflexible retrenchment provisions) affect exporters most.

## **4.4 Comparative Advantage and Competitiveness: Areas of Opportunity**

Nepal's current comparative advantage in international trade lies in resource-intensive and labor-intensive product areas. Today, 95% of manufactured exports are concentrated in these categories. Examining the following list of Nepal's exports that meet the *revealed* comparative advantage test in world markets—Nepal's share of the total world exports of a product must be greater than its share of total exports of all products—and their domestic resource costs (DRCs) makes this statistic more tangible:

- Dried leguminous vegetables (lentils), DRC .71
- Spices (large cardamom and ginger), DRC .78
- Leather and leather products (hides and skins and blue chromes), DRC .20
- Fibers (hand-knotted wool carpets), DRC .27
- Yarn and textiles (polyester yarn), DRC .23
- Garments and non-apparel textiles (ready-made garments, knitwear), DRC .33 and (pashmina shawls, mufflers, DRC .87

All of the exports on this list also meet with DRC criteria, which measure the economic cost of factors of production used in producing a product domestically, compared with the value of those resources internationally.<sup>60</sup> This indicates that policy imperfections are not seriously distorting trade patterns away from those that would be predicted by a review of the economy's prevailing factor endowments.

Since the mid 1980s, some change in comparative advantage and diversification has occurred, as indicated by the decline in export share in basic agricultural raw materials and the rise in export share in labor-intensive manufacturing. But manufactured exports have been highly concentrated in carpets and garments over the period with little diversification. Within the carpets category of exports there has been little sign of upward movement in export quality or sophistication. In fact, since the early 1990s, unit values in carpet exports have declined slightly. By contrast, garments exports have performed better—unit values have jumped 40% over the same period—indicating a significant upward shift in export quality.

Within Nepal's areas of comparative advantage, however, there are some indications that the country enjoys significant competitive advantages. Table 4.8 lists eleven product areas where exporters have clear price-margin advantages.<sup>61</sup>

What was the performance of these products for which Nepal has been identified to have comparative advantage? While it is almost impossible to have a perfect match between these products and standard product classifications, Table 4.9 attempts to do so by identifying seven products that are representative of the above list.

The share of these products in Nepal's exports has increased significantly over the past decade, although they fell after 1995. But this decreasing share after 1995 is probably not of concern, as it reflects the growth of the "surge" exports to India, which was largely based on tariff differentials rather than comparative advantages. In addition, net exports, the closest proxy to value added, also increased significantly, pointing to the potential contribution to economic growth. Moreover, the share in world exports has also risen significantly, even after one excludes carpets. While not shown in this table, the share of carpets fell after 1995 (when it reached a significant 12% share of global carpets) to about 7% in 2000. Hence, significant reforms and restructuring in the carpet industry are called for (see case studies in Chapter 8). However, as the market share in other products is still relatively small, the prospect for growth is significant. For example, if one defines textiles and clothing as a single category, then Nepal's export market share was only about 0.12% in 2000.

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<sup>60</sup> A DRC of  $< 1$  indicates an activity of comparative advantage; i.e., it should be a net foreign exchange earner. A DRC of  $> 1$  indicates comparative disadvantage; i.e., the value of domestic resources required to produce the product is greater than the value of the foreign exchange required to import it. The source of the DRCs listed above is Karmacharya, B., Khadaka, K., and Acharya, A., 1999, "A Study on Strengthening the Industrial Sector in Nepal," Kathmandu, Nepal.

<sup>61</sup> Interviews for this study also revealed other activities in which Nepal has competitive advantages; these are discussed in more detail in the Background Papers volume.



**Table 4.8 Selected Export Products and Price-Margin Competitive Advantages**

Product	Destination	Domestic Border Price (NRs/unit)	Export Parity Price (NRs/unit)	Competitive Margin
Niger Seeds	U.S.	37,600	49,572	32
Sunflower Seeds	India	20,600	23,680	15
Lentils	BNG	32,400	44,268	36
Large Cardamoms	India	205,600	238,080	16
Tomato	BNG	16,520	16,524	2
Cut Flowers				
Rose	India	65	96	48
Cladilious	India	65	96	48
Carpet (60 knots)	EU	2,360-3,672	3,672-4,012	27
Leather	EU			
Wet blue buff		21	34	62
Wet blue goat		25	46-71	130
Handicrafts	EU			
Stone-carved Buddha 4"		571	1,632	185
Citronella		320	388	21
Lemon Grass		550	864	57
Mentha		460	660	43
Tea (specialty)	EU	696	1,297	86

Source: Karmacharya, 2000.

**Table 4.9 Performance of Products with Comparative Advantage**

STC	Product	Nepal's exports (\$000)		
		1990	1995	2000
0542	Beans, peas, lentils and other	7,143	0	14,554
0752	Spices, cardamom and ginger	3,491	5,083	5,673
21	Hides, skins and fur skins (raw)	45	0	2,019
61	Leather manufactured products	10,471	11,731	2,699
6592	Carpets, carpeting and rugs (knotted)	952	154,376	145,988
65-659	Yarns and textiles, excluding carpets	1,637	11,405	35,863
84	Apparel, yarns and textile products	49,682	111,388	209,395
84712	Shawls, scarves, mufflers and veils	66	0	41,496
	Total	73,420	293,983	416,191
	Share in Nepal's total exports (%)	40.7	81.8	58.7
	Ratio of Net Exports to Total Exports (%)	21.4	70.1	62.9
	Share in World Exports (%)	0.03	0.09	0.12
	Share in World Exports (textiles, excl. carpets (%)	0.05	0.08	0.12

Source: Estimated from United Nations Comtrade Data.

#### 4.5 Summary

The analysis above reveals that Nepal's economy has demonstrated the potential to become competitive across a range of manufacturing and agricultural goods. While growth has been rapid in these areas of comparative advantage, the country's global market share is still extremely low, suggesting significant room for growth. Nonetheless, given the increasing volatility and competition in global markets, Nepal will have to make significant efforts to improve its competitiveness through trade facilitation and removing "behind-the-border" constraints.

There is considerable scope for doing so. Despite economic liberalization and growth of trade in the 1990s, the competitiveness of Nepal's economy is very low and labor productivity is among the lowest among its neighboring and competitor countries. Three key factors contribute to low price competitiveness and productivity in the economy: i) inadequate mechanisms and incentives for firms to acquire new technology, ii) poor infrastructure, and iii) an unfriendly investment climate. Rigid labor markets in the formal sector constrain investment in labor training and inadequate bankruptcy and foreclosure provisions raise the costs of reallocation of factors of production to more productive uses. Weak infrastructure, transport and transactions delays, and an unpredictable regulatory framework further lower price competitiveness. Removing these constraints will enable Nepal to raise its competitiveness markedly.

## 5. FACILITATING TRADE: CUSTOMS AND TRANSPORT

### 5.1 Introduction

Improving Nepal's trade competitiveness depends on faster, more efficient movement of goods into, out of, and throughout the country. Streamlined cargo-customs procedures, including transit, are important in reducing transaction costs for traders. However, improving customs procedures<sup>62</sup> in isolation will not achieve the intended result of reducing transaction costs. Equally important are the linked, interdependent issues of governance<sup>63</sup> and infrastructure.<sup>64</sup> Customs-procedure improvements will be short-lived without competent staff, supporting performance management system, sound legal framework, solid infrastructure, and managers that are accountable. These form the heart of a coherent strategy for customs reform and modernization.

### 5.2 Governance

#### **HMGN Revenue Collection Priorities and the Role of Customs**

Revenue collected by the Department of Customs (DOC) accounts for more than 50% of Nepal's total tax revenue when the value added tax (VAT) is included. Collecting revenue from taxes and duties is a priority for the Ministry of Finance (MOF), and revenue targets are used to measure performance of the DOC. Each Customs office has monthly revenue collection targets set by the MOF. While these rules are not strictly enforced, this sends a message to customs officers that revenue collection is the only objective of their work. Traders see the role of the DOC as revenue collection, control, and strict application of the Law and feel that the Customs interferes with their legitimate business. Performance criteria should usefully include elements other than revenue targets, such as trade facilitation, among key objectives.

To be an effective partner in improving trade competitiveness and reducing transaction costs, the DOC must also focus on **facilitating the movement of goods** and developing a **voluntary compliance** culture in the business community as its key roles, in addition to the collection of revenue. Customs officers are usually uncomfortable with these roles, as they have been oriented to control and revenue collection and do not yet have the tools, training, and procedures to support them. The existing Customs Act is also oriented toward control and enforcement, and traders complain of being generally treated as dishonest by Customs. To move in the direction of facilitation and procuring voluntary compliance, however, does not imply abdicating the enforcement role. On the contrary, a strong intelligence, audit, investigations, and

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<sup>62</sup> **Customs Procedures** are simple and transparent procedures in support of the mission and mandate of DOC and reflecting the principles and operation of a modern Customs organization, as outlined in the World Customs Organization (WCO) Kyoto Convention (Annex B of Chapter 5, Background Papers Volume), WTO accession requirements, and other relevant international practices.

<sup>63</sup> **Governance** refers to providing a legal and regulatory framework and enlightened fiscal and strategic direction from HMGN and MOF, underpinned by political will. The Director General of Customs requires the tools, authorities, mandate, and corporate direction to manage a department that is crucial to trade competitiveness. Customs reforms will have lasting effects only if accompanied by effective strategies on integrity and a commitment to their application.

<sup>64</sup> **Infrastructure** implies an effective Customs organizational structure and human resources management framework, resources, facilities, and tools in support of the mandate and objectives of the DOC. It also implies effective communication and partnership with the business community.

anti-smuggling capability will target offenders better, allowing resources to be used to facilitate shipments of those who voluntarily comply with the law.

As post-clearance functions, such as Post Entry Verification (PEV) and Post Entry Audit (PEA), and selectivity are implemented, the role of the customs officer in the field (clearance) will change, and the job will have to be re-examined to determine what new competencies are required, how work will be organized, and how people will be deployed.

### **Revision of Customs Act and Rules**

The existing Customs Act and accompanying Rules, although amended in 1997, do not reflect modern international Customs practices, as outlined in the Kyoto convention and requirements for WTO accession. Attempts at aligning new practices, such as the WTO Valuation system through yearly Finance (Fiscal) Acts is not effective in the long term as the Finance Act is applicable only for a given fiscal year (FY). The DOC has had the foresight to recognize the need for Customs modernization and has begun to revise the Customs Act and Rules. The DOC has requested assistance to cover new areas, such as post-clearance verification and audit, automation of Customs procedures, and the targeting of goods for inspection using selectivity criteria. These new procedures and approaches must be based on a sound and transparent legal framework.

### **Performance Management and Civil Service Reform**

Although civil service reform is in progress, it has not significantly improved DOC practices in human resources management, and managerial flexibility in Customs remains an issue. There is a dedicated management cadre in the DOC at the senior level, but they are handicapped by lack of authority. The Director General of Customs (DG) is accountable for Department operations but, in many cases, does not have the authority to make certain decisions to effectively manage operations. For example, the Director has faced difficulties in staffing, such as in critical information technology (IT) positions to support ASYCUDA implementation because of a freeze on hiring in the Civil Service. The move of the Departments of Customs, Taxation, and VAT to a Revenue Authority status could provide more flexibility to manage human resources, enhance their ability to set salaries at levels that discourage corruption, and achieve savings in terms of combined functions. However, this move would need to be revisited to assess whether other intermediate steps should be taken first, such as developing a well functioning, large taxpayer's unit, which balances the goals of trade facilitation and revenue collection, and providing greater autonomy and authority to the DOC within the existing framework.

Performance standards relating to trader and public service are apparently lacking. Measuring performance must be part of any Business Plan for Customs. Improving the range of performance criteria to include trade facilitation measures could also enhance the role of the private sector in a consultative process. At the individual level, performance standards are weakly applied and no objective criteria for measuring the performance standards have been set.

### **Integrity in Customs**

Recent MOF initiatives have sought to curb corruption in the DOC; however, it still remains an issue, especially with traders. Prosecutions of officials, including those of Customs, have markedly increased recently. Even with a poster and information campaign in DOC and these recent prosecutions, the acceptance of "speed money" and "schedules" of payments to Customs staff exist for "facilitating" clearance are still reported. Traders also indicate that Customs officers have harassed them to provide them goods from shipments. This goes completely against the expectations of traders and the public for

transparency and fairness in Customs. Attaining voluntary compliance with the law is more difficult when there is corruption.

Salary levels are public-service, “standard” rates; however, customs officers do not receive overtime pay for working longer hours or on holidays. As customs officers are in a position of public trust and have powers beyond many other public servants, their pay and classification structure needs to be examined in line with the new role.

There is a conduct and disciplinary code provided for in the Civil Service Rules. It does not appear that these rules are enforced in many cases and section 47 of the Rules Restriction on Receiving Donations, Gifts, and Loans should be re-formulated into a more job-specific Code of Conduct for DOC. Managers and supervisors should be reminded of their accountability regarding the conduct of their employees, and training should be conducted in this regard.

Section 22A of the existing Customs Act provides for “commissions” of up to 30% of goods seized to persons who capture or inform on smugglers and those who seize the goods, including customs officers. This does not support fairness and integrity, as it provides an opportunity for corruption and should not be included in the Customs Act revision. Moreover, it is not in line with the World Customs Organization (WCO), Arusha Declaration on Customs Integrity, which discourages this type of activity.

### **Informal Trade**

Informal trade *exists* along the border with India. Although there are 66 customs officers assigned to mobile teams in the customs offices, their role has to be made clearer to strengthen anti-smuggling operations. Mobile anti-smuggling teams need to be strengthened in line with an improved Intelligence and Investigation strategy and capability.

### **Operation of Birgunj ICD**

Nepal has a Trade Treaty and a Transit Treaty with India. The failure to come to an agreement on certain Customs procedures related to transit has resulted in the Birgunj rail Inland Container Depot (ICD) remaining closed for two years. This has greatly affected the movement of goods and related costs and has added to the logistical problems at the Birgunj road facility. Clauses in the existing Treaty of Traffic needed to be renegotiated to simplify the existing (Indian) Customs transit procedures on the Kolkata-Birgunj transit route for both rail and road traffic. The February 2003 draft agreement on these issues provides a foundation for progress, but it awaits ratification, pending legal review. Selection of the Terminal Management Company that will operate the ICD in Birgunj also needs to be made. These measures must be expedited, given the high cost of delay to Nepal’s traders and revenue.

### **Other Legislative Requirements**

There has been little reported progress in enacting key pieces of transport related legislation. The passage of Carriage of Goods by Rail, Carriage of Goods by Road, and Multimodal Transport Acts have been delayed, with Parliament suspended. Promulgation through the Ordinance System is an alternative for overcoming further delay.

## **5.3 Infrastructure**

### **Customs Organization Structure**

The DOC comprises 28 main land offices, including one international airport Customs office and more than 100 sub-offices. Ninety percent of trading volume is concentrated in 6 Customs offices. DOC has 1,480 employees. The current DOC organization structure in headquarters reflects a modern Customs organization, and the DG has taken steps to modernize in line with WTO accession requirements and Kyoto Convention elements, such as automation. There is still considerable work to be done, and the DOC has identified several areas within the organization such as PEV, Audit, Enforcement, Intelligence, Investigations, and automated systems that need to be strengthened in support of a post-clearance verification and audit regime. For example, while ASYCUDA has been installed in a further four customs offices, failure to network it through a wide area network (WAN) system and a lack of operationalization of the IT Division in Customs is hampering its effectiveness. Capacity to develop risk criteria and conduct risk assessment is an essential competency for these functions.

Implementation of a risk-based clearance system will also affect the resources of the clearance offices at the borders, ICDs, and TIA, as fewer officers will be required for inspection. With the evolution of a PEV function and the ASYCUDA Selectivity Module in the clearance offices, a review should be undertaken to determine the competencies required of the customs officers and how they will be deployed. It is not anticipated that strengthening the enforcement functions will require additional resources, only a redeployment from other areas, as automation and selectivity will reduce the need for front line inspection. A competency-based human resources management system for hiring, training, and promoting customs officers should be adopted to support this change.

### **Human Resources Development**

One of the most frequent complaints heard from traders is the lack of competency on the part of customs clearance staff. Competencies fall into two categories: attitude and behavior toward traders and technical competency. There is no training function or customs training strategy within DOC, and the Revenue Training Institute, although it has a staff of 44, has no customs specialist on the faculty. Training occurs in the case of new initiatives, such as ASYCUDA, but introductory training for new employees and re-training for existing ones is infrequent. Much training is informal (on-the-job) and lacks a DOC corporate focus in terms of supporting a defined Customs role and the consistency of application of standards and fairness across the country.

### **Tools, Equipment, and Facilities**

The physical infrastructure and equipment at Birgunj, TIA, and other offices are inadequate for the efficient clearance of goods. The facilities do not have weighbridges, X-ray machines, quarantine facilities, refrigeration storage, and in some cases, telephones, faxes, washrooms, fork lifts, or adequate parking. Security at the Customs houses' storage areas is a problem, with pilfering of goods being common. The Birgunj road facility was not properly designed as a Customs Office and is poorly set up for inspection, storage, and high-volume traffic. This is also a complaint about other offices there, with the exception of the Inland Container Depot (ICD). Many offices have restricted working hours, and traders are requesting some of the busier ones to be open for longer hours. Even though TIA has a new cargo clearance facility, procedures, restricted hours, and lack of equipment slow down clearance.

## **Customs Laboratory**

The classification and valuation of many products, especially new ones, depends on the testing of materials to determine their content and subsequent classification, as well as their risk in the case of drugs and toxic substances. Without the proper equipment and training of laboratory staff, the testing can be lengthy and slow down clearance. The laboratory manager has done exceptional work, given the limited equipment and lack of staff training. Developing stand-alone testing capacity is critical, as there are no private testing laboratories in Nepal. Testing is also done by other departments (e.g., food-testing), and coordination among other agencies is not apparent. Suggestions have been made for the delegation of some testing to the Customs Houses.

## **Inland Container Depots**

The advent of ICDs and privatization in two locations has had the effect of removing facility management from the responsibility of the DOC, with good results. Some logistical problems, such as storage fees being charged by DOC and the ICD, still exist, and better transit procedures will further improve their efficiency. Opening the Birgunj rail ICD will remove pressure from the Birgunj road Customs office, and a re-assessment of that facility can be done at that time. Development of ICDs in Kathmandu, Tatopani, and Kakarvitta should be examined, as well as the privatization of the TIA clearance facility. An assessment should be made of the staffing requirements at the Birgunj ICD and the equipment required for Customs. There are also logistical issues around downsizing the Birgunj road clearance facility and moving staff back and forth to the ICD. An ASYCUDA installation will be required at this site.

## **Export Processing Zones**

Although Export Processing Zones (EPZs) have advantages in terms of simplified export procedures and tax considerations, the investment is considerable. Further study or review of existing studies is needed to evaluate economic advantage and, if appropriate, its design. The establishment of such zones (EPZ Project) should be reassessed after reviewing the results of implementing the recommendations for simplifying import/export procedures and infrastructure improvement, which are contained in this report.

## **Consultation with Traders**

A trusting partnership is an essential ingredient to achieve win/win benefits for DOC and the business community. At this time, many traders indicate a lack of transparency and fairness on the part of Customs and a perception that they mistrust all traders. This behavior on the part of Customs is probably caused by their traditional role of control and enforcement. Although there is an existing forum for traders that is attended by the DG of Customs, the traders indicate that this does not go far enough and would like to expand the consultation process. They would also like to attend training sessions on new procedures. Customs modernization offers new opportunities for dialogue and problem-solving and even the development of memoranda of understanding (MOUs) with the business community.

## **5.4 Customs Procedures**

### **Customs Clearance of Goods**

The new Customs Declaration form, Single Administrative Document (SAD), introduced with the implementation of ASYCUDA at four major Customs clearance offices, has facilitated the completion of the declaration form by the declarant. Although the Accounting module of ASYCUDA automatically

calculates the duty and taxes owed, it has done little else to speed up the clearance process because the Selectivity Module is not yet in place. As a result, inspections of cargo, which are the most time-consuming part of the process (closely followed by Valuation), are still conducted at close to a 100% basis, though sample checking is reported to be increasing. The DOC has requested assistance to develop selectivity criteria for the Module. Introduction of the ASYCUDA Broker's Module would allow on-line submission of a declaration, and the Transit Module and related procedures would speed up shipments. The ASYCUDA value added would be further enhanced by introducing the Direct Trade Input Module (DTIM) under which traders can obtain custom's clearances online, without the need for direct contact with Custom's officials. This will also improve governance.

The process is still document intensive; around 15 documents may be required for imports and around 11 for export, depending on the goods. Three separate forms are required for Business, Income Tax, and VAT registration for import and export. This is an example of where a single business number could be used for all three purposes, and the number could be used on the SAD without any requirement for forms.

The 24-hour, cooling-off period procedure for exporting goods from TIA could be eliminated by the use of X-ray machines at the airport. No one seems to understand the rationale for this procedure anymore, which does not appear to have any legal basis.

Customs offices at Indian borders are also closed at night, and start in the morning. The effective operating hours are less than 9 hours a day, contributing to the long wait of trucks at the borders. Here, cooperation needs to be sought with India to keep customs border posts open for longer hours. This measure combined with greater use of selectivity modules will help to cut down waiting time significantly.

### **Valuation Procedures**

The current valuation procedures in Nepal are based on Article 13 of the 1997 Customs Act amendment, which states that the "Customs Duty on goods which are to be imported shall be assessed on the basis of transaction price" and the Fiscal Act of 2001, which specifies the application of WTO principles in determining transaction value. The DOC has difficulty in determining transaction value based on the invoice provided because procedures for determining value are not fully developed or understood. Field offices are limited to the value appraisal at the time of release of goods, but traders find this unsatisfactory because of the methods used to determine the provisional valuation, such as using reference valuations, which, in many cases, are out of date. Traders also perceive a lack of transparency, fairness, and competency in this area, and customs officers indicate they are uncomfortable with the process of appraisal and verification of transaction value. Traders also indicate that this is one of the most problematic areas for them (Box 5.1).



### **Box 5.1 Valuation Procedures**

**Post Entry Verification (PEV).** This function should be established at the six major Customs Offices. The PEV function should exist for further examination of entry declarations after initial valuation appraisal and the release of goods. Selection would be based on valuation selectivity or profile criteria or referral from a Customs (valuation) appraiser. Selectivity criteria for valuation review and those for inspection of shipments differ.

**Appeals.** The appeals process already exists, but cases could be reduced through development of better valuation appraisal (assessment) and verification criteria and procedures. Some traders do not bother with appealing, even when they have a valid case.

**Post Entry Audit (PEA).** This is a step beyond the PEV, in that audits are conducted where serious Customs infractions have occurred or are suspected; the PEA crosses all areas, including classification, valuation, and business practices of a trader. Procedures for PEA need to be developed.

**Investigation and Intelligence.** Valuation and other Customs functions must be supported by Investigation and Intelligence functions to follow up on fraud cases and to provide information for PEA and PEV selectivity. Procedures must be developed for these functions.

Pre-shipment inspection (PSI) for determining transaction value of goods before shipment by companies with this expertise has been suggested. Given the high cost of such a procedure and recent evidence of the questionable integrity of some of these companies, pursuing this option is not recommended.<sup>65</sup> The DOC should develop its own transaction value appraisal capability, as recommended for the Valuation unit, which is in the long-term interest of the DOC, traders, and Nepal.

### **Transit Procedures: Treaty of Transit**

There is currently a Treaty of Transit between HMGN and India, which was re-negotiated in 1999. Although there are procedures outlined in this agreement for transit from Kolkata to Nepal, the processing time at the port in Kolkata usually takes 3 to 5 days for transit of goods, even with all of the required transit documents and the one-time-lock (OTL) system for containers. One reason for the delay is that the Customs House is located 2 km from the dock area, and the importer or his or her representative must return several times to submit documentation. Processing the documents to clear Indian Customs is a time-consuming activity.

### **Documents**

A Cargo Transit Document (CTD) is used for shipments from Kolkata Port to Nepal, and the shipment is verified at the Indian border. There may be an inspection in India (depending on the type of goods or, if the seals are broken) of the containers (usually containers are not inspected in transit). The 1999 Treaty of Transit clearly specifies only four documents: Bill of Lading, Invoice, Packing List, and a copy of the Letter of Credit. These documents must be submitted with the CTD to Kolkata Customs. Although the CTD is intended to simplify the transit process, the handling and processing of the documents by both Customs administrations cause unnecessary, bureaucratic delays and is logistically cumbersome and time-

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<sup>65</sup> If PSI is to be considered, experience from numerous countries suggests that the following conditions must be fulfilled (by customs and the country) to ensure that Nepal gains the most from this expensive service (Goorman and de Wulf, forthcoming). These conditions include: contracting only with IFIA-member companies, transparent competitive-bidding procedures, have PSI contracts fully endorsed by Customs (not imposed by Finance/Central Bank), tie in the PSI with a customs modernization project that clearly delineates the respective responsibilities of customs and the PSI company, make the PSI contract explicit (in terms of services to be rendered, time limit, list of goods to be inspected with exceptions clarified upfront, clear performance criteria, reporting requirements, specify an arbitration or appeals procedure, reconcile PSI findings with customs declaration and values retained for calculation of duties and taxes, create a steering committee (outside customs, but with their participation) to oversee PSI activities and performance, have an exit strategy, and introduce a publicity campaign.

consuming. These delays would also occur by rail from Kolkata, if the Birgunj ICD were open today. Overall, Nepal's trade will stand to gain from simplification and harmonization of procedures and documents with its neighboring countries.

A good example of this is harmonizing information systems with India. India is currently issuing and receiving TBLs (Through Bills of Lading) for transiting their containers from Indian seaports to their more than 60 ICDs, using the Electronic Data Interchange for Administration, Commerce, and Transport (EDIFACT). EDIFACT is an internationally accepted United Nations data-transmission standard, compatible with ASYCUDA and the ASYCUDA Transit Module. It should be examined closely as the basis for a more streamlined, automated system from Kolkata or any other Indian seaport to Nepal, as the infrastructure already exists in India.

### **Transit and the Birgunj ICD**

The Birgunj ICD has remained closed for two years for two reasons:

- Although there is a Treaty of Transit, which includes transit procedures, there is lack of simplified procedures of customs for transiting containers to/from ICD in line with the common principles of dry port.
- There were also delays in finalizing the Nepal-India Rail Service Agreement. The selection of a private terminal management company to operate Birgunj remains pending and of high priority. A competitive bidding process needs to be established to ensure selection of a financially and technically competent service provider under market-based conditions.

The current manual system for processing transit shipments described in the Transit Treaty must be streamlined and automated in order for the Birgunj facility to operate efficiently. The manual system should be phased out.

### ***ASYCUDA Transit Module***

ASYCUDA is in the early stages of implementation, with four sites operational initially and four others recently approved. The Wide Area Network (WAN) that would connect these sites electronically has been postponed because of the delay in finalizing the real service agreement to operate the Birgunj ICD. The transfer of staff in IT division of DOC for ASYCUDA has been delayed because of a broad Government freeze on staffing. Operationalizing the Transit Module would require implementation of the WAN and negotiation of an agreement with India on automated Customs transit procedures to be incorporated into the module. Modes of communication with Indian Customs (on-line/off-line) would also need to be negotiated, as would use of EDIFACT electronic communication.

### ***ACIS (Advanced Cargo Information System)***

ACIS was implemented at the same time as ASYCUDA and designed to improve transport efficiency by tracking shipments on all transport modes and providing information in advance of cargo arrival to transport operators. The utilization of this system in an ASYCUDA/EDIFACT transit system will have to be assessed.

## 5.5 Customs: Conclusions And Recommendations

Shortcomings in governance, infrastructure, and procedures all raise transactions costs and require specific actions. Prioritized recommendations in each of these areas follow, along with indications of whether donor TA will likely be required. In a number of cases, WCO assistance will be required.

### **Immediate Actions** (within 6 months)

- Prepare Customs Reform Plan including the following measures.

### **Medium Term Measures** (2 years)

#### **Customs Procedures**

- Amend Customs Act and Rules to accommodate valuation compliance and other WTO compliance requirements. (HMGN/WCO/TA)
- Develop selectivity criteria for risk-based management of Post Entry Valuation and Audit; implement ASYCUDA selectivity module and train staff. Introduce Direct Traders Input Module into system. (DOC/TA)
- Align transit documentation with EDIFACT System. (DOC/WCO/TA).
- Harmonize laboratory testing with other departments. Consider decentralization to main border crossings. (DG/DOC/other departments).
- Increase Operating hours of Customs posts and seek Indian cooperation for this purpose. (MoICS)

#### **Customs Governance and Institutional Reforms**

- Introduce voluntary customs compliance and clearance facilitation.
- Develop customs clearance, non-compliance audit and investigation capability within DOC. Provide training in Post Entry Audit, Investigations and Intelligence. (DoC/WCO/Enforcement Consultant TA)
- Create a Post Entry Valuation section. (DoC/WCO/TA)
- Study benefits of amalgamating DOC into a revenue authority. (MoF/TA)
- Develop Code of Conduct specific to DOC employees (DoC/MoF/TA).
- Develop audit procedures, train staff in PEA procedures, and coordinate with revenue authority.

#### **Customs Infrastructure.**

- Develop customs clearance, non-compliance audit, and investigation capacity within DOC. Training in PEA and Investigations and Intelligence (DOC/WCO/enforcement consultant/TA).
- Create a PEV section (DOC/WCO/Valuation consultant/TA).

- Correct weighbridge, X-Ray, laboratory testing, quarantine and refrigeration facility deficiencies at major border points. (DOC).
- Undertake benefit cost appraisal of a dry port/Container Freight Station at Kathmandu, Tatopani, and Kakarbhitta. (MOICS/TA).
- Extend computerization and wide area network to major customs points. (DOC)
- Redraft Customs Act and Rules consistent with WTO provisions. (HMGN/WCO/TA)
- Introduce voluntary customs compliance and clearance facilitation. (MOF/DOC).

## **5.6 Transport and Logistics**

Improvements in Nepal's customs procedures, including governance and customs infrastructure, will not produce the full range of intended benefits unless corresponding improvements are made to the transport and logistics system. Both are concerned with facilitating the movement of goods, for which the principal objective is reduced transaction costs for traders. This can rarely be accomplished if each component is viewed in isolation, since more effective movement of goods via any one component must be matched by equivalent improvements in capacity throughout the system.

Nepal suffers from two, naturally occurring disadvantages in relation to an efficient and effective transport system. First, it is landlocked and therefore requires infrastructure supplied by another country (India) in order to reach a seaport. Second, the nature of Nepal's terrain has tended to encourage localized self-sufficiency, with little or no attention given to specialization and comparative advantage. For many centuries, the principal means of transporting goods in the hilly and mountainous regions was with porters and ropeways. Not surprisingly, productivity growth was exceptionally slow. When road construction began in the early 1950s, the shift in technology opened the way for specialization and inter-area trade, but the necessary institutional arrangements to facilitate the new technology were slow to develop. They remain incompletely developed a half-century later.

As a result of these institutional barriers, many communities are not yet linked effectively to the strategic road network and therefore have limited access to regional and national markets. Even with significant advances in roadway construction since 1975, the ratio of the total length of all roadways to area in Nepal is relatively low, at 0.11 km per sq km. By contrast, India's road density is about seven times greater, while its per-capita gross national income is less than double that for Nepal.

It is also necessary to ensure that limited funds are used effectively. For example, until recently, Government policies for transport sector development favored spreading thinly the public resources of the development budget for constructing new roads, rather than properly maintaining the existing road network. In 1992, less than half of the existing roadway in Nepal was considered to be in "good or fair" condition. Currently more than 20% of Nepal's roads ways is considered to be in poor condition. This not only increased travel time by road, it also increased maintenance costs for road vehicles. Much of the benefit that normally flows from road transport was therefore lost.

Excessive reliance on donor funding and donor feasibility studies to estimate the benefits of roadway development limited the development of assessment skills and project management capabilities within HMGN. Additionally, since roadway development prior to the Priority Investment Plan in 1997 depended mainly on the overlapping of internal political-administrative factors and the interests of external donors, long-term planning was perceived to have little or no useful purpose.

Recent improvements in planning capability have become visible at the central government level, but these improvements have not yet reached the local government level. For example, the Department of Local Infrastructure Development and Agricultural Roads (DOLIDAR) was recently established within the Ministry of Local Development to assume responsibility for village and district roads. The intention is to allow the Department of Roads to concentrate on the strategic roadway network. However, a transfer of planning and operational skills from the DOR to the local authorities is necessary before the new department can function effectively, and this is far from complete.

Both the sequencing and the timing of institutional changes have created unexpected difficulties. For example, Nepal Roads Board (NRB) is designed as an autonomous body consisting of representatives from relevant government departments (including Finance, Local Development, Industry, Commerce and Supply, and DOR), as well as private sector organizations and enterprises (including the Federation of Nepal Chambers of Commerce and Industry, Federation of District Development Committees, Municipal Association, engineering associations, transport industry, consumers and farmers). The NRB has the power to collect taxes and fees from road users on all highways in Nepal. A fixed percentage of this revenue is to be allocated for road maintenance.

There have been delays in the MOF providing (i) concurrence to NRB rules and regulations governing appointments, funds-flow mechanisms, financial management and control and (ii) transfer of fuel and other transport levies to the Road Fund for expenditure on roads. Both are urgent requirements to making the Board operational and effective.

### **Transit of Goods through India**

As noted in Chapter 2, Nepal's trade policies are inextricably linked to those of India. This is apparent not only from the traditionally large amount of Nepal's trade with India, but also from the quantity of Nepali goods exported through the Port of Kolkata.<sup>66</sup> This dependence is substantially greater than that associated with other landlocked countries (LLCs). Most LLCs depend on more than one transit country (TC) to gain access to port facilities. This provides a competitive element in ensuring that transport costs of imports and exports are not unreasonably burdened either through charges over which the LLC has no direct control (such as port charges, road tolls, and freight forwarding or brokerage fees applicable in the TC) or through TC customs duties or bilateral or multilateral trucking and shipping agreements, which set quotas for the percentage of traffic to be transported by carriers of the LLC or the TC.

In the case of Nepal, alternative routes to the sea through Bangladesh or the Tibet Autonomous Region of the People's Republic of China do not appear feasible for large freight movements, though they may be feasible for smaller quantities of specialized freight. Experience elsewhere suggests that LLCs carry the burden of enhancing their negotiating leverage by analyzing a variety of access corridors and determining the generalized costs incurred in using each. This refers to the overall economic cost, which includes transport cost, loss and damage, inventory costs due to delays in transit, and the shipping costs to the ports of exit/entry that are incurred when there is an important shipping rate differential between the ports serving each route (Rebelo 1992).

The relevance of this analysis and the importance of the generalized cost components can be illustrated by the existing transit route through India. In December 2000, a project was completed, with assistance from the World Bank, to provide Nepal with three border facilities to handle containerized cargo. Of these, the

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<sup>66</sup> An estimate of the quantity of Nepali shipments through the Kolkata Port Trust is about 425,000 tonnes per year. Nepal is a significant client of CPT, accounting for about 15 per cent of the 175,000 TEUs handled annually (UNCTAD, 2001).

principal ICD at Birgunj was given a direct rail connection to Kolkata Port by means of the Indian broad-gauged railway network. The other two terminals at Biratnagar and Bhairava are road-based.

The estimated cost of sending the equivalent of a 20-foot container of freight by road from the Port of Kolkata to Birgunj is about INR 30,000. The cost of moving a container by rail from Kolkata to Raxaul (on the Indian side of the border at Birgunj) is INR 15,000-20,000. Since the journey from Birgunj to Kathmandu adds an additional INR 15,000 to the transport cost, the transfer from road to rail would comprise a saving of 22-33% of the cost of the 1,160 km, road journey from Kolkata to Kathmandu. This is equal to an annual savings of approximately US\$5 million, based on recent traffic levels (UNCTAD 2001).

In addition, the travel time from Kolkata to Birgunj could be reduced from 10 to 3 days by using a block train and daily departures from Kolkata. This could reduce the transit cost from 12-15% of the CIF value of the freight to about 8-10% of the value (UNCTAD 2001). Reliable estimates of the average CIF value are not available, but Nepali shirts exported to the U.S. in 2000 had a CIF value of US\$33 million. The savings in transit time for these items would therefore be about US\$1.5 million.

Despite these substantial savings in both transport and transit costs, the ICD at Birgunj has been inoperative, as a result of lingering negotiations between the Indian and Nepali governments in matters relating to customs procedures and management of the ICD facility. While further details must also be worked out in relation to the physical infrastructure and equipment at the facility, the two Governments are now close to arriving at an agreement. This illustrates the importance of examining the full range of generalized costs for both transport and customs, and of considering the losses that can be incurred as a result of the failure to examine them in a timely manner. As noted previously, since these losses accrue mainly to the LLC, with a significantly smaller loss usually experienced by the transit country, the burden of responsibility for the analysis falls principally on the LLC.

A further illustration is available in connection to an alternative sea route for Nepal. The Kolkata Port Trust comprises the Kolkata Dock System and the Haldia Dock Complex. The former lies along the banks of the River Hooghly, approximately 232 km from the sea. The Haldia docks are located 128 km from the sea on the same river and are used primarily for dry bulk and liquid cargo. Though Kolkata Port has the advantage of being inland from the sea, it also has the disadvantage of being constrained to accept vessels with a maximum draft of about 7.2 m, depending on the tide. This effectively means that Kolkata is serviced by smaller, feeder container vessels from large trans-shipment ports, such as Singapore, and, to some extent, Colombo and Hong Kong.

The newer container terminal at Mumbai, operated by the Jawaharlal Nehru Port Trust, has no similar draft restrictions, so containerhips using that port can provide direct sailings to European or other destinations. Transit costs could be reduced by about US\$400 per 20-foot-equivalent unit (TEU), by avoiding trans-shipment at Singapore and the feeder service. Perhaps of greater importance, the existence of an alternative port increases the level of competition, which frequently results in a substantial drop in charges for container slots (UNCTAD 2001). Such possibilities for increased competition must be sought; they are not likely to emerge on their own.

## **5.7 Analysis of Logistics Costs and Time**

Apart from loading and discharging at origin and destination, the main divisions of logistics costs and times are as follows:

- Line-haul movements by road, rail, or inland water ways together with the modal interface, if transfers to a different mode are required;
- Intermediate handling of the freight at border crossings and ports; and
- Customs inspections and procedures.

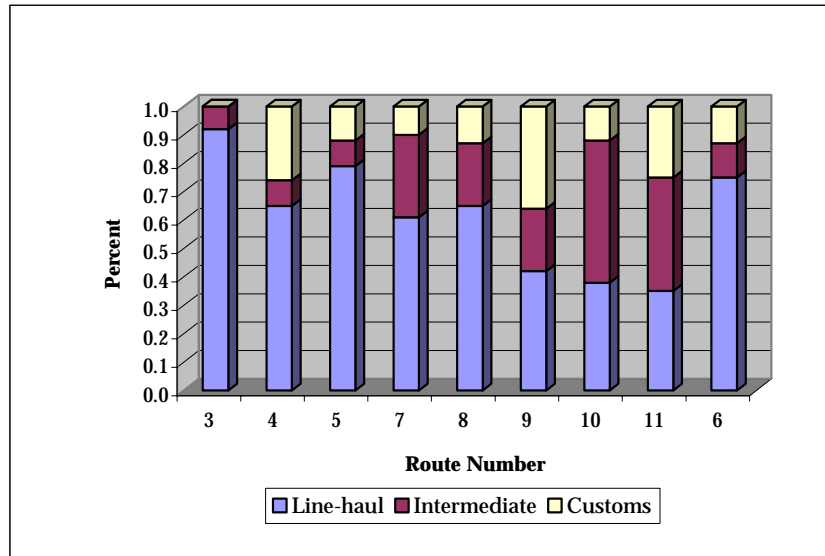
An analysis of these activities forms the basis for an assessment of productivity gains. Loading and discharging operations are usually examined in terms of the cost-per-weight unit of the freight. Line-haul tasks are measured in ton-kilometers in order to be independent of the size and type of vehicle (and hence to allow productivity growth to be apparent through increased size or greater technical efficiency). In general, line-haul costs vary by size of the consignments and the distances traveled.

Additionally, the suppliers of transport services typically offer better rates for shippers who have freight available on a regular basis. This creates an opportunity to seek back-haul freight or to organize a scheduled service around an assured level of capacity that will be used by the regular shippers. It does not affect the operating cost of the transport service, but helps to reduce undesirable levels of empty space on round-trip journeys.

Intermediate handling costs are expressed per weight unit and, ideally, also include the cost of time in transit. The latter typically varies with the value per unit of the freighted items (this was conveyed in the previous example by means of the CIF value). The upper range for this valuation is set by high-value, per-weight-unit items for which transport by airfreight may be viable. The lower range is determined by heavy items of relatively low value. Delays in transit are not usually a major factor for this freight, but it tends to be sensitive to increases in freight rates and other charges that are assessed on the basis of weight. Customs clearance costs generally vary inversely with the value of the freight, though this may not be the case for agricultural products that require testing or costly inspection.

To illustrate the approximate magnitudes of the main components, and the variations that are likely to arise from different routes or items, the World Bank's study of logistics costs contained the following comparisons (Subramanian and Arnold 2001):

**Figure 5.1 Comparison of Logistics Costs, by Route**



**Route code:**

- 3: *Cement from Kolkata to Agartala*
- 4: *Agricultural produce from Kathmandu to Dhaka*
- 5: *Limestone from Thimpu to Dhaka*
- 7: *Wool from New Zealand to Kolkata to Kathmandu*
- 8: *Tea from Karimganj to Kolkata to Liverpool*
- 9: ***Carpets from Kathmandu to Kolkata to Bremen***
- 10: *Polypropylene from Singapore to Kolkata to Thimpu*
- 11: *Garments from Dhaka to Chittagong to United States*
- 6: *Yarn from Kolkata to Dhaka*

As noted in the report, line-haul movements can be expected to account for at least 85% of the total costs (including handing at origin and destination) for regional shipments and at least 75% for cross-border shipments. Short distances will, of course, change this. For the first three routes shown in Figure 5.1, the cost of line-haul transport dominates. However, for agricultural products, the other costs tend to be about one-third of the total, and the relatively high cost for customs clearance is noticeable from the Nepali and Bangladeshi borders. This indicates considerable scope for significantly reducing both intermediate and customs components.

**Recommendations**

Immediate Actions (6 months)

- Complete legal review of Draft Nepal India Rail Agreement; finalize and implement. (HMGN)
- Appoint a terminal management operating company for Birgunj through competitive tender. (MoICS)



- Operationalize and fund Roads Board activities and expenditures, including fuel levy transfer; implement APP budget for rural roads. (MOF/Roads Board)
- Fund customs and ASYCUDA training. (DoC/TA)
- Review passbook scheme for duty drawback; implement or replace by exemption. (MOF)
- Simplification and Harmonization of Trade and Transport Related Procedures and Documents. (MOICS/DOC/TA)
- Introduce One Spot Export Clearance Arrangement in major customs. (MOICS/DoC/HMGN)
- Review constraints to market access, especially in EU. (MOICS/TA)
- Pass Carriage of Goods by Rail, Carriage of Goods by Road, Multimodal Transport Acts, and Marine Insurance Act or promulgate through Ordinances. (MOICS)

#### **Medium Term Actions (within 2 years)**

- **Conduct in-depth evaluation of transit corridors** starting with Kathmandu-Birgunj-Kolkata corridor especially those accessing Mumbai port, and Singhabad-Rohanpur with a view to communicating and negotiating these with the Government of India. (MOICS/MOLTMTM/TA)
- **Nepal Roads Board:** MOF concurrence with the Board's rules and regulations; funding mechanism and administrative procedures should be given as soon as possible and arrangements made for transferring fuel levies for road funding for the next FY. (MOPPW)
- **Priority Investment Program (PIP) and the APP:** The PIP should be more effectively implemented at the district and village levels so that local officials are able to evaluate the economic and social benefits of roadway infrastructure and initiate preliminary environmental assessments. Budgeted allocations for rural roads under the APP should be expended. (MOPPW/MOAC)
- **Rural-Urban Partnership Program:** The Rural-Urban Partnership Program (RUPP) should be extended to develop linkages for trade-transit-transport services to small enterprises in towns and rural regions. (NPC)
- **Program for Private sector Participation:** A seminar program should be initiated for countries in the South Asia region to exchange information and experiences related to increased private sector participation in trade-transit-transport.

## 6. LABOR MARKETS IN NEPAL

### 6.1 Introduction

Most people in Nepal are poor, not because they cannot find work, but because productivity is low—the lowest in the South Asia region. Growth and poverty alleviation are constrained by one of the most rigid regulatory frameworks for labor markets in the developing world and by the poor-quality educational system. Much work is needed to improve both the domestic policy environment for labor markets and the educational system.

Specific needs include:

- Reform of the legal environment for labor markets, based on providing greater freedom for employers and employees (and their unions) to enter into employment arrangements not subject to the constraints imposed by the existing rigid regulatory framework.
- Development of mechanisms to allow families, especially poor ones, better access to quality education and introduction of competitive forces into the education system, even if it means giving up some control of the public resources used to support education and related political patronage.

Despite recognition of a change in policies, these issues have become highly politicized in Nepal with rent seeking and political patronage often dominating the needs of economic efficiency, growth, and poverty alleviation.

### 6.2 Labor Market Characteristics

Labor markets in Nepal are characterized by a small formal sector (2% of employment) in which legislation has far-reaching effects and a much larger informal sector, commonly portrayed as having high unemployment, massive underemployment, stagnant or declining wages, and exploitative arrangements requiring extensive state regulatory intervention. This characterization needs to be reassessed,<sup>67</sup> especially since many of the resulting interventions have been counterproductive to both economic efficiency and poverty alleviation.

#### Unemployment and Underemployment

Available evidence on labor market outcomes has led analysts to different conclusions about the level of excess supply. Recent evidence suggests that there is high labor-force participation and relatively low unemployment and underemployment. Unemployment is more concentrated in developed, urban areas. This is consistent with a segmented labor market in which outcomes in the urban manufacturing and service sectors have little effect on more remote rural districts, where self-employment and family labor are so important. Poor people cannot afford not to work, and most people in rural Nepal are poor. Employment outcomes aside, the productivity of employed labor is demonstrably low by international standards, as Chapter 4 illustrates.

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<sup>67</sup> For a discussion of the evidence supporting the reassessment summarized in this section, see Bertrand, (2002).

## **Wage Movements**

There is a lack of conclusive evidence on the nature of wage-rate movements over time. The evidence put forward in many reports for declining real wages is weak and contradicted by other evidence suggesting a tightening labor market and rising real wages, mainly as a result of increased off-farm employment opportunities both within and outside the country. It is possible, however, that this tightening of labor markets and rising wages has been disrupted by the severe security problems now existing in Nepal. Wage outcomes are also the product of the distortion effects of labor legislation (discussed below) and minimum wage determinations in the non-agricultural sector.

## **Migrant Labor, Remittances, and Foreign Labor**

Nepal has a long tradition of its people working and seeking employment opportunities abroad, a process that has accelerated and diversified as Nepalese have sought work in the Gulf countries, other Asian countries, and in the West. Out-migration now accounts for 10-15% of the labor force, and remittances are estimated at about US\$800 million per year (4-5 times the inflows of foreign loans and grants from the international development community and more than the net inflow from export earnings). There is also extensive use of Indian labor within the Nepal economy, as both Indian and Nepali entrepreneurs look to migrants to meet labor requirements not easily met in their own markets and to evade excessively rigid labor market regulations in their own countries.

## **Child Labor**

With low incomes prevalent, few families can afford not to have their children work, even if they are in school. Some 2 million children work an average of 22 hours per week, accounting for 12% of total hours worked in Nepal. Although the vast majority of the hours worked by children are as unpaid workers helping out on their own farms (81%), fetching water or collecting wood (8%) or in their parents' businesses (2%), wage employment accounts for 6% of total hours worked. About 60,000 children (1.2% of working children), almost all in the age range of 10-14 year, are paid employees, mostly working as agricultural laborers. In addition, about 36,000 children (0.7% of working children) work in construction and manufacturing activities.

## **6.3 Labor Market Policies and the Regulatory Framework**

Many elements in Nepal's regulatory framework create significant rigidities in the formal sector labor market. Although applied mainly to permanent employees in larger firms, such regulations discourage investment and growth of firms and undermine operational efficiency and competitiveness.

### **Anti-dismissal Restrictions**

The Labor Act of 1992 makes it difficult, barring almost criminal behavior by a worker, to dismiss workers with permanent status. This regulation effectively covers less than 2% of the private sector labor force since it applies to establishments with 10 or more workers, and only to a portion of workers in these establishments with the status of permanent worker (status given to all workers employed for more than 240 days). Similarly, it is difficult to close large failing ventures. Any closure of the firm requires permission from the Department of Labor. Businesses have been unable to cut their final losses as they become entangled in prolonged disputes with their labor unions and with Government departments in trying to obtain the permit to shut down, and thereby discourage, investments in large and risky ventures.

The private sector makes extensive use of casual and contract labor that is not given permanent status and finds other ways to evade regulations. Anecdotal evidence suggests that firms can expect to pay premiums of 50% to attract labor with the required skills on a temporary basis rather than bear the full costs of permanent hire. In the private sector, anti-dismissal restrictions discourage growth of the formal sector, limit incentives for providing training, undermine the work ethic of those provided with such blanket protection, and discourage new investment and growth of small-scale firms that can evade the regulation by remaining small. These features all work to keep labor productivity low in Nepal, as highlighted in Chapter 4. In the public sector, this restriction limits the scope for improving the quality of governance and strengthening the education system.

### **Minimum Wage Rate Regulations and Related Regulations**

A minimum wage-rate system has been in place for almost four decades, covering four categories of skills in firms with 10 or more employees. Most wages are in excess of these, but the periodic revisions of the minimums are used by labor unions to bargain for higher wages in general. The minimum wage system may therefore have had some effect on wages in the covered sector. The covered sector is, however, small; any positive effects for those getting higher wages are probably more than offset by the negative effects on employment opportunities for the poor and unskilled. Recently a minimum wage rate has also been established for agricultural workers. If enforceable, it may limit the opportunities for those with little experience, skills, or social standing.

Many legislative interventions or trade-union agreements restrict business efficiencies. These include constraints on the number of hours worked, mandated rights to holidays and leave, hours of employment for female workers, and use of flat wage rates for set tasks, rather than based on productivity. In many negotiations, for example, trade unions often insist on flat pay rates for tasks with all employees undertaking that particular task compensated identically, regardless of productivity. Constraints are also imposed on using labor for multiple tasks, presumably to force the hiring of additional workers or to give workers greater control over their activities, but at significant cost to the efficiency and competitiveness of enterprises.

In more developed economies, many firms and industries operating without legislative constraints find it profitable to reward performance with bonuses related to productivity increases and profitability. Competitive entry and expansion of existing firms in profitable sectors of the economy tend to reduce above normal profits and increase wages for those with the skills needed in these industries. Nepal's 1973 Bonus Act mandates payment of 10% of profits to a workers' benefit fund. This is a poor alternative to the productivity enhancing incentive systems and competitive pressures common in more efficient economies.

### **Unionization**

While only a small part of the labor force is unionized, union workers play a significant role in both private- and public sector activity in the formal sector of the economy. Especially in the 1990s, trade unions have become highly politicized. With generous support from labor-friendly bilateral and multilateral organizations, the strength of unions is formidable, well out of proportion to their membership as a percentage of total labor force.

In an attempt to keep promises made by union leaders (at the time of union elections) or by politicians (during general elections), unions often support populist measures that undermine efficiency within the firm. Strikes and industrial disputes are common, and the low efficacy of the labor courts and dispute-settlement mechanisms compounds the problem. Firms caught up in disputes with unions are often faced with a costly and time-consuming legal process that has seldom, if ever, been resolved in their favor.

## 6.4 Options for Developing a More Flexible Labor Market

Legislative attempts to raise wages and provide guaranteed employment for a few in the sectors covered by the regulatory system can have significant costs in terms of improving skills and increasing investment, productivity, and job opportunities. While there has been a widespread recognition of the need to develop a more flexible labor market (an objective of the last Ninth Plan, as well as the present Tenth Plan), little progress has been made. Progress in this area is, however, an essential element of any program to enhance competitiveness.

### Adoption of Employment Contracts System

An important step in the development of a modern institutional framework suitable for a market-based economy is the establishment of a strong legal framework for contracts. One key element of this approach is an employment contracts law to:

- Affirm the rights of workers to organize and bargain for improved wages and working conditions with employers;
- Recognize the rights of employers and workers to negotiate mutually agreeable terms of employment, both within and outside the framework of union bargaining; and
- Relax all legislative restrictions on the outcomes of such bargaining.

There are several examples of such systems. This was the approach adopted in the major reform of the regulatory system for labor markets in New Zealand.<sup>68</sup> This approach has also been taken in Malaysia (Box 6.1).

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<sup>68</sup> New Zealand started a major economic reform program in the mid 1980s aimed at opening up the economy to foreign investment and liberalizing trade. Key elements in the reform were a trade liberalization and financial deregulation program begun in 1984, a macroeconomic stabilization and privatization program begun in 1987, and changes in social welfare and education programs begun in 1990. However, benefits from these efforts were limited prior to the passage of an Employment Contracts Act of 1991, which eliminated a rigid system of labor-market regulation, replacing it with a system based on freely negotiated employment relationships. The act guarantees the right to freely contract between employers and employees and the freedom of association for workers. This is now widely considered to have been a crucial missing element in earlier reform efforts.

### **Box 6.1 Potential Model for a Contracts-based System**

The 1995 Employment Act in Malaysia provides an example of a labor code that insists on, and respects, the employment contracts entered into freely by employers and employees. The lead Article of that act states that:

“Every employee must be given a written contract of employment which states the terms and conditions of the employment, including the notice period required to terminate it.” (See Malaysian Industrial Development website: [www.mida.gov.my/invest.html](http://www.mida.gov.my/invest.html))

This is a good example of a legal framework for the labor market that gives freedom to employers, workers and unions to work out mutually satisfactory working relationships that suit their own needs. The role of government then is limited to providing a legal system that respects and enforces contracts freely entered into by employers, workers, and their representatives.

### **Amendment of Existing Code**

An alternative approach would be to work within the existing labor code, but to relax some of its key elements. Mandatory compensation could be limited to those cases where no formal employment contract has been agreed to. This would encourage firms and workers to negotiate so as to explicitly define the terms of agreement when the nature of the employment makes legally mandated, compensatory payments inappropriate. Thailand provides an example where compensation must be paid to laid-off employees and procedures must be followed in notifying and compensating them (see the Thailand Board of Investment website: [www.boi.go.th](http://www.boi.go.th)). Under such a system, there is protection for those in jobs, those providing jobs, and those who would like an opportunity to compete for jobs.

In some countries, special labor regimes have been put in place for certain types of activities, most commonly for export-oriented industries operating in export-processing zones. There have been proposals for setting up special industrial zones geared toward export markets. If such zones were set up in Nepal, it might be feasible to introduce a special, less restrictive set of regulations for them.

Other chapters in this report demonstrate that some of the best prospects for developing wealth-creating industries are in labor-intensive, niche industries or in agricultural products, where special skills or local inputs are available (see Chapters 4 and 8). Experience suggests that these industries could find it difficult to operate in such special zones and most of the benefits may go to rent-seeking industries, based on trade diversion or preferential access to quota-constrained markets, unless these zones and their regulations are well designed.

### **Prohibitions on Child Labor**

The Nepal Labor Force Survey (NLFS) found that some 2 million children (aged 5-14) are in the labor force, working an average of 22 hours per week (hours are much higher for those who have dropped out of school).<sup>69</sup> In 1992, legal restrictions were introduced to make any employment of children under the age of 14 illegal and that of children aged 14-16 illegal in any hazardous jobs. However, the work of children is often an essential component of household survival and income-earning strategies; returns to education may be extremely low, given the quality of available schooling; work experience is, in many

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<sup>69</sup> Central Bureau of Statistics, 1999.

cases, essential to improving skills. These restrictions have not been effective in preventing massive dropouts from the school system and early entry of children into the labor force. Better results might be achieved by expanding options for poor families to access better-quality education and training for their children, as discussed below.

### **Policy Toward Foreign Employment**

Given the importance of foreign employment and remittances to Nepali households and the economy in general, the Government has tried to facilitate Nepalese working abroad and to ensure that recruiting agencies and foreign employers live up to their agreements with workers. This is a useful model for reform of the domestic regulatory framework. Foreign employees often bring with them vital technical and management skills, which can over time be naturally transferred to local employees through working together. Foreign workers in countries such as Bangladesh and Sri Lanka have contributed critically to the development of local knowledge and skills. Overall, instead of focusing on foreign employment regulations in Nepal, it would be preferable to concentrate on improving the quality of education and training in Nepal and reforming labor market policies to eliminate incentives for use of foreign workers.

## **6.5 Education and Training**

Despite massive, public sector investments in public education, results have been disappointing. A wide gulf is developing between those who have access to higher-cost, higher-quality education (often in private or foreign schools) and those who do not, with extensive dropouts by those who cannot afford private schooling. Finding mechanisms to bridge this gulf and provide poor families better access to quality education should be a high priority for Government, even if it means giving up some control of the public resources used to support education and the political patronage that accompanies it.

### **Improving Education**

An effort is being made to improve public schools through greater decentralization, increasing the role of communities and parents in school management, and increased budgetary expenditures.<sup>70</sup> The private sector appears to be doing a better job in education, despite lack of access to state funding, although the poor have little chance of sending their children to private schools. Consideration should be given to ways to encourage greater competition in providing education and to assist low-income families in accessing better schools (Box 6.2). While there is a strong argument for Government subsidies for education, these resources can also be spent on providing incentives for attending schools rather than on direct, public sector provision.

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<sup>70</sup> See World Bank, Nepal: Priorities and Strategies for Education Reform, March 2001.

### **Box 6.2 Piloting Subsidized Access to Better Schools**

A project carried out by the General Federation of Nepalese Trade Unions (GEFONT) aimed at providing parents with an acceptable alternative to early entry of untouchable-class children into garbage-cleaning occupations in Kathmandu provides a good example. Earlier interventions by various NGOs, based on the view that poverty was the only cause of non-schooling of children, failed to control the dropout rate. A GEFONT program supported access to private schools, in which there has been zero dropout.

The GEFONT report notes: “It is observed that the number of children enrolled in private school instead of government school is increasing. The preference of the families to admit their children in private school by spending more is associated also with the hope of better chance to get gainful employment in future.” (Gautam and Upadhyaya, *Garbage Cleaning Community and Child Labor in Nepal*, available at [www.GEFONT.org](http://www.GEFONT.org)).

This GEFONT effort was aimed at one small community to control dropouts from educational activities and curtail supply of child labor into the poorest working conditions. However, this could be replicated more broadly with the use of educational incentives, perhaps targeted to groups where public schools were failing and where dropout rates were high. The GEFONT program, as well as similar efforts to improve the quality of education available to low-income groups, has a better chance of success than efforts to keep children in schools by making their employment illegal.

## **Training**

Anti-dismissal regulations encourage firms to rely on various mechanisms to avoid giving employees permanent status. Discouragement to developing longer-term contractual relationships with workers also undermines incentives to provide these workers training. Often, employees provided with training at their employers expense are reluctant to sign such contracts since they would like the ability to seek other employment arrangements to maximize the return on their training. However, this is an area where both employers and employees can work out their own contractual obligations. Incentives for training could be increased by providing training vouchers or grants to employees or by providing favorable treatment in the tax system.

The Government is in the process of shifting the emphasis from training provided by Government institutions and training centers toward non-governmental and private sector training activities, where quality control is the responsibility of private sector groups. Soon after the Government made a policy of promoting the private sector in technical education, 118 technical schools were opened by private enterprises, in affiliation with the Council of Technical Education and Vocational Training. These private technical schools run short-term courses in various areas.

Business training is one component of the support provided to cottage and small and medium businesses. Any assistance offered to small businesses in terms of training is unlikely to be effective in an environment where many aspects of the regulatory environment provide incentives for remaining small. Large firms can use influence to avoid some of these burdens or use various loopholes to evade these regulations; however, this type of environment can greatly discourage the growth of small firms. Creating a more flexible labor market is likely to be more effective support for small firms than public sector provision of business training.



## 6.6 Implications for Actions

These above considerations suggest the following actions:

### Immediate Action (6 months)

- Review the Income Tax Act 2002, with a view to clarifying tax credits for accredited training to employees. (MOF/MOICS/FNCCI)

### Medium Term Actions (within 2 years)

- Legislate labor law consistent with a contracts-based legal framework for the labor market; alternatively, consider amending laws to allow dismissal with compensation. (NPC/Ministry of Labor/TA)
- Introduce performance related wages. (MOLTM)
- Amend Bonus Act of 1973 to remove mandatory contributions. (HMGN).
- Develop a proposal for a pilot project to assess design and implementation issues involved in providing direct financial support to families for use in covering educational expenses, including those incurred in private schools. (NPC/Ministry of Education/TA)
- Given the importance of real-wage movements in assessing effects on the poor, carry out a study to better document wage movements and establish a system for monitoring changes in wages in various sections of the country. (CBS/Ministry of Labor)

## 7. REGULATORY FRAMEWORK AND FOREIGN DIRECT INVESTMENT

### 7.1 Introduction

Following the liberalization of trade and investment regimes in Nepal in the early 1990s, and the opening up of private participation in infrastructure, private investment averaged about 17% of GDP, twice that of the previous decade, and accounted for nearly 75% of all investment in Nepal. Despite this increase, Nepal's investment climate remains fundamentally unfriendly. One telling indicator is that Nepal attracts the lowest level of foreign direct investment (FDI) among similar landlocked countries (LLCs) (Table 7.1).<sup>71</sup> Others include the perception of Nepal's private sector about the constraints they face from Government,<sup>72</sup> the low ratings of its investment climate by influential international bodies, and the deep regulatory and infrastructure constraints discussed in previous chapters.

Having a small, landlocked economy immediately puts Nepal at a disadvantage, compared to most of its competitor countries. To offset this disadvantage, it becomes particularly important that Nepal implement policies that makes its investment climate among the best in developing countries.

However, as this chapter notes, this is far from the case.<sup>73</sup> Ineffective implementation of policies, even when they are appropriate, diffusion of responsibilities and organizations, lack of clarity and unpredictability in policy implementation, restriction of foreign investment from key business support services and cottage industry, lack of bankruptcy arrangements, and inadequate consultations between and public and private sector—all contribute to creating an unfriendly business climate. Add to these factors customs, transport and logistics problems, costly and unreliable infrastructure, labor market rigidities, and security issues, and it becomes clear that the private sector in Nepal faces formidable constraints. Thus, it is not surprising that the Heritage Foundation's current index on economic liberalization ranks Nepal 119 out of 156 countries, with more than half of Sub-Saharan African countries and other small East Asian economies—Nepal's potential competitors in global markets—ranking above it. (Box 7.1).

Nepal can take a number of actions, some quickly, to improve its investment climate. Maintaining peace and restoring a minimum level of political stability are fundamental for investor confidence. Without security and some confidence about the future, investors will avoid Nepal. Beyond this, specific measures must be taken to improve customs, transport and logistics, power, and labor markets. Previous chapters have made a number of recommendations in all of these areas. This chapter focuses more specifically on the regulatory framework that governs investment entry and exit of firms, with a special emphasis on FDI and small and medium enterprises (SMEs).

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<sup>71</sup> There is good reason, though, to think that FDI statistics, especially those originating in India, are under-reported.

<sup>72</sup> A 2000 FNCCI survey and the follow-up survey of private enterprises for this study suggest that certain constraints perceived by the private sector are significant. Bureaucratic delays and red tape and administration of tax regulations were the key constraints identified by more than 40% of firms. The main problems were: power (most significant), transport (roads and trucking) infrastructure, labor markets, and lack of finance.

<sup>73</sup> See also UNCTAD, "Investment Policy Review – Nepal", Advance Draft, 2003, for a detailed discussion of constraints facing investors in Nepal.

### **Box 7.1 The Heritage Foundation Index: How To Improve Nepal's Investment Score**

The Index of Economic Freedom, published by The Heritage Foundation, uses a relatively objective and transparent scoring system to rate countries on a 1-to-5 (good-to-poor) scale, under a series of headings. While Nepal rates relatively well on critical macro indicators, such as monetary policy, where it scores a 2 for the low inflation environment produced, it rates poorly on investment-related indicators: capital flows and foreign investment (4, high barriers), property rights (4, low-level of protection), and regulation (4, bureaucratic delays, inefficiency, and pervasive corruption), contributing to an overall score of 3.5.

How can Nepal move this score closer to 1 or to even 2.5, as in such key competitor countries as Cambodia, Uganda, or Madagascar, which are able to attract much foreign investment and are increasing their world share?

Nepal can take the following steps:

- Facilitate business approval
  - Review functions of BOI, Fast Track Committee, IPB, OWC, and TPC to rationalize to a maximum of three bodies addressing investment approval, concessions/facilitation, and trade and investment promotion.
  - Implement policy of automatic business approval where license requirements are met.
  - Amend the Labor Act of 1992 and other measures that make labor markets rigid.
  - Implement bankruptcy and foreclosure laws to reduce investor risk.
- Attract Foreign Direct Investment
  - Remove accounting, consulting, marketing, and all business support services from the negative list (NL) for FDI.
  - Review other items on the list.
  - Improve infrastructure.
  - Clarify regulations.
  - Publish amended versions of the Industrial Enterprises Act and the Foreign Investment and Technology Act to fully reflect changes brought about by the Income Tax Act 2002 and any other policy changes on incentives.
  - Improve government-business relations.
  - Improve Tax and Customs Administration.
  - Establish a consultative Government-business body to gather business opinion on Government policy implementation, beginning with required changes to implementation of the tax code.

## **7.2 Legislative Framework for Investment**

The amended Industrial Enterprises Act of 1992 and the associated Foreign Investment and Technology Act of 1992 have, until recently, provided the legislative platform for both regulating and providing incentives to investment in the industrial (non-financial) sectors of Nepal. However, implementation has been poor because of the diffusion of responsibility among several institutions, including the Department of Industry within MOICS, One Window Committee (OWC), Investment Promotion Board (IPB), and, more recently, Board of Investment (BOI) and Fast Track Committees. Further, the picture has become even more unclear after important elements of these acts were overridden by the Income Tax Act of May 2002.

### 7.3 Business Approval Procedures and Lack of Government Coordination

The procedural steps for gaining approval for domestic investment are nominally straightforward if no concessions are involved. Approval for investments of fixed capital not exceeding 1 billion NRP is through the Department of Industry, which issues the required industrial licenses and registration certificates. It hosts the OWC, which has representation from the Ministry of Finance (MOF) and the Central (Rastra) Bank.

The OWC was intended to be closer to a “one-stop shop,” providing facilitation of utilities and infrastructure to the foreign industrial investor, as well as export facilitation and concessions. In practice, its role is restricted to the latter and its role is recommendatory rather than facilitative. Large investments are referred to the IPB, to which MOICS provides the secretariat function. IPB meets irregularly. Input may be required from other ministries. The BOI has also been established with a coordinating role, but it is not clear how this is either speeding up or enhancing investment decisions.

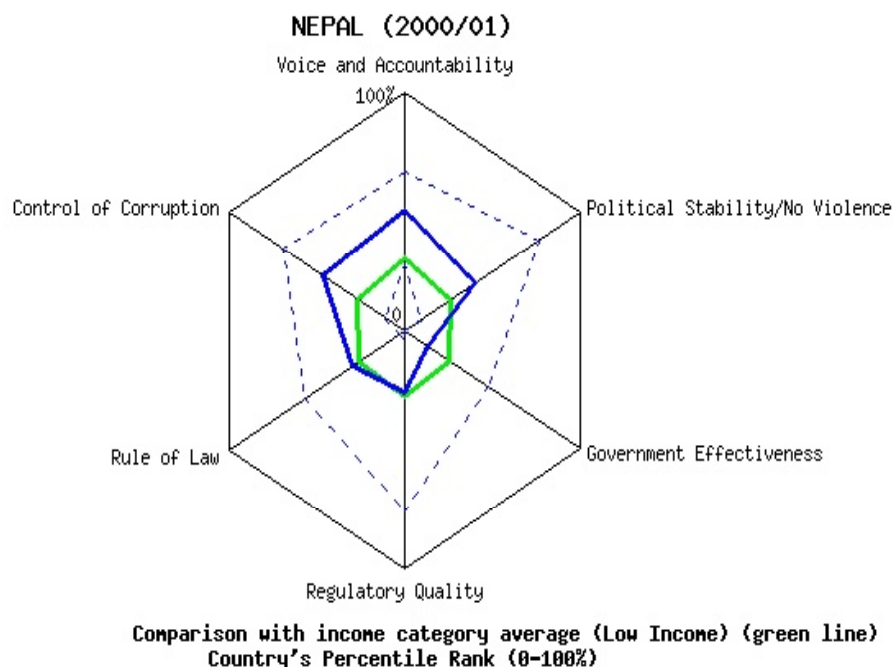
Registration of firms is not a constraint. Business people, both domestic and foreign, report that the step of registering their firms at the Department of Industry (DOI) is easy and takes less than the one-month maximum, regulated under the Industrial Enterprise Act. For foreign investments up to NRs 1 billion, the Director General of DOI has authority to approve the application. For investments greater than 1 billion, approval is given by the IPB, which is also housed in the MOICS. Implementation of these laws and procedures, however, is uneven and unpredictable.

The key issue is the lack of coordination among different line ministries and agencies, which leads to ineffective implementation and an unpredictable environment for investors. For example, frequent, but unexpected, changes in the import tariff schedule or uncertainty over Customs valuation and classification procedures has created an uncertain business environment.<sup>74</sup> The problem of ineffective implementation of regulation is well illustrated by Figure 7.1, which shows how Nepal measures against other least developed countries (LDCs), in terms of various governance indicators. Interestingly, while Nepal scores relatively well on most aspects of political governance and financial management, it does poorly in the area of government effectiveness.

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<sup>74</sup> For example, one investor recently established a dealership to sell imported electric vehicles. He contacted the MOF to verify the correct tariff heading as an electric vehicle and not a standard battery-operated vehicle, which is subject to a much higher import duty. According to the investor, the MOF confirmed the tariff heading as an electric vehicle, but declined to provide a letter of confirmation. Later, when the investor imported electric vehicles, Customs classified them as standard battery-run vehicles. The higher tariff rate made the imports prohibitively expensive, and the business ceased operations.

**Figure 7.1 Low Government Effectiveness – Implementation Constraint**



Source: D. Kaufmann and A. Kraay, 2002: Growth Without Governance  
(<http://www.worldbank.org/ubi/governance/pubs/growthgov.htm>)

Once registration is completed, the approval process can be complex and cumbersome, especially for foreign investors who are less familiar with the workings of the bureaucracy. Registering the firm at the DOI is only the first step in the investment process. A series of approvals may be required from other line ministries and agencies, depending on the sector, as follows:

- Subsequent approval to import raw materials and equipment is also required from DOI after industry registration has been issued.
- Industrial registration and licensing does not incorporate income or VAT and excise tax registration, which is done separately at the tax office. Payment of an arbitrary “advance tax” is required as part of registration. A single business number is not part of the process, which makes administration, including administration of the duty drawback scheme, more unwieldy.
- Separate “commercial production certificates” are also required from local authorities.

Best international practice has moved away from industry development boards that have multiple functions, such as regulatory, promotional, and policy implementation, to agencies that are facilitators of investment in the industry (see Chapter 8, case study on tea industry).

The Government has tried to address these poor coordination problems through the OWC and is currently considering establishing a “one-stop” service center. OWC members include DOI officials, IPB, Central Bank, MOF, Nepal Chamber of Commerce (FNCCI). The OWC was designed to speed up the investment process, particularly for foreign investors. It is also responsible for facilitating infrastructure, such as land, electricity and water connections, and coordination among the various Government

departments to solve problems of investors as they arise. The OWC is also responsible for administering the duty drawback facility for exporters. However, most firms complain that the OWC has been ineffective, and its resources are tied up in administering the duty drawback facility.

#### 7.4 Resource Mobility, Trade, Finance, and Exit Issues

Potential investors, large or small, are disadvantaged by unsatisfactory specification of property rights that deter lenders from providing capital because of an inability to access collateral when businesses fail, or they want to direct their investment elsewhere. Potential investors need to be confident that, when returns prove unsatisfactory in one sector, they are able to exit the industry at minimal cost and reallocate their capital. Existing labor laws in Nepal work against this for large firms. In general, an inadequate bankruptcy law under which bankruptcy can take as many as 5 years<sup>75</sup> to complete is a major barrier against factor mobility. Bankers explained that the current nature and interpretation of Nepal's bankruptcy law greatly limited the recourse of lenders and raised the risks of such lending unacceptably (Box 7.2). Bank officials identified a full review of Company Act and the Bankruptcy law, which the Government is now undertaking as a priority.

##### **Box 7.2 Case Study of an Enterprise in Limbo: No Exit Policy**

A joint-venture manufacturing company ceased operating due to mounting losses in 1996. After considerable effort, the company obtained permission from several Government departments to allow its plants to be closed down and lay off labor. But after that, the banks refused to foreclose the property and liquidate. Since one of the banks involved was a Government-owned bank, the officials refused to initiate the liquidation process, because, in their view, the proceeds from the liquidation could not meet the total debt due from the company. The company was forced to carry on the investments in the books. When the initial closure was planned, the company even had customers ready to acquire the assets, and the proceeds would have been enough to pay for bank principal and other creditors, and some proceeds would have accrued to the shareholders. The absence of legislative framework and procedures for failing businesses to exit led both the shareholders and bankers to lose money.

The cost or availability of trade finance is not a major barrier to trade finance in Nepal. Currently, export bill rates offered by banks vary between 7.5% and 12%. The Nepal Rastra Bank offers refinance facilities to the commercial banks for trade finance. Joint-venture banks are also active in this area. While the availability of short-term trade financing is not a constraint, there are transactions costs involved. For example, importers must first obtain a Business Credibility Requirement License from the DOI for opening letters of credit (L/C), which is the main trade finance instrument legally permitted in Nepal.<sup>76</sup> The business credibility license lists the items that the firm imports, as well as the products it exports. The L/C, in turn, is a required document for customs procedures to obtain COOs, customs duty rebates or exemptions, and compliance with foreign exchange regulations. The importer/exporter must also complete documentation from the Central Bank, as required for monitoring foreign exchange transactions.<sup>77</sup> Given the transactions costs involved, there is a need to develop alternative export

<sup>75</sup> The World Bank, "Doing Business in 2004", 2004.

<sup>76</sup> According to foreign exchange regulations, exports to countries other than India are allowed only against irrevocable L/Cs or advance payments by foreign banks. Export consignments not exceeding \$50,000 may be undertaken on the basis of a guarantee.

<sup>77</sup> Nepal has an open current account, but has controls on its capital account in the balance of payments. Payments in convertible currencies may be made without permission, subject to procedures prescribed by the Central Bank of Nepal. All exchange transactions must be settled through authorized dealers. Nonbank authorized dealers are

financing. The Government is now considering setting up an Export Import Bank and an Export Development Challenge Fund.

While trade financing does not appear to be a constraint, the banking sector, as a whole, represents a significant potential threat to Nepal's competitiveness. First, as the Government has recognized and is addressing through important reforms, poor governance and management in the Rastra Bank and the two largest commercial banks (who own around 50% of the assets) can threaten financial sector solvency. Beyond this key issue, term lending and financing for small and medium industries remain constrained. In the first case, the Nepal Industrial Development Corporation (NIDC) has been the principal source for lending for fixed investment, which accounts for 70% of its portfolio. Long-term, industrial loans account for 77 % of its total assets. While the NIDC is supported by refinancing facilities from the Rastra Bank, its balance sheet is weak and its sustainability is questionable. Similarly, despite the presence of directed lending facilities for SMEs, the share of credit going to these enterprises has been stagnant

### **7.5 Clarifying Laws, Regulations, and Bureaucratic Roles**

Another manifestation of policy ineffectiveness is the lack of clarity of regulation. Introduction of the provisions of the May 2002 Income Tax Act has led to ambiguities, at least in the minds of the investor community, which perceives apparent contradictions with either the Industrial Enterprises Act or the Foreign Investment and Technology Transfer Act, which have not yet been amended in published form to make them fully consistent with the later legislation. The industrial legislation, as originally drafted, gave expression to an industrial policy that provided fiscal concessions. Chapter 24 of the Tax Act, however, refers to the deletion of critical clauses in Section 15 of the Industrial Enterprises Act, which conferred tax concessions on industry. Any such concessions are now provided entirely through the tax code.

There is also confusion on the part of business groups over the current facilities afforded businesses, particularly businesses engaged in international trade. This confusion arises, in part, because privileges previously documented in the 1992 legislation have been removed; the overriding legislation is simply silent on these, leaving investors uncertain as to their current entitlements.

Expert opinion remains divided on the effectiveness and desirability of investment concessions as a means of attracting investment and FDI in particular. The evidence is mixed and often difficult to interpret. Those who advocate "matching the regional competition" with investment incentives often prefer not to consider the fiscal impact of prolonged tax holidays and the like. Admittedly, in Nepal's case, the threat of redundancy in these measures is low, simply because the number of investors is low.

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licensed to accept foreign currencies only for their services to foreign nationals. Exporters must repatriate all proceeds from exports within 180 days of receipt. They are permitted to retain 100% of their export earnings in a foreign exchange account with a local bank, but the foreign exchange can only be used for trade-related purposes, such as business promotion. According to sources in the financial services sector, these restrictions create a 4-5% premium in the parallel market or hundi system.

In summary, the facilities now available to investors have the following characteristics:

- Regional comparison of concessions shows that Nepal is prima-facie less generous to export-oriented industries than most of its neighbors. The amended Taxation Act has removed income tax exemption on export income, and export taxes remain in place.
- Exporters are entitled to duty drawback and VAT refunds on imported materials, but the system is moribund, as described in Chapter 8. Even with substantial progress in the Customs and trade facilitation area, which would be made possible through developments in transaction costs, there may be a case for replacing the current duty drawback system with a duty suspension system.
- Accelerated depreciation provisions (a preferable way to provide facilitation rather than tax holidays) have been narrowed by the Tax Act. Loss carry forward and R&D provisions remain.
- Replacement and repair cost allowances (capped at 5% of the written value of depreciable assets) and duty concessions, especially on transport equipment, are questionable, given the road infrastructure, as are limits on tourist promotion expenditure, which are limited to 50% of taxable income.
- The Financial Services sector is subject to higher income tax rates (30% compared to a 25% rate for other services or 20% for priority sector/infrastructure entities and manufacturing industries), which prima-facie discriminate against investment in that sector. However, this higher tax rate compensates for the absence of VAT on financial services.
- Certain service sector activities with business facilitation or export potential remain closed to foreign investment via the negative list. There is a case for removing these restrictions and discrimination.
- Taxation concessions discriminate in favor of large employer enterprises (establishments with more than 600 enjoy a tax rate set at 90% of the applicable rate) and locations outside the Terai and the Kathmandu Valley receive 25% off the applicable rate. While small enterprises are not subject to VAT, there may be a “disadvantaged middle.”

Advocates of the special industrial zone, or export-processing zone under discussion, have not put forward a detailed benefit cost analysis of the initiative. This needs to be carefully done to distinguish between relocation and attraction of new activities. Such zones typically offer tax privileges at a cost to revenue. Regarding the Malaysian experience, UNIDO (2002) reports estimates of total costs as high as 1.7% of GDP.

## **7.6 Government-Business Collaboration**

An improved investment climate in Nepal requires greater mutual trust between Government and investors. Government needs to give a reasoned response to business demands and change dubious practices, which are fomenting criticism. Fiscal concessions remain prominent in the list of demands by Nepali business interests seeking an improved investment climate. But tax holidays, investment allowances, concessional taxation of export income, dividends, and capital gains to match subregional competitors may be of limited effectiveness and come at a significant budget cost. As with further tariff reform, extensive tax concessions face revenue constraints. Neither income taxes nor VAT are set at high rates by regional standards, and, while tax-free status of export income is enjoyed in Bangladesh, it is far from universal. But businesses must have the benefit of seeing the tax regime that affects the profitability of their investment administered efficiently, equitably, and preferably non-confrontationally.



There are, however, questionable taxation practices that need addressing. The past practice of estimating current profit based on past turnover reflects both the poor accounting practices of businesses and the limited resources of the tax office. Its effects were onerous during periods of depressed economic activity, constrain even replacement investment, and increase the incidence of loan default. Options now available to businesses on self-reporting and presumptive taxation must be reviewed in light of the reporting capacity of businesses and compliance capacity of the Department of Revenue, with the aiming of easing compliance.

## 7.7 FDI's Special Role and Restrictions

### FDI Characteristics in Post-liberalization Nepal

FDI (particularly export-oriented FDI) has long been recognized as an important catalyst for trade-related growth. Despite substantial liberalization of its trade regime (a relatively small negative list of industries is closed to foreign investment and investment “facilitation” (incentives), which, until recently, nominally extended tax holiday and other concessions to foreign investors), Nepal has been relatively unsuccessful in attracting FDI.<sup>78</sup> As Table 7.1 indicates, the absolute size of FDI and FDI per capita and as a fraction of GDP is small, relative to other developing LLCs, other than the poorest African economies. It needs to be noted, though, these numbers probably underestimates investments from India.

**Table 7.1 Foreign Direct Investment in Selected LLCs**

Country	1997	1998	1999	2000	2001
Chad	15	16	15	15	80
Kyrgyzstan	83.0	109.2	44.4	-2.4	40.0
Lao PDR	86.3	45.3	51.5	33.9	23.9
Lesotho	269.1	262.5	163.4	119.1	117.9
Malawi	22.1	70.2	60.0	45.0	58.4
Mali	74.3	35.8	51.3	106.4	102.8
Mongolia	25.0	18.9	30.4	53.7	63.0
Nepal	23.1	12.0	4.4	-0.5	19.3
Niger	24.6	9.0	0.3	19.3	13.3
Paraguay	230.1	336.3	66.0	95.5	152.0
Uganda	175.0	210.0	222.1	254.4	229.2
Zambia	207.0	198.0	162.8	122.0	72.0
Zimbabwe	135.1	444.3	59.0	23.2	5.4

Source: UNCTAD.

The Industrial Perspective Plan (IPP) data shows FDI between 1987 and 2001 concentrated (in terms of *numbers* of projects) in non-export manufacturing activities and travel (hotels). When project *values* are taken into account, manufacturing is found to have attracted approximately 42% of total FDI for that period, with the textile and garment sector alone accounting for 11%. Coupled with project employment

<sup>78</sup> For a discussion on constraints to FDI in infrastructure in Nepal, see International Finance Corporation and the World Bank, “Nepal: Attracting Foreign Direct Foreign Investment to Nepal’s Infrastructure”, Foreign Investment Advisory Service, 1998.

data, FDI statistics suggest that the FDI-assisted capital per worker in approved projects is high by international standards, casting doubt on whether FDI is following channels of comparative advantage (labor intensive pursuits) in Nepal.

FDI in Nepal is free of restrictions on the share, which can be taken by foreign partners in joint venture manufacturing investments; 100% foreign ownership has been permitted since the introduction of the governing legislation in 1992. However, the level of foreign participation in joint-venture projects is quite low (on average, 26% of project fixed investment), while 100% is permitted.

### **FDI and Export Performance**

The IPP concludes that “a large number of FDI projects are based on a shaky foundation, motivated by quota hopping propelled by MFA and import deflection opportunities created by the vast tariff differential between Nepal and India (the major investor in Nepal)” (UNIDO 2002). Certainly, the weight of foreign investment in the manufacturing sector has been in broad industrial sectors, which fail the test of being both “competitive” (where Nepal is increasing its share of world exports) and “dynamic” (where the commodity itself is increasing worldwide as a share of world trade). Nevertheless, at the disaggregated individual commodity level, 35% of Nepalese manufacturing exports are goods that exhibit both features. The challenge is to attract FDI increasingly into these and similar industries.

Nepal’s hotel/resort sector has been an important recipient of FDI, accounting for 20% of total FDI during the 1987–2001 period. Associated foreign exchange earnings from the tourist sector have, until the recent security-induced slump, suggested that these investments have been both export enhancing and job generating. Data on export performance of individual FDI projects is needed for proper evaluation of the FDI-export link. There is little follow-up analysis to provide insights into the conversion of project approvals into implemented projects.

### **Restrictions on Foreign Investment: Negative Investment List**

Under the law on foreign investment, the Government publishes a “Negative Investment” List, which specifies sectors closed to foreign investors. The List is divided into two parts: Part A can only be modified by a parliamentary amendment to the law, while the sectors listed in Part B can be removed or added through a government regulation. Most of the sectors listed in Part A (such as arms, ammunition, explosives, and security printing) are included for security reasons. The cottage industry sector is also included in Part A. This sector is defined broadly in the Industrial Enterprises Act as activities that use traditional methods or materials. Several major sectors are listed as cottage industries in Annex 1 of the law. These include hand-knotted woolen mats, woolen carpets and *pashmina* (cashmere products), leather tanning, and dolls and toys. Part B lists 14 sectors closed to foreign investment, including travel agency, several tourist-related services (including trekking and smaller accommodation facilities), and consultancy services (business and engineering).

With the exception of restrictions on foreign investment in several large cottage industries (e.g., woolen carpets), tourist-related services and consultancy services, the Negative Investment List and regime does not appear overly restrictive. Most of the sectors closed are done so on public health and security grounds and not to protect domestic producers. Moreover, official minimum investment requirements (once as high as \$300,000) and equity restrictions have been abolished. There has been some interest in the reintroduction of a minimum investment level (\$20,000), but the Government does not have any such plans.

However, provided investors are asked to cover the efficient costs of processing applications for any required licenses and facilities (incentives), it is not clear why Nepal would benefit from exclusion of

small investors. Some (including certain foreign investors who set up operations before restrictions on foreign investment in negative list activities emerged), seem to favor such thresholds as a condition for weakening of the negative list to allow qualified entry of trekking businesses and engineering consulting services. It appears that better regulation of these entities in the interests of consumer safety and product quality would be a more meaningful approach. If there is concern, say, about small foreign investment enterprises in the tourist sector acting as a cover for importation of motor vehicles on concessional terms, without conducting a legitimate business enterprise, requirements on registration for tax and prepayment of income tax should help to discourage this.

There is one area in particular where clarity is needed to improve transparency in the investment process. Many sectors are defined broadly, which this creates uncertainty for investors, as they will be unsure about the status of other sectors not included in the list of industries, particularly in the case of cottage industries. An investor may ask whether a sector is not included on the cottage industry list or, if the investor intends to use modern production techniques in a sector defined as a cottage industry, whether that sector is still open to foreign investment. As currently written, this creates uncertainty and is not transparent.

However, the rationale for retaining restrictions on foreign investment in many cottage industries is not apparent, except for protecting incumbent firms from new entrants. For example, the carpet industry is a major industry and exporter. While all firms use traditional techniques for weaving carpets, many are sophisticated, modern medium-scale enterprises and not characterized in the conventional sense of a household cottage industry. The likely result has been to reduce investment and innovative activity and thus the competitiveness of industries (see Chapter 8, case study on carpet industry). Experience of other countries shows that foreign investment brings positive spillovers to the country, including technology transfer and international buyers.

#### **Box 7.3 Foreign Investment in Small-scale Activities: Lessons From Indonesia**

Success of the Indonesian furniture industry over the last 10 years is one example of the positive spillovers that can occur through small-scale foreign investment in a conventionally defined, cottage industry. Since the early 1990s, small-scale, foreign furniture makers have invested in Jepara, a district in Central Java famous for its furniture-making. Foreign companies brought with them new techniques, produced better quality furniture, and tended to be more responsive to fashion trends in the U.S., Japanese, and European markets. Through imitation and labor turnover, local firms' design capabilities improved. Foreign firms attracted more buyers to the area, which, in turn, had positive spillovers for local producers. Today, the industry exports nearly US\$1 billion of furniture around the world. Restrictions on foreign investment in management and accounting services have inhibited growth of the business development services sector in Nepal. This restriction is likely to have a larger effect on SMEs that, as a result, have limited access to professional services.

## **7.8 Investment and SME Issues**

### **An SME Policy?**

The relative importance of SMEs as employers in the Nepali economy has encouraged a strong focus by donors, researchers, and non-governmental organizations (NGOs) on their needs. Because they account

for 90% of enterprises and 95% of non-agricultural employment (Khatiwada 2001), there have been calls for a separate industry policy to cater to them. Yet, the fact that they are the overwhelmingly dominant business form suggests that sound industry policy should treat them as the norm rather than the exception. Any special or protectionist treatment for them inevitably means that the vast majority of Nepali business would have to be so protected or granted concessions. Moreover, size is hardly a sound criterion for intervention, as Nepali authors recognize (e.g., Rana 2001). There are genuine concerns that SME's face particular problems in marketing, developing entrepreneurship skills in accessing business development services, and attracting finance—all of which hold back investment in the sector. But there is a well-supported view that subsidized services to SMEs is not the appropriate long-term solution. Improvement in the market for business-to-business services is an alternative strategy to subsidized business development services. This builds on the recognition that services to SMEs are essentially private goods and are often provided by other SMEs. This is embodied in the approaches of both the GTZ and SDC to SME development in Nepal (GTZ 2000).

### **SME and Microenterprise Finance and Investment**

Priority sector (and deprived sector) lending policy of the Government commits the commercial banks to concessional lending to SMEs and others in the priority credit sector to comprise no less than 12% of their portfolios. Despite this and the proliferation of micro-finance institutions in particular (e.g., an estimated 2,000 of 6,000 registered cooperatives operate as savings and credit institutions), lending at this level has not increased as a share of total credit.

In the more remote areas, in particular, identification and development of viable business concepts may be a prior problem to that of financing investment. Elsewhere, credit accessibility, in a variety of forms, may present more of a constraint.

The Micro Enterprise Development Program (MEDEP) of the UNDP and the Participating District Development Program (PDDP) have focused on export production villages as one possible means of alleviating poverty through exports, including non-traditional export commodities. With work commissioned by the ITC and supported by UNDP and UCTAD, ongoing feasibility study work is being conducted in selected Nepali villages. The MEDEP approach has stepped away from the traditional approach to microenterprise development, which sees credit terms and availability as the focal problem. It prioritizes entrepreneurship development among low-income families and women. It is resource based and demand driven (see, e.g., UNDP 2002).

As a mechanism for developing investment in export commodities through small-scale producers located in favorable production pockets of the country, the EPV concept is in its early stages. The reports to hand on selected vegetable production, for instance, are lacking in any rigorous examination of export potential and contractual and marketing mechanisms. Nevertheless, the direction of microenterprise development need not be limited to import-replacing activities.

Views are mixed on the best way to deal with any perceived market failure in the provision of term lending for fixed capital investment in microenterprises and SMEs. The International Monetary Fund (IMF) has provided a skeptical review of the effectiveness of the microenterprise financing that currently lies behind attempts to address poverty through microenterprise development in Nepal. In its Article IV Consultation papers for September 2002, the IMF points to unrealistically and internationally low interest rates for microcredit in Nepal, and is critical of the Rastra Bank policy that underpins this. Those who compare interest rates available to small borrowers unfavorably with those available to large enterprises frequently fail to take account of the risk differences involved. Private sector commercial banks would find it difficult to match the subsidized rates that have been available through the state-owned banks.

Although some analyses continue to stress the constraining influence of credit on SME and microenterprise investment (see, e.g., SNV 2002), there are alternative accounts. The recent study report on the feasibility of export-production villages, which examined the natural fiber alloy (Thapa 2002), reported ADBN officers willing to consider financing for alloy production but lacking demand.

Microcredit still stands at less than 5% of total lending. Sustainability of many of microfinance institutions is an ongoing issue, with bailout funds from Government and donors creating a moral hazard. Start-up subsidies and interest-rate subsidies that simply cover the higher costs of operation in remote areas are suggested reforms. Appropriate regulation of the myriad microfinance institutions is a challenge, and a separate oversight body for the cooperative organizations and non-bank lenders may be appropriate.

The Rastra Bank has signaled its intention to move away from penalties on commercial banks for non-compliance with priority sector lending over the next four years. This will necessitate exploration of other measures to address small-enterprise needs.

## 7.9 Conclusions and Recommendations

A variety of measures put forward in other chapters of this report affect the investment climate and regulatory framework directly. This highlights the interconnected nature and necessary sequencing of reform requirements that affect investment in Nepal. Fundamental legislative and institutional changes are required to support a rational investment policy that is pro-trade and pro-poor. This chapter has focused on regulatory measures that affect the entry and exit of firms, with special emphasis on FDI and SMEs. Areas that require immediate Government actions and those that require further technical assistance (TA) are outlined below.

### High-priority measures (within 6 months)

- Review functions of BOI, IPB, OWC, Fast Track Committee, and TPC, with a view to rationalization to three bodies dealing with approvals, concessions, and facilitation. (MOICS/Private Sector/TA)

### Medium Term Measures (within 2 years)

- Create a maximum of three bodies with representation from MOICS, MOF/Department of Revenue to deal with investment approval, concessions, and trade/investment promotion. (MOICS, Private Sector/TA).
- Clarify and refine *cottage industry* and other broad category definitions that cause confusion among investors. (MOICS/FNCSI)
- Legislate Insolvency Bill and new Companies Bill and proceed with implementation. (MOICS)
- Review current assessment procedures of tax liabilities, including self-assessment and greater selectivity, to make compliance easier.
- Remove business support services (legal services, accounting, computer repair, management consulting, marketing services, printing, general construction) from the negative list for FDI.
- Expedite the setting up of a large tax-payer unit within the Department of Revenue that balances revenue collection and business facilitation objectives, as a possible first step in creating a Revenue Authority.
- Review existing studies and, as appropriate, conduct cost-benefit analysis on setting up a special industrial zone or EPZ, under public or private ownership.

## 8. CASE STUDIES

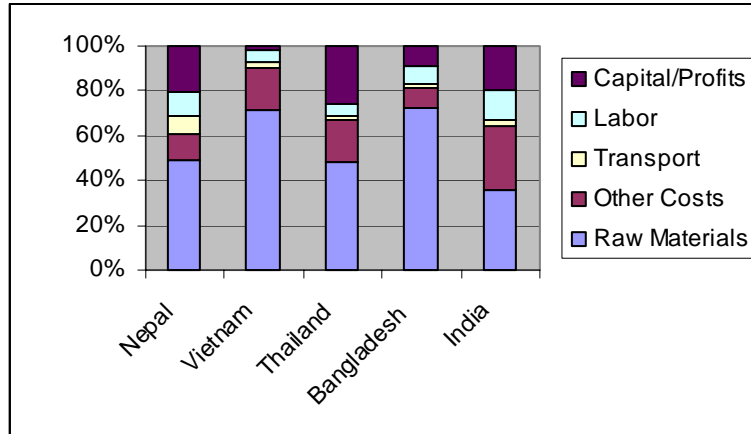
### 8.1 Overview

This section summarizes the results of case studies of selected key sectors in the Nepalese economy: carpets, garments, tea, agriculture, tourism and hydropower. All of these sectors can be characterized as having a potential for growth based on expansion of exports, which is currently not being exploited. Carpets and garments grew strongly during the 1990s, but both have seen a collapse in overseas sales in the past two years. Garments exports, however, have encouragingly rebounded and are expected to grow by 50% in 2003. International competition in these sectors is likely to intensify, but Nepal possesses a number of advantages, including relatively low labor costs, which should enable local firms to exploit available and emerging opportunities in external markets. At present, this potential is being constrained by a series of internal barriers and constraints, which raise costs, dampen productivity growth, and hamper the ability of Nepalese firms to compete in overseas markets. The main barriers, which are common across these sectors, are:

- *Inadequate marketing*, which is preventing adjustment to new market conditions and constraining the ability of Nepalese firms to exploit the advantages that they possess in penetrating new markets.
- *High transaction costs*, reflecting cumbersome, long, and expensive customs procedures and excessive red tape; these costs can be substantial in relation to the value-added in Nepal.
- *Restrictive labor regulations*, which constrain productivity growth.
- *Inadequate infrastructure*, particularly with regard to transportation.

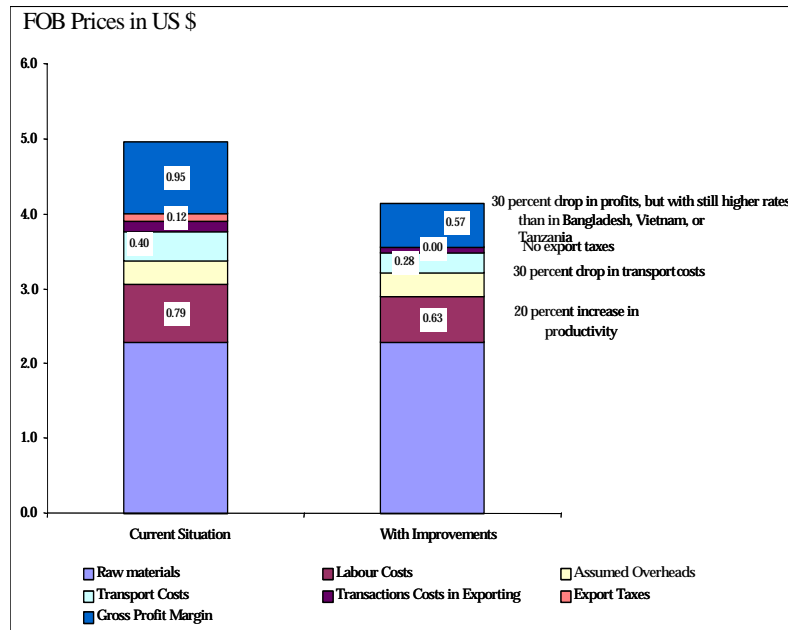
Addressing these issues will have a direct effect on costs. Below, the chapter presents an exercise to show how a plausible set of improvements can allow the important exports of carpets and men's shirts to remain competitive. Figure 8.1 illustrates the cost structure of the FOB price of men's cotton shirts for a number of countries, including Nepal. It clearly shows that transport, labor, and profits have relatively high share in Nepal. Following from this, Figure 8.2 shows how improvements in these areas can lower the FOB price for cotton shirts by about 17%. These changes involve a combination of a 20% increase in labor productivity (which still keeps labor productivity lower than in Bangladesh), more competitive profit rates (which suggest a 30% drop, but still keeps it higher than that of Bangladesh, Vietnam, or Tanzania), a 30% drop in transport costs to Kolkata, after making the Birgunj rail link active (which is expected), removal of export taxes, and 50% reduction in transactions costs. As a result, both the price of carpets and garments (men's cotton shirts) can be reduced by 17% in both cases, though only the case of garments is illustrated here. This is especially important in the case of garments, as it suggests that Nepal could remain competitive even after the MFA is phased out.

**Figure 8.1 Composition of FOB Prices of Men's Cotton Shirts**



Source: For Nepal data, see Figure 8.2; data on countries from World Bank, Research Department.

**Figure 8.2 Potential 17% Reduction in Export (FOB) Price of Men's Cotton Shirts after Improvements**



Source of Data: For men's cotton shirts, the export price and raw material costs supplied by the Nepal productivity commission. Estimates of labor costs and transportation costs are based on interviews with garment producers. Labor costs are estimated at 11% of total costs and transportation costs at about 10% of FOB value. The authors assume overheads account for about 10% of total costs.

Beyond prices, the case studies also show how investment and quality and design capabilities, which are key factors affecting the ability to compete in international markets, are being constrained by lack of FDI. The small flows of foreign investment result from both direct policy restrictions and indirect constraints from an unfavorable business environment. Foreign capital and know-how can play major roles in providing the conditions for successful exploitation of overseas market opportunities.

## **8.2 Carpet Industry: Re-Invigorating a Stagnant Industry**

### **Summary**

The hand-knotted carpet/rug industry is a major foreign exchange earner and employer of more than 50,000 workers, contributing significantly to incomes of both rural and urban households and poverty reduction. However, the industry has recently stagnated in the face of static global demand, more intense international competition from machine-made carpets, and a range of internal constraints, including relatively high transaction costs, restrictions on product variety, lack of FDI, and inadequate marketing networks and design capabilities.

### **Background**

Carpets were the dominant product in Nepal's exports in the early 1990s, accounting for almost half of total exports. Exports of carpets were highly concentrated on the German market, which accounted for about 70% of carpet exports in 1994. However, total exports declined from about US\$155 million in 1996–1997 to \$116 million in 2000–2001, reflecting a more than 50% fall in the value of exports to Germany, where total German imports of carpets fell by 40%. The share of carpet exports in total exports has also steadily declined in importance to 19% in 2000. Employment in the sector has fallen, recorded data showing a drop of almost 20% between 1991 and 1997.

It is against this background of rapidly declining exports that there is a need to review constraints, both externally and within Nepal, that are preventing the sector from exploiting opportunities for growth emanating from the advantages possessed by the sector in Nepal. These advantages are:

- Long tradition and know-how in production of hand knotted carpets,
- Large pool of skilled workers,
- Large production capabilities that allow for quick delivery of orders,
- Positive image as reliable suppliers,
- Exporters' long established business relationships with major importers, especially German, and
- Good product quality aimed at the mid to upper end of the German market.



## Priority Issues for Carpet Sector

### *External Challenges*

*Stagnant global demand for loose carpets* has affected exports from most countries. This trend in demand is not expected to change for some time.

*More intense competition from lower-priced carpets* marketed under the Indo-Nepal label. These are carpets of Nepalese design, but produced in India. This segment of the market has grown rapidly in recent years. These carpets are typically made from machine-spun yarn using synthetic fibers. Nepalese exporters believe that these carpets have undermined the image of high-quality Nepalese carpets. As discussed below, the challenge for the sector is to allow for more diversity in the types and qualities of products made in Nepal, without undermining the ability of firms to compete in the high-end market.

### *Internal Challenges*

*Government and private-sector policies.* Aspects of Government policy toward the carpet industry have been conducive to growth. Import tariffs on the major inputs, wool, silk, and dyes are zero or low. Classified as a cottage industry, carpet exporters are exempt from tax on profits.

There are, however, several Government policies designed to maintain Nepal's image as a producer of quality carpets that tend to inhibit growth of the industry compared to other carpet producers in the region, where products and qualities are more varied. These policies include:

- *Prohibition on FDI in the sector.* As a cottage industry, foreign firms are prohibited from investing in the carpet industry. Foreign investment would benefit the industry not only in terms of creating jobs, but also through transfer of new designs and attracting the attention of potential buyers;
- *Restrictions on product variety.* The industry specifies the quality of wool that can be imported. By contrast, many of Nepal's competitors, including India and Iran, permit the use of a variety of wool qualities and synthetic yarns. This policy limits product variety and therefore potential export sales. There are regulations that permit only hand spun yarn to be used. Machine-made rugs are viewed as undermining the image of Nepalese hand-knotted carpets. The use of both yarns would give more variety to the products. It should be possible to allow the production of lower-quality products without necessarily damaging the reputation of other quality Nepalese carpets through some form of certification process operated by the industry.
- *Floor price on exports.* The Government sets a floor price for exports of carpets for two purposes: 1) in the belief that a minimum price somehow maintains exports of high quality carpets and ii) to prevent carpet exporters from circumventing exchange rate controls by under-invoicing exports of carpets. This regulation is costly to exporters and appears to discourage importers in overseas markets from buying Nepalese carpets.

These policies should be reviewed as part of a strategy to introduce greater flexibility into the sector to respond to emerging patterns of demand in overseas markets. However, the issue of maintaining and expanding market share in high-quality segments of the market should not be ignored. The industry could be encouraged to introduce its own certification process, whereby producers label their rugs as using either hand-spun or machine-spun yarn. Some existing programs encourage private sector and donor

initiatives in the area of certification and overseas promotion of Nepal's image, which could be further expanded.

### **Marketing and Design Issues**

Marketing links are weak with the U.S. and the increasingly significant, large departmental stores in the German market. Concerns are that Nepalese producers are not responsive to changes in consumer fashions, designs, and colors in the major markets. The Central Carpets Association established a training center to introduce new weaving techniques to the industry, but there was little demand for the services.

## **8.3 Garments: Industry In Transition**

### **Summary**

During the 1990s, the ready-made garment (RMG) sector had been one of the leading sources of growth in manufacturing output, exports, and employment. However, exports have slumped in FY 01 and FY 02 before rebounding again this year by 50%. The external environment for garment exporters will change radically with the removal of quotas on all suppliers in the EU and the U.S. at the end of 2004, under the Agreement of Textiles and Clothing (ATC). Competition from such countries as China and India will intensify. In the U.S. market, Nepalese suppliers must now contend with the preferences granted to selected African and Caribbean countries. On the other hand, Nepal does have duty- and quota-free access to the EU, which has, to date, been little exploited.

This new trading environment will offer opportunities to efficient suppliers of garments. Nepalese garment exporters have a number of advantages, particularly low labor costs, which may enable them to exploit the available and emerging market opportunities. However, they are currently hampered by a series of cost-raising and productivity constraints, including the relatively high transaction costs of doing business in Nepal, labor regulations that constrain productivity growth, high transportation costs, and poor marketing networks. Policy interventions that help to alleviate these constraints will enable better adjustment to this new external environment and expansion of exports and output.

### **Background**

Nepal's export-oriented RMG industry grew, as a result of the MFA that governed international trade in textiles and clothing in the 1980s and early 1990s. In the mid-1980s, Indian producers, facing quota constraints on their major exports to the U.S., turned to Nepal to gain access to its unused quotas. Investment in the RMG industry grew rapidly and exports expanded. By 1994, RMG exports accounted for 30% of total merchandise exports. Over time, Nepalese entrepreneurs, many of whom started their careers working for Indian garment producers, entered the industry and, by the mid-1990s, more than 80% of producers were Nepalese-owned firms. Data on employment numbers are not systematically collected, but GAN reports that the industry employs about 50,000 workers.

However, since 2000, garment exports have fallen dramatically and quotas in the U.S. have been under-used in most categories. While many developing countries saw their apparel exports to the U.S. decline in 2002, Nepal appears to have been more affected by the slowdown in the U.S. than its neighbors. Various factors contribute to explaining poor recent performance, but a key factor is likely to have been effects from the Maoist insurgency, which disrupted production and transportation activities in some parts of the country.

The following key features of the Nepalese RMG industry may influence how the industry will respond when the MFA is phased out:

- There are few links with the rest of the economy, except with services and employment. The sector relies almost exclusively on imported fabrics and accessories. There is a textile industry, but it is small and considered high cost relative to imports. Thus, the cost and speed with which garment producers can obtain their fabrics from abroad are key elements in their ability to compete on international markets, particularly with regard to delivery times.
- Nepal's apparel exports are highly concentrated on the U.S. (90%), limited to a few product lines, and subject to high volatility. Nepalese producers have not exploited the duty- and quota-free access that is available in the EU market.
- Poor marketing is a characteristic of the sector. While many larger producers supply RMG directly to the large U.S. buyers (e.g., The Gap, Wal Mart), many other producers export through trading houses in India or operate as sub-contractors to other garment producers in Nepal and India. These producers' export orders are more volatile, compared to those producers that have direct marketing networks. They are likely to be the first to feel the effects of the end of the MFA in 2005.
- The allocation of MFA quotas does not promote growth of efficient firms. Around 88% of the quota is allocated on a "first come, first serve" basis for each shipment, and the export order must be shipped within five days after quota approval. This is designed to prevent firms from selling and buying quotas on the domestic market and to ensure that all firms, both large and small, have access to quotas whenever they have orders from overseas. However, this has also helped to perpetuate small-scale, and perhaps inefficient, producers and makes it difficult for firms to accept orders in advance. Average firm size is fewer than 250 workers, compared with an average firm size of 670 workers in Cambodian plants. Moreover, most factories in Cambodia are foreign owned, mainly by Taiwanese- and Hong King-based firms, which have extensive marketing links throughout the region and with the major U.S. and European buyers.

## **Priority Issues for RMG Sector**

### ***External Challenges***

A major issue facing garment producers and policymakers in Nepal is the effect of the removal of remaining quantitative trade restrictions on garments in major developed countries at the end of 2004. This development offers both challenges and opportunities. Competition in major overseas markets will intensify while overall demand is likely to increase as consumer prices fall. Well-placed and efficient suppliers should be able to exploit emerging opportunities. Less efficient suppliers will face greater difficulties. While producers in Nepal have a number of advantages, particularly low labor costs, they also face poor transit facilities and inadequate marketing networks, constraints on large-scale operations, and relatively high transaction costs related to excessive red tape.

China's recent accession to the WTO is likely to give rise to intense competition among other textile and garment exporters to the U.S. and European markets especially after the phaseout of the MFA, although China's access may remain restricted through the use of safeguard measures in the U.S. As a result of joining the WTO, China is scheduled to reduce tariff protection on imported intermediate inputs and

machinery. These reforms will encourage a more efficient garment sector. The World Bank estimates that Chinese apparel exports could account for 44% of global exports by 2005.<sup>79</sup>

In addition to the removal of quotas under the ATC, competitive conditions for Nepal's garment exporters are affected by discriminatory, regional-trade arrangements. In 2001, the African Growth and Opportunity Act (AGOA) and Caribbean Basin Trade Partnership Act (CBTPA) came into effect in the U.S. These two treaties grant certain producers in Sub-Saharan Africa and the Caribbean preferential access to the U.S. market. Large increases in exports experienced by Sub-Saharan countries in a year of overall slowdown point to the fact that these countries are making use of their preferential access under AGOA. It also suggests that their gains are partially at the expense of some other less developed countries (LDC) garment exporters outside the Treaty.

For a number of years, Nepal has had quota- and duty-free access to the EU market, and yet it has taken little advantage of this opportunity. Exports to the EU remain small, both in relation to total exports (less than 15% of the total) and compared to its regional neighbors and other LDCs. For example, during 1995–2001, Nepal's exports of garments and textiles to the EU increased from US\$16 to \$25 million; over the same period, exports of these products from Cambodia to the EU increased from US\$53 to \$359 million. Failure to penetrate the EU market, despite available preferences, suggests that marketing and market awareness are particularly important problems for the industry.<sup>80</sup>

### ***Internal Challenges***

In addition to more intensive competition in overseas markets as quotas are removed, rapid changes in global fashions and styles and structural changes in the U.S. and European retail markets in recent years (e.g., lower inventory levels and shortened lead times) are demanding innovative designs and speedy delivery of orders from suppliers. Successful exporters will be those that can reduce costs, meet shortened delivery times, and contribute to design efforts. How Nepalese garment exporters meet these challenges will depend on how well they build on their present strengths and, more importantly, how the obstacles that they currently face are tackled.

Nepalese producers' key advantage is the relatively low cost of labor, which compares favorably with most countries in the region. However, low wages are only part of the story. Low worker productivity will offset the advantages of low wages. The available information suggests that labor productivity in the production of garments in Nepal is about 60-70% that of Chinese workers, who are considered the most productive in the world. Information on unit prices of products exported to the U.S. also suggests a favorable position for Nepalese producers.<sup>81</sup> For example, for four categories of men's or boy's shirts exported to the U.S. in 2000, the Chinese unit value exceeded that of Nepal by 32-115%. While these differences might reflect variations in quality to some extent, they do suggest an ability of Nepalese producers to compete in the U.S. market. The unit values for Nepal's exports of these products were also lower than those of India and Sri Lanka. For two of the four categories of men's shirts, unit values were lower than those of Bangladesh, while the unit values for the other two categories were close. Only Vietnam's U.S. exports had unit values consistently below those of Nepal. Figure 8.3 presents a

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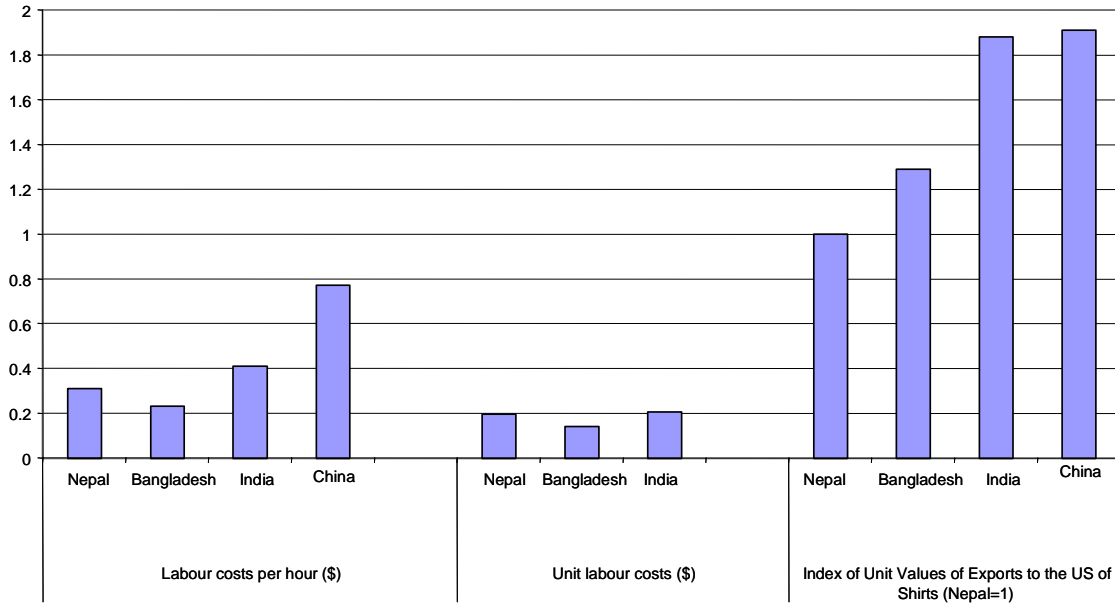
<sup>79</sup> See Ianchocichina, E. W. Martin and E. Fukase (2000), *Assessing the Implications of Merchandise Trade Liberalisation in China's Accession to WTO*, World Bank, Washington D.C.

<sup>80</sup> Duty-free access may be constrained by the rules of origin applied by the EU, which prohibit use of imported fabrics. The EU has allowed for a derogation from the strict rules, which allows Nepal to use fabrics from SAARC partners provided that 50% of value is added in Nepal. However, in practice, the cost of fabrics can exceed 50% of the value of the product; thus, this derogation may be of little value.

<sup>81</sup> Information from US Customs.

summary of the available relative cost measures, which shows the country's favorable position in ability to compete with other major garment exporters.

**Figure 8.3 Indicators of Labor Costs, Productivity, and Export Prices of Garments for Nepal, Relative to Key Competitors**



Source: World Bank estimates.

The ability to enhance and exploit, through greater export volumes, the advantages of low labor costs and competitively priced products will be determined by the ability to tackle a number of constraints in the domestic market, which currently hamper garment producers. These include:

- *Factors constraining productivity growth.* Current labor regulations and the industrial-relations environment constrain productivity improvements (see Chapter 6). In the garments sector, these regulations have led many firms to limit permanent workers to administrative positions and to hire contract workers for production positions. While this provides a measure of flexibility in overcoming many burdensome implications of the rigid labor rules pertaining to permanent workers, it affects long-term competitiveness, since employers are less likely to invest in upgrading skills of contract workers, and turnover and absenteeism rates are typically higher with contract workers. Furthermore, the labor laws and their effect on productivity deter investors, particularly foreign ones.
- *Inadequate infrastructure.* Transportation costs and delivery times for Nepalese products are higher than in neighboring countries, which increases costs. Currently, Nepalese goods can transit only through the port at Kolkata. The construction of a dry port at Birgunj, whereby goods can transit through India by rail or truck without having to be unloaded on the Indian side of the border, as is currently the case, could cut transportation costs by as much as 40%. However, as discussed in Chapter 5, operation of the dry port has been delayed by two years because of disagreement with Indian officials over management of the port and some legal issues. This issue requires immediate attention.

- *High transaction costs.* As discussed elsewhere, Nepal's slow, high-cost customs procedures, excessive red tape for importing and exporting, an inefficient duty drawback facility, and long delays in the rebate of VAT significantly raise exporter costs, which can be substantial. Estimates suggest that transaction costs in the export process for cotton shirts could amount to more than 5% of the value added in Nepal, and represent as much as 25% of the labor cost incurred in Nepal. Reducing these costs would significantly improve the ability of garment and other producers to compete in world markets.
- *Lack of quality.* Local producers in the garment sector lack innovative and design capacity. Most Nepali apparel producers have little or no R&D and design capacity and merely respond to orders that typically provide all design specifications and other information required for production. A key reason is the lack of FDI, one of the most effective ways of transferring new ideas and technology to local producers. Another reason is the absence of technology, extension, and other technical development services. The Government could contribute to the development of technical services by i) allowing the provision of consultancy services through foreign investment and ii) exploring ways to assist private-sector development of a textile research institute, which could provide testing, quality control, and design training.

#### **8.4 Tea Processing Industry: Laying the Foundations for Future Growth**

##### **Summary**

The tea processing industry, though currently small, is seen as a potential growth industry and an important channel for reducing poverty due to strong linkages to rural communities. The case study for tea also serves as an illustration of the issues facing commercial and estate farming. Large areas of Nepal are suitable for tea plantations, and global demand for niche teas, such as orthodox tea, continues to grow. The Government is addressing some of the constraints that are hindering growth of the sector through its tea sector policy. However, significant obstacles to investment and expansion remain. These are related primarily to Nepal's institutional framework, poor transport infrastructure, inadequate extension services, and lack of effective marketing.

##### **Background**

As many as 10,000 households are estimated to be directly involved in the tea sector, with total employment close to 40,000. Despite significant growth since the early 1990s, the Nepalese tea industry remains small in comparison with most tea exporting countries. The total area planted in 2001 is estimated at 12,400 hectares (ha), up from 3,500 in 1997. Total tea production doubled during the same period to 7,500 tons. Export quantities are small (less than 1,000 tons compared to more than 1.3 million tons of total world exports). The country has 136 large tea plantations, accounting for almost 70% of total planted area, with smallholders accounting for the remainder. Smallholders are concentrated in the hill areas and mainly grow orthodox tea, which accounts for about 15% of total tea production. As the Nepal industry is relatively young, the quality of tea plant is regarded as high, compared to those in India. For these reasons, various stakeholders have identified the development of the tea sector as a potential growth industry and agent for poverty reduction.

Until the early 1990s, there was extensive public ownership and mismanagement of tea plantations. The state-owned National Tea Development Corporation (NTDC) dominated the industry both as producer/processor of tea and regulator of the industry. In 1993, the Government transferred the

promotional and regulatory functions of NTDC to the National Tea and Coffee Development Board (hereafter referred to as Tea Board) and prepared NTDC for privatization. The environment for investment in the sector improved after these changes, and, as a result, the industry began to revive after 1993, with new private-sector investment.

In December 2000, the Government announced the Tea Sector Policy, to be administered by the Tea Board. The key features of the National Tea Policy are:

- *Financial Incentives*—Provisions that banks must provide loans to tea businesses as priority credit, subsidies on interest payments, income tax holidays, and duty drawback of customs duties.
- *Land Provisions*—Public land made available for tea plantation under lease for up to 50 years.
- *Institutional Issues*—Includes development of a tea auction in Nepal, Nepal's Rastra Bank to establish a Tea Development Fund to provide loans to the sector, administer Nepal label, and export promotion.
- *Manpower Development*—Establishes Tea Research and Training Center and training for smallholder growers.

## **Priority Issues for the Tea Sector**

### ***Institutional Framework and Government Policies***

While significant progress has been made in providing an institutional framework conducive to investment in the sector, substantial constraints remain. The key remaining issues are:

- *Tea Board is underfunded and understaffed. Many employees do not have adequate training* to carry out extension services. The Board only has one trained tea taster, for example.
- *Tea Board is overloaded with conflicting functions and responsibilities.* The Tea Board is a regulator, promoter, and facilitator. Given scarce financial and technical resources, the Board is unable to perform any of these functions satisfactorily.
- *Investment approval process is cumbersome and complex,* which is a major deterrent to investment. It also provides officials with wide discretion, which creates investor uncertainty.
- *Inadequate private sector participation on the Tea Board* ensures that there is little policy engagement with the private sector.
- *Extension services to smallholder growers are inadequate.* Improved extension services and development of human resources are areas where greater public, private, and donor partnership could be strengthened.
- *Land fragmentation remains an obstacle to large-scale investment in the sector.* Under the Tea Sector Policy, tea investors can request a waiver from the regulation limiting the amount of land companies can hold. However, the criteria for obtaining this waiver are unclear and opaque, and it is a lengthy process involving various agencies.

## **Infrastructure**

*Poor road infrastructure hinders growth of the industry in Nepal.* Transport is crucial, as tea leaves need to arrive at the tea processing plant within three hours of being plucked; otherwise, quality deteriorates.

Of particular importance is that many areas lack proper feeder roads and are often inaccessible during the monsoon season.

## **Marketing of Tea**

*Lack of international marketing channels for tea is a significant constraint.* Producers of orthodox tea believe there is a large niche market for their tea in Japan, Germany, and the U.S.; however, they have few contacts with buyers and lack know-how in marketing their products. Producers believe that the lack of an image for Nepal tea has partly contributed to this problem. Nepalese tea is not sold through the major international auctions, which is seen as a major obstacle to trade. Industry participants believe that acquisition of an auction floor at the Kolkata Auction Center is important to gain greater awareness of tea from Nepal, as it is the largest gathering of buyers and sellers. However, reportedly, Indian tea growers have resisted previous attempts by Nepal to gain entry into the auction. If true, this issue should become part of the Nepal-India economic dialogue.

## **Conclusions**

All these case studies show sectors where there is potential for export expansion based on Nepal's natural endowments of climatic conditions suitable for the growing of tea and a low-cost, but relatively skilled, labor force for the production of carpets and garments. However, Nepal will be better placed to exploit these advantages and face future competitive challenges in world markets if a range of barriers and constraints that raise the costs of operating in the country and that limit product diversification are tackled.

Certain constraints could be alleviated quickly by direct Government action to:

- Reduce the high costs of customs clearance;
- Reduce excessive red tape;
- Facilitate faster refund of VAT and duty drawback;
- Remove policy-related restrictions on product diversification (e.g., minimum price for export of carpets); and
- Act to resolve cross-border issues with India, which substantially raise the costs of transportation.

Other barriers will require a process of interacting with relevant stakeholders to:

- Review and remove labor regulations that constrain flexibility and dampen productivity growth;
- Identify priority transport issues for export facilitation, such as feeder roads for the tea sector;
- Redesign policies that directly and indirectly constrain FDI, which, in turn, limits design capacity and quality upgrading;
- Address the key problem of lack of marketing in the main overseas markets.



## 8.5 Agriculture

The agriculture sector is central to the livelihood of Nepalese, contributing to around 40% of the country's GDP and employing 76% of its labor force. For 90% of the poor, i.e., households in the bottom 25% of the consumption scale, agriculture is the only income-generating activity. The importance of agriculture as the single most important provider of livelihood for 90% of Nepal's population implies that the competitiveness of agriculture will have a decisive effect on poverty reduction, especially in the medium term.

Agriculture value added grew at an annual average rate of 2.8% during the 1990–2001 period, slightly exceeding the average annual population growth rate of 2.3%. Agriculture growth accelerated during the second half of the 1990s to about 3.6%, with implementation of the Agriculture Perspective Plan (APP) and increased presence of the private sector in trade, along with the withdrawal of the highly inefficient parastatals. The recent decline of agricultural growth (about 2% during 2001–2002) has been due to inclement weather and disruptions created by the Maoist insurgency.

Exports of agricultural products also showed greater dynamism in the second half of the 1990s. Indeed, the late 1990s witnessed rapid growth in agricultural exports of items such as foods and feeds at an annual average rate of 11%, compared with 7% growth in agricultural imports.

India remains the most important partner in agricultural trade, accounting for 80% of Nepal's agricultural exports and; 36% of its agricultural imports. Exports to India have been the major source of growth in agricultural exports during the second half of 1990s. Despite stronger performance of exports relative to imports in recent years, Nepal suffers from chronic deficit in its agricultural trade, with exports receipts accounting for less than half of import payments. In contrast to formal agricultural trade, informal imports from India are dominated by agricultural products (mainly food items), while Nepal exports some spices and vegetables. The extent of informal trading in agricultural produce is estimated to be much higher than that of formal trade between Nepal and India.

### Constraints and Issues

Several factors constrain the competitiveness of agricultural products. First, the productivity of Nepalese agriculture is low. Nepal's labor productivity is about half that of India, while yields of most crops are also low compared with its South Asian neighbors (e.g., some 33% less than neighboring Bangladesh). Crop agriculture is characterized by little diversification, with cereal crops accounting for more than 80% of gross cropped area.

Underdevelopment of markets and lack of commercialization are key factors underlying this weak performance. Currently, only half of Nepali households sell any agricultural produce in the market, while nearly all households in Bangladesh sell some of their produce. Such low levels of commercialization and productivity of agriculture stand in sharp contrast with the country's significant potential, arising from its inherently favorable agro-climatic conditions and regional diversity. Domestic policies affecting agriculture that restricted trade and distorted prices until a few years ago, competition from Indian producers who are supported by large subsidies, and the poor state of Nepal's infrastructure are the key factors behind the country's low labor productivity and lack of market development.

Nepal's agriculture-sector policies were liberalized relatively late in the second half of the 1990s; since then, however, there has been significant progress. Until 1997, the Nepal Food Corporation and the Agricultural Inputs Corporation dominated agricultural inputs trade and, to a lesser extent, food procurement, which adversely affected supply and utilization. Currently, their role has diminished almost

completely. All price interventions have been withdrawn, with the exception of deep-tube wells in agriculture. Nepal has greatly liberalized its external trade regime for both agricultural and non-agricultural products, with average tariffs currently falling below 12%. Long-needed reforms in land markets (e.g., elimination of dual ownership) have been implemented recently.

Agricultural credit in Nepal has experienced rapid expansion (at a rate of 7% per annum in real terms) during the 1990s, keeping abreast with rising costs of inputs due to withdrawal of subsidies, and allowing intensity of input use (fertilizer) to rise. Despite this progress, there is now concern about the sustainability of the credit delivery mechanism, which is dominated by public-sector finance institutions, such as the Agriculture Development Bank of Nepal (ADB). The poor financial state of all public- and semi-public banks catering to rural areas threatens future supply of agricultural credit. Moreover, formal credit reaches only a fortunate few (14% of agricultural households). Transformation of Nepali agriculture from subsistence to a highly productive, commercial activity will require reforms in the formal credit delivery mechanism, complemented by use of innovative instruments to ensure access by the majority of farmers, including poor ones.

India's agricultural policies are another major issue for Nepal. Although India liberalized its agricultural trade regime during the second half of the 1990s, it still applies quantitative restrictions on agricultural imports. Several price interventions and subsidies also distort producer incentives in agriculture. The Central Government provides subsidies to all major purchased inputs (fertilizer, seed, and pesticides) using a rate scale based on farm size and caste status. Irrigation water from surface schemes are heavily subsidized, along with power subsidies for irrigation pumps. State governments also supplement subsidies provided by the Center. The farm-gate prices for 24 major commodities are influenced greatly by massive procurement by State trading agencies at fixed procurement prices. The large subsidies and price support programs accorded to major agricultural produce in India provide important cost advantage to Indian farmers (accounting for some 25-50% of purchased input costs). While some of the Indian subsidies on traded inputs (e.g., fertilizer) tend to benefit Nepalese farmers located in close proximity to Indian borders, most interior input markets are not well integrated into Indian markets, limiting such spillover of benefits. On the other hand, output markets appear to be better integrated, exposing Nepalese farmers to artificially low border prices, due to heavy subsidization of Indian agriculture.

Despite heavy subsidization of inputs, the Aggregate Measure of Support (AMS) for Indian agriculture was negative during the 1990s, as it pursued a policy of balancing high AMS for a few cereal products with negative AMS for most of them. As a result, under the current WTO agreements, India is not required to make any further reduction in domestic subsidies. On the positive side, the next round of WTO negotiations will address the issue of domestic support and State Trading Enterprises (STEs), two areas in which commitments from India could have positive benefits for Nepal.

Analysis reveals that access to market and road infrastructure is a major constraint to commercialization, diversification, and technology adoption in Nepal's agriculture. In addition, Nepal has a low productive processing sector (e.g., the costs of rice milling are twice that of Uttar Pradesh, India). Similarly, product losses during transport, as well as transport margins, are extremely high. Nepal also ranks low in both rural electrification and telecommunications. Only about 9% of rural households have access to electricity, and less than 0.2% have a telephone connection.

To improve the competitiveness of Nepalese agriculture and stimulate non-farm activities in rural areas, significant investments in rural roads, electrification, and communications will be essential. Indeed, these are the areas where implementation of the APP has lagged considerably, due partly to resource constraints.

Other requirements include mechanisms to test and verify quality according to international standards, disseminating marketing information in order to link domestic producers to foreign markets, developing mechanisms to enforce sanitary and phytosanitary standards, and establishing facilities to test and handle chemical residue restrictions. Nepal will also need to develop a research and extension infrastructure to provide farmers TA on appropriate farming, harvesting, processing, and preservation techniques. An important way to gain market access and access to technical knowledge will be to attract foreign investment in these areas, which will require simplifying regulatory procedures to facilitate foreign investment.

## Opportunities and Recommendations

Despite its current low level of competitiveness, the potential for Nepalese agriculture remains high and can be realized by strategic interventions and investments. Among the many sources of comparative advantage and opportunities, three are major:

- *Large gaps in actual and potential yields for major crops.* Given its agro-ecological conditions, yields of major crops (both traditional and non-traditional) can be enhanced significantly. For example, yields of cereal crops can be doubled.
- *Untapped potential in non-traditional, high value crops and non-crop agriculture.* Nepal has strong comparative advantages across a wide range of non-traditional products, due to its agro-climatic conditions. These include forestry products<sup>82</sup> (including medicinal plants and aromatic herbs), honey, various horticulture products, livestock and fisheries products, and fiber. The under-utilization of this potential is dramatically illustrated by the forestry sector. While 40% of Nepal's land mass is under forest cover (the highest in South Asia), it contributes less than 2% to agricultural GDP (the lowest in South Asia).
- *WTO accession and emerging opportunities.* The overall domestic policy environment for agriculture in Nepal presents few distortions and anomalies, eliminating the need for drastic adjustments following its accession to the WTO. On the other hand, existing WTO commitments, as well as the commitments expected under new rounds of WTO negotiations, may lead to reducing disincentives caused by distortionary policies in neighboring countries, particularly India. From this perspective, Nepal's accession to the WTO promises better incentives and opportunities for Nepalese farmers, provided strategic investments, as discussed below, are undertaken to enhance the country's competitiveness.

In the short term, a number of steps are necessary to allow Nepalese farmers to take advantage of emerging opportunities opened up by the country's accession to the WTO. These include:

- Investment in building capacity in the relevant ministries and agencies dealing with agriculture, livestock, forestry, fisheries, and agro-processing issues. Such capacity-building will ensure that Nepal is able to conduct its trade negotiations to benefit its farmers/consumers and to identify domestic policy changes required to ensure its competitive edge in the medium and long term.
- Simplification of border-crossing procedures, which, according to both formal and informal traders, have acted as an important obstacle to international trade. This would require simplifying the

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<sup>82</sup> Nepal is endowed with rich forest resources, which supply timber, fuelwood, fodder, medicinal herbs, and aromatic plants. The country has more than 700 species of medicinal and aromatic plants, of which 250 species are endemic.

customs clearance procedure, licensing requirements, removing bottlenecks to transport, and investing in storage and laboratory facilities in border posts.

In the medium-to-long term, the benefits of globalization will depend critically on developing a competitive, well diversified, and commercialized agriculture, including crops, livestock, forestry, and fisheries. Developing a competitive agriculture that benefits rural areas including the poor, would require:

- Investments in infrastructure, including irrigation facilities, roads, electricity, and telecommunications. These are needed not only for ensuring producers access to markets, but also for reducing the intermediate cost margins instrumental in both productivity growth in agriculture and in ensuring competitive edge relative to international norms.
- Development of a viable rural financial system to finance agricultural development, including the processing and marketing sectors.
- Promote large-scale private commercial and contract farming by removing clauses from existing legislative acts (e.g. Forest Act, Lands Act and Cooperatives Act).
- Technical assistance at the farm level (research and extension for both agriculture and agro-processing sectors) and in enforcing quality standards and SPS requirements at both farm and processing stages. As international experience on agricultural commercialization and development suggests, there is a strong role for the public sector in all of these areas, particularly at initial stages of development.

## **8.6 Tourism**

### **Introduction**

Until the recent Maoist insurgency, tourism had been a mainstay, foreign exchange earner and was firmly based in the comparative advantage Nepal enjoyed through its landscape and religious and cultural attractions. Hotel bed capacity doubled in the last half of the last decade. But visitor numbers have been seriously affected since FY2000. Internal instability and environmental degradation both pose threats to this source of growth, as do inadequate transport-related infrastructure and infrastructure management, unnecessary legislative restrictions on foreign investment, inappropriate mechanisms for funding tourism promotion, and confusion over promotional and regulatory roles for Government bodies. There are opportunities with the return of stability to set tourism on a higher growth path by addressing these shortcomings.

### **Slow Growth by Regional Standards**

Between 1995 and 2000, tourist arrival numbers in Nepal grew by 28%, from 363,395 to 463,646, having peaked in 1999 at 491,504. While beneficial, this is below the growth rate of 49% for South Asia (including Afghanistan, Iran, Maldives, Pakistan, and Sri Lanka). It is also significantly lower than that of Cambodia, which has experienced growth of 60% over the same period. The foreign exchange earnings from tourism was estimated at US\$167 million in 2000, a 43% increase on the 1995 earnings. Tourism's contribution to GDP was 3.1%, and it accounted for about 13% of total foreign exchange earnings in FY2000. The estimated per-capita tourist receipt for Nepal is US\$454, reportedly the lowest in the sub-region (ADB 2002).

**Table 8.1 Estimated Earnings from Tourism in SASEC Countries**

Country	1995	1996	1997	1998	1999	2000	Growth 1995-2000 (%)
	(US\$, millions)						
Bangladesh	20	34	42	51	50	59	24
Bhutan	5	6	6	8	9	9	12.4
India	2,754	2,963	3,155	2,948	3,009	3,296	3.6
Nepal	117	161	164	153	168	167	7.4
SASEC Region	2,896	3,164	3,367	3,160	3,236	3,531	4.0
South Asia	3,643	3,914	4,151	4,300	4,600	5,100	6.9
US \$ per capita SASEC region	1,096	1,109	1,126	1,053	1,026	1,073	-

Source: Tourism Sector Working Group Report and Pre investment Survey (Draft), ADB RETA, 2002.

### **Impact of Legislative and Policy Restrictions on the Industry**

Existing provisions of Nepal's Foreign Investment and Technology Transfer Act of 1992 reserve certain component activities of tourism for domestic providers. These include travel agencies, trekking agencies, water rafting, pony trekking, and tourist lodges. Foreign investment is therefore restricted to hotel accommodations and resort operations. There is nevertheless significant foreign presence in the industry, with some investors in longstanding closed activities preceding the introduction of the negative list in FDI. But domestic operators of many of these activities are well entrenched and organized to withstand any foreign entry.

### **Travel Infrastructure Constraints**

#### ***Airline Services and RNAC Capacity***

The Asian Development Bank (ADB) reports that there are some 10 airlines connecting Nepal to Asian and European cities with a weekly seating capacity of approximately 17,000 (ADB 2002). Internally, RNAC and the seven small private airlines, which have emerged since the industry was opened up to competition, provide about 20,000 seats per week of capacity. This internal capacity and the servicing of internal demands does not appear to be a constraint.

Sustainable development of RNAC is included as an explicit objective in the Draft Tenth Plan. Its poor capacity (two Boeing 757 aircraft are its main aircrafts) and precarious financial status will remain major impediments to tourism growth when the normal security climate is restored. RNAC does not publish annual reports, but is encumbered by a significant number of bad debts and unpaid government accounts. Previous attempts to contract out the running of the airline proved unsuccessful. Privatization might seem an obvious option; however, the commercial value of the airline to a prospective buyer relates more to the value of the ownership of gate access in Japan and China, rather than to current operations. Any sale of the airline would not therefore be an automatic solution to servicing of the tourist market. A full independent review of RNAC is urgently required though the Government can also initiate steps to privatize it.

### ***Air Transport Regulation and Regulatory Charges***

The Civil Aviation Authority (CAAN) is responsible for regulating Nepal's air transport industry and looks after the enforcement of 31 bilateral air services agreements, according to the most recent CAAN annual report published for the year 2000 (CAAN 2001). An assessment of CAAN's capacity to discharge its functions is made difficult by lack of published accrual-based accounts for the Authority. Its main revenue source is the imposition of various airport landing and service charges. One possible impediment to servicing travel demand is the level of landing and parking fees at Tribhuvan International, the only gateway airport, in comparison to other airports in the region and globally. However, without an adequate set of accounts for the CAAN, it is not possible to establish how cost-reflective these charges might be. Also, the degree of cost recovery involved at the airports used in the comparison is unknown.

### ***Road Networks***

Visitors from the sub-region are the most dependent on Nepali and neighboring road networks. As with the freight transport issues addressed elsewhere in this report, efforts by Nepal to improve road infrastructure within its borders will help, but cross-border improvements are required if full advantage is to be gained from domestic investments when it comes to international road-based tourism. The possible development of the New Asian Highway linking Singapore in the southeast with Turkey in the northwest will boost sub-regional, road-based travel, with benefits to Nepal, as it provides a link route between the Subcontinent and the Silk Route to Turkey. Nepal's East West Highway makes up part of the route. At present, facilities along this route are poor, and there is need to ensure adequate rest-stop facilities, convenient refueling sites, breakdown services, and other characteristics of modern highway travel if it is to emerge as a generator of road travel growth. Improved Trans Himalayan highway links may also ultimately provide a stimulus to tourism, although, like the Asian Highway, the greater part of the benefits are likely to be in terms of freight access and related transport cost savings.

### **Improving Industry Promotion and Regulation**

*Allocation of promotional and regularity responsibilities.* Government involvement in the tourism sector occurs through the activities of two bodies: National Tourism Board (NTB) and Tourism Industry Division of the Ministry of Culture, Tourism and Civil Aviation. The Nepal Tourism Board Act (1997) and Regulation (1999) confers broad powers on the Board. In addition to a promotional and coordinating role, the Act empowers the Board to formulate infrastructure development plans and mobilize investment in the sector, extend cooperation for training, standardize services and facilities provided by operators to tourists, implement codes of conduct through various professional bodies, and request the Government to take action against entrepreneurs who breach standards. These inclusions appear to give the Board a regulatory role. In practice, however, it does not appear that it exercises any significant regulatory function, and such regulation falls instead to the Division of the Ministry.

Licensing of travel industry operators, including travel agents and tour and trekking operators, is undertaken by the Division. There have been complaints from operators of more dangerous activities, such as rafting, that no attempt has been made to regulate, in the interest of safety.

*Inadequate Funding of Tourism Promotion.* Currently, the NTB has responsibility for tourism promotion, funded from a 2% levy on the billable services provided to each of certain tourist providers above a specified size threshold. The Board's Act empowers it to collect this service fee to fund its activities. Only VAT-registered businesses are capable of being assessed for levies, in terms of their billings, through their interaction with the Department of Inland Revenue. This means that, in practice, only a subset of VAT-registered tourism businesses are funding the promotional activity of the NTB, but all stand to benefit. Therefore, a disproportionate share of national promotional funding falls on the hotel

and travel agent sector. Funding relies on tourist numbers and expenditures and is therefore badly placed to deal with the downturn of the past two years, especially in the current period when it is most needed.

*Limitations of the Current NTB Framework.* There is strong criticism of the capacity of the NTB to understand or represent the views and needs of industry constituents. The current constitution of the Board is reportedly subject to ministerial interference, contrary to the original concept of an independent Board that would have a majority private-sector representation. The three-person Nomination Recommendation Committee that effectively selects the private-sector nominees is itself appointed by the Government.

## **Recommendations**

High-priority actions to move tourism growth back onto a higher-growth path are bound up with restoration of security. However, to be ready to take advantage of increased confidence, Nepal should undertake the following actions within the next 12 months:

### Immediate Actions

- An independent review of landing fees at Tribhuvan airport to review the possibility of removing cross subsidies to domestic airports (requires TA).
- Stabilize funding for NTB with its own revenue and private sector support.
- Individual businesses should undertake their own promotion, be completely free to determine the amount spent on promotion as a commercial decision, and receive tax exemption for it, provided the expenditures are properly documented and accounted for. The industry is sufficiently competitive in all facets (with the possible exception of the international air-services sector) so that any concerns about abuse of tax privileges relating to promotional expenditure are misplaced.

### Medium- and long-term requirements (within 2 years):

- A full independent review of finances, pricing policy, and management of RNAC airline are required prior to privatization, as the latter, by itself, may not promote tourism.
- NTB representation and independence need to be enhanced. One model could be to look to a delegate system, whereby each of the major associations selects a candidate and the Government nominates Ministry representative and a member to represent the remainder. There is also a need to consider ways of making the appointment of the CEO non-political and to draw heavily on industry input in that selection. It must be able to allocate funds free from interference and then stand accountable to the Ministry for the outcomes of its promotional budgeting. The private sector's ownership of the NTB should be enhanced.
- Clear separation of powers of the NTB as promoter and the Department as regulator is required. The Department should have industry operators draw up services standards and codes of practice, which it must then enforce for any activities where licensing or registration is required. In high-risk activities, such as rafting, registration should be mandatory, and the Department should look to strengthening links with the association, whose members must be relied on to report on unsafe practices as they occur or the operation of unregistered operators.
- Visa requirements for intra-regional travel need to be simplified and standardized. Complexity and lack of uniformity in immigration control and visa requirements are an impediment, not only to tourism in Nepal, but to sub-region countries generally.

## 8.7 Hydropower<sup>83</sup>

The potential market for selling power from Nepal to India—and particularly the Northern Grid Region that lies to Nepal’s west—is large indeed. The Northern Region –Uttar Pradesh (UP), and, Delhi – faces chronic power shortages, which are likely to continue in the foreseeable future. The Indian Central Electricity Authority (CEA) has estimated a shortage of roughly 10,000 MW in the Northern Region at the end of the Tenth Five-Year Plan (2007). At the same time, Nepal has a significant hydro resource base that is far greater than its foreseeable domestic requirement, presenting an opportunity for regional trade that may bring substantial economic benefits to both nations. By 2020, Nepal’s total domestic power demand is estimated at around 1,650 MW, compared to a hydro potential of about 43,000 MW. It is evident that there is significant scope for exports without compromising likely domestic requirements.

The present level of exchange between Nepal and India is limited in capacity to 50 MW per annum, or less than 0.5 per cent of the amount India needs to satisfy peak-load requirements. Agreement was reached to extend this capacity to 150 MW, but that would satisfy less than 2 per cent of the need.

The most effective hydropower strategy for Nepal is to overcome the reputation acquired during the past two decades as a high-cost producer of hydropower. Changing the reputation will not guarantee a speedy solution to the interconnectivity problems, but it will almost certainly raise the framework for Nepal-India power transfer above the present insignificant level.

### *Constraints on the Indian Market*

However, there are significant constraints to any large-scale absorption of Nepalese exports. First, the Indian State Electricity Boards (SEBs) – the principal potential buyers -- are financially weak, in resulting problems of financing Indian IPP projects. This has led to extensive delays in implementing new generation and this problem would apply equally to any dedicated generation projects that are located in Nepal. Even in the case of surplus power sales, timely payment from insolvent SEBs is highly unlikely.

Second, as any Nepalese hydro projects will need to compete with Indian hydro projects (located in such states as Himachal Pradesh and UP) that are quite similar in hydrological and geological conditions, the cost of Nepalese hydro projects must be below those of the corresponding Indian projects so that there is enough benefit for both parties to share. Thus, even in the case of “surplus” hydro power from Nepal’s domestic projects, power has to be sold in India on a large scale to be cost effective.

Nepal’s fundamental power sector development dilemma follows from its small size compared to its Indian neighbor. In a perfect world, Nepal would be synchronized to the Indian grid. This would permit optimal development of Nepal’s hydro resources in large storage-hydro projects that can exploit significant scale economies, serving the needs of the power pool as a whole. The utilities in both countries would operate on commercial lines and in accordance with international standards of grid discipline; creditworthiness would make routine the transactions that characterize inter-utility power pool electricity transfers elsewhere in the world.

However, such a perfect scenario is at least 20 years distant. For the foreseeable future, Nepal has to deal with the high domestic cost of electricity. In addition to the institutional changes proposed above, promotion of trade through regional inter-connections would contribute towards this objective by reducing the cost of power. While we recognize the importance given by HMGN to self-sufficiency, clear economic benefits to importing cheap energy need to be considered: coal-based power from India’s

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<sup>83</sup> This section draws heavily from the report “Nepal – Proposed Power Sector Development Strategy”, World Bank, 2001.



eastern region, likely to be in surplus for some time, could be imported over the same asynchronous transmission link as would be used for export of surplus hydropower.

Recently, several positive developments recently in India may enhance the opportunities for Nepalese hydropower exports. Developments in India such as the Power Trading Corporation (PTC) and the financial restructuring of the state electricity boards with the aim of making the power sector creditworthy in India, improves the prospects for developing power pool trading arrangement into which Nepal could sell its output. There has been progress in Electricity Board reform. Orissa, Haryana and AP have all taken significant steps toward reform over the past two years, and these states may well be joined by several more in the next few years, for example, UP, Rajasthan and Karnataka. Reform is fundamental for restoring creditworthiness, without which, hydro-export IPPs in Nepal cannot be financially viable.

### **Options for Increasing Power Trade**

*Large Storage/Multi-purpose projects* are unlikely as the prospects for *commercial* absorption of this potential is at least 15 years distant, even under optimistic assumptions about the pace of power sector reform in Indian states. Moreover, private financing of such large projects will be extremely difficult.

*Incremental expansion of present arrangements:* Given the present financial condition of the two State Electricity Boards immediately adjacent to Nepal—Bihar and Uttar Pradesh State Electricity Boards (BSEB and UPSEB)—expansion of exports to these two states, beyond the presently planned 150 MW, would involve unacceptable risk to Nepal. In order to benefit from the wider Indian market, until such time as grid synchronization becomes feasible, the option of an asynchronous link into the POWERGRID's transmission network should be considered.

*Medium-Small Sized dedicated export projects:* The best prospects for increasing hydro exports over the medium term are smaller dedicated export projects in the 200-300 MW size range, whose output can be absorbed by a creditworthy buyer. Even so, such projects would still be difficult to implement— even under ideal conditions, hydro projects are more difficult to implement as IPPs than thermal projects. However, their prospects are materially better than those for mega-hydroprojects. Haryana—as noted, the first reforming State in the Northern Region and Uttar Pradesh—represents such a potential market opportunity. An “under-designed” run-of-river project (such as Upper Karnali) is likely to be more bankable than a traditionally optimized storage hydro project, not least because run-of-river projects involve minimal litigation and schedule risks consequent to environmental and R&R issues. Moreover, the worldwide experience with hydro IPPs clearly shows greater success with smaller run-of-river projects.

Recently there has been an announcement that Snowy Mountains Engineering Corporation (SMEC) signed an agreement with the Power Trading Corporation of India (PTC). Under this understanding SMEC and the PTC will jointly reach an agreement with India's state electricity boards (SECs) on the delivery price for power generated by the proposed 750 MW hydropower station in Nepal's West Seti. Final agreement that is necessary for financial closure has not yet been reached, but it is now associated with a greater probability of success than could reasonably have been assigned prior to the agreement between SMEC and the PTC of India. A statement from SMEC indicated that they were satisfied with the relationship they had with HMGN through the Department of Electricity Development (DOED) and NEA.

Caution is warranted in evaluating the estimates of potential revenue from export projects. For example some estimates in the case of West Seta are in excess of \$350 million (properly discounted at 12 percent in constant US \$). This is much less than the developer's undiscounted estimate of excess of \$1.5 billion

and has raised unrealistic expectations. Certainly, such levels of revenue would raise a number of macroeconomic issues.

However, at the more probable levels of revenue from smaller projects such as Upper Carnal – based on an internal rate of return [IRR] of 21 percent for the developer), the value to HMGN is \$53.5 million (in present value terms). With first year (2007) flow based on the GoI tariff norms (and a 15.8 percent IRR), the revenue take of HMGN is reduced to \$46 million. In 2005, NEA hydro exports would earn some \$38 million/year, while the first year revenue to HMGN from the Upper Karnali project would be \$13-15 million.

### ***Recommendations***

In order to implement this hydropower export strategy, HMGN should consider taking several immediate actions, as follows:

- The incremental expansion of exports to neighboring areas in Bihar and UP requires some urgent action to put in place the required transmission capacity. The Power Exchange Committee, established under the Power Trade Agreement, which has been assigned the task of coordinating this expansion of transmission capacity from the present 50 MW to 150 MW, needs to be made active. For this Power Trade Agreement also needs ratification.
- Facilitate direct sector negotiations on the power development and trade between two countries. This will increase the probability of the appropriate design and choice of projects.
- The Masterplan's export promotion scenario needs to be updated to reflect recent developments in India that would allow for thermal imports as well as exports.
- A detailed engineering study needs to be undertaken to quantify the costs, benefits, and optimal timing of asynchronous links and grid integration. Such a study needs to consider recent development in **intertie** technology (including the "HVDC-light" technology, which Nepal may be able to access under bilateral aid from Sweden).
- Efforts should be undertaken to identify daily peaking in the run-of-river sites in the 200-300 MW size range for potential IPP development as dedicated export projects of this size range could be marketed more easily in Indian reforming states.
- Efforts to continue with the development of larger storage hydro and multi-purpose projects should continue, but an important step should be to explore new models of public-private partnerships to address the difficulties of attracting private financing into such projects. These options are not unrelated to institutional reforms in the sector, requiring at a minimum an unbundled hydro-generation company mandated to run on commercial lines, initially government owned, but established in a form suitable for raising private capital through joint ventures and/or special purpose project companies.

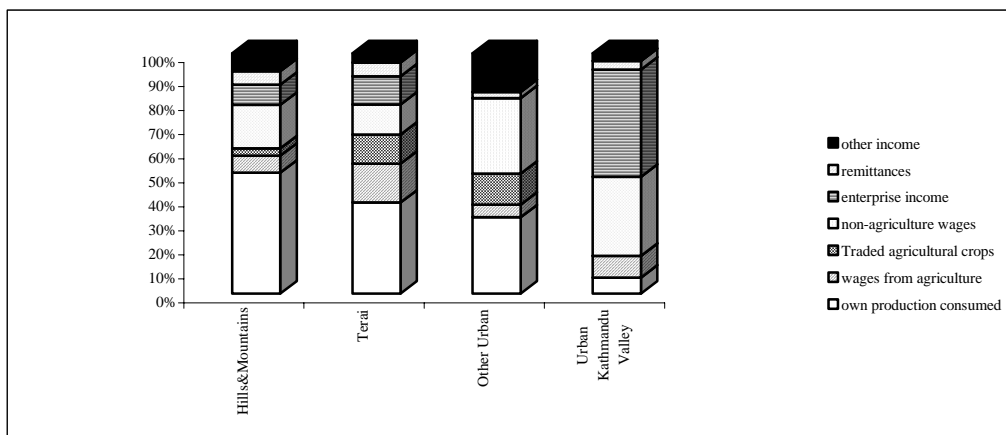
## 9. TRADE AND POVERTY IN NEPAL: RESULTS OF A SIMULATION EXERCISE

### 9.1 Overview

With a per capita income of US\$250 per year, Nepal is the twelfth poorest country in the world and the poorest in South Asia.<sup>84</sup> Poverty remains widespread, with 42% of the population living below the poverty line, despite improvements in macroeconomic conditions and infrastructure over the last two decades.<sup>85</sup> As stated in the Nepal Poverty Reduction Strategy Paper (Tenth Plan), international trade could help Nepal grow faster and reduce poverty. This chapter analyses poverty from a trade perspective and assesses whether the recommended institutional reforms and policy changes undertaken to increase trade integration would help the poor.<sup>86</sup>

In Nepal, the main sources of household income are agriculture, wages from export manufacturing (including garments and textiles), tourism and services, and remittances. However, wide variations in the relative importance of these income sources are observed at the regional and household levels. While income from own enterprises and non-agricultural wages comprise the main sources of income in the Kathmandu Valley and other urban areas, own production dominates in the Terai and Hills and Mountain regions (Figure 9.1). Wage income is an important source of income in the Terai and rural Hills while wages from non-agricultural activities are important for the poor in urban areas. Remittances are another source of household income although its source and relative importance vary substantially across regions.

**Figure 9.1 Sources of Household income for the poor, by region**



*Source: Calculations using 1995/96 NLSS. Note: "Poor" are defined as those households in the bottom three deciles of the expenditure distribution, which roughly corresponds to those living below the dollar a day poverty line in 1996.*

<sup>84</sup> These are based on nominal, per capita incomes in U.S. dollars. In purchasing power parity (PPP) terms, Nepal's per capita income makes it the thirtieth poorest country in the world.

<sup>85</sup> Nepal's poverty profile is briefly discussed in Chapter 1. More detailed discussions can be found in the Government's Draft Poverty Reduction and Strategy Paper (2003), Prennushi (1999), and Duygan and Sivri (2003).

<sup>86</sup> This short-term impact analysis of changes in trade and trade-related income-distribution policies is carried out using the 1995–1996 Nepal Living Standards Survey (NLSS) (household survey of income and expenditures). This is the most recent nationally representative survey providing information on both household income and consumption. It should be noted, however, that, since 1996, economic growth has been slowing as a result of the global recession, which affected Nepal's exports significantly, and especially because of the Maoist insurgency, which resulted in increased instability, destruction of physical assets, loss of working hours, and loss of business confidence.

## 9.2 Simulation Analyses

Simulation exercises have been carried out in this chapter to show how changes in two broad areas, linked to trade, affect poverty: i) the effects of increased growth in the formal sector (manufacturing, textiles and tourism) on employment following the removal of impediments to growth and trade such as improved customs facilities, transport and logistics, labor market rigidities and other transaction costs; and ii) improvements, specifically in transportation infrastructure, which is a major impediment to integration into the world as well as the local markets. The impact of the transportation issue is analyzed through its effects on fertilizer costs, increased yields, and creation of jobs for the poor (construction and management), as well as its impact on the incentive to switch to higher margin tradable crops such as tea and herbs in the agriculture sector, demonstrating how increased international integration can help the poor. Not surprisingly, the latter impact (switching to higher margin crops) is significantly higher. In the absence of a recent social accounting matrix, a partial equilibrium model has been used to derive these indicative results – which are biased towards underestimating the poverty effects. For instance, this model does not take into account the effects of rural-urban migration and its impact on wages in considering its income effect.

### *Methodology*

The analysis of the distributional impact of changes in structural policies including trade policy is complex despite the availability of a number of methodologies. Among these, a computable general equilibrium (CGE) model in conjunction with household survey data is generally agreed to produce useful results. Due to the lack of a recent national Social Accounting Matrix (SAM) in Nepal, this approach cannot be followed and we use the simple partial equilibrium model developed by Nicita et al. (2002) to analyze these questions.

In this framework, the household is the unit of analysis whose income can be written as the sum of following three components: own production, wage employment and net transfers. The underlying idea is that policy changes affect poverty in two ways: (i) Trade increase manufacturing output and employment on a one to one proportion (i.e. an elasticity of one). Employment in manufacturing sectors increases the wages of the newly employed relative to their old wages in the informal sector where they are coming from; also, the newly employed come to manufacturing because of certain demographic characteristics; thus, gains in urban incomes are more than in rural areas because they have these special characteristics; (ii) Transport improvements associated with the growth of trade lead to an increase in the use of high yielding inputs and increases the relative prices and production of non-traditional non-cereal crops (e.g. fruits, vegetables, spices, and tea), which in turn lead to higher incomes.<sup>87</sup>

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<sup>87</sup> In this framework, households cannot change their activities in response to a change in prices in the short-run. Consequently the effects presented are only first-order short term effects and they therefore provide the “maximum” estimate for losses and the “minimum” estimate gains from policy shifts. In reality, because households will be able to adjust their activities given changes in prices and because of multiplier effects (e.g. through increased demand for non-tradables as a result of increased incomes of workers who work in the tradables sector), the gains will be much bigger and losses smaller. Finally, to analyze the impact of growth and employment creation in the formal sector on the poor, we follow the approach developed by Nicita et al. (2002) which combines the matching methodology of Heckman et al. (1998) with the industry wage premium of the labor literature. The summary of these frameworks are presented in the methodology Annex of Duygan and Sivri (2003). The detailed methodology for this is explained in the Volume on Background Papers, Chapter 5.

### 9.3 Formal Sector Growth and Employment Creation

Substantial pro-poor employment gains can be achieved if the trend growth rate of manufacturing and textiles (around 6% annual growth) of the last five years of the 1990s is maintained over the next five years. This can lead to an increase in the average incomes over consumption of all by 5% and up to 48% for poor urban households over the next five years. This average assumes that the current urban-rural ratio does not change and that the overall effect of gains from rural-urban migration to these manufacturing jobs is not included. While households from urban areas and the Terai benefit more, rural households in other areas also benefit (Table 9.1).

The effect of achieving higher growth rates and employment levels by 2 percentage points (i.e. from a trend of 6% growth to 8% growth) over the next five years is an income increase of over 50% of consumption) for poor urban households. While household incomes in the poorest three deciles in rural areas increase by about 3% under the low growth regime of 2%, this increase jumps to 4.5%, on average, under the higher growth regime.<sup>88</sup> The effect on poor urban and poor, female-headed households is even higher (Table 9.1). The benefits of expanded employment in manufacturing and textiles are unequally distributed.

**Table 9.1 Income Effects (%) of Employment Growth in Manufacturing  
(Low- vs. High-growth Scenario)**

Region or household type	Low Growth				High Growth			
	Poor (1st-3rd deciles)	Middle (4th-7th deciles)	Non-poor (8th-10th deciles)	Overall	Poor (1st-3rd deciles)	Middle (4th-7th deciles)	Non-poor (8th-10th deciles)	Overall
Urban	47.89	4.95	5.09	19.31	52.03	7.55	6.01	21.87
Rural	3.17	2.65	0.45	2.09	4.55	3.27	1.05	2.96
Terai	7.31	4.46	3.24	5.00	9.31	5.72	5.23	6.75
Rural Hills	1.64	0.59	0.20	0.81	2.08	0.59	0.20	0.96
Urban Hills	7.47	3.86	2.42	4.58	10.33	4.75	6.66	7.25
Mountains	3.06	1.12	0.00	1.39	3.06	2.08	0.00	1.71
Eastern Nepal	2.80	2.98	1.07	2.28	4.00	2.98	1.07	2.68
Central Nepal	5.74	6.12	3.99	5.28	10.09	8.53	6.23	8.28
Western Nepal	6.10	0.70	0.33	2.38	6.68	1.17	1.35	3.07
Male-headed household	4.34	2.67	2.02	3.01	5.89	3.55	2.92	4.12
Female-headed household	0.00	3.82	1.05	1.62	3.57	4.94	1.05	3.19
Nepal	4.89	2.77	1.82	3.16	6.45	3.61	2.90	4.32

Note: The numbers presented are the average increase in income, as a percentage of total household consumption.

Source: Authors' calculations, using 1995–1996 NLSS.

<sup>88</sup> The low-growth scenario is defined based on past growth performance over the last five years. In this scenario, manufacturing and textiles growth slow or stop in 2005, when the MFA phase-out starts. High-growth scenario rates are set as a few percentage points above these low rates. This is motivated as an outcome of the improvements in the areas discussed above. Assuming that output/labor ratios remain constant over time, these growth rates translate into employment growth in these sectors. Using the simulation exercise described in Duygan and Sivri (2003), the cumulative effect of this increase in jobs in these sectors over the next five years is analyzed. Finally, the underlying assumption of the model is that labor supply is perfectly elastic. That minimum wages remained constant over the last few years, despite growth in these sectors, supports this assumption.

## 9.4 Agriculture Sector and Growth of Transportation

A major determinant of whether a household produces a marketable crop is distance to markets. The effect of growth of the transport sector, which is assumed to grow at the same rate as manufacturing, would be more households producing marketable crops, such as vegetables, fruits, herbs, and tea. Assuming, illustratively, that all households currently involved in subsistence agriculture switch to producing a marketable crop,<sup>89</sup> the results show that the gains, especially to the poor, are significant, with increases up to threefold, especially in the rural Hills and Terai (Table 9.2). Other key results are:

- Gains from switching to marketable crop production are even higher for poor, female-headed households and are significant for households living in the remote Western region—Nepal’s poorest region (Table 9.2).
- Expansion of the transportation sector has additional effects through job creation. Increased transport sector employment increases urban household income 11%, on average, as well as the incomes of the poor in other areas. Benefits are likely to accrue largely to Central and Eastern regions and to male-headed households (Table 9.3).
- There is a direct link between market access, as measured by transportation time, and fertilizer use.<sup>90</sup> A 50% reduction in travel time to markets benefits all, especially poor rural households, by increasing fertilizer use and yields (Table 9.4).

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<sup>89</sup> In Nepal, as in many LDCs, almost half of household consumption is that of goods produced by the household. The share of consumption of home production increases with distance to markets. Most marketable crops are produced near markets in the Terai and Urban Kathmandu Valley. These crops include fruits and vegetables, oilseed crops (e.g., mustard), spices (e.g., ginger), tea, and cash crops (e.g., sugarcane). Cash crops are mainly produced in the Terai and in Central and Eastern regions; spice production is more evenly distributed, except in far-Western areas; fruit and vegetable production is also spread, though it is concentrated in the rural Hills and Terai; and tea is produced mainly in the Eastern areas.

<sup>90</sup> This is done by means of a probit regression on the probability of fertilizer use. Independent variables include a distance-to-markets variable recorded in minutes, together with control variables, such as region, crop type, land size, age, and education of household head. For more detail, see Duygan and Sivri (2003).

**Table 9.2 Income Effect (%) in Households that Switch to Producing Marketable Crops**

<b>Region or household type</b>	<b>Poor (1st-3rd deciles)</b>	<b>Middle (4th-7th deciles)</b>	<b>Non-poor (8th-10th deciles)</b>	<b>Overall</b>
Urban	203.13	92.14	63.32	116.79
Rural	147.28	78.22	41.23	87.84
Terai	161.14	83.87	49.02	96.59
Rural Hills	145.58	85.62	44.57	91.29
Urban Hills	79.15	41.78	23.91	47.63
Mountains	117.03	65.47	33.23	71.26
Eastern Nepal	106.53	56.63	27.94	62.99
Central Nepal	212.74	82.98	45.53	110.68
Western Nepal	125.06	91.19	49.52	88.85
Male-headed household	136.19	69.74	41.51	81.21
Female-headed household	204.60	124.20	52.25	126.73
Nepal	148.00	79.00	43.00	89.00

Note: The numbers presented are the average increase in income as a percentage of total household consumption.

Source: Authors' calculations, using 1995–1996 NLSS.

**Table 9.3 Income Effects (%) of Growth on Employment in Transportation Sector**

Region or household type	Poor (1st-3rd deciles)	Middle (4th-7th deciles)	Non-poor (8th-10th deciles)	Overall
Urban	4.08	20.21	8.34	11.81
Rural	0.49	0.43	0.32	0.42
Terai	1.32	1.67	1.99	1.66
Rural Hills	0.00	1.04	0.08	0.44
Urban Hills	12.25	7.32	0.04	6.61
Mountains	1.03	0.00	0.00	0.31
Eastern Nepal	5.57	2.32	0.62	2.79
Central Nepal	0.00	2.72	4.22	2.35
Western Nepal	0.00	0.00	1.86	0.56
Male-headed household	0.90	1.80	3.45	2.03
Female-headed household	0.00	0.00	0.00	0.00
Nepal	0.71	1.52	2.76	1.65

Note: The numbers presented are the average increase in income as a percentage of total household consumption.

Source: Authors' calculations, using 1995–1996 NLSS.

**Table 9.4 Effect of 50% Reduction in Transportation Time on Agricultural Income  
(% Household Consumption, Through Increased Fertilizer Use and Yields)**

Region	Decile										Avg.
	1	2	3	4	5	6	7	8	9	10	
Terai	0.03	0.02	0.02	0.01	0.01	0.01	0.01	0.01	0.04	0.01	0.02
Rural Hills	0.70	0.31	0.45	0.33	0.41	0.29	0.47	0.42	0.26	0.16	0.38
Urban Hills	0.01	<b>0.01</b>	0.00	0.00	0.00	0.00	-0.01	0.00	0.00	0.00	0.00
Mountain	0.64	0.55	0.39	0.72	0.80	0.89	0.52	0.63	0.41	0.57	0.61
Nepal	0.47	0.25	0.24	0.28	0.25	0.31	0.24	0.28	0.21	0.14	0.27

Note: The numbers presented are the average increase in income as a percentage of total household consumption.

Source: Authors' calculations, using 1995–1996 NLSS.

It should be noted that these results show only the direct, first-order effects of trade-related activities. They do not reflect changes in household behavior, with respect to a relative price changes. Consequently, the effects presented provide an upper bound for the losses and lower bound for the gains



from policy shifts. In reality, households can adjust their activities to price changes, and multiplier effects will occur (e.g., through increased demand for non-tradables, as a result of increased incomes of those who work in the tradables sector, through remittances). As a result, the gains will be much larger and losses smaller.

## 9.5 Conclusions

The above simulations have shown the following:

- Growth in manufacturing and export sectors, such as textiles, can have potentially significant, positive effects on the urban poor.
- The major impact of trade on the poor can come from switching to high value cash crops from subsistence agriculture. A key constraint to that is inadequate transportation infrastructure. Growth of transport can lead to welfare effects for the poor through enabling farmers to switch to commercial crops and use more fertilizers. Transportation also has direct welcome effects through creation of employment and income-generating opportunities<sup>91</sup>.
- To achieve agricultural growth and help the rural poor, transition from traditional subsistence agriculture toward higher-margin, tradable crops (such as spices, tea, and vegetables) can be promoted by increasing access to year-round irrigation, inputs, technology, and, most importantly, markets.

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<sup>91</sup> Public work programs might be beneficial in this regard.

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