



# Economic Freedom Country Audit Report Nepal 2015

Summary of analysis and recommendations

September, 2015

Around the world, economic freedom has generally led to positive social and economic outcomes, including higher economic growth, enhanced job creation, increased political stability, and the peaceful development of other freedoms. It has been empirically demonstrated that economic freedom is effective in creating prosperity and other positive outcomes than central planning or any other system not based on free and open market. Since 1996, The Fraser Institute, a Canada based think tank has been publishing the Economic Freedom of the World Report (EFWR). As of 2014, the EFWR ranked 152 countries and territories.

Nepal's score in the Fraser Institute's annual Economic Freedom of the World Report has stayed within 5.3 to 6.3 (out of 10) since 1980, which was the first year of Nepal's evaluation in the report, till 2014. This has put Nepal in the bottom quartile of the ranking for most of the evaluation years. While political and civil freedoms have gradually expanded over the years in Nepal, it is worth wondering why has economic freedom not followed suit. Economic freedom has proven to be the recipe for prosperity for countries around the world and examining Nepal's performance in the framework of Economic Freedom was a relevant pursuit for us as an institute dedicated to finding policy solutions for Nepal's prosperity. Therefore, Samriddhi, The Prosperity Foundation came together with US based Atlas Network and Fraser Institute to conduct a Country Audit on economic freedom of Nepal. The process involved seven consultation meetings from April 20-22, 2015 on six headings aimed at examining specific areas of economic policies and understanding how they contributed to the current state of economic freedom in Nepal. The discussion topics for those meetings were selected from the structure of the Economic Freedom of the World (EFW) Index published by Canada based think tank Fraser Institute as outlined in the next page. Attended by economists, business and political leaders, government officials and other stakeholders (See the end of the document for detailed list of attendees), the consultation meetings came up with discussions, conclusions, and recommendations on each topic. Based on the consultations, secondary research and guidance from respective research guides (experts<sup>1</sup> on the topic) the authors came up with a detailed analysis on each topic and came up with recommendations aimed at spearheading a series reforms to improve the status of economic freedom in Nepal. **The document is a summary of the main Country Audit Report, which is available at [samriddhi.org](http://samriddhi.org).** The main report is divided in six chapters where each chapter could be viewed as a report in its own. Each chapter details challenges in the given topic and outlines reform measures to improve Nepal's performance in the given area. This summary document is organized in a similar fashion.

<sup>1</sup> Late Mr. Bharat Upreti (Former Hon'ble Justice at the Supreme Court), Mr. Bhaskar Mani Gnawali (Former Deputy Governor of Nepal Rastra Bank), Dr. Bhimarjun Acharya (leading constitutional expert), Prof. Dr. Bishwambher Pyakuryal (Senior economist), Mr. Rameshwor Prasad Khanal (Former Secretary at the Ministry of Finance), Dr. Ram Krishna Timilsina (Executive Director, National Law College), and Dr. Yuba Raj Khatiwada (Former Governor of Nepal Rastra Bank)

# The Areas and Components of the EFW Index

## 1. Size of Government

- Government consumption
- Transfers and subsidies
- Government enterprises and investment
- Top marginal tax rate
  - (i) Top marginal income tax rate
  - (ii) Top marginal income and payroll tax rate

## 2. Legal System and Property Rights

- Judicial independence
- Impartial courts
- Protection of property rights
- Military interference in rule of law and politics
- Integrity of the legal system
- Legal enforcement of contracts
- Regulatory restrictions on the sale of real property
- Reliability of police
- Business costs of crime

## 3. Sound Money

- Money growth
- Standard deviation of inflation
- Inflation: most recent year
- Freedom to own foreign currency bank accounts

## 4. Freedom to Trade Internationally

- Tariffs
  - (i) Revenue from trade taxes (% of trade sector)
  - (ii) Mean tariff rate

(iii) Standard deviation of tariff rates

- Regulatory trade barriers
  - (i) Non-tariff trade barriers
  - (ii) Compliance costs of importing and exporting
- Black-market exchange rates
- Controls of the movement of capital and people
  - (i) Foreign ownership/investment restrictions
  - (ii) Capital controls
  - (iii) Freedom of foreigners to visit

## 5. Regulation

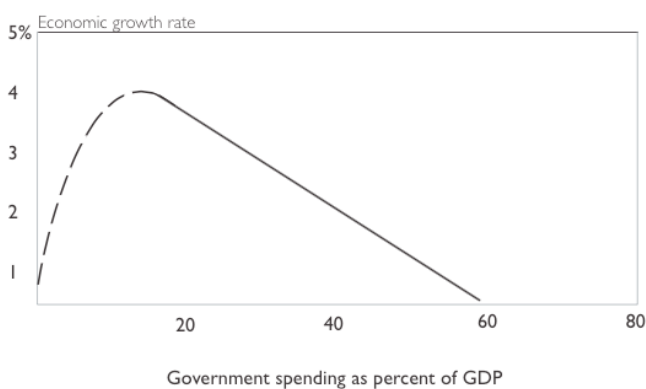
- Credit market regulations
  - (i) Ownership of banks
  - (ii) Private sector credit
  - (iii) Interest rate controls/negative real interest rates
- Labor market regulations
  - (i) Hiring regulations and minimum wage
  - (ii) Hiring and firing regulations
  - (iii) Centralized collective bargaining
  - (iv) Hours regulations
  - (v) Mandated cost of worker dismissal
  - (vi) Conscription
- Business regulations
  - (i) Administrative requirements
  - (ii) Bureaucracy costs
  - (iii) Starting a business
  - (iv) Extra payments/bribes/favoritism
  - (v) Licensing restrictions
  - (vi) Cost of tax compliance

# Part I: Country Audit of the Area - Size of Government

Nepal has scored highly in the size of government area in the Economic Freedom of the World Reports (EFWR) over the years, which considers government consumption, transfers and subsidies, government enterprises and investment, and top marginal tax rate as its subcategories. In the year 2010, 2011 and 2012, Nepal scored 8.3, 7.6 and 7.4 (respectively) out of 10 in the category size of government[1] (Gwartney, Lawson, & Hall, 2014). The 7.4 score in from the 2014 report, is the highest score among other categories in the report that year. As government spending, taxation, and the size of government-controlled enterprises increase, government decision-making is substituted for individual choice and economic freedom is reduced. Although Nepal scores well in the size of government category in the Economic Freedom of the World Report (EFWR), the country—as one of the poorest in the world—is not in a position to afford the inefficiency and ineffectiveness in delivering services mentioned in many national and international indicators. The figure below taken from Mitchell (2005) demonstrates that up

GDP had averaged at 20.39 in the past three years and has been on an increasing trend (Rabi, 2014). Hence, based on Brimelow (1993)'s graph, Nepal's government spending is at its optimum level and increase in spending level might have an adverse effect on the economy. Mitchell (2005) explains that the downward slope might be caused due to excessive taxation that higher levels of spending might require, displacement costs such as crowding out of the private sector, negative multiplier costs including large regulatory cost imposed in the economy, subsidization of economically inefficient activities, market distortion cost and few other costs. As the government spending is at optimum level and a further increase is likely to have a negative impact on growth, focusing on getting a better 'value for money' in the current spending level becomes very important. The country audit consultation on this topic brought about important discussion on spending on delivering better services and development outcomes by improving the ways in which spending is currently taking place.

**The Rahn Curve: Economy Shrinks When Government Grows Too Large**



Source: Peter Brimelow, "Why the Deficit is the Wrong Number," *Forbes*, March 15, 1993 as cited in Mitchell (2005)

to a certain point, government spending will help achieve economic growth. But excessive government spending has negative consequences on growth. In Nepal's case, government spending as a percent of

**Fragmentation of resources was cited as a problem in government spending during the consultation.** With limited amount of resources that the country can afford, there is certainly a trade off for the government in its decisions to work across sectors. Focusing on service sectors (such as, education and health,) law/courts receive very little funding and on the EFWR 2014, Nepal scores poorly in Protection of Property Rights (4.1), Legal Enforcement of Contracts (3.4) and in Business Costs of Crime (3.8). Although police service receives relatively higher funding, the country again scores poorly with a score of 4.5 in the category Reliability of Police (Gwartney, Lawson, & Hall, 2014). In 2013, Nepal ranked in the 26th percentile in Rule of Law in The World Bank's Worldwide Governance Indicator

(The World Bank, 2014). Another consequence of such fragmentation is that the quality of the output is often compromised.

**Slow progress in government-implemented programs was mentioned as another major problem during the consultation.** The Auditor General's (OAG) Report published in 2014 and 2015 mention low annual progress in government-implemented programs. The OAG Report published in 2014 states that zero percent annual progress was made in 844 programs, 0-25% progress in 357 programs, 26-50% progress in 1013 programs, and 51- 75% progress in 5725 programs under 28 different entities in FY 2012-13. Similarly, OAG's 2015 report states that zero percent annual progress was made in 1103 programs, 0-25% progress in 264 programs, 26-50% progress in 627 programs, and 51- 75% progress in 337 programs under 19 different entities in FY 2013-14.

A longstanding trend in the way government consumes resources in Nepal has been that of accumulating a major portion of its spending at the end of the fiscal year. **This received due discussion among the participants.** Out of the total capital expenditure, 73% in FY 2011/12 and 75% in FY 2012/13 were made in last trimester of the Fiscal Year and the trend has not been any different in the recent past (Aryal, 2014).

**Low level of accountability was said to be another major problem in this category during the consultations.** "We have a tolerance for inefficiency" shared the Former Vice Chairman of National Planning Commission, Dr. Jagadish Chandra Pokhrel, who was a part of the consultation. This tolerance has perpetuated the low levels of accountability we have seen. As mentioned above, the budget gets spent at the last moment and this leaves little room to spend it accountably.

**Duplication of work among different government ministries and departments, including among the central and local level institutions was also mentioned as a problem in the consultation while discussing government consumption in Nepal.** Tamang & Malena (2010) note "duplication and ambiguity in the division of responsibilities between local bodies and the central government". The OAG Report published in 2015 (2071) observes duplication in a number of programs across government ministries.

**Public enterprises, subsidies and transfers were other areas of government spending deemed as being burdensome during the consultations.** The Economic Survey of 2013/14 published by the Ministry of Finance states "government operated PEs have been a burden to the public with more liabilities than benefits" (Ministry of Finance, 2014). Representative from the Office of the Auditor General in the consultation meeting shared that while there is no clear classification of subsidies or a guiding policy, it is also directly politically influenced. The participants showed concern that such practice, along with the limited practice of privatization taking place without following due processes and influenced by corruption is giving rise to cronyism. They also mentioned that while incurring the above-mentioned direct costs, these subsidies were further burdening the consumers by distorting the markets.

Many of the challenges discussed in the consultations (as mentioned above) are rooted in the dysfunctional budgetary system, the current state of the political economy where short-term interests of the political leadership get entrenched in development planning and administration, and procedural delays. In such, long term and institutional problems remained unfixed perpetuating the ineffectiveness in service delivery.

# Recommendations

Based on the above analysis, the Country Audit report on the Size of government came up with the following recommendations:

- **Public Enterprises & Privatization:** Public enterprises need to be given specific objectives, in which performance can be measured. If these objectives cannot be met, they should be sold off. However, ensuring solvency of the enterprises is important before embarking into privatization. This could be done through structural reform such as strategic partnership with other enterprises. Wagle, Shrestha & Acharya (2014) take the case of Nepal Airlines Corporation (NAC) and provide details on introducing strategic partnership as a reform measure.
- **Subsidies:** Subsidies need to come with a sunset clause. There should be precise and well-defined policies and procedure for granting subsidies. Focus should be on ensuring those subsidies that help capital formation and are targeted to people and sectors. Subsidy administration should be such that the leakages are kept to lowest level possible using measures as direct cash transfers. This will also help address the issue of measurement of impact and transparency that is currently a problem with subsidies.
- **Prioritizing the role of government:** A discourse on the functions of the government should take place from efficiency perspective. The core idea is that if the government focuses on smaller number of things, basics such as Rule of Law could be more accessible to the people. Going by the principles of lean management, this will also help strengthen the government. A lean government can minimize a lot of wastage.
- **Information management within government:** Digital infrastructure should be introduced to improve data management, which is essential in making more informed policy decisions. Additionally, it is also important to building a repository of knowledge on what has worked in Nepal based on successful examples in the past.
- **Budgetary process reform:** Although budgetary reform is a long and complex process, Krause, Sweet, Hedger, & Chalise (2013) provide a couple of practical recommendations to improve the budget process “Budget actors should work to ensure projects in the budget have a full 12 months available for execution. Specifically, the MoF could ensure the final budget is presented to Parliament at least two months prior to the start of the fiscal year so that parliamentary approval is obtained before the fiscal year begins. These efforts will improve budget credibility and budget annuality. Another “quick win” would be a joint consultative review of inter- ministerial arrangements in budget planning, formulation, and execution to establish a clear division of roles between the National Planning Commission, Ministry of Finance, Financial Comptroller General Office line ministries, and local bodies regarding the procedural requirements of budget planning, formulation, and execution [...] The realistic aim would not be to remove political input, but rather to ensure all proposals are considered in a more timely way before the start of the fiscal year.” Another significant improvement that is due is to have a sound pre-budget that enables wider public to provide guidance to government in formulating budget that addresses to emerging needs of the economy. This would be a good step towards budget transparency.

*For detailed justification on claims and analysis presented above, find the full Country Audit Report at [www.samriddhi.org](http://www.samriddhi.org)*

## Part II: Country Audit of the Area - Legal Structure and Security of Property Rights

Security of property rights, protected by the rule of law, provides the foundation for both economic freedom and efficient operation of markets. When individuals and businesses lack confidence that contracts will be enforced and the fruits of their productive efforts protected, their incentive to engage in productive activity is eroded. Therefore, a sound legal system and property rights institution is the harbinger of a country's economic growth and prosperity.

Nepal scores the lowest in legal structure and security of property rights in the Economic Freedom of the World Report, 2014. An important observation to make here would be that such is not the case only in the year 2012<sup>2</sup>, but has been the case throughout the very recent history. As of 2012, the country has been held hostage to weak legal and property rights system, well below 80% of the total countries studied, with a dismal score of 4.2 out of 10.

### Sub-component scores and their interpretation (all scores are in scale of 1 to 10)

**Judicial Independence (Score-3.8):** there is low level of independence within the judiciary and additionally, it is subject to political interference of members of the government.

**Impartial Courts (Score-3.3):** the legal framework for private businesses to settling disputes, and challenging government's actions or regulations is inefficient and subject to manipulation. It further hints that there is an unwelcoming legal environment for private enterprises, in terms of them being able to thrive in Nepal.

**Protection of Property Rights (Score-4.1):** the country lacks a strongly-defined property rights system. Such low score further hints that there exists some form of violation of property rights (by either state or non-state actors) in the country.

### Policy and Implementation Challenges

Based on consultations and secondary research, the following were seen as major challenges in this audit area.

#### Judicial Independence

- The composition of the Judicial Council that is responsible for appointment and oversight of the judges is flawed. The presence of members of the judiciary and the executive in the council creates avenues for exercising influence.
- Power politics is prevalent within the judiciary, so much so that it creates factions and affects the performance of individual judges.
- Nepal practices appointment of temporary judges within the judiciary, the prospect of great professional gains following it compromises their professional integrity
- The budgetary dependence, huge resource inadequacy and lack of incentives and benefits for the practitioners of judiciary within the judicial system further weakens judicial independence.

"While discussing the country's legal framework, it is important to note that the country is seeing a degeneration of 'Rule of Law' into 'Rule by Law.' "  
-Dr. Bhimarjun Acharya (Constitutional Expert)

<sup>2</sup> The Economic Freedom of the World Report uses data from two years back. Hence, the score for 2012 was published only in 2014.

## Impartial Courts and Contract Enforcement

- It takes 910 days to enforce a contract in Nepal<sup>3</sup> and the court system is sitting on a backlog of over 76,000 pending cases, meaning the court system cannot deal with the demand placed on it. On the other hand, people are losing confidence in the effectiveness of the court system.
- There is no consistency in upholding the precedents set by competent benches, meaning there is no predictability within the judicial functions
- There is no commercial court in the country, which means there is no specialized state institution to handle commercial cases.
- Commercial benches that fill up the vacuum created by lack of commercial courts consist of temporary judges, which means that they cannot build sectorial expertise, on top of creating avenues for compromising the professional integrity.
- Pronouncements of arbitration rely on the court system for enforcement.
- “Public employers” in Nepal do not recognize the arbitration award until they are forced to do so by a competent court

## Protection of Property Rights

- Property (esp. land) recording system is inaccurate and ineffective
- Violation of property rights is widespread. The state itself has, in the past, expropriated private properties without compensation and disregarding the due processes of expropriation.
- The draft constitution, as of August end, 2015, neither lays down any provision for a due process, nor does so for a just and fair compensation. There is no constitutional protection against expropriation of private property.

<sup>3</sup> Nepal ranks 134th out of 189 economies in terms of ‘Enforcing Contracts.’ “This is determined by following the evolution of a payment dispute and tracking the time, cost, and number of procedures involved from the moment a plaintiff files the lawsuit until actual payment.” – Ease of Doing Business Report, 2015.

# Recommendations

## Judicial Independence

- The Judicial Council could be reformed by replacing the members of the Judiciary and Executive in the Council by independent juries and professional experts, to check influence.
- The new constitution, which is being drafted (as of September, 2015), needs to define the duties and responsibilities of the members of the Judicial Council, in addition to defining their eligibility. Clear deadlines should be set for fulfilling the posts of permanent judges in the Supreme Court.
- A clear criteria for the appointment of judges needs to be laid down in the Constitution. Appointment of judges on the basis of competence, and zero-influence of political recommendations need to be guaranteed.
- The provision to appoint provisional judges in the courts should be removed.
- Financial autonomy of the judiciary should be guaranteed.
- A parliamentary oversight body for overseeing the functions of the judiciary, including the functions of the Judicial Council could be created.

## Impartial Courts and Contract Enforcement

- Judges in the commercial bench should be declared non-transferable and a provision of appointment for fixed period needs to be made.
- The existing Contract Act, 2000 could be amended to include a special provision for disputes relating to commercial cases. Special Procedures could be made under the Contract Act, allowing commercial contracts to be dealt with within six months of the case being filed at the court. Furthermore, to compliment this amendment in the Act, it should be guaranteed that the existing commercial benches in the Courts of Appeal run hearings on a daily basis.

- Only the full bench of the Supreme Court should be allowed to make precedents.
- A mechanism should be created whereby the pronouncements of third-party arbitrations are enforced without having to rely on courts.
- Commercial courts should be established and given the responsibility to deal with all commercial cases.

### **Protection of Property Rights**

- Nepal should continue to recognize and uphold property rights as a fundamental right in the new constitution.
- In the case of making provision for expropriation, it should be guaranteed that there are only very narrow and well-defined reasons for it, and property acquisition can only be made after complying with a due process, including a just, fair and reasonable compensation.
- A proper central registry should be developed for the registry of immovable property.
- Cadastral mapping of the districts requiring re-mapping should be expedited and completed as soon as possible.

*For detailed justification on claims and analysis presented above, find the full Country Audit Report at [www.samriddhi.org](http://www.samriddhi.org)*

## Part III: Country Audit of the Area - Freedom to Trade Internationally

Trade is an integral aspect of a modern economy. One of the important contributions of modern economics has been the establishment of trade as a positive sum game. It is now generally accepted that trade benefits both the recipient and supplier of the traded goods/services. 'Freedom to trade internationally' is one of the areas of the Economic Freedom of the World (EFW) Index.

### Nepal's performance & analysis

Nepal scored 6.4 and was ranked 117 in the category of Freedom to trade internationally in the year 2012 on the latest 2014 report.

Table. Nepal's Score on the area freedom to trade internationally at the EFW index

SN	Year	2010	2011	2012
	<b>Freedom to Trade Internationally</b>	<b>6.43</b>	<b>6.35</b>	<b>6.40</b>
<b>A</b>	<b>Tariff</b>	<b>6.29</b>	<b>6.25</b>	<b>6.36</b>
i	Revenue from trade taxes (% of trade sector)	5.72	5.73	5.66
ii	Mean tariff rate	7.54	7.54	7.54
iii	Standard Deviation of Tariff rates	5.62	5.47	5.87
<b>B</b>	<b>Regulatory Trade Barriers</b>	<b>4.72</b>	<b>4.44</b>	<b>4.58</b>
i	Non-tariff Trade Barriers	4.9	4.52	4.94
ii	Compliance cost of Importing and Exporting	4.54	4.35	4.21
<b>C</b>	<b>Black-market exchange rates</b>	<b>10.00</b>	<b>10.00</b>	<b>10.00</b>
<b>D</b>	<b>Controls of the movement of Capital and People</b>	<b>4.69</b>	<b>4.71</b>	<b>4.65</b>
i	Foreign ownership/investment restrictions	4.08	4.14	3.96
ii	Capital Controls	0.00	0.00	0.00
iii	Freedom of foreigners to visit	10.00	10.00	10.00

Source: Gwartney, Lawson & Hall, (2014)

A. Tariff: 17 percent of Nepal's revenue was from taxes on international trade in 2013 (World Bank, 2015). This is higher than the South Asian average. Compared to Nepal's neighbors, India and China, Nepal has a higher mean tariff rate. In addition to tariff rates, Nepal also imposes para-tariffs such as excise duties on several import items. Taxing international trade implies discouraging it. For a poor economy like Nepal, this is a counter-intuitive move since international trade can prove to be the engine of growth for Nepal.

B. Regulatory Trade Barriers: Non – tariff trade barriers such as quotas, lack of adequate infrastructure and procedural delays through lengthy bureaucratic requirements increase the cost of doing business in Nepal. In addition, Nepal being a land locked nation faces severe transportation and logistic issues owing to the quality of its surface transportation and bureaucratic hassles traders have to face in India (being the largest surface transit route to Nepal).

C. Black Market Exchange rate: Thankfully, Nepal does not impose restrictions on foreign exchange and therefore, it scores perfectly in this sub category.

D. Controls of movement of capital and people: Nepal imposes controls and has a restrictive environment for foreign investors. These restrictions come in the form of minimum investment requirement, procedural approvals required for investment, restrictions on ownership of land and restrictions on hiring foreigners to work in Nepal.

### **Policy and implementation challenges**

Nepal's biggest challenge comes from its weak economic diplomacy and a regulatory regime that is tied up in miscoordination between various government agencies. Nepal's outlook on trade policy also impedes its development of trade further. Policymakers are often convinced of 'import substitution' outlook, which has resulted in the creation of a myriad of regulations that only add to the arbitrariness of the policy environment. Due to this, it takes more than a month to export or import in Nepal and the cost of compliance crosses USD 2000 (World Bank, 2015). Nepal has not been able to negotiate with India on the trade and transit treaty with favorable outcomes (Kharel, 2009). In addition, it has not been able to improve its trade infrastructures. Although custom departments were upgraded with the use of technology, due to the lack of coordination and continuous investment, most of these technologies have only added to the confusion that the manual process had in the first place (Rajkarnikar, 2010). Entrepreneurs have to spend additional time and money to go to various government agencies to seek permission to conduct business. For instance, small-scale entrepreneurs willing to trade in forest products have to acquire documentation from 7 to 8 different government agencies before they are able to trade (FAO, 2009).

### **Way forward: Improving Economic Freedom in international trade**

In order to improve economic freedom in the international trade category, Nepal needs to re-orient its trade policy outlook. Instead of being inward looking, Nepal would greatly benefit by developing a trade policy that facilitates Nepali Entrepreneurs to become global players. In order to do so, Nepal needs to improve on the following aspects:

- International trade needs to be encouraged: Rationalize the tariff regime, remove the revenue dependence on tariff and move away from para-tariffs.
- Improve economic diplomacy with special training to diplomats on economic negotiation.
- Simplify regulatory regime by removing requirements to contact multiple government agencies for permits and authorizations to trade. This would help resolve coordination failures amongst government agencies.
- Improve trade infrastructure through continuous investments in custom offices, roads and internationally recognized accreditation facilities.
- Remove capital controls and facilitate foreign investment both inward and outward such that it can become a credible player in the international market.

With a well thought out reform strategy, Nepal's potential in the international market need not be hampered by its landlocked geography. In fact, Nepal can serve as the transit between two major markets – India and China – and reap benefits of international trade across its length and breadth.

## Part IV: Country Audit of the Component - Credit Market Regulations

“Credit market regulations” is a sub-component under the “Regulation” heading in the Economic Freedom of the World Report and looks at possible regulatory hurdles affecting the market for credit. Nepal has been an average performer in the category of Credit Market Regulation.

Table: Nepal’s scores through the years on Credit Market Regulations

Year	Score out of 10
1980	4.00
1990	5.56
2000	6.25
2005	7.23
2010	8.19
2011	8.23
2012	7.28

Source: Gwartney, Lawson, & Hall (2014)

As part of Nepal’s country audit process, a series of meetings were held with prominent members of the Nepalese civil society, banking sector, and government officials in order to receive views and recommendations regarding the scorings set by the report. From the deliberations, several points regarding the cause of Nepal’s low score were discussed. Similarly, steps, procedures, and policies, the implementation of which, would lead to the alleviation of Nepal’s situation, were also brought forth. Some of the main challenges outlined during the consultation were:

### **Low public participation in formal banking:**

Given the relative infancy of the Nepalese banking sector in comparison to that of other more developed nations, it is natural that a large portion of the population is deprived of banking facilities. This can be evidenced with the paltry number depicting per capita deposit, in real 1984/85 terms, which was just a little above Rs. 20 in the year 2007 (Maskey et al.,

2009). The fact that deposits per capita are low allows us to infer that credit per capita may also be low which is a problem because loans and other forms of credit are used to make investments and accumulate capital. The low rate of public participation in formal banking may also be symptomatic of Nepal’s anemic growth rate.

### **Mandating investment in certain sectors, government insurance of banks, and direct control of interest rates through spread:**

Pressures from the government to provide low interest loans or collateral free loans to certain ‘deprived & marginalized groups/sectors’ exacerbate pressure on banks to make riskier investments in order to increase revenue generation from alternative sources. Moreover, banks are protected by the government and depositors’ savings are almost always insured by the government; such guarantees may add to the moral hazard of banking and foster risky investments.

There is a provision regarding refinancing in the Monetary Policy of 2012/13 that places controls on interest rates related to refinancing in the “productive sector.” It prohibits banking and finance institutions from charging more than 9 percent on such activities (Monetary Policy 2012-13). Similar intentions are seen in the case of loans forwarded for entrepreneurs in milk and meat related industries. Refinancing rates are capped at 6 percent while BFIs are not allowed to charge more than 9 percent for loans (Monetary Policy 2012-13). Other sectors such as sick industries, small and cottage industries, exporting industries, foreign employment and deprived sector also enjoy caps on the interest rate that can be charged. However, this controlled

interest only applies to commercial banks if the funds are acquired from the central bank itself. While it is important that all social groups should have access to finance, even humble attempts at bettering the economic situation of one group via coercion may have unintended consequences. For example, the inability to charge higher interest rates to one group due to regulation may lead to banks charging higher rates to other groups not protected by regulation.

Banks and financial institutions are one of the most important vehicles of economic growth because they help convert savings into investment and capital, yet, to regulate them is a direct violation of freedom. In July of 2014, the central bank released a directive that restricted the spread rate—the difference between interest given to depositors and interest taken from lenders—to 5 percent (NRB, 2014).

When a supervising body intervenes to benefit a particular group or as an attempt to ameliorate a deteriorating situation, the ability of the market to correct its failures may be compromised.

### **Alternative forms or channels of investment**

Nepalese market also requires other alternative forms or channels of investment. In countries with developed financial markets entities like hedge funds, mutual funds, and venture capital are prevalent. Such institutions specialize in making high risk/high return investments. Giving these entities a space in the market is important to create opportunities for those with surplus capital to invest instead of simply saving in banks or physical assets.

## **Recommendations**

- Since the era of liberalization started in Nepal in the decade of the 1990s, the central bank has not directly set forth regulations to control interest rates. While this is a noble intention to move forward by allowing the market to set its own course, it is not fully established in practice. The 2014 directive from the central bank that instructed commercial banks to keep the spread rate between interest on saving and loans within 5 percent showcases a duality in the central banks commitments and actions. This direct regulatory control needs to be ended.
- The policy requirement to compulsorily lend money in government categorized 'deprived sector' needs to be removed for the reasons mentioned in the above section. A solution could be forged together with existing financial institutions, which does not require the use of mandatory provisions through regulations to address the underlying challenges that keep investment away from the 'deprived' sector.
- Many government funds such as the Youth and Small Enterprise Self Employment Fund, which remain mostly dormant, could be pooled together to create a larger fund and mobilized through a private party agency.
- The government wishes to increase the number of people who are covered by the formal banking sector: one idea to move this forward would be to allow or create an environment for private banks to work along with the government. For example, since utility companies in Nepal are government owned, it would encourage more individuals to bank if bill payment or tax payment could be done via private banks. Such developments would encourage private banks to move into areas that have remained devoid of banks and banking services. While this may require other changes such as the development of online or mobile-based business models and

online based payments, it is high time that these services become commonplace in Nepal, giving such tools the 'proliferation and advantages seen in other countries.

- Another requirement for an improved Nepalese banking sector, as for any other market, is more competition. Liberally allowing foreign owned banks or their branches to enter the Nepalese banking sector would not only give consumers more choices, it would also introduce existing banks to banking practices used in other parts of the world. The subsequent technology transfer would aid in the development of Nepalese banking sector.
- Opening the Nepalese market for foreign banks should be complemented by liberalizing the entry of foreign direct (FDI) environment. Allowing FDI would also help local banks as it would give them more clients to serve. There was also a moratorium on the registration of commercial banks set in place in 2009 in order to review the licensing procedure of commercial banks, which needs to be revisited.
- A liberal policy framework for opening alternative forms of channels of investment such as hedge funds, mutual funds, and venture capitals should be established to offer predictability for investors.

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## Part V: Country Audit of the Component - Labor Market Regulations

Labor regulation comes under the fifth area of the Economic Freedom of the World Index of Regulation of Credit, Labor and Business. The index has identified several indicators that determine the scale of regulation of labor in any nation and is inclusive of: hiring regulations and minimum wage, hiring and firing regulations, centralized collective bargaining, (working) hours regulations, mandated cost of worker dismissal and conscription (compulsory military enrollment).

Nepal has a score of 5.82 out of 10 in the labor regulation component of the 2014 index, with lower ratings reflecting more stringent regulations (Gwartney, Lawson, & Hall, 2014). The country scores well in hours regulations and conscription (10.00 in both) but has been given ratings of close to or much below 5.5 in all other sub-indicators. An examination of challenges to achieving a better score in the category reveal the following problems:

**1. Stringent hiring and firing regulations:** The governing Labor Act of 1992 dictates that a worker needs to be hired permanently by the enterprise after he/she has completed a year of continuous working period (240 working days) and if the person is deemed to have a number of desirable work qualities. In practice however, any worker having completed 240 days of service demands automatic hiring, despite the employers reservations, if any. Additionally, firing a worker in Nepal is an incredibly long and arduous process, requiring third party intervention for the dismissal of even one worker alone. The cost of dismissing one employee thus reaches thousands of dollars, with having to handle litigation costs and additional severance compensation if charged with wrongful firing by the court.

Table. Selected countries and their corresponding requirement of third-party approval when dismissing one worker.

Countries	(Requirement of) Third-party approval if 1 worker is dismissed?
Afghanistan	No
Bangladesh (Chittagong & Dhaka)	No
Bhutan	No
China (Beijing) (Shanghai)	No
India (Delhi) (Mumbai)	No
Maldives	No
Nepal	Yes
Pakistan (Karachi) (Lahore)	No
Sri Lanka	Yes

Source: *Doing Business Report 2015*

Additionally, though the law also states that a retrenchment application shall be reviewed and granted acceptance within 2 months, practice dictates otherwise with applicants being left in a state of limbo for years. (For more, *Cost of Firing in Nepal* by Arpita Nepal and Labisha Uprety for Samriddhi Foundation, 2015).

**2. Existence of multiple-trade unions in an enterprise; more than mandated by the law:**

Though the law mandates no more than 4 trade unions in an enterprise, almost 6 such unions have been found to exist in a single enterprise. Floating and/or ghost members are seen to largely make up a number of union memberships. Because trade unions are indispensably linked to political parties, a split in the parent party invariably causes a split in the trade union. This has to be seen in juxtaposition with the fact that 73.9% people work in largely the union-devoid agriculture sector (NLFS, 2008). This points to a burgeoning non-formal economy that is neither officially recognized nor governed by existing acts and unions.

For detailed justification on claims and analysis presented above, find the full Country Audit Report at [www.samriddhi.org](http://www.samriddhi.org)

### **3. Problems in dispute resolution mechanisms:**

Nepal is home to only 1 labor court and 10 labor offices, and the existing 'labor inspectors' are found to be inadequate in number and inefficient in handling and resolving enterprise conflicts. Also, Labor Act 1992 has provisions for 'authorized' trade unions to engage in collective bargaining but employers often engage the parent political party in discussions rather than dealing with lower level union members.

### **4. Industrial action and disruption in enterprise operations:**

Strikes and forced closures called on by trade union members have become commonplace in the country; these are chosen to deliberately disrupt enterprise operations often for fulfillment of demands. Further, these strikes do not follow provisions set in labor rules which only works to dilute the workers' claims.

**5. The minimum wage:** Though it is understood that effects of the minimum wage depend upon wage and worker elasticity, it is common knowledge that a stringent minimum wage regulation pushes workers (usually those low-skilled) out of the formal economy. Those driven out of the formal economy eventually join the informal one because those in developing countries in particular have neither sufficient unemployment benefits to fall on nor the time to wait for an official opening in the formal economy (Jones, 1997).

## **Recommendations**

- **Hiring and firing made easier:** Removing the 240-day permanence clause is imperative in allowing employers the flexibility to choose the number and type of workers they would like to retain as it obviously differs in every enterprise. Employers should also be able to fire at will (with the law prohibiting defining terms of unfair dismissal) and providing adequate compensation and early notice. Third-party approval (such as that of the labor office) should not be mandatory when firing one worker alone. The time and cost-consuming process of retrenchment should also be duly shortened in practice, with workers being given required compensation. Easing such entry and exit barriers shall eventually cause domestic industry grounds to be deemed attractive investments.
- **Handling industrial disputes better:** Employing Alternative Dispute Resolution mechanisms rather than formal litigation has a number of advantages: arbitration is a less time, effort and money consuming mechanism, there is no stigma of a court case represents, it is final and binding decision, and it is definite and consensual agreement. Nepal already employs an Arbitration Act of 1999 for commercial disputes and is not inclusive of labor dispute handling. The simplest recommendation from this paper is to incorporate labor disputes under the existing Arbitration Act and bring such conflict under its jurisdiction. The growth of private mediators and arbitrators could also help implement and facilitate this. In addition to this, increasing the number of labor courts particularly in labor and industry heavy areas in Nepal, better equipping labor officers and inspectors with conflict-resolving skills and formally employing a single-union rule in one enterprise with representatives from all existing unions are key solutions to better handling disputes.
- **Removing the national minimum wage and employing the rule of law:** The minimum wage, in effect, displaces highly elastic labor (usually low skilled workers) forcing them into the informal economy, where they are more open to exploitation than ever before. In effect, removing the national minimum wage and allowing enterprises to fix their own entry-level wages, in accordance to skill and qualification required, can account for a better standard of living for workers. A revision thus of the existing labor law with these provisions in mind and its effective implementation shall cause both entrepreneurs and worker productivity to increase.

## Part VI: Country Audit of the Component - Business Regulations

The regulatory environment of an economy is a key determinant of the success of its business enterprises. Economists around the world agree that burdening an enterprise with regulations will not only reduce the enterprise's productivity but can be a deterrent to economic growth and prosperity. Nepal scores 6.07 out of 10 in business regulation and is ranked in the 89th position in the Economic Freedom of the World (EFW) Index (Gwartney, Lawson, & Hall, 2014). The scores Nepal has obtained in the component Business Regulations in past three years are shown in the table below. The expanded use of regulation in key growth sectors has been an important factor contributing to the low ratings in business regulation category of the report. Some key challenges outlined during the consultation on this category are presented below:

**Administrative Requirements:** Administrative formalities like additional paperwork and having to register and take permits from several different government agencies plague the business environment of Nepal thereby reducing the operational efficiency of business and increasing the cost of doing business in Nepal. These kinds of authorization requirements create rent-seeking

opportunities for the civil servants and various tactics such as deliberate delays in authorization are used. This is true especially in a country where rule of law is lax (Tanzi, V., 1998, p. 10). Perhaps the most onerous of administrative requirements in Nepal are the exit regulations. While it is relatively easy to open an enterprise in Nepal, exiting an industry is extremely difficult. Exit is next to impossible because no company can commence liquidation without the permission of the court (Insolvency Act, 2006, p. 1). It takes at least two years for the liquidation to be completed. During the liquidation phase, it is necessary to get approval from the Department of Industry (DOI) at each stage such as while appointing a liquidator, during disposal of fixed assets, and so on. Similarly, exit barriers include complexities involving tax clearance and labor retrenchment. Owing to the administrative complications, almost all enterprises in Nepal fulfill their regulatory requirements through agents that are specialized in navigating the opaque bureaucracy. This further adds to the cost of doing business in Nepal.

**Bureaucracy Costs, Extra Payment, and Bribes:** When administrative requirements are numerous, it automatically increases bureaucracy cost. Delaying

Table: Nepal's scores through the years on business regulation on the EFWR index

		2011	2012	2013
Area	Business Regulation	5.66	6.07	6.12
Component i	Administrative requirements	3.13	3.65	3.48
Component ii	Bureaucracy costs	6.68	6.68	6.68
Component iii	Starting a business	8.68	8.72	9.09
Component iv	Extra payments/bribes/favoritism	3.22	3.18	3.02
Component v	Licensing restriction	5.93	7.86	8.12
Component vi	Cost of tax compliance	6.35	6.35	6.35

Source: Gwartney, J., Lawson, R., & Hall, J. (2014)

tactics often induce the service seeker to pay 'extra fees' through brokers who can 'speed' the Government processes. This is true for procedures like company registration, custom clearance, and vehicle registration in Nepal. The agency costs mentioned above in the administrative requirement section point towards additional bureaucracy costs that result from opaque regulations and languages that only lawyers can understand or are open to several different interpretations.

Nepal ranks 126th out of 175 countries on the Corruption Perception Index of 2014 produced by Transparency International (TI, 2014). Similarly, the Enterprise Survey conducted by the World Economic Forum for its Global Competitiveness Index points to corruption as the second most prominent factor that adversely affects doing business in Nepal. Arbitrary decision-making created by unclear legislation allows ample space for bureaucracy to create unnecessary administrative requirements, and this is one of the primary sources of corruption for businesses in Nepal.

**Starting a Business:** While Nepal does well in this category, there are numerous areas for improvement. Nepal can ease the process of doing business by streamlining procedures by setting up a one-stop shop, making procedures simpler or faster by introducing technology and reducing or eliminating minimum capital requirements. As of today a company registration requires two documents Memorandum of Association (MoA) and Article of Association (AoA) for incorporation, which could be combined into a single document. Similarly, the registration process is currently centered in urban areas. Lack of online payment and a digital signature means that although entrepreneurs can do most of their form filing online, they have to make a trip to the OCR and the bank to make final payments for registration.

**Licensing Restriction:** Agriculture, education, energy, infrastructure and tourism are the major components of the Nepalese economy and growth and development of these sectors are hindered by the licensing system. A study by the International Finance Corporation (IFC) identified 125 different kinds of licenses issued by 41 institutions in Nepal. Out of these, more than half (67 out of 125) of the business licenses are pre-operational business licenses. This indicates that the current licensing regime and regulatory environment are still quasi-restrictive in nature (IFC, 2011). The licensing procedures are characterized by lengthy processing time, lack of coordination among institutions and lack of information, and they involve numerous interactions with government officials. A complex licensing environment creates barriers to entry and inadvertently supports the formation of cartels in the private sector. A licensing system also implies that in a country like Nepal where corruption is rife, favoritism and rent seeking ensures that licenses are limited to a small elite thereby marginalizing large groups of people in terms of economic opportunities. A 'license raj' in essence does not complement the vision of 'inclusive growth' that Nepal has undertaken.

**Cost of Tax Compliance:** The redundancies and legalities of tax regulation in Nepal has created ample space for arbitrariness. Owing to a complex tax code, tax compliance is minimal in Nepal. For an entrepreneur with a small enterprise, it is difficult to understand all the complexities of the tax code and the cost of hiring a tax compliance attorney or Chartered Accountant is beyond their budget. Therefore, most SMEs choose to function in the informal economy. The lengthy process involved also increases cost of tax compliance, which is mainly due to loopholes in the law and discretionary power given to the bureaucracy by the law (Adhikary et al., 2013). There have been some improvements in this

area with introduction of IT in tax administration. To pay taxes in Nepal, documents are electronically submitted but payments have to be made to stipulated banks only. There is no digital signature verification system. For example, the entrepreneurs in Namchebazar – which is situated at the entrance of Mount Everest--complain that they have to go to Salleri to pay taxes. Nepal achieved small gains in 2011 and 2012 in comparison to 2010 in all components of business regulation except in areas of extra payments/bribes/favoritism. However, the score Nepal gets in business regulation is still unfortunately low and the situation is worrisome with an increasing public deficit, inflation, and a low rate of GDP growth rate.

## Recommendations

- **Simplify Registration Process:** Although the e-registration system has been introduced, the reform in this area will not be complete unless Nepal enables the online payment system as well as digital signature verification system. Therefore, both these systems should be introduced. Only then we can have a business registration system that enables Nepalese to easily register an enterprise from any corner of Nepal. Similarly, companies currently have to produce two documents – the MoA and AoA for registration. This can be simplified to one Certificate of Incorporation. The business registration system can simplify the ‘name registration process’ and the ‘objectives verification process’ by allowing companies to register under any objectives as long as they comply with the law of land (i.e. do not trade or produce illegal substances). Similarly, all the registration processes can be handled through the Office of Company Registration instead
- of companies having to register at multiple government offices such as Department of Industry, Department of Small and Cottage Industries, and Department of Commerce and Supplies. This simply requires a central database that can share the information of registered companies between different government agencies.
- **Simplify the Process of Exit:** The process of liquidation should be simplified by removing unnecessary administrative requirements such as requiring approval from OCR on each and every step and speeding up the process in the court. Similarly, exit procedure from Internal Revenue Department should be simplified. Once the Company has settled its tax liabilities, it should be able to close down its tax account instead of having to wait for a mandatory period of time.
- **Remove certain licenses and simplify the ‘absolutely necessary’ ones:** An overhaul of the licensing system needs to be undertaken. This is also important from a viewpoint of curbing corruption and extra payments. Licenses in categories such as educational institutions, agro-enterprises, and tourism-related enterprises need to be removed overall since Nepal requires more enterprises to enter these sectors. With regards to natural resource usage (like in the case of hydropower), licensing procedures need to be simplified (one license that gives both survey and generation license) and handed out from one independent agency. Any license that has been created to limit the entry because the Government lacks the capacity to maintain rule of law, should be removed immediately and instead the focus should be on enforcing contracts and improving

the legal system with regards to commercial enterprises. This includes strengthening the 'Competition Authority' and 'Competition Act' of Nepal.

- **Curb Corruption and Culture of Favoritism:**

Corruption cannot be curbed by employing additional inspectors and oversight agencies, but by significantly reducing the need to have 'an inspection'. This needs simplification of the administrative requirements and elimination of many requirements that simply provide 'approval authority' to certain government agencies. Amending laws that grant 'arbitrary power' to government agencies is a first step in that direction. Similarly, the language of the legalese that leaves laws open to various interpretations needs to be simplified such that those in authority cannot use them for rent-seeking. Introduction of modern information technology and automatic procedures in regulatory agencies and ensuring their independence through institutional checks and balances can result in significantly minimizing corruption. Corruption control will also require reviewing Nepal's Civil Service Act and redesigning the incentive system for bureaucrats.

- **Simplify and Clarify Tax Rules:** Complex tax codes deter revenue collection for the government and push legitimate businesses into the informal economy. This is a loss to

the government as well as to the society. Entrepreneurs often complain that the authorities do not accept a 'profit and loss statement' with 'losses' and resort to blackmailing to extort extra payments from them. They often resort to disallowing some cost items on the pretext that these costs are not business related. A simplified tax code that clearly lays out what can be claimed as cost will reduce the scope for varied interpretation. This is possible through simplification of tax rules.

- **Reduce the Costs of Tax Compliance:** Small entrepreneurs in Nepal complain about the high cost of tax compliance. Some of the cost could be reduced by minor changes like allowing the electronic transfer of tax payment from any commercial bank, eliminating the need to go to the tax office for getting a tax clearance certificate, making the tax administrators liable for their actions/inactions and employing mechanisms to administer tax clearances to large number of people who fulfill broad required requirements. Taxpayers should be treated with respect rather than be treated with suspicion. There is no doubt that some reform in the taxation system have been initiated so far in Nepal. There is an urgent need to push forward more reforms in this sector that can reduce the cost of tax compliance in Nepal.

*For detailed justification on claims and analysis presented above, find the full Country Audit Report at [www.samriddhi.org](http://www.samriddhi.org)*

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# List of Annexes

## Annex I: Country Audit Report preparation team:

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Dr. Bhimarjun Acharya, Constitutional expert	Akash Shrestha, Samriddhi Foundation	Legal Structure and Security of Property Rights
Prof. Dr. Bishwambher Pyakuryal, Senior Economist	Anurag Pant, Samriddhi Foundation Arpita Nepal, Samriddhi Foundation	Freedom to Trade Internationally
Dr. Ramkrishna Timalsena, Former Supreme Court Registrar	Arpita Nepal, Samriddhi Foundation Labisha Upreti, Samriddhi Foundation	Regulation of Labor
Mr. Rameshore Prasad Khanal, Former Finance Secretary	Sarita Sapkota, Samriddhi Foundation	Size of Government: Expenditure, Taxes and Enterprises
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	Fred McMahon, Fraser Institute	Content Editor
	Geoff Matthews	Language Editor

## Annex II: List of participants for all consultations:

Date: 20-22 April 2015

Venue: Hotel Radisson, Lazimpat

Name	Organization
Analraj Bhattarai	Freelancer
Anjan K. Dahal	Associate professor/ KSL
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Biswanath Pyakurel	
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Hansa R. Pandey	FNCCI
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Ram B. Thapa	Consumer Rights Activist
Himal C. Aryal	Nepal Law Commission
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Yogendra Kunwar	CLASS – NEPAL
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07. Review & Overview of Economic Contribution of Tourism Sector in Nepal
08. Review of Agriculture Sector & Policy Measures for Economic Development in Nepal
09. Contract Enforcement: The Practicalities of Dealing with Commercial Disputes in Nepal
10. Foreign Direct Investment: Towards Second Generation of Reforms
11. Industrial Relations An Institutional Analysis
12. Doing Business in Nepal: Ground Realities
13. Analysis of the Performance of the Public Enterprises
14. Policy Options for Improving Industrial Relations in Nepal
15. Policy Options for Improved Electricity Transmission System in Nepal
16. Policy Options for Public Enterprises reform in Nepal: A look at two public enterprises
17. Economic Freedom Matters : Does Economic Freedom Effect *Kirana Pasals* in Nepal
18. Trade Study Series: A look at Petroleum and Fertilizer Supply in Nepal
19. Better Education Outcomes Through Education Entrepreneurs : Cost of Registering Private Schools in Nepal
20. Better Education Outcomes Through Education Entrepreneurs : Cost of Complying with Applicable Regulations
21. Cost of Firing in Nepal
22. Regulatory Reform in Transportation Services: Revisiting Taxi Licensing in Bagmati Zone
23. Regulatory Reform in Transportation Services: Understanding Why Cartels Exist and Sustain

## ABOUT SAMRIDDHI, THE PROSPERITY FOUNDATION

Samriddhi, The Prosperity Foundation is an independent policy institute based in Kathmandu that focuses on economic policy reform. Established in 2007, Samriddhi aims at facilitating a discourse on pragmatic market based solutions for a free and prosperous Nepal.

Known for bringing together entrepreneurs, politicians, business leaders, bureaucrats, experts, journalists and other groups and individuals to make an impact on the policy discourse of Nepal, Samriddhi works with a three-tier approach - Research and Publication, Educational and Training, Advocacy and Public Outreach. Some of its highly successful efforts include the annual economic policy reform initiative named "Nepal Economic Growth Agenda (NEGA)", a sharing platform for entrepreneurs named "Last Thursdays with an entrepreneur" and a regular discussion forum on contemporary political economic agendas named "Econ-ity". Samriddhi also hosts the secretariat of 'Campaign for a Livable Nepal', popularly known as Gari Khana Deu campaign.

One of Samriddhi's award winning programs is a five day residential workshop on economics and entrepreneurship named Arthalya, which has produced over 400 graduates over the past few years, among which more than two dozen run their own enterprises now.

The organization is also committed towards developing a resource center on political economic issues with its Political Economic Resource Center (PERC). Besides this, Samriddhi also undertakes localization of international publications on the core areas of its work. Samriddhi was the recipient of the Dorian & Antony Fisher Venture Grant Award in 2009 and the Templeton Freedom Award in 2011.

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