Economic Liberalization in Nepal

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1 Background

Nepal is a tiny south Asian country situated on the Southern slopes of the Himalayas. Nepal's total area is 147,181 square kilometers, of which two thirds is hills and mountains. Nepal is one of the least developed countries in the world. The Nepalese economy is primarily an agrarian one. The agriculture sector provides a livelihood to about 90 per cent of the total population and accounts for over half of the Gross Domestic Product (GDP). Due to the topography, only 18 per cent of total land area is brought under cultivation. Agriculture is traditional and it largely depends upon the monsoon. Although Nepal abounds in water, less than one-fifth of cultivable land is irrigated. Due to the rapid growth in population[2], marginal lands and forests are being

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1) I am extremely indebted to Professor Horst Zimmermann for his insightful comments, to Dr. David S. Weiss for his editorial help, to the Alexander von Humboldt-stiftung for their financial support, and to the Philipps University for their institutional facilities.

2) The total population of Nepal was 18.49 million in 1991. It grew with an annual rate of 2.66 per cent from 1972 to 1981 and 2.1 per cent between 1982 and 1991.

converted to cultivated land, resulting in the loss of valuable forest land and low productivity per acre. The country, which exported food until the 1970s, has been facing food shortages since the early 1980s.

Enormous problems exist in the industrial sector as well, and the industrial base is quite limited. In 1989-90, the total number of manufacturing establishments employing ten or more persons was only 2,382 which provided employment to 135,677 persons, less than two per cent of the economically active population. The industrial sector contributes less than 7 per cent of GDP.

Several factors are responsible for the low level of industrialization. Nepal remained virtually unknown to the outside world for many centuries due to the isolationist policies of various rulers. Isolationism was adopted from the very begining of the creation of united Nepal. For example, His late Majesty King Prithvi Narayan Shah the Great, who about two and a half centuries ago united several principalities into a great Nepal, adopted a policy of not allowing foreign industrialists and businessmen to participate in the country's business. The Rana family which seized power in 1846 and established an autocratic hereditary Prime Minister that lasted 104 years, also made every effort to keep the country closed to foreigners. Due to such policies Nepal, inter alia, failed to join the industrial revolution taking place around the world, including in the neighbouring country India.

Although the country has been open to the foreigners since the introduction of a multi-party democratic system in 1951, no significant changes had taken place in the economy in general and industrial sector in particular. This was due mainly to political instability. The first parliamentary election was held only in 1958. The Nepali Congress, a democratic party, secured an absolute majority and formed a democratic Government. While the elected Government launched several measures to develop the economy and to establish democratic socialism, the Govenment was dimissed in 1961 when the multiparty political system was killed. The Panchayat, a partyless political system, was adopted instead, and continued until April 1990.

The partyless system was less open not only politically but economically as well. Under this system, state intervention was considered crucial for economic development. The role of Govenmemnt was enhanced through the creation of several Public Enterprises (PEs) through which the Govenment become involved — in addition to the provision of public services such as drinking water, education, and health — in the production of bricks, cement, cigarettes, paper, tea, and in other trading activities which of course could have been more satisfactorily undertaken by the private sector. By doing so, the Government not only competed with the private sector, but some PEs achieved almost a monopoly status. The performance of the most of these PEs, however, was not and is not satisfactory; some of them have been running at a loss while others have been earning only a nominal profit. Instead of becoming an instrument for industrial development, they have become burden on Government. The main reasons that PEs have been so unsuccessful are excessive Government control, mismanagement, lack of professionalism, and overstaffing.

In addition to the above mentioned reasons, there are other factors responsible for Nepal's low level of industrialization. In addition to being mountanous, Nepal is landlocked[3] as well, making it costly to import

3) Nepal lies between China and India. The former lies to the north of

into and export from Nepal. Sometimes the free flow of goods through India[4] is hindered. "As evident from the past, trade and transit arrangements with India affect the health of the Nepalese economy in general and industries in particular. Since the agreement is made for a specified period of roughly five years, entrepreneurs for large-scale investment always feel uncertain about a continuation of similar policitical environment in the future and hence the persistence of Government commitment".[5] Further reasons for a low level of industrialization in Nepal are a lack of infrastructure, a narrow domestic market, a shortage of skilled manpower and Government's policies that have been restrictive and unstable, and were sources of corruption and uncertainty.

Government policies were changed slightly during the 1980s. A new industrial policy was announced in 1982. The policy invited an active role of the private sector in the development of the industrial sector. Several facilities have been granted to attract private investment. Similarly, some attempts were made to attract foreign investment, including adoption of a foreign investment and technology act in 1982. Moreover, foreign banks were allowed to operate in joint ventures and some autonomy was granted to the commercial banks to fix the

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Nepal while the latter lies in all other directions.

4) Nepal has had to depend on India for transit routes. Bilateral trade between these two countries has been conducted under the special trade and transit treaty completed in 1950, as modified from time to time. The special trade relation, however, was sometimes severed. For example, trade over surface routes with India was restricted to only two border points between 23 March, 1989 to June 1990, causing great inconvenience to the Nepalese industrialists, businessmen and others.

5) Bishwambher Pyakuryal, "Foreign Investment in Industry", The Rising Nepal, January 24, 1993.

interest rate within a prescribed limit. Three joint venture banks[6] were opened in the country, which has created a competitive environment in the banking sector. Consequently, banking services have gradually been expanding and improving.

Overall success in attracting both domestic and foreigh investment, however, was limited. The thrust of the new policy was not reflected in the working style and mentality of bureaucrats. Investors had to go through a large bureaucratic network to establish and operate their industries. The process of obtaining industrial facilities was not automatic. Request for such facilities including tax exemptions had to be made to the Department of Industry or the Department of Village and Cottage Industries. These departments, in turn, had to make recommendations for tax exemptions to the Tax Deparment. This department further used to obtain the views of the tax office in whose jurisdiction the industry concerned was located. The tax offices had to fill in a form that contained 18 different items, including the estimated amount of annual tax to be exempted and whether the industry is eligible for exemption under the Industrial Enterprise Act. It must be noted that tax offices were not capable of estimating the amount of annual tax to be exempted in a meaningful way and the decision regarding whether an industry is eligible for exemption under the existing law could have been made directly by the department itself. It was a herculean task for a geneuine industrialist who did not want to be involved in under the table payments or did not or could not use political or other underground power to obtain tax incentives. It was

6) They are : Nepal Arab Bank Pvt. Ltd. (1984), Nepal Indosuez Bank Pvt. Ltd. (1986), and Grindlays Bank Pvt. Ltd. (1987).

quite possible that industries established mainly to take advantage of tax incentives were more successful in obtaining these facilities than genuine industries.

Nepal's trade sector was highly distorted as well. Import trade was subject to different regimes, such as administrative bans, quantitative restrictions, auction, and an open general license system. Under this complex system, import of some items was banned while that of others was subject to quantitative restrictions. Commercial import was run under the license auctioning system while the import of industrial materials was brought under a more liberal regime known as the open general license system. A highly differential import tariff was used to achieve several conflicting objectives, including protection and revenue. A high wall of protection was created to develop infant domestic industries. However, mainly screwdriver type industries appeared behind the protective wall.

Foreign exchange was controlled. Foreign exchange rates were determined by the Nepal Rastra Bank, the central bank; these rates were artificially fixed at a high level as revealed by the difference between these rates and the black market rates. A recent study has estimated that the Nepalese Rupee was over valued in terms of the US Dollar by about 30 per cent between 1986/87 and 1988/89.[7] Under this situation, the earners of foreign exchange had to sell foreign earnings at low prices. This policy encouraged the black marketing of the foreign exchange and the retention of foreign currencies abroad.

Industrial and trade policies, in the main, failed to direct trade and

7) Maxwell Stamp PLC, Second Industrial Sector Study, Nepal, Final Report, April 1991, p. 45.

industry in the right direction. Rather, they encouraged rent-seeking activities. Some persons were involved in quick-yielding activities such as diversion to India of industrial materials imported under concessionary tax rates. Others were involved in trade-like activities such as establishment of assembling, blending or packaging type industries which generate very little employment and value added. Such business would disappear or change names, ownership or place of business after the expiration of the tax holiday period. These activities caused only loss in revenue and scarce foreign currencies.

2 Move Towards Economic Liberalization

The policy emphasis has changed since the restoration of a multiparty democratic system in April 1990.[8] The newly elected Government seems to be dedicated to creating an open and liberal economic environment in which industry and trade can flourish. The Government has already announced several liberal policies, particularly in the fields of industry and trade. The major thrust of these policies is to create a more open, competitive and liberal economic environment in which the private sector can play the leading role. This section deals with these recent endeavours towards liberalization.

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8) An interim Government was formed, inter alia, to formulate a constitution and conduct a general election. The new constitution was promulgated on November 9, 1990: it institutionalizes the multi-party democracy and constitutional monarchy and recognizes the supremacy of people and guarantees their fundamental human rights. The parliamentary general election was held on May 12, 1991. The Nepali Congress got a majority and formed a new Govenment on May 12, 1991. The local level election was conducted in the spring 1992.

2. 1 Industrial Policy

Industrial development is necessary to provide employment for a rapidly increasing population, to increase production, to enhance export and ultimately to boost overall economic development of the nation. To this end, a new industrial policy was announced in 1992. This policy intends to create a favourable investment climate. It assures that no industry will be nationalized and that industries will be allowed to operate freely with a minimal level of government intervention. Licensing requirements for the start of most industries have been relaxed. Registration procedures have been made simple and time bound. The policy also has made provision for the grant of all industrial facilities through one unit in a simple and easy way.

The new policy, however, is not much different from the old one and it has inherited some of the limitations of its predecessor. For example, the scope of tax incentives has been rather stretched which does not fit well with the philosophy of the market-oriented economy. If the objective was to maintain a more friendly attitude towards the private sector and to stimulate industrial development through tax incentives, it would have been better to fix some criteria on the basis of such factors as value added, use of local materials, employment generation, ratio of export to total sales etc. for the grant of tax incentives. Although such a system would have been more complicated, it would have minimised the misuse of tax incentives and stimulated genuine industrial development. Further, experience shows that formulation of policy is not alone adequate ; its proper implementation is important in order to achieve the intended objective. It is necessary to develop a monitoring system in order to check the misuse of tax incentives on one hand, and on the other, to make the working procedures more simple and transparent in line with the new liberal policy so that bureaucratic hassles, red-tape, and commissions will be reduced and confidence between private investors and Government will be improved. Now is the time to change the mentality and working style of the Government officials. It is said that "the biggest single taxation incentive to a business firm is probably good, fair, reliable tax administration, and swift settlement of disputes in the courts".[9]

2. 2 Foreign Investment Policy

The new Government has been actively involved in attracting foreign capital. To this end, the Government announced a new Foreign Investment and One Window Policy 1992. Like the industrial policy, this policy assures that no industry will be nationalized. It allows up to 100 per cent foreign investments in most medium and large scale industies. Permission will be given for the transfer of technology even in the case of cottage and small scale industries.[10] Similarly, several other positive provisions have been made in the field of visa[11] and

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9) Carl S. Shoup, "Integrating Tax Policy, Industrial Policy, and Trade Policy in Jamaica" in Roy Bahl (ed.), The Jamaican Tax Reform, Lincoln Institute of Land Policy, Cambridge, 1991, p. 694.

10) A few industries that mobilize specific skill or local raw material or resources are specified as traditional cottage industries. Industries other than traditional cottage industries with a fixed capital investment not exceeding Rs. 10 million are grouped as small industries and industries with fixed capital investment of between Rs. 10 million and Rs. 50 million and above Rs. 50 million are classified as medium and large industries, respectively.

11) A non-tourist visa will be issued to a foreign investor who wants to come to Nepal for the purpose of study and research in connection with investment in Nepal, a non-tourist visa will be granted to a foreign investor, his sole representative and his dependents for the whole period

foreign exchange.[12] Further, facilities granted under the industrial policy will be granted to foreign investors as well. Only a 15 per cent income tax will be levied on interest earned on foreign loans and royalties, technological and management fees.

A one window policy has been declared to channel, inter alia, industrial facilities through one unit. While this concept is not new in Nepal, it is likely to be implemented for the first time. Under this system, all facilities including the permission and registration of industry, acquisition of land, provision of water, electricity, import of industrial machinery and material, and tax facilities will be provided in a simple and easy way through one window. This unit has been set up in the Department of Industry in coordination with all concerned units of the Government. This should bring administrative efficiency since the investors do not have to run from one organization to another to get their things done.

Several other attempts have been made to attract foreign investment. Different investment promotion delegations of Nepalese industrialists, traders and Government officials were sent abroad in September and October, 1992, in order to furnish information about the industrial facilities, concessions, and foreign investment prospects in Nepal and about the Nepal Investment Forum Meeting, which is

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of investment, and a permanent residential visa will be granted to a foreign investor and his dependents who invests at one time more than US Dollar one million foreign currency.

12) A foreign investor will be allowed to take foreign exchange outside Nepal equivalent of (a) part or all of foreign investment received from the sale of share, (b) profit or dividend on foreign investment, (c) payment on account of principal and interest of foreign loans, and (d) amount received under the contract of technology transfer.

discussed below. One delegation headed by the Minister of State for Industry and Labour visited France, Germany, Italy, and the United Kingdom. Another team led by one of the members of the National Planning Commission visited Bombay, Calcutta, and New Delhi in India. The third group headed by the Industry Secretary visited Hong Kong, Malaysia, Singapore and Thailand. These delegations attended several seminars organised by the chambers of commerce and industry, held discussions with several members of the commercial or industrial sectors of the respective countries, and furnished information about the prospects for industrial investment in Nepal.

A Nepal Investment Forum Meeting was jointly organized by His Majesty's Government of Nepal, United Nations Development Programme, and United Nations Industrial Development Organisation and held from November 30 to December 4, 1992, in Kathmandu. The meeting was attended by 345 industrialists and investors from 21 countries and by 225 industrialists from Nepal. The meeting was meant to discuss the potential for joint venture industries in Nepal. Several proposals were presented by the Nepalese side. Moreover, a description of several feasible projects was published in the national daily newspaper, The Rising Nepal, on November 30, 1992. Thus information regarding the investment opportunities was provided to foreign investors and foreign and domestic industrialists could talk face to face. More than 100 joint ventures totaling about 640 million US Dollar were approved in such different areas as mulberry paper, ready-made garments, lead acid batteries, electronics, motors, tractors, mushrooms, mineral water, sugar, tents, tarpentine, bags, suitcases, luggage items, solar energy, steel, soyabeans, knitwear, hydroelectricity projects, hotels, and cultivation and processing of tea. Foreign investment is invited both in joint ventures and industries solely owned by foreign investors.

Foreign investment in the form of joint ventures is particularly fruitful since it promotes the transfer of technology and helps retain some investment income inside the country. Further, it is necessary to attract investment in those sectors which have comparative advantages so that quality goods can be produced at lower costs, thereby benefiting domestic consumers and promoting exports. As unilateral tax relief alone is not effective in attracting foreign investment, it is necessary to negotiate with major trading partners to arrange treaties that will prevent international double taxation.

2. 3 Privatization

Under the new liberal policy regime, the Government intends to act as a promoter of the private sector : the Government will neither intervene nor compete with the private sector. The Government has adopted a policy to transfer PEs gradually to the private sectors and to invite private investment in any sector including air service, banking and water resources. To this end a Privatzation Unit has been created, inter alia, to develop criteria for the transfer of PEs to the private sector. The Finance Minister himself is in charge of this cell. In October and November, 1992, three PEs[13)] were transferred to the private sector while the management of the five Tea Gardens[14)] was handed over to the private sector on a contract basis. In addition, four

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13) They are : Bansbari Leather and Shoe Factory, Bhrikuti Paper Factory, and Harisiddhi Brick and Tile Factory.

14) They are : Barne, Ilam, Kanyam, Soktim and Tokla Tea Gardens.

private air line companies[15] were established in 1992. It must be noted that only a state-owned airline, the Royal Nepal Airline, was operating domestic flights until 1991. Protected by its monopoly and the limited supply of air services, the staff of this airline had become involved in illegal practices regarding ticket sales. Establishment of private airline companies has definitely created a competitive atmosphere in the area of domestic flights and has helped the economy as well as the people, particularly in regions where air transport is the only means of modern transportation.

In the banking sector, a joint venture bank was established in 1992. The operation of this bank should bring competition and improve services. It is also expected to help generate additional resources and accelerate the pace of economic development. Nepal's vast water resouces have provided this country enormous hydro-power potential; second only to Brazil. The difficulties in exploiting water resouces are, however, considerable, so a liberal attitude is required for development of this resource. The new open policy is expected to attract joint venture industries, which will have far reaching effects in the Nepalese economy.

While it is now a common phenomenon in the democratic world to privatize PEs, it is necessary to keep a close watch on the activities of the private sector so that it will not run against the interest of the consumers. It is not uncommon, particularly in a country where social obligations are poorly met by people of different spheres, to run private enterprises only for the interest of a few entreprenuers. Due to the

15) They are: Everest Air, Himalayan Helicopters, Necon Air, and Nepal Airways.

control of a few big houses over the Nepalese economy, there is a lack of competition, so a cartel system, if not a monopoly, may develop. Moreover, the private sector might run its business haphazardly. It has been said that private air lines have been charging fares on the basis of passengers' body weight.[16] Similar undesirable activities might appear in the other sectors. Thus, the Government has to be very cautious. It has to create an environment that promotes competition and acts against anti-competitive activities so that consumers will not be exploited. It is necessary to develop anit-monopoly and anti-cartel laws. The Government also has to develop a system that prevents the private sector from causing environmental problems.

2.4 Trade Policy

Considering Nepal's limited domestic market, export attracts special attention as it opens a vast foreign market. Experience elsewhere, such as in the South East Asian Countries, indicates that export-oriented economies can achieve very high rates of growth. In view of this the Government has announced the Trade Policy 1992 which emphasizes a outward-oriented growth strategy. Under this policy, several incentives have been granted to exports. These incentives are also granted to sales in foreign currencies within Nepal. Further, a drastic change has been introduced in the field of foreign exchange by abolishing the restrictions on the exchange of Nepalese and foreign currencies. Initially, the Nepalsese currency was made partially convertible. To this end, on March 4, 1992, it was decided that 65 per cent of the foreign exchange earnings could be converted at the market exchange rate and

16) Editorial, The Rising Nepal, February 8, 1993.

35 per cent at the official exchange rate. These percentages were fixed at 75 and 25 per cent, respectively, on July 10, 1992. Finally, the Nepalese currency has been made fully convertible as of February 12 1993.

An export retention scheme has been introduced in order to discourage black-marketing of the foreign currencies and encourage exporters to bring foreign couriencies in the country. Under this system, the amount of foreign currency that exporters are allowed to maintain in a commercial bank account is 30 per cent of the amount of foreign currency they may convert at the market exchange rate. This can be used to pay for imported raw materials and machinery, loans, commissions and royalties. Five per cent of this can also be used in market promotion and travel. In the course of liberalization, this per cent will gradually be increased to 100 per cent. Recently, earners of foreign exchange were allowed to open call, current, fixed, and saving accounts in British pounds sterling, German marks, Japanese yen, Swiss francs or US dollars at any commercial bank on presentation of documents showing the source of foreign exchange.[17]

Import trade has been liberalized as well. Several restrictions on import have been relaxed. Import tariffs have been lowered and administrative procedures relating to both export and import have been simplified.

2. 5 Other Measures

Similarly, reforms have been introduced in some other areas. These measures, like industry and trade policies, are intended to create a

17) The Rising Nepal, April 26, 1993.

more open and competitive environment, and to develop infrastructure to ensure development of the private sector. For example, the Government has adopted a policy to develop and manage tourism in a systematic way by creating adequate infrastructure at various tourism places. Because of the presence of the Himalayas, cascading waterfalls, an interesting cultural heritage, important holy places, and a sincere and an hospitable people, tourism has been a flourishing industry that is of considerable importance to the Nepalese economy. To promote tourism, several mountain peaks have been opened to tourists recently. Other new areas will be declared as tourism areas. Cultural and religious tourism will be developed. In view of the deteriotating environment in the Himalayas, royalties for climbing the mountains have been raised and it is now mandatory to pay a deposit which is refunded after the expedition team fulfills the prescribed formalities regarding the management of garbage.

Now the Government is implementing the Eighth Five Year Plan (July 16 1992-July 15, 1997). Like other policy measures, the major thrust of this plan is to move towards an open and liberal economy. The plan aims at reducing poverty, achieving a higher rate of sustainable growth and fostering regional balanced development. To this end, it emphasises rural development. Some broad targets of the plan are : a 5.1 per cent annual growth rate of GDP with 3.7 per cent for the agriculture sector and 6.1 per cent for the non-agriculture sector, a 10.3 per cent annual growth rate of Government revenue and a total capital investment outlay of Rs. 170 billions. The Government also has recently announced a three year economic policy action plan "for perpetuating and consolidating the structural and policy reforms already initiated in various sectors of the national economy as well as for striking a comprehensive economic balance."[18]

3 Concluding Remarks

Nepal is one of the least developed countries in the world. Per capita income was only US dollar 170 in 1990. The Nepalese economy is primarily agrarian. The agriculture sector provides a livelihood to about 90 per cent of the total population and accounts for over half of the GDP. The Nepalsese economy lacks a sound industrial base and the industrial sector contributes less than 7 per cent of GDP. The situation is bleak in other sectors as well, even after more than three decades of planned development. Despite the completion of seven periodic plans and the introduction of a series of development oriented programs in the past, economic growth has been sluggish at best.

The strategy for economic development has been changed since the restoration of democracy in April 1990. The new Government is moving towards a more market-oriented economy. It has already announced several liberal and transparent policies, which seek to move towards a more open and competitive economy by creating a liberal environment in which trade and industry can flourish. While the outcomes of these policies are yet to come, there is ground to believe that the new policy environment will have a positive impact on the economy. Liberal and open policies are likely to create a congenial environment for private sector invesment while at the same time discouraging illegal and anti-social activities such as corruption. The one window system should create a favourable atmosphere for industrial development and

18) The Rising Nepal, October 29, 1992.

measures relating to foreign currencies should promote exports.

There is, however, a long way to go and the Government still faces formidable challenges. Due to past expericence, the private sector does not have much confidence in Govenment administration. This lack of confidence still stands as an impediment to economic growth. It is, therefore, necessary to bring substantial improvements in the Government administration. The mentality and working style of the Government officials has to be changed. Working procedures need to be made more simple and transparent so that bureaucratic hassles, red-tape, and commissions will be reduced and confidence between private and public sectors will be improved. It is necessary to create adequate economic infrastructure and a more liberal economic environment for the promotion of the private sector. At the same time the Government has to keep an eye on the activities of this sector so that it will not act against the social interest. Furthermore, a responsible Government has to be involved not only in maintaining law and order, but also in providing such social services as drinking water, education, and health services which are crucial for economic development. It must be remembered that a stable political atmosphere is essential to attract high investment, domestic as well as foreign. For all this, Government has to proceed forward boldly but with caution and abundant patience.