

**Policy Paper
on
Private Sector Development**

Nepal Development Forum-2002

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Private Sector Development in Nepal

1. Overview

Role of private sector for sustained economic development is always at the forefront. The present global economic experiences reaffirmed the notion that the invisible hand of the market would always contribute to accelerate growth process in a sustained manner. Market oriented development strategies encourage increasing private sector involvements in the development process, limiting the government's role as a facilitator & developer of the private sector through the investments on building physical infrastructure and human resources so as to create an environment conducive for private sector development.

Nepal, though embarked to the periodic development planning exercise as early as 1956, failed to realize the importance of private sector and market oriented policy in the process of overall development of the country till late eighties and this resulted to several economic distortions. However, a distinct departure took place in the overall development policy & strategies in the country, particularly after the restoration of multiparty polity in 1990 and consequently under the new policy paradigm, a liberal policy anticipating greater role of private initiatives in the economy has been in place replacing the controlled economic policies practiced under the Mixed Economic Approach. Since then, the private sector development policy has been reoriented to identifying & removing the barriers for private investments, and creating private sector friendly economic environment so that the private sector would play pivotal role in the economy. Thus shift in the role of the government from active participant to facilitator not only brought positive psychological change in the private sectors, but also added economic dynamism through the active participation of private sectors in all sectors, ranging from

financial to aviation, to manufacturing, to trade, to tourism and other service sectors.

2. Recent Policy Initiatives for Private Sector Development

Recent policy and other initiatives undertaken to create an enabling environment for increased private sector involvement in the country's economy included reforms in industrial policy & relevant legislation, adoption of transparent procedures for granting permission to set up industrial units, adoption of liberal sectoral policies in consonance with overall economic policy and establishment of institutions supportive to the private initiatives.

In the early 1990's new democratic government initiated a series of market oriented policy reforms to integrate the economy towards globalization and economic growth. A remarkable progress in terms of growth, investment and employment has been achieved.

Private sector led growth was the main thrust of the policy reform initiatives taken during 1990's. The private sector response in the policy reform initiatives was dramatic. The average growth rate GDP increased from 4.8 percent in the pre reform period to 5.2 percent in the post reform period of 1992-96. The real fixed private investment increased from 4.7 percent in 1985-91 to 13.2 percent in post reform period of 1992-96. Employment in manufacturing increased by 36% in reform period and declined to 19% after 1996. Manufacturing value added increased from 5.3 percent to 13% in the reform period.

The impetus of post reform growth trends could not be made sustainable after mid 1990's due to slowdown in the reform process. After 1996 the real average GDP has declined, manufacturing value added and employment has fallen back and real private fixed investment has stagnated.

The continuity in the reform process was affected due to external and internal factors. In the external front, unfavorable weather condition for Agriculture, the Asian crisis and the changes in the policies of the key export market are

attributable to the poor performance of the economy. Moreover, in the domestic front the poor implementation capabilities, the increasing resource gap, absence in the commitment at the policy level for further reform, lack of legislative framework and the performance of the bureaucracy are the important contributors.

2.1. Industrial Policy 1992 and Foreign Investment Promotion Policy, 1992

The Industrial Policy, 1992 embarked upon encouraging industrial development through the operation of market forces, substantive reduction in licensing, other government interventions and administrative hurdles, granting liberal tax incentives and strengthening support institutions. Opening up of different economic sectors to private investments and establishment of one window system for giving single point service to the investors are other major steps taken by the government to encourage private investments. Institutional, Infrastructural and Policy support from the Government are necessary to develop small and medium enterprises in countries like Nepal. These SMEs are the source of income and employment opportunities, which directly support economic generation and are effective tool towards poverty alleviation.

Similarly transparent foreign investment policy providing unabated repatriation and easy visa facilities to the foreign investment has contributed to increasing the numbers & amounts of foreign investments in the country. In addition, the policy of non-nationalization of industries, inception of one window system for providing one- point service to the investors, provision of dispute settlement through mutual consultations and in accordance with arbitration rules of the United Nations Commission on International Trade Law (UNCITRAL), and permission for 100% equity participation are other policy instruments aimed at inviting foreign investments in the country.

2.2 Trade Policies

As the trade policies have a direct bearing in the national development process, the forward-looking liberal policies of the nineties have definitely encouraged promoting trade in Nepal. Adoption of realistic exchange rates, simplifying procedures and instituting support mechanisms has contributed to the growth of trade.

However, to sustain the trade promotion in a meaningful manner, both the tariff and trade policies would be reviewed in the context of the country's accession to the World Trade Organization (WTO) and South Asian Free Trade Area (SAFTA) Agreement and her preferential trade with her largest trading partner, India. The customs tariff rates would be rationalized in such a way that it would neither obstruct the growth of country's international trade, nor jeopardize effective protection given to various industrial sectors nor reduce the competitive edge in the global and regional trade. Removal of the structural rigidities in the international trade such as less diversified the trading regime, in terms of destinations and products, has become the main challenge for sustaining the gains so far in trade front.

The Government's trade, industry and investment policies are based on the following elements:

- integrated trade and investment policies with overall development policy,
- consultative and participative mechanism between main stakeholder i.e. private sector, government and civil societies,
- Strengthened intra-governmental policy coordination mechanism,
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2.3 Other Sectoral Policies

In addition, various sectoral development policies are designed to cater the need for private sector development in consonance with macroeconomic policy. Major policy initiatives are taken to open the hitherto restricted sectors to private investments; for example, the banking and non banking financial sector, the aviation sector and so on. Easier entry policy in banking & other financial sector not only increased the number of these institutions & the financing base in the country, but also contributed to easy access to finance, innovating new instruments, and improving quality services through increased competition & professionalism.

Similarly, under an open sky policy, the private sector played lead role in aviation business. Pursuant to the respective liberal policies adopted in different service sub-sectors, the private sector has been playing dominating role on them. The liberal hydro-power policy could promote private investments and similar policies in other utilities sectors such as telecom and drinking water are expected to encourage private investments in these sectors.

Tourism, one of the leading sectors of the economy and the trade sector virtually have been initiated, developed, and operated by the private sector albeit with favorable government policies and support. The private sector through the participation in Tourism Board has been actively involved in the formulation & implementation of the tourism policy. Agriculture Prospective Plan (APP) is being implemented basically to transfer subsistence agriculture system into commercial agriculture system through active participation of private sector in the whole process and Information Technology Policy, 2000 has encouraged private initiatives in information technology sector.

2.4 Tax Policy Reforms

Various reforms have been initiated to improve the quality of services in tax administration, make the administration taxpayer friendly and increase the

revenue yields required for meeting expenses of various development activities. Sweeping changes have occurred in the tax policy in recent years, as it changed from the regime of high tax incentives for directing private sector investment in predefined priority areas to the regime of equal treatments to all sectors. In early stage of private sector development, tax incentives were taken as the instruments for attracting private investments whereas in recent years maintaining neutrality and rationalizing tax rates have been the main agenda of tax reformers in the country. Despite significant reforms, there still persists the problem of inefficiency, narrow base and procedural rigidity and non-clarity in the tax system, which requires further reforms in policy, legislation and procedures. In addition, creation of a taxpayer friendly environment as well as competent and professional tax administration capable of functioning efficiently in the changed context of global economic integration has become the need of the time.

HMG/N has introduced value Added tax (VAT) in the process of taxation reform. The performance of the VAT regime at the beginning although was not satisfactory however, very recently the government has reorganized the tax administration creating a new Inland Revenue Department as well as enacting a new Income tax legislation. These steps will bring positive impact in creating investment and taxpayers-friendly environment.

2.5 Labor Laws

In general for the efficient functioning of market economies and private sector enterprises, the laws need to be simple, unambiguous, consistent and transparent and framed with due consultation with the stakeholders; and also should keep the element of flexibility and track of development. However, the labor laws in the country, as perceived by the investors or the industrialists, have been very rigid and more labor biased, which prompted increasing uses of cheaper foreign labors and capital-intensive technologies. A careful thought shall be given on giving greater flexibility in labor laws so that a balance between labor interest and

private sector development would be stroke. Thus, labor laws shall be reviewed in such a way that safeguarding clauses for labor's interest and controlling for possible labor's exploitation would, in no way, be detrimental or obstructive to investment possibilities and the private sector development.

2.6 Financing Possibility

In any development process, the availability of adequate financial resources for productive investment is a primary requisite and in market economies financial institutions and markets provide the opportunity and facilities to save as well as channel these savings to productive private sector investment in an efficient way. A free flow of information and the existence of a clear and effective regulatory framework are of utmost importance. Various reforms in financial and capital market sector have been initiated in the Kingdom since late eighties under the liberal economic frameworks. The easy entry policy in the financial sector contributed to increase the number and widen finance base of financial institutions in the country. The prudential norms have been in place to ensure the efficient and effective uses of resources available in these institutions and market forces are allowed to determine the interest rates.

However, the gap between deposit and lending rates, lack of easy accessibility to the finances, narrow capital base of the institutions, accumulation of high amount of non-performing assets in financial institution, particularly in two government run commercial banks and concentration of activities of newly established units in urban areas still persist as the problems in the sector. Nonetheless, the joint venture banks and new financial institutions have been performing more efficiently but their capacity is limited. Thus a substantive financial sector reform program incorporating packages for the revival of two government-owned commercial banks and other private institutions shall be undertaken to make the sector more vibrant and enabling them to play a motivating and contributing role for the development of the private sector.

2.7 Infrastructure

Investments have been made to build new infrastructures as well as improve the condition of already developed; as a result significant improvement in the infrastructure development has taken place viz. transport network, communications and other support services. The private sector is also encouraged to invest on infrastructure project under B-O-T and B-O-O-T schemes. Despite these initiatives, requisite infrastructure support service has not reached in many areas. The infrastructure shall be improved on a continuous basis to ensure high quality of services to attract more private investments in the economy.

2.8 Public-Private Partnership

Various flora having representation from private sector have been instituted to promote dialogues between government and the private sector while formulating the macroeconomic and sectoral policies. The major consultative bodies to this end are Board of Investment, Environment Council, Industrial Promotion Board, Revenue Consultative Committee, and Export Promotion Board etc. Apart from these, there are many other agencies in which private sector representation is created to enable the private sector to play and contribute in policy dialogue process in a meaningful way. The most notable is the Nepal Tourism Board, in which private sector representation has been in the majority.

Apart from these, public private partnership (PPP) approach has been recognized and used as a beneficial approach to implement development activities and provide services to people. Local agencies and in other sectors, PPP approach is increasingly being adopted. This is a manifestation of not only recognition of the role of the private sector in Nepalese economy but also a commitment on the part

of the government to push forward the process of development by putting together all resources.

There is a suspicion among the general people that private sector is motivated by profit only and the people in the general also feel that public goods and public utilities services should remain in the domain of the government responsibilities. However, increased involvement of the private sector involvement in power, telecommunication and civil aviation has reflected the positive signals to foster the private sector development and to gain the public confidence.

2.9 Privatization of State Owned Enterprises (SOEs):

Privatization of public enterprises initiated under the framework of overall economic reform program in early nineties is another commitment of the government for private sector development. Under the program, the government, so far, has privatized about 18 companies of various sizes and areas by experimenting with the sales of assets and business, sales of shares, leasing out, management contract, and liquidation as the methods of privatization. The privatization process went smoothly and could get active participation of private sector at the initial phase; however, the slow down in the economy experienced in latter part of last decade has plagued its momentum. Replacing public monopolies with competition, particularly in utilities sector, under appropriate regulatory arrangements would further improve the environment for promoting the private sector.

2.10. Institutional Support System

Various institutional arrangements have been framed to facilitate and support the private initiatives in the economy. The set up of One Window Committee, as provisioned by the Industrial Policy, 1992 to facilitate various services like

electricity, water, telecommunications and tax incentives under a single roof, has been one of the several arrangements made to this end.

In addition, several government, semi-government like Industrial Enterprises Development Institute, Cottage and Small Industry Development Board and private institutions are involved on developing entrepreneurial skill and providing support to private sector through the productions of skilled and semiskilled manpower as per the market requirements.

3. Problems and Challenges

There are many challenges to be addressed to make private sector viable and conducive for propelling the economic growth. By and large ensuring the investment friendly environment is the key challenge before us. Specifically some of major challenges are:

- Diversification of export trade in terms of both destination and product.
- Establishment of inter-linkages between trade and industry.
- Equity in the distribution of benefits of liberalized trade policy between small and cottage industries, and large industries.
- Maintaining balance between labor interest and private sector development.
- Mobilization of public resources for infrastructure development.
- Strengthening institutional effectiveness to provide support for private sector development.
- Stability and predictability of the policy environment.
- High dependency on unorganized commercial sector.
- Inadequacy in entrepreneurship and professional maturity in the private sector.

- Establishment of inter-industrial linkages.
- Identification of private sector investment.
- Establishment of standard accounting practices and transparency in business transaction.
- Procedural simplification to minimise transaction cost.
- Establishment of mechanism for risk management in time with international practices and trend.
- Transparency in the regulatory mechanism of the government.
- Consistency and confidence in the economic policies.
- Comprehensive tax reform to widen tax income tax revenue and objectivity in administration.
- Participation of worker and deprived section of the society in the economic life through generating employment opportunities.
- Developing good corporate governance leading towards instilling professionalism in the private sector activities.

4. Strategies for Reforms

In order to ensure private sector participation in the economic development to fullest extent to alleviate poverty by overcoming the challenges and addressing the issues following strategies need to be adopted:

- Ensuring stable policy environment and harmonizing various policies through regular consultation within the government and between the government and private sectors.
- Developing mutual trust and congenial environment by ensuring a sound corporate governance.
- Specifying details of rules and procedures to reduce possibilities of miss-interpretations.

- Overcoming procedural hassles by streamlining procedures, establishing clear and transparent systems and elaborating rules/guidelines/system to reduce chances for interpretation.
- Enhancing transparency, accountability and predictability in the service delivery system.
- Reorienting the role of the government as a facilitator by doing away with its involvement in commercial activities at a faster pace.
- Encouraging professionalism and good corporate governance practices through devising appropriate incentives structures.
- Promoting and developing schemes for enhancing skill and knowledge among entrepreneurs and investors.
- Extending one-window facility to the investors to overcome hassles and red tape.
- Reforming the financial sector in order to improve access to banking service.

5. Priority Areas and Key Actions

The key actions of the government should focus on.

- Redefining government's role and subsequently reviewing policies.
- Initiating new phase of economic reform program and increasing the participation of the private sector in consultative processes.
- Ensuring improvised quality of governance through the development and institutionalization of a transparent system, wherein the scope for interpretations has been reduced.
- Strengthening institutions through capacity building to address problems and challenges.
- Strengthening institutions for making easy access to rural credits.

The priority areas should be,

- Fostering a process of dialogue between the public and the private sector in policy formulations.
- Building mutual trust.
- Providing adequate security to the industrialists and businessmen.

6. Key Outcome

The expected key outcomes are:

- Enhanced participation of the private sector in all areas of economic activities viz., agriculture, industry and the services sector.
- Efficient delivery of services at competitive prices.
- Greater operation of the market forces.

7. Implementation Modality

In order to ensure successful implementation of the suggested strategies the implementation modality should cover the followings:

- Creation of a mechanism to oversee public-private partnership and fostering cooperation.
- Incorporating changes in policies, rules and laws.
- Clearly defining targets, goals and activities to all responsible agencies.
- Providing a strong leader to enable the mechanism to operate smoothly.
- Defining responsibility center and executing tasks/policies precisely on defined basis.
- Developing human resources well versed with the challenges of competitive environment.

Liberalization is not an end in itself however it could enhance the capability of the private sector to the asses of capital, technology and knowledge by which the

overall objective of economic development could be achieved. Private sector as the main actor in the process of liberalization can inject more capital, acquire new and modern technology, generates additional resources for development and alleviate poverty. Private sector has to play a key role in the integration of the national economy with global economy. The process of integration possesses various opportunities and challenges and such challenges which are complex as well as needs competitiveness have to be dealt with joint effort of the government and private sector through appropriate institutional mechanism.