

Private Sector Development Including Privatization

1. Overview

The earlier emphasis of Nepal's economic policy on import substitution through active participation of the public sector in mixed economy model beginning from the early 1960s led to lower economic growth and macro-economic instability. It was unfortunate that Nepal though embarking on 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. The present global economic experiences have reaffirmed the notion that the market force would always contribute to accelerate growth process in a sustained manner making the role of private sector always at the forefront. Market-oriented development strategies encourage increasing private sector involvement in the development process, limiting the government's role as a facilitator and 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.

The restoration of democracy in 1991, coinciding with the wave of liberalization through out the world, heralded the introduction of new open and liberal economic policies in Nepal too. Keeping with the demand of time and also learning from past mistakes, the new Government formed after the restoration of democracy accelerated liberal economic policies with a view to facilitate private sector led growth. The successive Governments have continued to reaffirm their commitment to reform programs. The impacts of economic reforms have been encouraging especially in the non-agricultural sector. The acceleration in trading activities, improvement in balance of payment situation, controlled inflation, etc all indicate the indispensability of new economic policies. The macro-economic stability has been maintained thanks to the various market oriented and liberal policy instruments. The Government's present economic policies are geared towards enhancing the environment for market-oriented/liberal economy with full participation of private sector.

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 development policy has been reoriented to identifying and removing the barriers for private investments, and creating conducive environment for private sector so that this crucial sector would play pivotal role in the national economy. This shift in the role of the government from active participant to facilitator has 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 manufacturing, trade to financial, aviation, health, tourism, communication and other service sectors.

Now Nepal's entry into global trade body like WTO and being a signatory to the Free Trade Agreements like SAFTA & BIMST-EC have added a new dimension in the private sector development of the country with all the underlying challenges and opportunities at the same time. In today's globalized and fiercely competitive world, the Nepalese private sector has no alternate except to become more dynamic, proactive and competitive to sustain in the long run. A vibrant private sector in an open and market-oriented economy, by virtue of its favorable impacts on social and economic sectors, can undoubtedly enhance the efficiency in dealing with Nepal's primary objective namely, poverty alleviation. In fact, it can create favorable impacts in all sectors of national economy through the maximum mobilization of available resources.

2. Review of Ninth Plan on PS Development

- 2.1 Considering the very poor physical infrastructure base of the country, it was not surprising that since embarking on periodic planning in 1956, the early emphasis of Government was mainly on building this vital sector and erecting the foundation of the development. It was only after the Fifth Plan that efforts were made to launch with priority the productivity sectors such as agriculture, forestry and human resource development. It was the Eighth Plan which, compared to previous plans, featured some fundamental differences in the sense that the earlier plans followed controlled economic policies whereas the Eighth Plan made a distinct departure with placing emphasis on somewhat liberal and market-oriented economy. The role of the government as well as the private sector was demarcated at the policy level.
- 2.2 Private sector development was an important part of the Ninth Plan Strategy which saw the continuity of the policies, legal and administrative reforms initiated in the Eighth Plan. The involvement of private sector while formulating policies and plans, encouragement rather than protection in trade and industrialization, and enabling the private sector for coping with the challenges and utilizing the opportunities in the aftermath of accession to WTO and SAFTA are among the major tasks undertaken for enhancing the capabilities of private sector. Likewise, privatization of the state owned enterprises (SOE), implementation of financial sector reform programs are other important tasks undertaken during the Ninth Plan. Apart from these, initiatives have been taken for making private sector-friendly tax administration by bringing improvement in tax policy and laws, adjustment in tax and custom duties through the procedural and administrative reforms. Amendments have been made in the procedures to grant permission for foreign investment and entry visa regulations.

Having elaborated on the above achievements for the private sector development during the Ninth Plan, it must be admitted that the mixed performance of the Plan also reflects the lack of sufficient progress in this area. While political instability, attacks on business establishments and the implosion of some industrial sub sectors have eroded business confidence; the poor implementation of policies governing the private sector continues to be an important constraint on private investment. A survey of private sector firms carried out in 1999 identified several such impediments including, among others, excessive bureaucratic delays in the provision of government services, lack of clarity of laws and unpredictability in the enforcement of government policies, discretionary implementation of tax laws, excessive documentation requirements, and labor laws that prevent retrenchment of workers (encouraging firms to employ more casual labor). To address this situation a regulatory framework reflecting clarity of laws and predictability of government policies, procedural simplification and reduction in discretionary powers of the authorities will be made the basis for making the private sector vibrant and dynamic.

Compared with the first three years of the Ninth Plan which witnessed a great deal of activity and contribution of private sector in the economy, the political instability and disruption of economic reforms thereof, slowdown in the identification of obstacles/constraints for private sector investment promotion and its remedial measures, deteriorating law and order situation in the country during the last two years of the Plan had adverse impact on the private sector investment. Similarly, the adverse effects of the worldwide recession, event of September 11 in the USA, and the consequent lull in the economy on Nepal's

export and tourism sector as well as some income / property policies adopted in the country have also badly affected the investment climate.

The country will be plagued with further economic problems if there is no improvement in the law and order situation and acceleration in the economic reform programmes with the involvement and participation of private sector. It is imperative that following issues are addressed in time to develop the private sector.

In the context of competitive environment arising out integration of national economy with the global economy, the private sector has to play a leading role in the mobilization of available resources through the development of market-oriented economy. It is, thus, obvious that in order to consolidate and make the market-oriented economy and its achievements sustainable in the long run for transforming it as a sound strategy for poverty alleviation, further packages for the policy, legal, administrative procedures and structural reforms are inevitable.

3. The Tenth Plan and Private Sector Development - HMG's Vision, Objective and Strategy

3.1 Overall Strategy

Despite some noticeable progress made over the last decade, the overriding objective of development efforts in Nepal is poverty alleviation. The Tenth Plan through its poverty reduction strategy paper (PRSP) represents a renewed commitment by HMG, Nepal to this all-important task. Its sole objective is to achieve a remarkable and sustainable reduction in the poverty level in Nepal from 38 percent of the total population at the beginning of the Plan period to 30 percent by the end of the Plan, and to further reduce the poverty ration to 10 percent in about 15 years' time.

After the completion of nine succeeding plans the problem of poverty is still unsolved. Absence of high, sustainable and broad-based economic growth, exclusion of the masses of the poor from the mainstream of development process, slow improvements in the indicators of human development, low productivity and dependence of agriculture on climate, increasing pressure of population growth and ineffective governmental administration are the prime causes of failure. Therefore, the Tenth Plan's strategy for poverty reduction is built on following four pillars:

- (a) High, sustainable and broad-based economic growth
- (b) Development of social sector and rural infrastructure
- (c) Targeted programs
- (d) Good governance

(a) High, Sustainable and Broad-Based Economic Growth.

Poverty alleviation is not possible without rapid economic growth and which in itself is not sufficient to reduce poverty, so economic growth will be made high, sustainable and broad-based. To strengthen open and liberal economic policies, economic reform will make them more effective and concrete.

To attain the high, sustainable and broad-based economic growth; agriculture, forest, industry and water resources will be developed maximally, where the employment and income generating opportunities are maximum. Domestic and export oriented industries will be given priority while developing these sectors. To increase rural employment

and income generation, agriculture sector will be commercialized. Special emphasis will be given on the service sector mainly tourism, communication and information technology, finance and housing, construction and transportation. Similarly, to reduce production cost, productivity growth strategy will be taken as a campaign. For this appropriate technology will be encouraged.

Role of public sector will be as a facilitator and referee in those sectors where private sector is interested. But, the strong and direct role of government will be established in the backward and remote areas, oppressed caste, group, and areas where the private investment is not attractive. For policy transparency; favorable environment will be created; by which local bodies, private and other sectors play effective role in development process. To make development process sustainable and transparent, local bodies and private sector will be promoted.

b) Social Sector and Infrastructure Development

Emphasis will be given on the infrastructure development as a corner stone of rapid economic growth and development of social sector for improvement in human lifestyle. More priority will be given to the sub-sectors like basic education, health and drinking water, which contribute directly to the human capability building and human development. It in itself is indicator of human development and directly contributing in poverty eradication. Economic viability in the infrastructure development, people's approach in the social services and quality improvement of services will be taken mainly.

c) Targeted Programs:

To improve the capabilities of backward sectors and communities, which are not able to participate in the mainstream of the development process; efforts will be taken according to liberal, market-oriented economic management; through targeted programs. Targeted and empowerment programs will be prioritize to promote the interest of oppressed, deprived, helpless disabled and senior citizens which creates the base to live in decent life for them.

d) Good Governance:

In order to manage more effectively and in a result-oriented manner, drawbacks in its implementation will be removed and emphasis will be given to the good-governance. Stress will be given on participatory economic development for good-governance. Monitoring and evaluation system will be strengthened and process of decentralization at local level will be emphasized to make decision-making process and public expenditure more responsive and transparent. More emphasis will be given to make administration punctual and disciplined. Effective mobilization of local resources, capacity building and reliability of local bodies will be strengthened through effective implementation of decentralization. To make implementation of development programs effective, transparency and clarity in selection and prioritization in project implementation will be emphasized.

To implement above-mentioned strategies and maximize its effect to achieve the goal, priority will be given to the use of technology, productivity and efficiency and population management. Apart from government sector and local bodies effective participation of private, non-governmental and civil society will be emphasized in the process of

poverty alleviation through rural economic and social transformation. Women empowerment and mainstreaming is identified as a focal point in this strategy of poverty alleviation.

3.2 Tenth Plan – Vision/ Objective & Strategy on PS Development

The experiences of many advanced countries have proved that the role of the government alone is not sufficient for economic development and private sector plays a crucial role in development process. In these countries, the governments have played primary role to create a suitable environment for speeding up the process of development allowing market forces operate freely and undertaking economic activities mainly with private sectors participation.

It has been proven that market oriented economic model accelerates the tempo of development. In Nepalese context, besides its favorable impacts on social and economic sectors, it can enhance the efficiency in dealing with Nepal's primary objective of poverty alleviation and create conducive environment for overall national development through the maximum mobilization of available resources.

A suitable policy environment is an essential pre-requisite for the proper development of market oriented economic system. It is, thus, imperative that the government, confining itself to the creation of a favorable environment and taking the role of facilitators, introduce necessary reforms for open and market-oriented economy in the overall economic policies like tax, customs, revenue, national and foreign investment.

Against this backdrop, the Tenth Plan has adopted following long term concept and objective with various strategies in order to develop the private sector in Nepal

3.2.1 Long Term Concept / Vision of the Tenth Plan

Private sector shall be developed as a focal point for the entire economic activities and the role of HMG will be confined to the policy making, monitoring and facilitating. Private sector will be made direct partner of the whole economic activities. For this, necessary strategies will be adopted to create a conducive environment, make policy and legal arrangements, and inculcate corporate culture in the private sector in order to develop a skilled, effective, responsible and competent private sector.

3.2.2 Objective

Since the private sector through the maximum mobilization of available resources for developing a strong, robust, dynamic, and competitive economic sector more integrated with external economy, and by maintaining, broad, sustainable and high economic growth rate has to play a very vital role for contributing in the poverty alleviation efforts, the objective of the Tenth Plan will be to develop a private sector-friendly mechanism.

3.3.3 Strategy for the Development of Private Sector

The following strategies have been adopted for the development of the private sector in the Tenth Plan:

- ?? Emphasis shall be laid on creating an investment-friendly environment by ensuring the forward-looking economic reforms and policy stability.
- ?? The flow of private investment shall be facilitated by defining the roles of private sector in every sphere of the economy.
- ?? Providing equal facilities and incentives in the investment sector shall enhance competitive ability.

In order to achieve the given objectives and implement the strategies, government shall adopt various policy measures and implementation strategies. Some important ones are:

- The private sector shall be established as the major carrier of economy by conducting awareness activities and changing mind-set towards the private sector.
- Initiatives shall be taken to develop necessary quality infrastructure, financial arrangements, human resource and other services for the private sector development.
- Emphasis shall be laid on the development and expansion of capital market.
- Privatization pace of public enterprises shall be accelerated.
- All the basic sectors that are attractive to the private sector such as manufacturing industry, services, social sector, tourism and trade sector, information technology and communication sector, hydropower, financial sector, roads, irrigation, and water supply will be opened for the private sector investment.
- Private sector investment shall be encouraged in the areas having simple and easy comparative advantages by making amendments in the Industrial Policy and Foreign Investment Promotion policy and their corresponding Acts, rules and regulations.
- Operating procedures shall be made simpler and transparent by removing complications during the approval and registration process of the industry/enterprises.

- Identification of sectors with comparative advantage and easy entry of private sector in such sectors shall be ensured in order to create an environment wherein investors can themselves take the decisions regarding the investment.
- Amendments shall be made in the labor and company acts for ensuring the interests of investors on the basis of business condition.
- Emphasis shall be laid on the simplification and administrative transparency in the income tax, custom and value added tax laws by timely reform measures.
- One window system shall be made effective in order to provide services to the investors under a single roof.
- Reforms in passbook system under duty drawback scheme, bonded warehouse and bank guarantee systems meant for export oriented industries shall be made more effective.
- Emphasis shall be given to operate the public enterprises in commercially competitive basis after improving management of those entities which can not be privatized immediately.

4. PS Development - Reform Initiatives

Notwithstanding the impending internal security and various other issues elaborated earlier, Nepal can do a number of things to promote private sector development, enhance competitiveness and boost the growth especially of the non-agricultural sector. The core objective of private sector development is to enhance the scope for private participation in economic activities through the creation of a private sector friendly environment, so that the private sector can make a meaningful contribution to poverty eradication. The major strategies to achieve this objective include: the acceleration of economic reforms; ensuring policy-wise consistency in order to create an investor friendly environment; simplifying entry and exit procedures for businesses; enhancing competitive environment by providing equal opportunities and facilities, and sectoral reforms. As per liberal economic policy, the government will gradually reduce its role in economic activities, while private involvement will be encouraged in a wide range of economic activities, such as investments in social and economic infrastructure and service delivery. Policies have been already formulated and announced to facilitate private investment in power, roads, telecommunications and other infrastructure development. To create a level playing field, the privatization of public enterprises will be accelerated and those areas will be fully opened to the private sector. The Government intends to increase the involvement of the private sector in a number of public enterprises including Nepal Electricity Authority, Nepal Telecommunications Corporation and the Royal Nepal Airlines, among others. Efforts will be made to streamline the regulatory processes and to make them more transparent, for example by reducing complicated documentation requirements for exports; and improving tax administration so as to reduce discretionary power of tax officials. HMG had formed a fiscal reform

Commission to make important recommendations in this regard. Legal reforms will be initiated and new liquidation, merger and bankruptcy laws will be enacted. Finally, reforms currently under way in the financial sector (aimed at creating an efficient and competitive banking system and transferring state-owned banks to private management and ownership, among others), will help considerably in facilitating private sector development.

4.1 Enhancing Trade Competitiveness

Nepal's trade, tourism and industrial regime is quite liberal. However, the size of the private sector is small and inefficient, and lacks competitiveness. The country

needs to expand output capacity and improve the efficiency of the private sector through the adoption of appropriate measures. As Nepal is also seeking to join the World Trade Organization, it needs strong efforts to strengthen its international competitiveness. Therefore, in order to create a favorable environment to achieve private sector led growth, the government will focus on removing impediments to private sector development. In this regard, a strong promotional package especially for export-oriented industries measures to increase incentives for investment, and an appropriate technology and information program will be introduced to enhance competitiveness. Concurrently, steps will be taken to reduce costs of exporting. For example, as noted earlier, initiatives are underway to reduce trade transport costs (through the multimodal transport strategy and developing internal container depots); while improving customs and tax administration and tax policy reforms also will help in this regard. In addition, programs in the trade sector aim to increase the number of private sector managed customs terminals, expand technical assistance programs for export commodities and revise existing Acts and regulations to make them compatible with WTO and SAPTA requirements.

The core objectives of the Tenth Plan in the industrial sector is to accelerate the pace of industrialization through increased participation of private sector and to create additional employment in both rural and urban areas to reduce poverty. The main strategies to achieve these objectives are: improving policies to attract domestic and foreign investment, strengthening the role of SMEs in national production and improving the overall industrial environment. Tariffs will be further rationalized, and existing policies and Acts relating to foreign investment and industrial development will be revised. Up-gradation process of SMEs through technological improvements and policy of sub-contracting will be further accelerated. Incentives to improve backward linkages of industries will be continued; and information technology development will be given emphasis. The effective implementation of these policies and activities during the Tenth Plan will help improve industrial competitiveness, expand industrial production and employment generation, and raise the contribution of the industrial sector to GDP.

Measures will also be taken to attract more foreign investment, along with appropriate technology, particularly in areas of comparative advantage in order to enhance competitiveness. As noted, policy and legal framework will be improved in line with the market economy; administrative mechanisms will be streamlined and made more efficient; and necessary physical infrastructure and human resource development will be undertaken. Ensuring macroeconomic stability (thereby assuring repatriability of capital and dividends) and a stable financial system will also help in this regard.

4.2 Development of Tourism sector

Apart from its contribution to economic growth and the balance of payments, the tourism sector can be an important instrument of poverty reduction by increasing employment opportunities directly and indirectly in urban as well as rural areas, particularly in the hills and mountain areas along trekking trails and tourism sites. A major objective of the Tenth Plan is to increase the contribution of the tourism sector to the national economy through the expansion of tourism activities and generation of greater employment opportunities. Similarly, conservation and promotion of historic, cultural and religious sites, and the development of a safe reliable and easily accessible air transportation system are other objectives in the sector. The sector strategy aims to develop and market new tourism products, and to improve tourism facilities and services for promoting faster growth of the

sector. Accordingly, the ongoing promotional activities will be further expanded, focussing on regional markets; developing and conserving national heritage sites will be emphasized; and new areas will be opened up for rural tourism. With effective promotion and the spread of tourism into rural areas, and resulting increases in incomes and employment generation, tourism will positively contribute to reducing rural poverty.

4.3 Improvement of Labor sector

In order to provide employers more flexibility to adjust their labour requirements with due compensation to those affected, the Tenth Plan will take a number of measures to reform existing labour laws. The major objective outlined in the Tenth Plan for the labor sector is to ensure a congenial industrial environment by maintaining a flexible labor market while safeguarding the basic rights of workers. The major strategies adopted in the Plan to achieve this objective are the initiation of timely reforms in labor laws to promote private investment, promotion of better industrial relations, increasing productivity and elimination of child labor. The Government will also give even greater emphasis to its present policy of encouraging foreign employment. Similarly, to make Nepal free from child labor, legal measures would be adopted along with strict monitoring; and the ongoing programs for rehabilitation of child labor would be strengthened. With the effective implementation of these policies and programs, it is hoped that both productivity and rights of labor would be enhanced and that industrial relations will improve. Existing child labor would be eliminated.

In general, for the efficient functioning of market economies and private sector enterprises, the laws need to be simple, unambiguous, consistent, transparent and framed with due consultation with the stakeholders; and also should keep the element of flexibility and track of development.. A careful thought will be given on bringing greater flexibility in labor laws so that a balance between labor interest and private sector development would be struck. 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.

4.4 Infrastructures Development

Infrastructure development has a major role to play in facilitating the development of the private sector. Despite significant progress in the expansion of road density, penetration of telephone and electricity is still low. The government will give priority to strategic road network, maintenance of major roads and highways and expansion of electricity and national communication infrastructure. The government, however, in the medium term, will gradually reduce its involvement, especially in the areas where private sector can increasingly take over, including telecommunications, hydroelectricity and roads, among others.

The process of PS participation in the infrastructural Development is going to be accelerated through the enactment of BOOT Act 2003 which is a major legal provision to attract PSP to develop sustainable long term activities. There is a provision of alternative modalities of management, lease, operate transfer and built options for different kinds of infrastructures. There is also provision for both unsolicited and solicited bidding both for unidentified and identified project for development of infrastructures for and has provisions for the repatriation of funds.

Road Sector

The main objectives of the Tenth Plan in the road sector are to develop and manage the road transport network to support the socio-economic development efforts and to promote private sector participation in the construction of new road networks and their maintenance. The major strategies to be adopted in this regard include increased participation of the private sector in road construction and maintenance, enhancing institutional capacities of both the roads department and the private sector to ensure cost effective

New policies initiated to meet the Ninth Plan's goals included the creation of a separate institutional mechanism (DOLIDAR) for the construction of agriculture roads, delegation of responsibility and resources to local authorities to construct local roads; and the formulation of a Public Infrastructure Construction and Transfer Policy to promote private sector participation. These initiatives so far are yet to produce the desired results. While there has been considerable progress in terms of road construction by local bodies, considerable technical support and supervision are necessary to ensure appropriate planning and road quality in order to avoid environmental problems

At the end of the Plan period, 1025 kms of road will be added. An additional ten district sustainability of the road network, and transferring to DDCs the responsibility for rural roads. An additional 10 District headquarters will be connected by road, taking the number of HQs having road connections to 70.

A framework has been established for improved road maintenance, the Road Fund Board is fully operational and financed by a road levy. The Road maintenance Fund Board established under RMFB Act 2002 is a major initiative, undertaken by HMG/N. The Board is managed by members with majority representation from private sector. The Act also facilitates performance maintenance contracts of major highways through private sectors for effective maintenance.

Hydro Power

The Tenth Plan's key objectives in the power sector include: expanding electricity coverage in a sustainable and environmental friendly manner by generating low-cost power; accelerating rural electrification to promote economic growth and improve living standards in rural areas and to develop hydro power as an important export item. The major strategies of the sector include promoting private sector participation in power generation and distribution, unbundling the activities of NEA and improving its financial viability, integrating rural electrification with rural economic development programs, and strengthening power infrastructure.

Hydropower policy was revised to allow the private sector entry into a full range of power sector activities i.e. generation, transmission and distribution. Considerable private investments have already taken place under the previous policy in a number of power generation projects. The Electricity Act 1992 and Regulations 1993 & Hydro Power Development Policy 1992 is a practical and detailed framework for PS participation. Reforms like unbundling of NEA in Hydropower generation, Transmission and Distribution, establishment of an fully autonomous and independent Regulatory Authority , more competitive bidding for

Power purchase agreement from Independent Power producers are under consideration.

Major initiatives/activities to be undertaken to improve power sector development include the establishment of a Power Development Fund; the creation of an independent regulatory authority; initiation of an explicit subsidy policy for grid-based rural electrification; and promotion of small, medium and storage hydropower projects. The major expected outcomes are that the proportion of population having access to electricity will increase from 40 percent to 55 percent by the end of the Plan period, and adequate power will be supplied as needed to support economic growth.

Telecommunication/ IT sector

In the information and communications sector, the Tenth Plan's main objective is to improve the access of people to information and telecommunication facilities, facilitating their participation in economic activities, as well as personal development. The major sector strategies are to enhance private sector participation in the expansion of information and communication network and facilities, and clarify the roles and responsibilities of private and public operators and to give them (as well as the postal service) functional autonomy.

In telecommunication, progress has been made in opening up the sector for private investment. A new Telecommunication Act was enacted to introduce competition in basic, cellular and value-added services and the private sector is now involved in their provision. A private operator was also selected to provide basic telecommunications services to 534 rural communities i.e. roughly one-fourth of the rural communities which are under-served. Thus the monopoly which the public sector agency—Nepal Telecommunication Corporation (NTC)—enjoyed has been broken; and a Telecommunications Authority has been set up to oversee the sector.

Regarding policies and activities, necessary steps for the promotion of private sector involvement in telecommunications will be taken. NTC will be converted into a public company under the Company Act, and general and rural telecom services will be opened up to the private sector. A policy of expanding broadcasting services will be adopted. A legal framework for functional autonomy of postal services will be finalized by FY 2004. With the effective implementation of these policies and activities, it is expected that the telecom market will be liberal and competitive. All VDCs will have access to telecom services with penetration rising to 40 lines per 1000 inhabitants. Broadcasting services will be available to all. Likewise, ICT services will be available in various urban areas.

4.4 Financial Reforms

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.

Reforms are also needed in corporate and financial governance. Nepal lacks sound accounting and reporting standards. Disclosure requirements for companies are inadequate and information available to lenders is incomplete, and sometimes inaccurate. Similarly, institutional capacity for regulation and supervision is weak. Improvements in these areas will help increase trust and confidence in the private sector and in turn reduce bureaucratic hassles.

Strengthening the financial system is of critical importance for private sector development, to ensure that national savings would be mobilized and intermediated at competitive interest rates to meet the private sector's financing needs, as its role in the economy progressively expands. Nepal's financial sector is in a critical stage. The main problems of the banking system are inefficiency, inadequate financial discipline, as well as political and other influences in lending decisions. These have resulted in poor loan quality, high spreads and high lending rates to borrowers, and increasing non-performing assets. To address these problems, a Financial Sector Strategy has been prepared and is being implemented. The reform agenda in the financial sector, currently underway, involves, among others: (i) restructuring and privatizing state owned banks, (ii) improving auditing and accounting standards, (iii) strengthening monitoring and regulatory functions and capacity of the NRB, (iv) strengthening legislative and institutional framework for effective loan recovery, and (v) improving loan quality and banking discipline. The reform program in the non-banking sector is expected to include the restructuring of the two government owned development banks (Agricultural Development Bank and Nepal Industrial Development Bank) as well as ensuring healthy growth of the finance companies and the micro-finance sub-sector. They will be brought under a transparent and more accountable regulatory framework. And the Government will also reform the rural development banks with a view to minimizing its involvement in rural finance.

Reforms in this vital sector have been deemed essential for ensuring solvency of the banking system and for providing adequate and predictable credit flows to sustain a vibrant private sector. However, for a variety of reasons, the implementation of the reforms has been slower than expected. A Financial Sector Strategy Statement was prepared in 2001 and its key recommendations are now being implemented. These include: (i) Strengthening the autonomy and authority of the Nepal Rastra Bank; (ii) Enhancing its capacity for supervision and regulation of commercial banks; (iii) Concurrently, the two major banks (which own nearly 60% of the banking assets) have been placed under external management in order to address their deep-rooted management and financial problems and possible restructuring needs. However, much remains to be done to complete the reform program.

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.

In order To improve revenue collection, a major tax reform program was introduced. Its main elements included: (i) The introduction of a Value Added Tax (VAT) and extending its coverage to include many small and medium enterprises; (ii) Improving the import valuation system for customs and requiring payments to be made through banks; (iii) Revising the Income Tax Act in order to consolidate tax laws and simplify payments procedures; (iv) Strengthening the tax administration by amalgamating the Departments of Taxation and VAT into one; and (v) Strengthening anti corruption measures. These measures, however, had little impact in the short term in improving the Ninth Plan's revenue performance.

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 are expected to bring positive impact in creating investment and taxpayers-friendly environment.

4.5 Industrial Policy Reform

Nepal's stand during the accession to the World Trade Organization also was made clear that a major objective of national economic policy was to promote and encourage a transparent and fair business environment for both domestic and foreign investment, and to increase the role of the private sector in Nepal's development process. For this purpose, a liberal industrial policy as mentioned above also was adopted in 1992 consisting of the Industrial Enterprises Act, 1992, the Foreign Investment and Technology Transfer Act, 1992, and the One Window Policy of 1992. Sections 2, 3 and the annex of the Foreign Investment and Technology Transfer Act, 1992 are relevant for all foreign investment and cover the major criteria for the permission of foreign investment. Under this policy, a high level committee had been formed with the Director General of the Department of Industries as its Coordinator in order to coordinate the activities of various agencies related to industrial enterprises. The major thrust of these Acts and policies lies in their openness with emphasis on market-driven strategies, and the dominant role of private initiative and enterprise. The Government acts as a facilitator to the private sector and concentrates its efforts on the development of the infrastructure required, as well as in guaranteeing a stable macroeconomic environment. The policies and Acts mentioned above apply to all sectors of economic activities within the country. The Industrial Policy of 1992 identified foreign investment promotion as an important strategy in achieving the objectives of increasing industrial production, meeting the basic needs of the people, creating maximum employment opportunities, and paving the way for improvement in the balance of payments situation. Foreign investment was expected to supplement domestic private investment through foreign capital flows, technology transfer, and providing access to international markets.

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 organizations like Cottage and Small Industry Development Board, National Productivity and Economic Development Centre, Trade Promotion Centre, Council for Technical and Vocational Education, Industrial Enterprises Development Institute, and private institutions are involved on developing entrepreneurial skill and providing support to private sector through the production of skilled and semiskilled manpower as per the market requirements, and providing other industry and trade related services to the entrepreneurs.

4.6 Public-Private Partnership

Various fora having representation from private sectors 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 general also feel that public goods and public utilities services should remain in the domain of the government responsibilities. However, increased 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.

4.7 Privatization of Public Enterprises

In Nepal, most public enterprises (PEs) were established beginning from the Second to the Seventh Five Year Plan periods as a vehicle of development. These units were created as instruments for production and for achieving socio-economic policies of the Government. This initiative of the Government was essential and justified at a time when private sector investment was not forthcoming in the provision of basic social and economic services. The number of such enterprises in the industry, business, service, social and public utility sector exceeded 60. Many of them were established with the assistance of donor countries. From these public sector organizations, it was expected that they would create an industrial base in the country, enhance domestic production, substitute imports, generate employment opportunities, and contribute to the national treasury. But most PEs characterized by operating deficits, overstaffing, heavy dependence credit, and inefficient management and low capacity utilization /sub-optimal use of resources, etc incurred losses. The performances of public enterprises, particularly those involved in industry and trade sector, turned out to be very poor.

On the basis of analysis and evaluation of the roles and performance of these enterprises, the elected government which assumed power after the restoration of democracy in 1990, concluded that the economic conditions and financial

efficiency of the government corporations were unsatisfactory. Lack of basic elements contributing to the development of professional culture in their inherent structure and operating procedures was singled out as the main cause for their poor performance. Public enterprises confronted with various problems and hindrances such as lack of managerial autonomy, inefficient use of means and resources, shortsightedness and weakness on the part of political leadership/ production of low quality goods and services, uncontrolled administrative expenses, lack of competitive ability, lack of motivation in incumbent human resources, adoption of traditional technology and minimum use of professionalism. All these factors brought about a progressive decline in their output and made the vast amount of government investment unproductive. Thus, these public corporations have not only failed to achieve their objectives but also become a heavy burden on the national economy.

According to the observation of the World Bank" their performance has been deteriorating steadily since the 1980s, while no attempts have been made to eliminate shortfalls in spending for operation and maintenance as such by public corporations, a review of their operation suggests not only that their operation and maintenance function is seriously deficient but furthermore many of these corporations are becoming a serious drain on fiscal resources."

Nepal implemented Structural Adjustment Program (SAP) as early as in 1985 which included tariff rationalization, reduction of fiscal deficits and privatization of PEs. But the efforts at privatization were not materialized until the political change in the country in 1990.

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, so far Government has privatized 24 companies (including one leased brick and tile making unit which was taken back by the HMG but again leased out recently) 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.

Table 1: Privatization of Government-Owned Enterprises

S.No	Name of the Company	Year of Privatization	Method of Privatization	Sales Proceeds (Rs. '000) ¹	Sale of Shares %
1.	Bhrikuti Paper Mills	Oct. 1992	Asset and business sale	229,800	-
2.	Harisidhi Brick and Tile Factory	Oct. 1992	Asset and business sale	226,900	-
3.	Bansbari Leather and Shoe Factory	Mar. 1992	Asset and business sale	22,400	-
4.	Nepal Film Development Corporation	Nov. 1993	Share sale	64,662	51
5.	Balaju Textile Industry Ltd.	Dec. 1993	Share sale	17,716	70

¹ It includes the price of management share only.

S.No	Name of the Company	Year of Privatization	Method of Privatization	Sales Proceeds (Rs. '000) ¹	Sale of Shares %
6.	Raw Hide Collection and Development Corporation Ltd.	Dec. 1993	Share sale	3,990	
7.	Nepal Bitumen and Barrel Udhog Ltd.	Jan. (1994)	Share sale	11,640	65
8.	Nepal Lube Oil Ltd.	Jan. 1994	Share sale	30,424	40
9.	Nepal Jute Trade and Development Company	1993	Liquidation	Liquidation	-
10.	Tobacco Development Company	1994	Liquidation	Liquidation	-
11.	Nepal Foundry Industry	Mar. 1996	Share sale	14,473	51
12.	Raghupati Jute Mills	Aug. 1996	Share sale	82,204	65
13.	Biratnagar Jute Mills ²	Dec. 1996	Management contract	Business contract	-
14.	Nepal Bank Ltd. ³	Mar. 1997	Share sale	125,140	
15.	Agriculture Tools Factory	May 1997	Share sale	95,100	Now liquidated
16.	Bhaktapur Bricks Factory ⁴	Aug. 1997	Lease	20,300 (10 years lease)	-
17.	Nepal Tea Development Corporation	June 2000	Share Sale & Lease	267,105	65
18.	Agricultural Project Services Centre (APROSC)	2001	Liquidation	-	-
19.	Cottage Handicraft Sales Emporium	2002	Liquidation	-	-
20.	Nepal Coal Ltd.	2002	Liquidation	-	-
21.	Hetauda Textiles Ltd.	2002	Liquidation	-	-
22.	Nepal Transport Corporation	2002	Liquidation	-	-
23.	Butwal Power Company	January 2003	Share Sale	874,200+U	75
24.	Birgunj Sugar Mills	2003	Liquidation	-	-

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.

Challenges in the Privatization of Public Enterprises

²BJM is a semi-government enterprise in which private sector have majority shares. The decision to contracting out was taken by the company's board and all the procedures were taken accordingly.

³In this bank the government had majority shares. The government decided to sell some of its shares in the market, so that the private sector could become the majority shareholder. So it floated 10 per cent of the shares in the share market. Now the government is a minority shareholder i.e. it holds only 39 per cent of the total shares.

⁴Was taken back by the government and again leased out in December 2003.

Most of the public enterprises have been unable to meet their targets of producing goods and provisions of effective service delivery. Government's investment in the forms of share capital and loans has been on rise due to lack of capital management and capital formation of public enterprises. Most of the public enterprises are overstaffed and there exists absence of uniformity in the provision of facilities to their staff. These enterprises have created large liability as a result of their inability to manage their funds properly making it difficult to ascertain the extent of their liability. Therefore, creating congenial environment to establish these enterprises as viable entities with the improvement in their efficiency has been a big challenge. Moreover, overstaffing and settlement of unlimited liability of these enterprises have been an obstacle on the way of privatization and their restructuring.

5. Gap Analysis

5.1 While political instability, deteriorating law and order situation / security environment have eroded business confidence, the poor implementation of policies governing the private sector continues to be an important constraint on private investment. Several impediments such as excessive bureaucratic delays in the provision of government services, lack of clarity of laws and unpredictability in the enforcement of government policies, discretionary implementation of tax laws, excessive documentation requirements, and labor laws that prevent retrenchment of workers have been identified which are coming on the way of private sector development in Nepal. For addressing this situation, a regulatory framework reflecting clarity of laws and predictability of government policies, procedural simplification and reduction in discretionary powers of the authorities will be made the basis for making the private sector vibrant and dynamic.

Besides the above mentioned internal institutional flaws, a number of other external factors such as the worldwide recession, event of September 11 in the USA, etc. and the consequent lull in the economy on Nepal's export and tourism sector have also badly affected the investment climate. Soundness of investment climate is a vital pre-requisite for private sector development in the country.

Along with the adverse investment climate, low competitiveness and productivity are other bottlenecks for the private sector development in Nepal. Before embarking upon problems identification and coming up with remedial measures/ implementation strategies in the private sector development, it will be quite relevant to examine the key issues such as competitiveness and productivity, and investment climate in Nepal.

5.2 Competitiveness and Productivity: Constraints and Potential

Despite liberalization and growth of trade and investment in the 1990s, a recently conducted study (Nepal: Trade and Competitiveness Study/World Bank) 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.

There are three factors contributing 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) unfavorable business climate. Rigid labor legislation in the formal sector with strict anti-dismissal rules

prevents 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 countries. A comparatively weak infrastructure and one of the highest charges for electricity in the region further diminish Price competitiveness. Transport and transaction delays lead to exceptionally high inventory costs. An inadequate regulatory framework, unpredictable implementation, the security environment and related uncertainty further add to costs.

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 economic growth.

5.3 Investment Climate

With its considerable natural barriers, Nepal is making an extra effort to improve its investment climate relative to its competitors. The Heritage Foundation's index of Economic Freedom (based on relatively transparent and objective 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.

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. Further reforms are still under way in the same direction. The Government is also trying to address private sector concerns about policy opacity and unpredictability, as well as lack of consultation on policy changes.

The recently conducted World Bank Study on Nepal's Trade and Competitiveness 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 ten to about three, iii) removing constraints on exporters by easing access to duty drawback, and iv) introducing a bankruptcy law and its implementation.

6 Problems and Challenges in the Development of Private Sector

The private sector in Nepal faces a host of problems ranging from government policy and bureaucracy, market, finance, infrastructure, labor, business support, and raw materials/inputs to the trade policy of foreign/destination countries. It is obvious that there are many challenges to be addressed to make private sector viable and conducive for propelling the economic growth. Ensuring the investment friendly environment is the key challenge before us. Specifically some of major challenges are:

?? Stability and predictability of policy environment.

- ?? Creating consistency and confidence in the economic policies.
- ?? High dependency on unorganized commercial sector.
- ?? Identification of private sector investment.
- ?? Transparency in the regulatory mechanism of the government.
- ?? Procedural simplification to minimize transaction cost.
- ?? Comprehensive tax reform to widen tax income tax revenue and objectivity in administration.
- ?? Establishment of inter-industrial linkages.
- ?? 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.
- ?? Inadequacy in entrepreneurship and professional maturity in the private sector.
- ?? Establishment of inter-linkages between trade and industry.
- ?? Diversification of export trade in terms of both destination and product.
- ?? Establishment of standard accounting practices and transparency in business transaction.
- ?? Establishment of mechanism for risk management in time with international practices and trend.
- ?? 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.

7. 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 sound corporate governance.
- ☒ Specifying details of rules and procedures to reduce possibilities of misinterpretations.
- ☒ 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 incentive structures.
- ☒ Promoting and developing schemes for enhancing skill and knowledge among entrepreneurs and investors.
- ☒ Extending one-window facility effectively to the investors to overcome hassles and red tape.
- ☒ Reforming the financial sector in order to improve access to banking service.

8 Priority Areas

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.

9 Key Outcome

- ?? 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.

The key actions of the donors or development partners should focus on:

- ~~///~~ The donors should encourage recipient partners to formulate their own development strategies setting out local priorities, plans and instruments for implementing such strategies.
- ~~///~~ They should give attention to building the institutional capacity of the recipient to make the development sustainable in the long run.
- ~~///~~ The donors should focus their attention on the - tangible benefits of the projects rather than indulge in some abstract concepts or publicity gimmicks/populist measures.

10. 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 leadership 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.