ECONOMIC FREEDOM COUNTRY AUDIT NEPAL 2015

A COMPREHENSIVE ANALYSIS OF NEPAL'S ECONOMIC POLICY REGIME

- Government Consumption
- Transfer & Subsidies
- Judicial Process & Efficiency
- Property Rights
- Contract Enforcement
- International & Domestic Trade
- Credit Market Regulations
- Business Regulations
- Labour Regulations

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Samriddhi, The Prosperity Foundation

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Message from Honorable Minister of Finance

Government of Nepal
Ministry of Finance

Government of Nepal

Dr. Ram Sharan Mahat
Finance Minister

Message

I am pleased to learn that Samriddhi, The Prosperity Foundation has collaborated with a noted Canada based think tank in conducting the Economic Freedom Country Audit for Nepal and has prepared this report. I take this opportunity to thank Samriddhi, for taking the initiative and bringing the issue of economic freedom to the fore of our discussion. A country's prosperity can be ensured when people are able to put their entrepreneurial zeal to improve the lives of their own and their fellow citizens. I believe this is possible in an economically free environment only.

The Economic Freedom of the World Report allows us to compare where we stand in various economic freedom indicators vis-a-vis other countries. As countries are facing fierce competition in attracting investment, it is important to take note of the achievements of various countries, many of which are reflected in the annual economic freedom index.

It was with the restoration of the Multi Party democratic polity that we embarked on a path of economic liberalization. I am glad that I was personally involved with this process. After the reforms, we saw a robust growth of the economy and exports, but unfortunately the country plunged into insurgency and period of political instability which took a toll not only in terms of reduction in growth rate but also in the decline of the economic freedom itself. The new constitution is expected to guarantee freedom including economic freedom to the citizens.

This country audit, I am told is the first of its kind analysis for Nepal concerning its economic freedom. This in itself is a good beginning for improving our rankings. Higher rankings will enhance the confidence of the international market in the Nepalese economy and I am hopeful that you have come up with concrete and actionable suggestions. It is not sufficient to say 'we need economic freedom and we need to improve our performance in this or that area'. It is more important to suggest how those recommendations can be implemented. In a democratic policy environment, it is important to take supporters as well as opponents along and a truly good recommendation is not only sound in its analysis of several implications but is also acceptable to stakeholders involved. So I hope the suggestions and recommendations included in the country audit reflect the view and interest of the range of stakeholders and am happy to consider such recommendations to enhance economic freedom in Nepal. I wish Samriddhi Foundation success in its endeavors.

Thank you.

RSMahat

Dr. Ram Sharan Mahat

September 9, 2015

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Message from Honorable Governor, Nepal Rastra Bank

गभर्नर
Governor

नेपाल राष्ट्र बैंक
NEPAL RASTRA BANK

केन्द्रीय कार्यालय
बालुवाटार, काठमाडौं ।
Central Office
Baluwatar, Kathmandu

Message

It gives me immense pleasure to congratulate Samridhhi, The Prosperity Foundation for successfully conducting a country audit on Nepal's Economic Freedom.

The devastating earthquake on 25th April this year and the subsequent aftershocks have had significant negative impact on all sectors of production of the Nepalese economy. However, the economy has been able to maintain low annual consumer price inflation with BoP having registered a record high surplus in FY 2014/15. Although these indicators reflect a stable macro-economic situation, the slackening of economic activities is still a matter of concern with constraints and challenges in overall development.

In this regard, I am confident that the report will provide a valuable insight on Nepal's current situation and contribute to enhance the country's status as an economically free nation with helpful policy recommendations.

On the occasion of the release of this audit report, I thus extend my best wishes to the Foundation for the success of this launching ceremony.

(Dr. Chiranjibi Nepal)

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Foreword

Nepal has astonishing potential. It can be a land of ever increasing opportunity and growing prosperity. It is unnecessary for so many Nepalese to live in poverty. The nation has within its means the ability to create prosperity for all. It is unnecessary for so many Nepalese to go to other nations to work. Many new jobs can be created right here in Nepal. With Nepal's great opportunities, all it requires is improved economic policy—and that is the great value of this document.

What determines a nation's fate is not its starting point or its geographic location, but the policies it adopts: whether land-locked nations, like Switzerland, Botswana, the Czech Republic, or Nepal; or whether the nations started as intensely poor and war ravaged, like Singapore, Hong Kong, and South Korea, and to some extent Nepal. What all the successful places have in common is economic policy that stresses free choice, open markets and the rule of law to protect property and choice. In other words, the people of these places are economically free to make their own choices.

Nepal can be on the path to prosperity with actors like Samriddhi, The Prosperity Foundation enriching the economic policy debate. I have worked with think tanks in over 40 nations, and I can say that Samriddhi is filled with dedicated people of great competence. Samriddhi's capabilities match those of think tanks in rich nations with many times the budget.

In April 2015, I participated with Samriddhi in an overall review of Nepal's economic policy, supported by the US-based Atlas Foundation and designed to increase the economic freedom of Nepalese. I have worked on such programs in over a dozen nations, and again Samriddhi's program was second to none.Over three days of intense meetings with high level politicians, thinkers, academics, and business leaders, we worked through the overall Nepalese economic structure, testing and exploring where it is strong and where it is weak—and where Nepali policy makers could look for global best practices. The following week was another of intense meetings, as Samriddhi's team and I sat down to review all the discussions to work them into a cogent, overall economic strategy to move Nepal forward.

This report is based on the intensive discussions that took place in April, 2015 and includes the contributions made by all the participations and moderators of the discussion. As a result, the document entails a comprehensive economic plan that has the potential to drive Nepal on the path to prosperity.

If the people and leaders of Nepal implement the reform measures outlined in this report, the benefits can be absolutely astonishing. Nepal could experience the type of growth and job creation experienced by Hong Kong, Singapore, Botswana, and Chile when they adopted policies based on the same principles that were used in preparing this report. But none of these nations ever had a reform agenda as wide-ranging and comprehensive as this. The reform agenda aims to increase the economic freedom and thus the prosperity of the people of Nepal. This report details the reform measures that Nepal needs to adopt in the areas outlined below to increase its economic freedom.

Economic freedom is simply the ability of individuals to control their own economic destinies. The cornerstones of economic freedom are personal choice, voluntary exchange, freedom to compete and security of property. It is based on five areas: 1) Size of government, 2) legal system and the protection of private property, 3) sound money, 4) freedom to trade, and 5) business, labor and credit regulation.

Economic freedom allows producers and sellers to compete freely against each other on equal terms, unhobbled by bureaucracy and regulation, which all too often are designed to give the advantage to the powerful and restrict the freedom of others. With economic freedom, consumers, businesses, and workers have a free choice – not one restricted by government or by the powerful.

In the world's top peer-reviewed research journals, economic freedom has been shown to generate positive social and economic outcomes, including higher economic growth, increased political stability, reduced poverty, increased ability to resolve political and ethnic disputes non-violently, and the peaceful development of other freedoms.

It is easy to see how economic freedom promotes well-being. Any transaction freely agreed to must benefit both parties; any transaction that does not benefit both parties would be rejected by the party that would come up short. This has consequences throughout the economy. Consumers who are free to choose will only be attracted by superior quality and price.

Producers and sellers, including new ones, are welcome to the marketplace and must constantly improve the price and quality of their products to meet customers' demands or customers will not freely enter into transactions with them. Billions of mutually beneficial transactions occur every day, powering the dynamic that spurs increased productivity and wealth, new job creation, and reduced poverty.

But in Nepal many of these transactions are blocked by, among other things, powerful cartels and unions, an inefficient bureaucracy, corruption, and a failure of the rule of law to protect property rights and contracting, two necessary features of free transactions.

Restrictions on freedom prevent people from making mutually beneficial transactions. Such free transactions are replaced by government action or by restricted, unfree markets often controlled by elites connected to the government.

These transactions are marked by coercion in collecting taxes and lack of choice in accepting goods and services. Instead of gains for both parties arising from each transaction, citizens must pay whatever bill is demanded in taxes or by crony capitalists and make do with whatever good or service is offered in return.

Fred McMahon
Dr. Michael A. Walker Research Chair in Economic Freedom
Fraser Institute

Preface and Acknowledgements

Nepal's score in the Fraser Institute's annual Economic Freedom of the World Report has stayed between 5.3 and 6.63 (out of 10) from 1980 to 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 has become imperative for us to identify why economic freedom has 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 an institute dedicated to finding policy solutions for Nepal's prosperity.

Therefore, in April 2015, Samriddhi came together with the prestigious Fraser Institute and Atlas Network to undertake the Country Audit process, which would help us identify what kept Nepal from being economically free and utilizing economic freedom as a road to prosperity. The Fraser Institute has been publishing this Economic Freedom of the World report annually since 1996 and the Institute's Economic Freedom project leader, Fred McMahon, was invited to participate in the process in Nepal.

Mr. McMahon brought with him the experience of facilitating discussions amongst key policy makers to analyze different country environments and identify factors that hampered the progress of Economic Freedom in the country. He has led the 'Country Audit process' of several countries including Panama, Lebanon, and Jordan. The larger goal of the Country Audit was to formulate a guideline for reform, which would lead us towards specific improvements in specific areas for more economic freedom.

Samriddhi organized a series of meetings in a three-day long event engaging bureaucrats, senior journalists, politicians and political analysts on a number of topics from the components and sub-components of the Economic Freedom of the World Index. The topics were: Size of Government (Expenditures, Taxes, and Enterprises), Legal Structure and Security of Property Rights, Freedom to Trade Internationally and Regulation of Credit, Labour, and Business. Sound Money was the only component from the index, which was not discussed separately as part of the country audit process.

Each session was moderated by well-known experts in their respective fields, such as Late Mr. Bharat Upreti (Former Honourable Justice at the Supreme Court), Mr. Bhaskar Mani Gnawali (Former Executive Director of Nepal Rastra Bank), Dr. Bhimarjun Acharya (leading constitutional expert), Prof. Dr. Bishwambher Pyakuryal (Senior economist), Dr. Ram Krishna Timilsena (Former Supreme Court Registrar), Mr. Rameshore Prasad Khanal (Former Secretary at the Ministry of Finance), and Dr. Yuba Raj Khatiwada (Former Governor of Nepal Rastra Bank). These experts acted as research guides, providing direction and feedback on the final reports compiled in this publication. Based on the input gathered from the three-day event, relevant secondary research and feedback from the experts, Samriddhi Foundation has developed this report, which compiles analysis and recommendations on each of the six topics mentioned above. Based on the challenges outlined in the areas of discussion in the audit process, our attempt has been to develop reform prescriptions that are practical and acceptable to the stakeholders.

In discussing the six topics, the report analyzed some of the most important economic issues for Nepal such as government consumption, taxes, transfers and subsidies, law enforcement, judicial process and efficiency, property rights, contract enforcement, international and domestic trade and barriers to them, credit markets and banking, labour relations, price controls and regulations regarding entry and exit in the market. Therefore, the report's recommendations will be directly relevant to policy actors, opinion leaders and those affected by the policies in discussion. Moreover, the overall content and analysis of the report is sure to have something important for anyone who looks at the economic section of the newspaper every day and worries about Nepal's future. In that sense, the report is relevant for lawmakers, government officials, consumer groups, and entrepreneurs, and also for journalists, scholars of economics and political science and institutions working towards helping Nepal become economically prosperous.

This first exclusive country audit on Nepal's economic freedom by any private or public organization has been a massive undertaking for us. We have innumerable individuals and organizations to thank for bringing this process into successful conclusion. We are indebted to the Fraser Institute and Mr. Fred McMahon, Resident Fellow at the Fraser Institute, without whom we could not have envisioned and executed the process. Our warmest gratitude goes to our Senior Research Fellow, Dr. Hemanta Dabadi, whose input has been crucial in making the analysis as rooted to Nepal's realities as possible. We are also indebted to all sectorial experts and stakeholders who came to our consultation

meetings and engaged in robust discussions that helped us understand and analyze the issues discussed in the report.

Our research guides who took the time to chair our consultation sessions as authorities in their own fields and guide the report preparation have added enormous value to this initiative. They reviewed and provided useful feedback on our final work, the result of which you hold in your hands. We thank them from the bottom of our hearts.

We would also like to take this opportunity to express our deepest condolences to the family of Mr. Bharat Upreti; the Honourable Justice, whose sad passing only a month after the consultations left us with heavy hearts. May his values of justice reign supreme and his soul rest in peace.

Samriddhi would also like to acknowledge and thank all interviewees who were kind enough to grant time to our researchers and answer their innumerable queries. This report would not have been possible without them.

We would also like to formally recognize the vast responsibility that our researchers/writers undertook in creating, reviewing, editing and re-writing these individual reports. They worked tirelessly even during the aftermath of the earthquake that hit Nepal on April 25. 2015.

Finally, we are indebted to all those who worked internally in any role to bring about the culmination of this project, in terms of designing, proofreading and also organizing the report release. We would like to end by thanking the Washington, DC-based Atlas Network USA, and especially Gonzalo Schwarz, Director of Grants and Awards, for having supported this endeavor and seen it through to the end. We look forward to working with like-minded individuals and organizations in taking the reform agendas from this report forward so that we hand over an economically freer nation to the next generation.

Samriddhi Foundation
September 2015

About Economic Freedom Country Audit Process and Organization of the Report

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. Economic freedom essentially constitutes the ability of individuals and families to make their own economic decisions with limited interference from government or crony capitalists. Put simply, the ingenuity and drive of individuals are more effective in creating prosperity and lead to other more positive outcomes than government 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) that "measures the degree to which the policies and institutions of countries are supportive of economic freedom. The cornerstones of economic freedom are personal choice, voluntary exchange, freedom to enter markets and compete and security of the person and privately owned property. All together 42 data points are used to construct a summary index which is divided into five broad categories viz., Size of Government: Expenditures, Taxes, and Enterprises; Legal Structure and Security of Property Rights; Access to Sound Money; Freedom to Trade Internationally; Regulation of Credit, Labor, and Business (EFWR, 2012)". As of 2014, the report EFWR ranks 152 countries and territories.

Samriddhi, The Prosperity Foundation along with US based Atlas Network and Canada based Fraser Institute came together to conduct a Country Audit on economic freedom for Nepal. The process started with a series of consultation meetings for each of the following headings aimed at examining specific areas of economic policies and understanding how they contributed to the current state of economic freedom in Nepal.

Chapter 1: Size of government: Expenditures, Taxes, and Enterprise

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.

Chapter 2: Legal Structure and Security of Property Rights

Protection of persons and their rightfully acquired property is a central element of both economic freedom and civil society. Indeed, it is the most important function of government.

Chapter 3: Freedom to Trade Internationally

Freedom to exchange – in its broadest sense, buying, selling, making contracts, and so on – is essential to economic freedom, which is reduced when freedom to exchange does not include businesses and individuals in other nations.

Chapter 4, 5 & 6: Regulation of Credit, Labor & Business (respectively)

Governments not only utilize a number of tools to limit the right to exchange internationally, they may also develop onerous regulations to limit the right to exchange domestically, gain credit, hire or work for whom you wish, or freely operate your business. This area measures the limits on economic freedom caused by excessive regulation.

A total of seven consultation meetings were held on the above six topics from April 20-22, 2015. 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 below.

1. Size of Government

- A. Government consumption
- B. Transfers and subsidies
- C. Government enterprises and investment
- D. Top marginal tax rate
  - (i) Top marginal income tax rate
  - (ii) Top marginal income and payroll tax rate

2. Legal System and Property Rights

- A. Judicial independence
- B. Impartial courts
- C. Protection of property rights
- D. Military interference in rule of law and politics
- E. Integrity of the legal system
- F. Legal enforcement of contracts
- G. Regulatory restrictions on the sale of real property
- H. Reliability of police
- I. Business costs of crime

3. Sound Money

A. Money growth
B. Standard deviation of inflation
C. Inflation: most recent year
D. Freedom to own foreign currency bank accounts

4. Freedom to Trade Internationally

A. Tariffs
    (i) Revenue from trade taxes (% of trade sector)
    (ii) Mean tariff rate
    (iii) Standard deviation of tariff rates
B. Regulatory trade barriers
    (i) Non-tariff trade barriers
    (ii) Compliance costs of importing and exporting
C. Black-market exchange rates
D. Controls of the movement of capital and people
    (i) Foreign ownership/investment restrictions
    (ii) Capital controls
    (iii) Freedom of foreigners to visit

5. Regulation

A. Credit market regulations
    (i) Ownership of banks
    (ii) Private sector credit
    (iii) Interest rate controls/negative real interest rates
B. 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
C. 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

Attended by economists, business and political leaders, government officials and other stakeholders (see Annex II for a detailed list of attendees), the consultation meetings came up with discussions, conclusions, and recommendations on each topic. This report is an outcome of those meetings and aims to provide a comprehensive series of policy recommendations to enhance economic freedom in Nepal. Based on the consultations, secondary research and guidance from respective research guides (experts on the topic) the authors penned each of the following chapters providing an overview and analysis on the topic and produced reform recommendations. Presented to the government, media, researchers, business, opinion leaders, and the public, this report aims at spearheading a series reforms to improve the status of economic freedom in Nepal.

PART I

COUNTRY AUDIT OF AREA
SIZE OF GOVERNMENT

Abbreviations

BS	Bikram Sambat
CBS	Central Bureau Of Statistics
EFWR	Economic Freedom Of The World Report
FY	Fiscal Year
GDP	Gross Domestic Product
GON	Government Of Nepal
MOF	Ministry Of Finance
NOC	Nepal Oil Corporation
NPC	NATIONAL PLANNING COMMISSION
NRS	Nepali Rupees
OAG	Office Of Auditor General
PE	Public Enterprise
UNDP	United Nations Development Programme
USD	United States Dollar
WGI	Worldwide Governance Indicator

The Nepali year is based on Bikram Sambat calendar and is approximately 57 years ahead of the gregorian calendar. (2062/1/1=2005/4/14)

Therefore, fiscal year 2014-15 =fiscal year 2071/72

The Nepali fiscal year is 16 or 17 July– 15 or 16 July.

Section I: Economic Freedom and Size of Government

(This section is taken from the Economic Freedom of the World Report, 2012).

The cornerstones of economic freedom are (1) personal choice, (2) voluntary exchange coordinated by markets, (3) freedom to enter and compete in markets, and (4) protection of persons and their property from aggression by others. Economic freedom is present when individuals are permitted to choose for themselves and engage in voluntary transactions as long as they do not harm the person or property of others. Individuals have a right to their own time, talents, and resources, but they do not have a right to take things from others or demand that others provide things for them free of charges. The use of violence, theft, fraud, and physical invasions are not permissible in an economically free society, but otherwise, individuals are free to choose, trade, and cooperate with others, and compete as they see fit.

The EFW index measures the degree of economic freedom present in five major areas: [1] Size of Government; [2] Legal System and Security of Property Rights; [3] Sound Money; [4] Freedom to Trade Internationally; [5] Regulation.

Within the five major areas, there are 24 components in the index. Many of those components are themselves made up of several sub-components. In total, the index comprises 42 distinct variables. Each component and sub-component is placed on a scale from 0 to 10 that reflects the distribution of the underlying data. When sub- components are present, the sub-component ratings are averaged to derive the component rating. The component ratings within each area are then averaged to derive ratings for each of the five areas. In turn, the five area ratings are averaged to derive the summary rating for each country.

The following section provides an overview of one of the five major areas – Size of Government.

Components of the Size of Government

1. Size of Government

A. Government consumption

B. Transfers and subsidies

C. Government enterprises and investment

D. Top marginal tax rate

(i) Top marginal income tax rate

(ii) Top marginal income and payroll tax rate

The four components of this area indicate the extent to which countries rely on the political process to allocate resources and goods and services. When government spending increases relative to spending by individuals, households, and businesses, government decision-making is substituted for personal choice and economic freedom is reduced. The first two components address this issue. Government consumption as a share of total consumption and transfers and subsidies as a share of GDP are indicators of the size of government. When government consumption is a larger share of the total, political choice is substituted for personal choice. Similarly, when governments tax some people in order to provide transfers to others, they reduce the freedom of individuals to keep what they earn. The third component in this area measures the extent to which countries use private investment and enterprises rather than government investment and firms to direct resources. Governments and state-owned enterprises play by rules that are different from those to which private enterprises are subject. They are not dependent on consumers for their revenue or on investors for capital. They often operate in protected markets. Thus, economic freedom is reduced as government enterprises produce a larger share of total output. The fourth component is based on the top marginal income tax rate and the top marginal income and payroll tax rate and the income threshold at which these rates begin to apply. These two sub-components are averaged to calculate the top marginal tax rate. High marginal tax rates that apply at relatively low-income levels are also indicative of reliance upon government. Such rates deny individuals the fruits of their labor. Thus, countries with high marginal tax rates and low-income thresholds are rated lower.

Taken together, the four components of this area measure the degree to which a country relies on personal choice and markets rather than government budgets and political decision-making. Therefore, countries with low levels of government spending as a share of the total, a smaller government enterprise sector, and lower marginal tax rates earn the higher ratings in this area.

A. Government consumption

This component is measured as general government consumption spending as a percentage of total consumption. The rating for this component, as with many of the following components, is designed to mirror the actual distribution of the raw data but on a 0-to-10 scale. The rating is equal to: (Vmax – Vi) / (Vmax – Vmin) multiplied by 10. The Vi is the country's actual government consumption as a proportion of total consumption, while the Vmax and Vmin were set at 40 and 6, respectively. The 1990 data were used to derive the maximum and minimum values for this component. Countries with a larger proportion of government expenditures received lower ratings. In contrast, as the ratio approaches the maximum value, the ratio moves toward zero.

The data sources to calculate the indicator are World Bank, World Development Indicators; International Monetary Fund, International Financial Statistics; United Nations National Accounts.

B. Transfers and subsidies

This component is measured as general government transfers and subsidies as a share of GDP. The rating for this component is equal to: (Vmax – Vi) / (Vmax – Vmin) multiplied by 10. The Vi is the country's ratio of transfers and subsidies to GDP, while the Vmax and Vmin values are set at 37.2 and 0.5, respectively. The 1990 data were used to derive the maximum and minimum values for this component. The formula will generate lower ratings for countries with larger transfer sectors. When the size of a country's transfer sector approaches that of the country with the largest transfer sector during the 1990 benchmark year, the rating of the country will approach zero.

The data sources used to calculate the indicatore are International Monetary Fund, Government Finance Statistics Yearbook; World Bank, World Development Indicators; International Monetary Fund, International Financial Statistics; United Nations National Accounts.

C. Government enterprises and investment

Data on government investment as a share of total investment were used to construct the zero-to-10 ratings. Countries with more government enterprises and government investment received lower ratings. When the government investment share was generally less than 15% of total investment, countries were given a rating of 10.

When government investment was between 15% and 20% of the total, countries received a rating of 8. When government investment was between 20% and 25% of the total, countries were rated at 7. When government investment was between 25% and 30% of the total, countries were assigned a rating of 6. When government investment was generally between 30% and 40% of the total, countries received a rating of 4. When government investment was between 40% and 50% of the total, countries were rated at 2. A rating of zero was assigned when government investment exceeded 50% of total investment.

In cases where government investment data were unavailable, we used qualitative data on the scope of SOEs to assign ratings. Also, in some cases, this rating was estimated from the Global Competitiveness Report questions: "State-owned enterprises in your country: 1 = Play a dominant role in the economy; 7 = Have little or no role in the economy"; and "State-owned enterprises in your country: 1 = Are heavily favoured over private sector competitors; 7 = Compete on an equal basis with the private sector".

The data sources used to derive the indicator on government enterprise came from International Monetary Fund, Government Finance Statistics Yearbook; World Bank, World Development Indicators; International Monetary Fund, Inter- national Finance Statistics; World Economic Forum, Global Competitiveness Report; United Nations National Accounts; European Bank for Reconstruction and Development, Transition Indicators.

D. Top marginal tax rate

i. Top marginal income tax rate

Countries with higher marginal tax rates that take effect at lower income thresh- olds received lower ratings based on the matrix below. The income threshold data were converted from local currency to 1982/1984 US dollars (using beginning-of- year exchange rates and the US Consumer Price Index). These figures include sub- national rates if applicable.

ii. Top marginal income and payroll tax rate

Countries with higher marginal tax rates that take effect at lower income thresh- olds received lower ratings based on the matrix below. The income threshold data were converted from local currency to 1982/1984 US dollars (using beginning-of- year exchange rates and the US Consumer Price Index). These figures include sub- national rates if applicable.

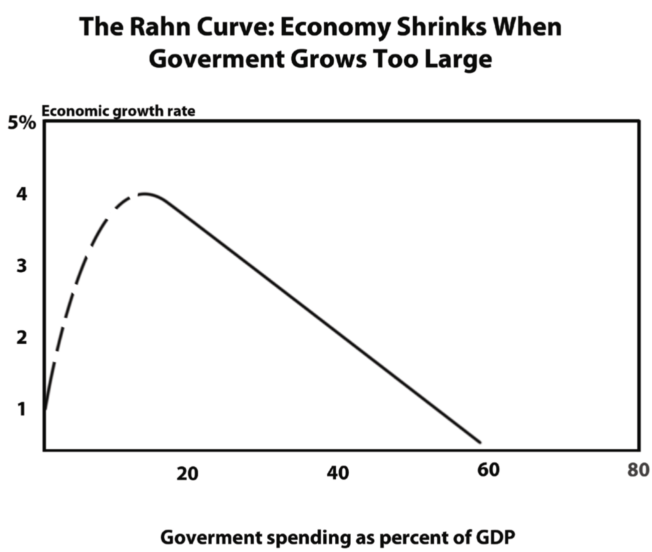
Source The data from PricewaterhouseCoopers, Worldwide Tax Summaries Online; Pricewater-houseCoopers, Individual Taxes: A Worldwide Summary (various issues) were used to derive this indicator.

Top Marginal Tax Rate	Income Threshold at Which the Top Marginal Rate Applies(1982/1984 us$)			
	<$25000	<$25,000-$50,000	$50,000-$150,000	>$150,000
<20%	10	10	10	10
21%-25%	9	9	10	10
26%-30%	8	8	9	9
31%-35%	7	7	8	9
36%-40%	5	6	7	8
41%-45%	4	5	6	7
46%-50%	3	4	5	5
51%-55%	2	3	4	4
56%-60%	1	2	3	3
61%-65%	0	1	2	2
66%-70%	0	0	1	1
>70	0	0	0	0

Section II: Analysis of- Nepal's performance in the category

Different studies provide varied conclusions on the optimum role of government in enhancing economic growth and freedom. Some of the important components of economic freedom mentioned above, such as ensuring the rule of law, have always been the function of governments around the world. Hence, only little economic growth can be achieved when the government spending is zero (Mitchell, 2005). However, disagreements can be found on the degree of government involvement – whether the government should assume only the role of a facilitator, step in to carry out a wide variety of welfare activities or run state owned enterprises and be an active participant in the economy. Figure 1 taken from Mitchell (2005) demonstrates that up to a certain point, government spending will help achieve economic growth. But excessive government spending has negative consequences on growth.

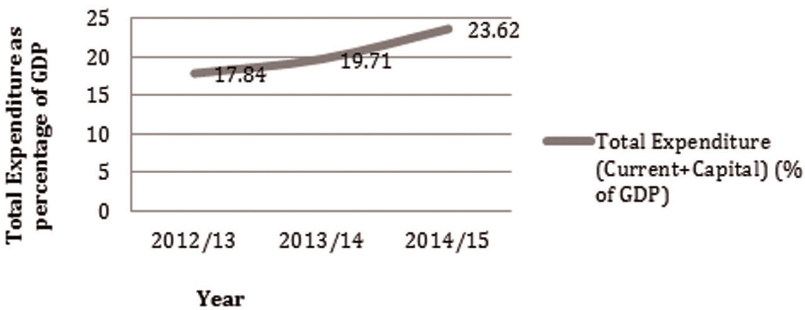
Figure 1: Relationship between government spending and economic growth rate



Source: Peter Brimelow, "Why the Deficit is the Wrong Number", Forbes, March 15, 1993.

In Nepal's case, government spending as a percent of GDP averaged 20.39 in the past three years and has been on an increasing trend (Figure 2). Hence, based on Brimelow's (1993) graph (Figure 1), Nepal's government spending is at its optimum level and an increase in spending levels might have an adverse effect on the economy. Mitchell (2005) explains that the downward slope might be caused by excessive taxation that higher levels of spending would 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 and other costs.

Figure 2: Government Spending as percentage of GDP, Nepal (2012/13 – 14/15)



Source: Based on data from Ministry of Finance (2014) and IMF (2014) as presented in Rabi, A. (2014)

Nepal has also scored relatively high in the size of government in the Economic Freedom of the World Reports (EFWR) over the years. 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, J., Lawson, R., & Hall, J., 2014). In EFWR 2014, Nepal scored 7.4 out of 10 in the Size of Government category, which is highest score among other categories of the report (Gwartney, J., Lawson, R., & Hall, J., 2014).

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

Table 1: Comparison of Nepal's performance with other countries in Size of Government in 2014
(The figure in parenthesis in the first column is the overall ranking of the economy in 2014)

Countries (Rank)	1A Government Consumption	1B Transfers and subsidies	1C Government enterprises and investment	1Di Top marginal income tax rate	1Dii Top marginal income and payroll tax rate	1D Top marginal tax rate	1 Size of Government
Hong Kong (1)	8.1	9.4	10	10	10	10	9.4
Armenia	8	8	10	9	7	8	8.5
Jordan (9)	6.3	7.4	10	10	8	9	8.2
Chile (10)	7	8	10	7	7	7	8
Mauritius (5)	7.3	8.5	7	10	8	9	7.9
Singapore (2)	5.9	8.8	7	10	10	10	7.9
Peru	7.7	9.6	8	8	4	6	7.8
UAE (6)	8.2	9	4	10	10	10	7.8
Switzerland (4)	7	6	10	9	7	8	7.7
Costa Rica	5.4	8.6	10	9	4	6.5	7.6
Top 10 average	7.1	8.3	8.6	9.2	7.5	8.4	8.1
World Average	5.8	7.6	6.2	7.4	5.4	6.5	6.5
Landlocked	7.1	8.2	3.9	8.8	6.6	7.7	6.7
South Asia	8	9.3	6.3	9	8.8	8.9	8.1
Nepal	8.1	9.4	7	5		5	7.4

As shown in Table 1, in consumption, Nepal scores as high as Hong Kong (which was the most economically free country in 2012), and higher than Armenia and the United Arab Emirates (6). Consumption in Nepal is also above the South Asia Average, the top 10 average, world average and landlocked average.

In transfers and subsidies, Nepal again scores as high as Hong Kong, a little less than Peru, better than the South Asia Average and better than top 10 average, world average, and landlocked average.

In government enterprises and investment, Nepal does not score as high as in the former two categories, but nevertheless scores better than the South

Asia Average, far better than landlocked average, and a little above the world average. It scores 1.6 points lower than the top 10 average in this one.

In top marginal tax rate (where Nepal is scored in top marginal income tax rate only and not in top marginal income and payroll taxes) Nepal scores the least. It scores well below the top 10 average, world average, landlocked average and south Asia average.

Section III: Policy and implementation challenges

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 other national and international indicators. In Transparency International's National Integrity System (NIS) Assessment Nepal 2014, the public sector's performance was described as dismal. The World Bank's Governance Indicators have shown similar findings over the years. In 2013 Nepal ranked in the 18th percentile in Government Effectiveness in The World Bank's Worldwide Governance Indicator (WGI). In the past decade, the highest Nepal ranked in this category was in the 29th percentile in 2007 (The World Bank, 2014). Similarly, World Economic Forum's Global Competitiveness Report identified "inefficient government bureaucracy" as the third most problematic factor for doing business in Nepal in 2013 (World Economic Forum, 2013).

As government spending is at the optimum level, and a further increase is likely to have a negative impact on growth, focusing on getting a better 'value for money' from current spending becomes very important.

The country audit consultation on this topic brought about important discussion on delivering better services and development outcomes by improving the ways in which spending is currently taking place. Some of the major issues raised during the discussion are presented below.

Major issues

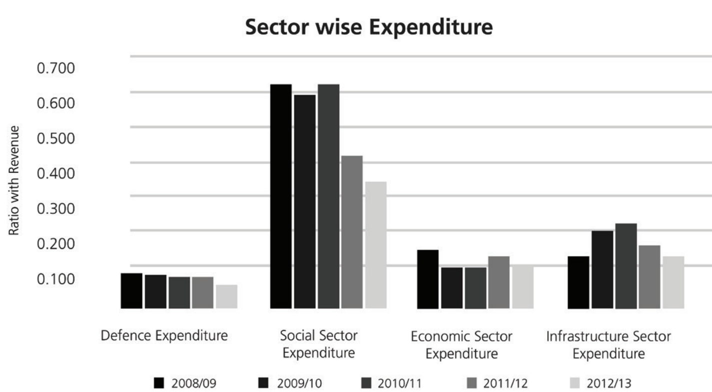
1. **Fragmentation of resources was cited as a problem in government spending during the consultation.** A look at the National Planning Commission's publication outlining the spending plan of Development Budget reveals that money is spread over a thousand different programs in the following four categories: projects of national pride, programs with designated work area, programs of central, regional and local nature, and district specific programs. For instance, the document makes provision to

build 430 road sections, each with a budget of NRs. 740,000, to connect two or more districts (National Planning Commission, 2014). Based on the Road Sector Assessment Survey, this amount allows construction of 0.48 km of a 15 cm riverbed gravel road and 0.67 km of road with Single Otta seal over existing surface (The World Bank & GoN, 2012).

The budget gets thinner in the district specific program category. In categories such as cultural preservation, small amount grants ranging from NRs. 100,000 to 500,000 are given to hundreds of different religious establishments, such as, temples, monasteries, etc., across the country (NPC, 2014). Categories like gender equality and inclusion, youth and sports are allocated similarly small amounts.

In another case, Social Security Allowance is given to elderly and differently-abled people and also to widows. Everyone above the age of 70 years is entitled to a monthly allowance of NRs. 500. Differently-abled people above the age of 16 receive NRs. 1,000 per month and partially disabled persons receive NRs. 300 per month as Disability Allowance (UNDP, 2014). According to Nepal Living Standards Survey II, per capita nominal expenditure for all of Nepal stands at NRs. 34,829 per year, which is NRs. 2902.4 per month (NPC & CBS, 2011). Clearly, the social security allowance is low. However, overall in the social sector (comprising education, health, drinking water and other social sectors) spending by government has remained high in comparison to defence, economic and infrastructure sector expenditures over the past five years as shown the figure below. Aryal (2014) also highlights scattered allocation and spreading budget across a huge number of small projects as part of the allocation inefficiency.

Figure 3: Sector wise Expenditure, 2008/09 – 2012/13



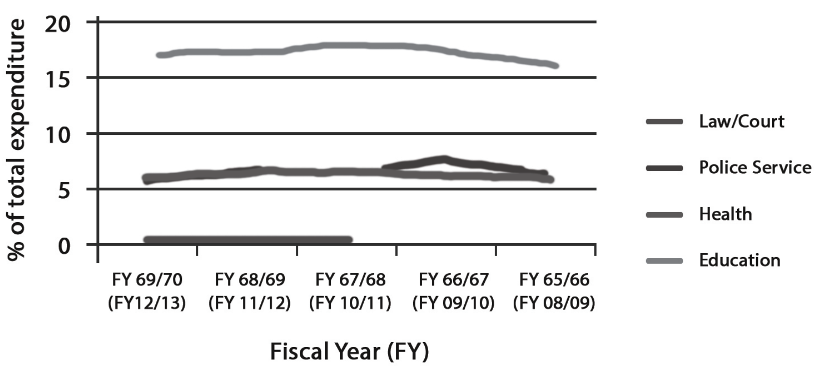
Source: GoN (2014). Consolidated Financial Statement of the Fiscal Year 2012/13, Published May 2014, Financial Comptroller General Office.

Members of Parliament present in the consultation voiced the opinion that the accommodative approach to budget allocation, combined with significant political influence, has led it to simply be a 'distributive exercise' rather than a results-oriented development activity. They also talked about the need to clarify the role of the government and set spending priorities.

> With the 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, leaves the law/courts sector with 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, J., Lawson, R., & Hall, J., 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). In the past decade, the highest Nepal ranked in this category was in the 32ndpercentile in 2006 (The World Bank, 2014).

Figure 4: Comparison of expenditure in health, education, police, and law



Based on Consolidated Financial Statement of the Fiscal Year 2012/13, 11/12, and 10/11, Financial Comptroller General Office.

The consequence of such fragmentation is that the quality of the output is often compromised. A striking example of this is the alarming number of road accidents in Nepal, which are often attributed to the poor quality of roads (as well as overcrowding and negligent practices). As mentioned in the earlier paragraph, budgets as low as of NRs. 740,000 are allocated to connect two or more districts when the amount is barely enough to construct 0.48 km of a 15 cm riverbed gravel road and 0.67 km of road with Single Otta seal over existing surface (The World Bank & GoN, 2012). The result is that very poor quality roads get constructed, contributing to high accident rates (Thapa, 2013). Due to the inadequacy of funds ensuing from budget fragmentation, projects do not get completed in time and spending ends up merely as spending and not as an investment enabling people to reap longer-term benefits.

2. Slow progress in government-implemented programs was mentioned during the consultation as another major problem with regards to government consumption. The Auditor General's Report published in 2014 and 2015 mentions low annual progress in government-implemented programs. The OAG Report of 2014 states that zero per cent annual progress was made in 844 programs, 0-25% progress in 357 programs, 26-50% progress in 1,013 programs, and 51- 75% progress in 5,725 programs under 28 different entities in FY 2012-13. Similarly, OAG's 2015 report sates that zero per cent annual progress was made in 1,103 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.

Case of Projects of National Pride:

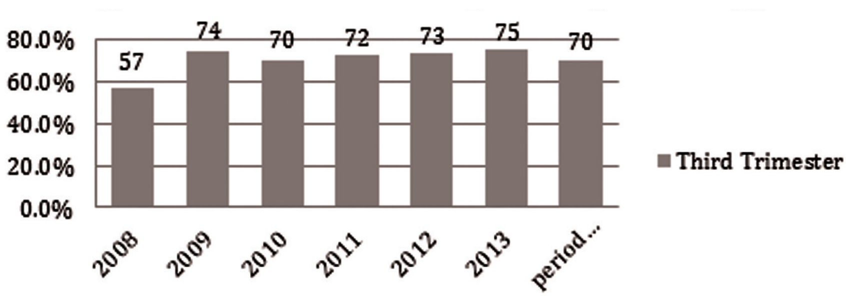
In January 2012, then Prime Minister of Nepal Dr. Babu Ram Bhattarai released a very ambitious "Immediate Action Plan for Economic Development and Prosperity". Among other things, the action plan listed ten big infrastructure projects as "National Pride Projects". It is important to note that most of the projects listed in the "National Pride Projects" were old projects and were facing delays and challenges related to implementation. The move, in fact, came as a response to those challenges whereby the listed projects were to receive an uninterrupted supply of resources (human and monetary), face no strikes and get a realistic deadline. Since 2012, the projects under the "National Pride" have grown to 21 and progress has been slow.

World Bank's Economic Update on Nepal put is as (World Bank Group, 2014):

The fate of so-called 'National Pride Projects' illustrates deep absorptive bottlenecks, especially for capital projects. Of the 21 projects that have received allocations in the government budget under this category, three projects (Bhairahawa International Airport, Second International Airport, and West Seti Hydropower Project) have not spent anything at all in the first half of the year, while a further two projects (Bheri-Babai Diversion Multipurpose Project and the Kathamandu-Terai Fast-track project) have spent less than 1% of their allocations.

3. 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 total capital expenditure3, 73% of spending in FY 2011/12 and 75% in FY 2012/13 were made in last trimester of those Fiscal Years and as demonstrated in Figure 5, the trend has not been any different in the past years (Aryal, 2014).

Figure 5: Capital Expenditure in the Third Trimester
(% of total capital spending)



Source: (Aryal, B.). 23 April 2014. Presentation made by Baikuntha Aryal Joint Secretary Ministry of Finance in Nepal. Portfolio Performance Review Meeting. Kathmandu

The OAG Report of published in 2015 noted that 39 offices under the different ministries/entities spent NRs. 20,353 million – which represented 37.28% out of the total allocated capital budget of NRs. 54,598 million – in the twelfth month of the fiscal year. In FY 2013/14, a total of NRs. 5,493.8 million was disbursed to 22 different entities in the months of June-July, which marks the end of the fiscal year (OAG Report, 2015). Additionally, 37.46 percent of total capital expenditure was made in the twelfth month of the fiscal year (OAG Report, 2015). The same report points out that, out of the NRs. 22,844.9 million budget for the School Sector Reform Program, NRs. 1,167.5 million was sent to District Education Offices only at the end of the fiscal year (OAG Report, 2015). Furthermore, in FY 2013/14 (2070/71), a total of NRs. 5,172.4 million budget was allocated under 1,213 sub-headings. Of this, NRs. 8,955.9 million was not spent at all in 36 sub-categories. A number of government agencies have not returned the unspent money to central treasury (OAG Report, 2015).

4. **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. Spending the budget only at the last moment leaves little room to spend it accountably.

In 2013 Nepal ranked in the 29th percentile in Voice and Accountability in The World Bank's Worldwide Governance Indicator (WGI). In the past decade, the highest Nepal had ranked in this category was in the 32nd percentile in 2009. The Office of Auditor General's (OAG) reports in 2070 (2014) and 2071 (2015) both mention: "Though the Financial Procedures Rules, 2064 (2007) rule 26 specifies that necessary action will be taken to responsible person after reviewing the progress, it was found that no action whatsoever, has been taken by the related institution/ministry or the department for not achieving targets." The Office of Auditor General's (OAG) Report in 2014 made the following observations:

- Increasing trend of spending more than approved budget
- making budget transfers against budget principles
- incurring expenditure in the situation of negative net budget even after transfer
- not seeking reimbursement from donors on time
- appropriating bulk amount under contingency heading and the Ministry of Finance distributing such budget
- not appropriating required amount in budget, and
- practice of spending without making provision in budget

Although rule 35(2) of Financial Procedures Regulations, 2007 requires that disbursements for programs and activities should be within the limit set by approved budget, Ministry of Finance invariably makes supplementary disbursements under its contingency heading almost every year. In the latest fiscal year for which the audit report is available, Ministry of Finance disbursed NRs. 8,958 million to entirely new programs not envisioned in the annual budget and provided additional budget to ongoing programs. A total 497 programs received additional budget during the year (Source: OAG annual report, 2014 (2070)

This complicated, chaotic, non-transparent and ad-hoc system clearly feeds the massive amount of corruption that takes place in Nepal (Nepal ranked 126 out of 175 in Transparency International's Corruption Perception Index 2014). There are grounds to question the effectiveness of the processes, and when effective processes are not in place, there is no direction to be followed.

5. **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 the following programs and ministries:

- Food Security program in Ministry of Agriculture Development and Ministry of Federal Affairs and Local Development
- Program for squatters and settlement for underprivileged group in Ministry of Land Reform and Management and Ministry of Urban Development
- Construction of bridges and their management among Ministry of Urban Development, Ministry of Federal Affairs and Local Development, and Ministry of Physical Infrastructure and Transportation
- All roads except Strategic Road Network appear to have been approved to be built by the Ministry of Urban Development whereas all local level roads and bridges were to be built by the Ministry of Federal Affairs and Local Development. All Strategic Road Networks are expected to be built and maintained by the Ministry of Physical Infrastructure and Transportation. However, no clear definition or demarcation on what is a strategic road network and what is local road and bridge seem to be in practice. There is a similar case with irrigation.

- Duplication of irrigation work among Ministry of Irrigation, Ministry of Federal Affairs and local Development and MOAG, water and sanitation programs in Ministry of Urban Development and Ministry of Federal Affairs and Local Development
- Despite having a Ministry of Youth and Sports, the Youth Self Employment Fund is being administered from Ministry of Finance
- Multiple ministries separately focusing on industrial and professional skills development training for women, youth, people with disability, laborers, etc.
- Duplication in works related to poverty reduction among the Poverty Reduction Fund under the Prime Minister's Office and Cabinet, the Ministry of Cooperatives and Poverty Alleviation, Ministry of Federal Affairs and Local Development, and Ministry of Finance.

6. Public enterprises, subsidies and transfers

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). It makes the statement based on the following facts it mentions in the same publication:

- By the fiscal year 2012/13 (Nepali fiscal year 2070-71), the government share of investment in 37 PEs totaled NRs. 107,663.8 million while total loan investment during the same period amounted to NRs. 106,501.7 million. Share investment in these PEs in FY 2011/12 amounted to NRs. 102,413.7 million and loan investment NRs. 101,236.7 million.
- By fiscal year 2012/13, the total accumulated loss of 37 PEs reached NRs. 21,171.5 million. Enterprises with accumulated loss of over Rs. one (1) billion are Nepal Oil Corporation (NRs. 24.54 billion), Nepal Electricity Authority (NRs. 14.43 billion), Rastriya Banijya Bank (NRs. 11.53 billion), Nepal Food Corporation (NRs. 1.18 billion) and Nepal Airlines Corporation (Rs. 1.10 billion). Likewise, PEs with accumulated gain of over Rs. one (1) billion are Nepal Telecom Company Ltd (Rs. 38.64 billion), Nepal Civil Aviation Authority (Rs. 1.80 billion), Citizen Investment Trust (Rs. 1.25 billion) and Agriculture Development Bank Ltd (Rs. 1.19 billion).
- In this period, GoN has received a dividend only from Nepal Telecom Company Ltd., Nepal Stock Exchange Ltd., Industrial

Estate Management Ltd., and Hydroelectricity Investment and Development Company Ltd.

- The unfunded liability of PEs has been growing every year due to various facility entitlements to the PE employees upon their retirement such as gratuity, pension, medical treatment, insurance, payment against accumulated leave etc. Such unfunded liability of PEs totaled Rs. 26,509.9 million in fiscal year 2012/13, marking an increase of 25.03 per cent from Rs. 21,202.1 million in such liability over the previous fiscal year 2011/12.

Wagle, Acharya & Sapkota (2013) attribute the key factors affecting the poor performance of Public Enterprises to contradiction in the profit and non profit goals of the public enterprises, inability to find a balance between autonomy and accountability, running public enterprises like bureaucratic institutions rather than commercial entities, and an overall systemic flaw in the alignment of the interests of the workers, the institution and the government. Furthermore, Wagle, Shrestha & Acharya (2014) identify the structure of the enterprises as a root problem and explain that "both commercial and non- commercial goals assigned to PEs, which entail both making profit for sustainability and fulfillment of social objectives, creates enormous pressure in the management of PEs and in most of the cases, this pressure combined with ineffective organizational structure leads to the downfall of PEs."

Participants in the consultation also focused on the problems related to data availability, mismanagement and data discrepancy on PEs, which is a beginning point in analyzing their performance. Participants of the consultation raised the issue that, between several data sources of the government, there is a difference of billions of rupees. (Read more about data discrepancy in the Yellow Book containing information on State Owned Enterprises published by Ministry of Finance at http://econitynepal.com/the-yellow-book-and-accounting-jokes-somehow-the-administrative-costs-dont-administer/)

Participants of the discussion also highlighted that a single yardstick for measuring the performance of all public enterprises was not justified, as the size and nature of public enterprises are vastly different.

Top loss-making public enterprises are also naturally top recipients of direct and indirect subsidies. Participants in the consultation questioned the relevance of subsidies on two important grounds: a) is it reaching the targeted groups? And b) does the cost justify the outcome? i.e. Are subsidies leading to increased productivity? In both cases, subsidies in the agriculture sector provide a fitting example.

Rijal, Shrestha, Khatiwada & Basnyat (2015) study on fertilizer trade demonstrates that subsidies in the agriculture sector are not reaching those at whom it is targeted:

> Following more than 10 years of deregulation, the Government of Nepal re-introduced a subsidy scheme in chemical fertilizers in 2009. Much of the market has been primarily supplied by state entities such as Agriculture Inputs Company Limited (AICL) and its affiliates along with National Trading Corporation (in recent years) under government subsidy. […]Despite an annual subsidy of $33.4 million - which accounts for almost 25 percent of the government budget in 2012 - followed by another one Billion Rupees ($10.22m USD) subsidy in 2013, fertilizers remain unaffordable for farmers and yields remain at an all-time low (IRIN, 2012). […] Evidently, Nepal's subsidy scheme has failed to meet its policy goal. According to the Agriculture Perspective Plan (APP), fertilizers and related subsidies are expected to constitute around 70 percent of the total economic growth target in Nepal (FAO, 2011, p. 59). However, of the estimated 700,000 – 800,000 tons, only approximately 75,000 tons is demanded from formal channels. About 75-80 percent of the demand is currently met by black market trade (Pandey, 2013).

With regards to the other important question of whether the costs of providing subsidies justify the outcome (i.e. are the subsidies leading to increased productivity), the OAG Report published in 2015 makes the following point:

Table 2: Comparison of subsidy and productivity in agriculture sector

SN	Nepali FY	Subsidy amount (in Crores) (Rs.)	Economic Growth Rate of the Agriculture Sector		Production of food in Mt. Ton	
			Target	Progress	Target	Progress
1	2067/68	267	3.9	4.5	7762	8615
2	2068/69	323	3.9	4.6	9050	9561
3	2069/70	489	3.9	1.1	9561	8738
4	2070/71	899	4	4.7	9480	9563

Source: Annual Report of Auditor General, 2071 (2015)

Although the production has outdone set targets, when the subsidy increased by 20.97 per cent in 068/69 compared to the previous year, production rose by only 10.98 per cent. The next year, when subsidies rose by 51.39 per cent, production decreased by 8.6 per cent. The year after that, when subsidies grew by 83.84 per cent, production grew by only 9.44 per cent. The OAG report suggested that subsidies needed to be channeled based on production and productivity (OAG Report, 2071). A report by the task force commissioned by the Ministry of Finance to evaluate the impact of tax breaks reaches a similar conclusion by saying that the tax breaks have not increased the production of cash crops such as wheat, mustard, etc. (Taskforce Report to MoF, 2014)

Nepal's energy sector is another area where the relevance of subsidies is highly questionable. Two top loss making PEs are from the energy sector: Nepal Oil Corporation (accumulated loss Rs. 24.54 billion by the end of 2012/13) and Nepal Electricity Authority (accumulated loss Rs. 14.43 billion by the end of 2012/13). Samriddhi Foundation conducted a study on Petroleum and Agricultural Trade in Nepal in 2014. The study by Rijal, Shrestha, Khatiwada & Basnyat (2015) details the dynamics of subsidies geared towards Nepal Oil Corporation (NOC) and its impact:

> The NOC subsidizes LPG gas, but attempts to fund it through increased taxes and increasing prices on its other products. […] The combined profits from all other products still fall short of losses made on LPG by hundreds of rupees per cylinder. As a result, the NOC fails to recover its investment made in the import of products from the Indian Oil Corporation (IOC). This renders the NOC unable to pay the installments for the previous lot of petrol imports from the IOC, at which point, the IOC refuses to do any further business with the NOC until the past due amounts are cleared. Foreseeing the impending shortage of petroleum products in Nepal, the GoN intervenes and directs institutions such as the Employees Provident Fund (EPF), Citizens' Investment Trust (CIT), and some commercial banks in the country to provide loans to the NOC as a government guarantee. […] The NOC continues to make losses and continues to acquire taxpayers' money as loans. Amidst all of this, the loans acquired via CIT and EPF have never been paid. Interest, however is paid duly by adding the interest payment component to the selling price of petroleum products. […] Under current trends, NOC has arranged loans as and when required, under government guarantee and without taking into account whether or not it has a repayment plan.

As with the case of NOC, huge losses incurred by Nepal Electricity (NEA) and an overall poor financial health has made the government substantially increase its loan provisioning towards this state owned monopoly, which is a form of indirect subsidy (Neftake, 2015).

Neftake (2015) takes the case of the energy sector (direct/indirect subsidies to state owned monopolies Nepal Oil Corporation and Nepal Electricity Authority) and makes the following case:

> … a comparison of government investments and indirect subsidies indicates that subsidies are far greater than investments, with investments comprising only 2%-6% of the subsidies within the last six fiscal years. This is indicative of the precarious situation of the country's energy sector, wherein the government is more reactive in its efforts, rather than being proactive and investing towards development of the energy sector.

Direct subsidies have also recently been introduced for the renewable energy sector under the Subsidy Policy for Renewable Energy 2069 BS (2012 AD) to support the development of micro and pico hydropower projects (Neftake, 2015).

However, subsidies are given not only to public enterprises. They are also given in a lot of other sectors in several ways such as tax exemption, deduction, rebate, VAT exemption, exemption in excise duties, income tax exemption etc. A report by the task force commissioned by the Ministry of Finance to evaluate the impact of tax breaks estimated that the country forgoes about NRs. 30 billion worth of revenue annually through these concessions (Taskforce Report to MoF, 2014a). The study points out an increasing trend in providing such breaks and highlights the challenges in implementation, given that the provisions are not "completely clear, result-oriented and objective." It also mentions that Ministries and Departments recommending those breaks have no mechanism to monitor, assess or ensure that the concessions reach the target group. Although the report boasts some positive impact of the concessions in protecting domestic industries, it also points out that for a lot of industries evaluated in the report, despite receiving VAT rebates and including it in their income, they have not gone into profit. This shows that the VAT rebates are not contributing to further revenue for the government, and rebates have simply been a cost that went towards sustaining inefficient business enterprises. Singling out the mobile phone industry, the report demonstrates that the customs and excise duty exemption, along with up to 60 PC VAT rebate, has not benefitted consumers and also has not encouraged the import of mobile phones through formal channels (Taskforce Report to MoF, 2014a).

Representative from the Office of the Auditor General in the consultation meeting shared that there is no clear classification of subsidies or a guiding policy. The subsidies are also directly politically influenced, they said. The participants showed concern that such practices, along with limited privatization, are taking place without following due processes, and are influenced by corruption. This, they felt, is giving rise to cronyism. They also mentioned that while incurring the above-mentioned direct costs, these subsidies were further burdening consumers by distorting the markets.

Some major factors

1. Dysfunctional budgetary system

Some of the major issues discussed above, such as fragmentation of resources, slow progress in government-implemented programs, etc., are rooted in the country's budget making and execution process. Hence, a greater degree of efficiency can be achieved by making the budgetary process more functional. In the bifurcated budget preparation process whereby the Ministry of Finance (MoF) prepares the regular budget and the National Planning Commission (NPC) prepares the development budget, there is little integration between the two (The World Bank, 2000). Moreover, NPC has been affected by rising politicization in the recent years (Krause, Sweet, Hedger, & Chalise, 2013). While NPC is responsible for development planning and is constantly accommodating new projects and programs, MoF is responsible for cash management and maintenance of fiscal stability, creating considerable tension in the budget preparation process. (The World Bank, 2000).

Krause, Sweet, Hedger, & Chalise (2013) study challenges, risks and entry points for reforming Nepal's Public Finance Management System and highlight the 'dysfunctional budget process' which is an important contributing factor in the challenges discussed above. Some key problems highlighted in Krause, Sweet, Hedger, & Chalise (2013) relevant to this paper are:

> In practice, there is no hard deadline for inclusion of new capital projects [in the budget]. In addition, expenditure ceilings set by the MoF have yet to become a credible constraint, which undermines efforts to link budget allocations to policy priorities.

> The approved budget is not a predictor of actual spending. Instead, it is in some ways the beginning of a new set of budget negotiations and constant streams of reallocations and virements that continue throughout the budget year. The disarray of the budget process leads to much execution occurring in the final trimester of the year; the first and second trimesters often see a continuation of planning and negotiation, with the exception of salary expenses.
>
> The budget calendar is in disarray because of failure by budgetary actors to adhere to reasonable time periods for budget planning, formulation, and execution, and a reluctance to jointly stick to deadlines after which one phase of the budget process transitions into the next.

2. Short term interests of the political leadership

Given the political instability in recent decades, the political leadership is more interested in short term programs, which can be shown as their contribution in their constituencies. Hence, the focus is on starting new projects and dispersing funds, thus leading to some of the problems explained in the earlier section. The other side of this is, effective implementation and delivery of output and outcomes are compromised. As a result, long term and institutional problems remain unfixed, perpetuating the ineffectiveness in service delivery.

3. Procedural Delays:

Procedural delays in requesting authorization for release of funds and the cumbersome procurement processes are other factors in delayed capital spending in Nepal, which is one of the major issues mentioned above (Sapkota, 2013). The World Bank's Report on Public Expenditure Review of Nepal published in April 2000 puts it succinctly:

> Although the annual budget is presented to the Parliament in early July (the fiscal year begins on July 16), it is usually approved by the government only in mid-to-late September, after prolonged debate. Thereafter, in Nepal budget implementation requires two further steps: (i) finalization of work programs consistent with the ratified budget for each spending unit by the respective line ministries and their approval by the NPC, and (ii) formal delegation (through official notification) of authority to spend from the Secretary of Finance

to line ministries and project managers. These intermediate steps, which could be taken early in the budget cycle, unnecessarily hold up implementation for several weeks, so that very little work is carried out in the first trimester of the fiscal year. Similarly, given its generally tight cash position and limited capacity for expenditure monitoring, the Finance Ministry often issues instructions to spending units to "freeze" spending a month or two before the end of the fiscal year. In effect, project implementation activities can generally take place at full capacity only during seven to eight months of the fiscal year! A second factor, which affects the timeliness and quality of work particularly for multi-sector projects or those involving more than one agency, is the lack of co- ordination among government entities. A good example is urban roads in Kathmandu, where the Department of Roads (DOR) routinely carries out its maintenance work, while the Nepal Telecommunication Corporation (NTC) and Nepal Water Supply Corporation (NWSC) dig up the same roads for operational activities on their own schedules, so that urban roads are in a permanent state of disrepair, while considerable public money is wasted."

4. **Public Procurement:**

With the goal of making the procurement activities of Public Entities of Nepal competitive, transparent and accountable to the public, Government of Nepal (GoN) enacted Public Procurement Act (PPA) on 14th January, 2007. In the years following the enactment, PPA has become the topic of discussion for various reasons. One of the major issues has been the reward and punishment mechanism provisioned by the Act. On one hand, complying with all the processes as directed by the Act is considered to be time consuming and on the other hand, the clauses of the Act have been interpreted in various contradictory ways over the years. Fundamental principles of public procurement include equal and non-discriminatory access to participate by all potential suppliers of goods and services and value for money for the government. Government officials often do not make preparations that are necessary for a fair and transparent procurement, citing law as problematic. As a result, many procurement decisions are disputed and become subject of scrutiny by accountability institutions. There are primarily two reasons for this: (a) mollified intentions of the people involved in procurement and (b) lack of adequate capacity of building of procurement officials. Both are correctible, but most of the time is spent not on these issues but on blaming the laws.

There are certainly some weaknesses in the laws. The provision of a mobilization advance in the amount of 20 percent of bid amount that can be paid to a works contractor upon signing the contract was introduced years ago with a view to promoting domestic contracting business. This has now outlived its utility and has been the major reason for contractual delays. Many contractors, in recent years, started using money so received for speculative purposes and delayed fulfilling their contractual obligations. This needs to change.

Secondly, there is a provision of sub-contracting. This provision has also been misused and actual work often gets placed in the hands of people who cannot actually deliver.

Section IV: Recommendations:

A) Public Enterprises & Privatization

Public enterprises need to be given specific objectives, in which performance can be measured. If these objectives cannot be met, the enterprises 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.

B) Subsidies

Subsidies need to come with a sunset clause if they are of a distributive nature. There should be precise and well-defined policies and procedure for granting subsidies. The focus should be on ensuring subsidies help capital formation and are targeted to people and sectors. Subsidy administration should be such that the leakages are kept to the lowest level possible using measures such as direct cash transfers. This will also help address the issue of measurement of impact and transparency that is currently a problem with subsidies.

C) Prioritizing the role of government

A discourse on the functions of the government should take place from the perspective of efficiency. The core idea is that if the government focuses on a 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.

D) Information management within government

Digital infrastructure should be introduced to improve data management. This is essential in making more informed policy decisions. Additionally, it is also important to building a repository of knowledge about what has worked in Nepal based on successful examples in the past.

E) Budgetary process reforms

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 among the NPC, the MoF, the FCGO, 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 would see the Government develop a sound pre-budget process that enables wider public input to guide it in formulating a budget that addresses emerging needs of the economy. This would be a good step towards budget transparency.

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PART II

COUNTRY AUDIT OF AREA

LEGAL SYSTEM AND PROPERTY RIGHTS

Section I: Economic Freedom and Legal System & Property Rights

The freedom of an individual to retain ownership of the fruits of his/her labour is the foundation of private property rights. This right manifests itself by giving the owner of a property the freedom to use, dispose of, or transfer the ownership of a property to any other individual or group through voluntary transaction. Engaging in this sort of voluntary transaction can allow people to become better off as each party gives up what s/he has in order to acquire something that s/he does not have but the other transacting party can offer (both intrinsic and extrinsic). These exchanges benefit both parties because an exchange would not be made voluntarily if they did not.

For private property rights to hold, and in order to give confidence to individuals to engage in productive economic activities – mobilizing their properties – the private property right needs to be protected through enforcement of contracts and rule of law. An independent and unbiased legal system is essential to the effective and impartial enforcement of contracts, enforcement of the rule of law, and to lend a sense of predictability and stability to different economic actors.

Security of property rights, protected by the rule of law, provides the foundation for both economic freedom and the efficient operation of markets. Freedom to exchange, for example, is meaningless if individuals do not have secure rights to property, including the fruits of their labour. 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. Perhaps more than any other area, this area is essential for the efficient allocation of resources. Countries with major deficiencies in this area are unlikely to prosper regardless of their policies in the other four areas.

The nine components in this area are indicators of how effectively the protective functions of government are performed. These components are from three primary sources: the International Country Risk Guide, the Global Competitiveness Report, and the World Bank's Doing Business project.

Legal System and Property Rights

i. Judicial independence
ii. Impartial courts
iii. Protection of property rights
iv. Military interference in rule of law and politics
v. Integrity of the legal system
vi. Legal enforcement of contracts
vii. Regulatory restrictions on the sale of real property
viii. Reliability of police
ix. Business cost of crime

Of these nine sub-components, this paper will focus on:

a) Judicial independence,
b) Impartial courts and
c) Protection of property rights.

Scoring in the category Legal System and Property Rights

A) Judicial independence

This component is from the Global Competitiveness Report question: "Is the judiciary in your country independent from political influences of members of government, citizens, or firms? No—heavily influenced (= 1) or Yes—entirely independent (= 7)." The question's wording has varied slightly over the years. All variables from the Global Competitiveness Report were converted from the original 1-to-7 scale to a 0-to-10 scale using this formula: EFWi = ((GCRi − 1) ÷ 6) × 10.

Source: World Economic Forum, Global Competitiveness Report.

B) Impartial courts

This component is from the Global Competitiveness Report question: "The legal framework in your country for private businesses to settle disputes and challenge the legality of government actions and/or regulations is inefficient and subject to manipulation (= 1) or is efficient and follows a clear, neutral process (= 7)." The question's wording has varied slightly over the years.

Note: The "Rule of Law" ratings from the World Bank's Worldwide Governance Indicators (WGI) project have been used to fill in country omissions in the primary data source since 1995.

Source: World Economic Forum, Global Competitiveness Report.

C) Protection of property rights

This component is from the Global Competitiveness Report question: "Property rights, including over financial assets, are poorly defined and not protected by law (= 1) or are clearly defined and well protected by law (= 7)."

Note: This replaces a previous Global Competitiveness Report question on protection of intellectual property.

Source: World Economic Forum, Global Competitiveness Report.

D) Military interference in rule of law and politics

This component is based on the International Country Risk Guide Political Risk Component G. Military in Politics: "A measure of the military's involvement in politics. Since the military is not elected, involvement, even at a peripheral level, diminishes democratic accountability. Military involvement might stem from an external or internal threat, be symptomatic of underlying difficulties, or be a fullscale military takeover. Over the long term, a system of military government will almost certainly diminish effective governmental functioning, become corrupt, and create an uneasy environment for foreign businesses."

Note: The "Political Stability and Absence of Violence" ratings from the World Bank's Worldwide Governance Indicators (WGI) project have been used to fill in country omissions in the primary data source since 1995.

Sources: PRS Group, International Country Risk Guide; World Bank, Worldwide Governance Indicators.

E) Integrity of the legal system

This component is based on the International Country Risk Guide Political Risk Component I for Law and Order: "Two measures comprising one risk component. Each sub-component equals half of the total. The 'law' sub-component assesses the strength and impartiality of the legal system, and the 'order' sub-component assesses popular observance of the law."

Source: PRS Group, International Country Risk Guide.

F) Legal enforcement of contracts

This component is based on the World Bank's Doing Business estimates for the time and money required to collect a debt. The debt is assumed to equal 200% of the country's per-capita income where the plaintiff has complied with the contract and judicial judgment is rendered in his favor. Zero-to-10 ratings were constructed for (1) the time cost (measured in number of calendar days required from the moment the lawsuit is filed until payment) and (2) the monetary cost of the case (measured as a percentage of the debt). These two ratings were then averaged to arrive at the final rating for this sub-component. The formula used to calculate the zero-to-10 ratings was: (Vmax – Vi) / (Vmax – Vmin) multiplied by 10. Vi represents the time or money cost value. The values for Vmax and Vmin were set at 725 days and 82.3% (1.5 standard deviations above average in 2005) and 62 days (1.5 standard deviations below average in 2005) and 0%, respectively. Countries with values outside the Vmax and Vmin range received ratings of either zero or 10 accordingly.

Source: World Bank, Doing Business.

G) Regulatory restrictions on the sale of real property

This sub-component is based on the World Bank's Doing Business data on the time measured in days and monetary costs required to transfer ownership of property that includes land and a warehouse. Zero-to-10 ratings were constructed for (1) the time cost (measured in number of calendar days required to transfer ownership) and (2) the monetary cost of transferring ownership (measured as a percentage of the property value). These two ratings were then averaged to arrive at the final rating for this sub-component. The formula used to calculate the zero-to-10 ratings was:

(Vmax – Vi) / (Vmax – Vmin) multiplied by 10. Vi represents the time or money cost value. The values for Vmax and Vmin were set at 265 days and 15% (1.5 standard deviations above average in 2005) and 0 days and 0%, respectively. Countries with values outside of the Vmax and Vmin range received ratings of either zero or 10 accordingly.

Source: World Bank, Doing Business.

H) Reliability of police

This component is from the Global Competitiveness Report question: "To what extent can police services be relied upon to enforce law and order in your country? (1 = Cannot be relied upon at all; 7 = Can be completely relied upon)".

Source: World Economic Forum, Global Competitiveness Report.

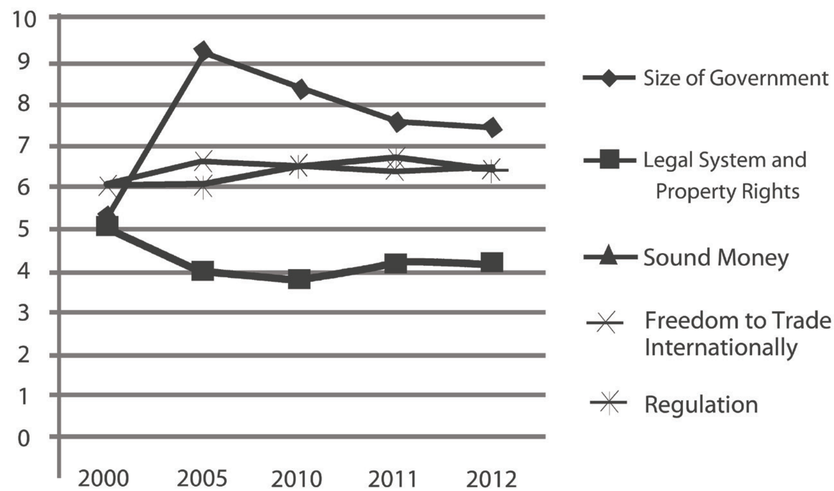
I) Business costs of crime

This component is from the Global Competitiveness Report question: "To what extent does the incidence of crime and violence impose costs on businesses in your country? (1 = to a great extent; 7 = not at all)".

Source: World Economic Forum, Global Competitiveness Report.

Section II: Analysis of Nepal's performance in the category

Figure 1: Comparison of Nepal's scores on different components of Economic Freedom

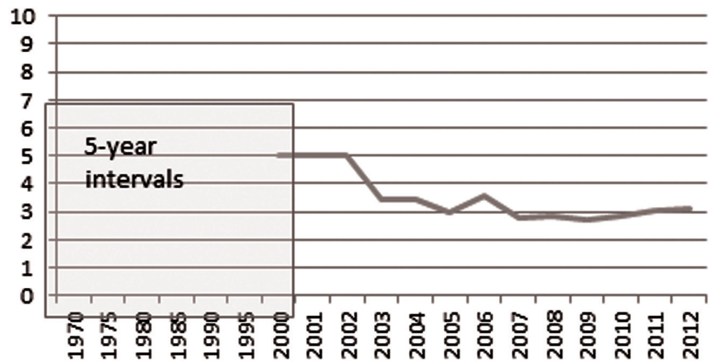


Source: Economic Freedom of the World Report, 2014

The component 'legal system and property rights' has been recognized as the most important of all components under the Economic Freedom of the World Report in terms of creating prosperity for the people of the respective countries., Nepal, however, scores the lowest in this very component. An important observation to make here would be that Nepal's weakness in this component is not the case only in the year 2012[1] , but has been the case throughout the country's recent history.

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

Figure 2: Legal System & Property Rights



Source: Economic Freedom of the World Report, 2014

Even when this component is considered in isolation, we can see a trend – a downward one. Interestingly, a noticeable but a short-lived surge in Nepal's score under this category can be seen in the year 2006 – the same year that the decade-long civil war ended. However, following the brief surge, the index takes a dip again. Therefore it could be very well be just a manifestation of change in people's perception about the rule of law and protection of private property rights after the end of the war, especially considering the rampant abductions and land grabs observed during the period, in addition to the death of over 13,000 people. Things started going downwards soon after the war was effectively out of the way, but other equally important factors still affect the legal system and property rights component. These factors include lack of enforcement of contracts, external influences on the judiciary, failure to enforce court awards, weak protection of private property rights, among other issues, in the years following the war. As of 2012, the country itself 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.

Comparison of Nepal's performance with other countries in Legal system and property rights[2]

Table 1: Comparison of Nepal's performance with other countries in Legal system and property rights

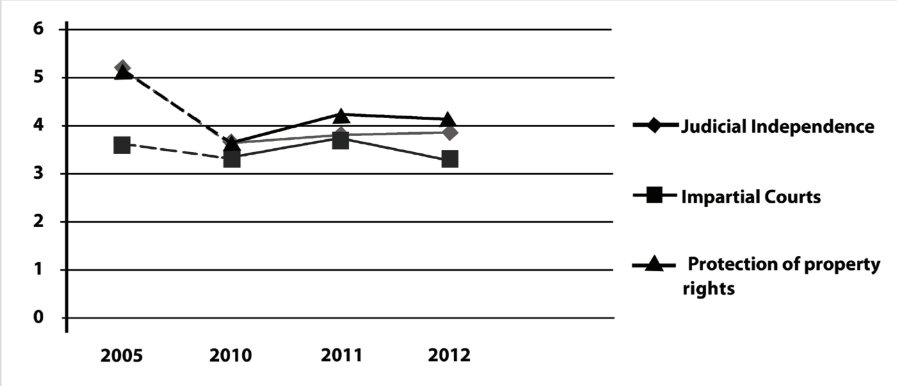
Countries	Judicial independence	Impartial courts	Protection of property rights
Finland	9.3	8.3	9.0
New Zealand	9.5	7.8	8.2
Norway	8.8	7.2	8.3
Switzerland	8.5	7.5	8.7
Singapore	7.8	7.5	8.9
Sweden	8.6	7.6	8.1
Netherlands	8.6	7.4	8.3
Qatar	8.5	7.2	8.3
Austria	6.8	6.0	8.1
Canada	8.6	6.8	8.4
Top 10 average	8.5	7.3	8.4
World Average	4.8	4.4	5.4
Landlocked	4.6	4.4	5.1
South Asia	4.7	4.3	4.8
Nepal	3.8	3.3	4.1

Source: Economic Freedom of the World Report, 2014

As evinced by Table 1, Nepal ranks the lowest in all three sub-components of 'Legal System and Property Rights' compared to: a) the World's top 10 performers, b) land-locked countries, c) other countries in South Asia, and d) the world average figures.

2 Only three of the nine sub-components under 'legal system and property rights' are considered here.

Figure 3: Legal System and Property Rights, Sub-component scores



Source: Economic Freedom of the World Report, 2014

Nepal's score of 3.8 in the 'judicial independence' sub-component hints that there is low level of independence within the judiciary and additionally, that it is subject to political interference by members of the government.

The score of 3.3 in the 'impartial courts' sub-component suggests that the legal framework for private businesses to settle disputes, and challenge government 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.

Likewise, the score of 4.1 in the 'protection of property rights' sub-component suggests that the country lacks a strongly-defined property rights system. Such a low score further hints that there exists some form of violation of property rights (by either state or non-state actors) in the country.

Another important observation to make in the above figures would be that Nepal not only performs worse in comparison to the majority of other economies under consideration, but it also performs worse than itself in these sub-components compared to the country's own performance in the past decade.

Section III: Policy and Implementation Challenges

Apart from the Economic Freedom of the World Report, various other international reports have also identified some serious concerns regarding the legal system and property rights issues in Nepal, lending further validation to the findings of this report. Transparency International's National Integrity System (NIS) Assessment Nepal 2014 identifies problems like external influence, delays and bribery within the judiciary. Its report puts the judiciary at a level below desirable despite it being one of the strongest institutions of Nepal (ranking third among the 11 pillars the international assessment studies). The report further states that the law enforcement is heavily influenced by the political leadership, rendering it unprofessional and ineffective.

World Bank's Doing Business Report, 2015 ranks Nepal at 134th (out of 189 countries) in terms of contract enforcement, with the process lasting 910 days on average. This fact paints a very worrisome picture in a country aiming for an environment conducive for businesses to thrive under institutions that allow private businesses to challenge the legality of government actions or settle disputes when the cases arise. Similar conclusions can be drawn from the World Economic Forum's Global Competitiveness Index, where Nepal is ranked 119th 92nd, and 120th in terms of property rights, judicial independence, and efficiency of legal framework in settling disputes respectively (World Economic Forum, 2013). This is a ranking out of 144 economies.

The following sections will look at some of the policy and implementation challenges confronting the 'Legal System and Property Rights' in Nepal as identified by the sectorial experts during the consultation meeting.

1. Judicial Independence:

Under Economic Freedom of the World Report, judicial independence is a measure of how free a country's judiciary is from the political influences of the members of its government, citizens or firms. As mentioned, Nepal's score of a mere 3.83 under this sub-component is a manifestation of these influences on our judiciary.

1.1 Influences on the process of appointment and oversight of judges:

Article 113 of the Interim Constitution of Nepal, 2007 provisions for a Judicial Council that is mandated with making recommendations for: appointment of judges, their transfers, taking disciplinary actions, and dismissals. It consists of the following five members:

- Chief Justice – Ex-officio chairman
- Minister of Justice – Ex-officio member
- Senior-most justice of the Supreme Court – Ex-officio member
- An expert on law, appointed by the President, on the recommendation of the Prime Minister - Member
- A senior advocate, or an advocate with at least 20 years of experience, appointed by the Chief Justice, on the recommendation of Nepal bar Association – Member

With this composition, the independence of the council has come under scrutiny. There are avenues for the political wings of the government to exercise some degree of influence in the judiciary, given that the council consists of members from both the judiciary and the executive (Reliance Law Firm, n.d.). The same study by Reliance also talks about how the judiciary has been made accountable to the people by guaranteeing that there is a presence of the elected representatives of the people on the same council that appoints judges. However, since the constitution has only made provisions regarding the qualifications of these members and keeps silent on the duties and responsibilities of members, there are avenues for political influences to intrude. (Upreti, 2014).

In March 2013, the then Chief Justice of the Supreme Court of Nepal took office as the Chief Executive. He was sworn in as the Chairman of Nepal's Interim Election Council of Ministers. With this, he became the head of both the Judiciary and the Executive. This quickly came under widespread criticism for being a plain violation of the Principle of Separation of Powers between the two bodies. A constitutional provision had been made prior to his instatement into the position of Chief Executive of the Council of Ministers.

This act also meant that an avenue had been constitutionally created for members of the Judiciary to make a switch to more lucrative positions within the government. Scope of such scales of professional gains bear great capacities to undermine the Judicial Independence.

There have been instances where the appointment and promotion of judges have been subject to political bargains between the judiciary and the government (Reliance Law Firm, n.d.). The influence on the judiciary has been so massive that today, in Nepal's court system, the majority of judges bear close ties with and represent different political parties (Shrestha, 2015). The court system has consequently come under strong scrutiny.

Political influence can affect not only judicial appointments, but can also be used to frustrate any appointment at all. Since the constitution sets no clear deadline for filling the posts of permanent judges in the Supreme Court when they become vacant, the Judicial Council can choose to just keep posts vacant and not have any other permanent judge in the Supreme Court at all (Upreti, 2014). This provision can be manipulated in such a way that the members of the Judicial Council can wait until one (or a group) of the favored judges makes it to the lower-tier courts first, and pull them directly into the vacant posts in the Supreme Court (Upreti, 2014).

The Council is also the body responsible for oversight of the judiciary. When there are avenues to exercise influence during the appointment of a judge, or that none should be appointed, it is likely that the oversight of the same judiciary be taken for granted.

1.2 Power politics within the judiciary

In judicial politics and law, there is a difference between individual independence and institutional independence. There is a judge's individual independence to make a decision – further meaning that he is free from any unwarranted intervention once he hands down a verdict on a specific case, and there is the institutional independence of the judiciary, which means the judiciary is free from "other branches of power," including any form of political influence (Acharya, 2012).

In Nepal, the judiciary has at times come under the influence of power politics among judges. Experts have, at times, hinted at some of the malpractices in which judges have been observed engaging. Former Attorney General Dr. Yubaraj Sangroula has written about judges aspiring to become the Chief Justice in hopes of being able to get involved in the administration of the judiciary (Sangroula, 2015). Here he hints at how Chief Justices have the leeway to influence the administration of the entire judiciary.

Influencing the administration has been seen at various levels within the judiciary. Some of the off-shoots of such politics include taking promising officers with good knowledge and research credentials under one's wing. When the young promising people start showing signs of going against the conventional practices and start bringing in some innovation, they are intentionally transferred to districts that have fewer cases to deal with. This directly discourages creativity and innovation (Sangroula, 2015). The transfer of judges working in the commercial bench has also been observed as one of the problems in Nepal. In the Federal District Courts in the U.S., for example, there are insolvency benches that have judges instated for a period of 15 years. This not only allows them to concentrate on a specific kind of case and build an expertise in that field, but also allows the judges to practice their profession independently due to secure tenure for a lengthy period of time.

In the same article, Dr. Sangroula talks about the Nepalese judiciary losing its independence. He argues that, instead of staying true to the principles of judicial independence, judges are guided by the prospect of earning fame by either being published or being acknowledged on law papers, magazines or other similar platforms. A similar practice has also been discussed in various studies about judicial behavior. Judges, since they are human, seek the same "popularity and respect" from their colleagues and people/groups that are affected by their decisions as other people do (Baum, 2006). In the process, however, these sorts of practices jeopardize the independence of the judiciary. Thus procedures, incentives, structures, and checks must be established to limit such behavior.

1.3 Provision of appointment of provisional (temporary) justices

Article 102 (5) of the Interim Constitution of Nepal, 2007 has a provision whereby the Supreme Court can have a total of 15 judges including the Chief Justice. It further states that if at any point, the court sees a surge in the number of cases, and the existing judges cannot handle the cases, then "ad hoc" judges may be appointed for a "fixed term."

The provision of temporary justices carries a serious concern regarding the independence of judiciary. 'Montreal Declaration, 1983 - Universal Declaration on The Independence of Justice' describes the appointment of temporary judges as being inconsistent with judicial independence.

In Nepal, there have been instances where the Supreme Court has had as many as 10 temporary judges (Upreti, 2014). The Chief Justice holds constitutional power to assign any case to any judge, based on his/her discretion (Upreti, 2014).

Given that the appointment is done by a council made up of some of the most senior members of the Judiciary and Executive, independence of the temporary judges can be greatly diminished, especially considering that they temporary judges aspire to become permanent judges, or perhaps even the Chief Justice. The prospect of great professional gains can create big incentives for temporary judges to compromise their professional integrity (Upreti, 2014).

1.4 Financial autonomy of judiciary

Financial autonomy can play a crucial role in maintaining the independence of the judiciary. Factors like budgetary dependence on other authorities, inadequate financial resources and remuneration for "judges and judicial administration" can affect the independence of the entire judiciary, especially in poor countries (Shakya, n.d.). However, like the case of institutional and administrative autonomies, the one of financial autonomy is also one that is practically missing from the Nepalese judiciary (Upreti, 2014).

Under the current practice, the entire budget of the judiciary is planned by the government (Ministry of Finance) through its annual budget, which is based on the national priorities. All revenues generated by the court system are accumulated in the consolidated fund. Such revenues cover a small portion of the consolidated fund, while the majority of it is funded by taxes. From this consolidated fund, allocations are made for different tiers of judiciary. The allocation is based on three criteria: caseload, number of staff, and geographical location of the court, irrespective of the performance of individual courts (Shakya, n.d.).

Over the years, the budget of the judiciary has been approximately 0.6% of the fiscal budget or less [3], and has been subject to the discretion of the Ministry of Finance. This budgetary dependence, resource inadequacy and lack of incentives and benefits for the practitioners of the judiciary within the

3 For more, refer to Budget Details, Red Book, Ministry of Finance, Government of Nepal. More at http://www.mof.gov.np/en/archive-documents/budget-details--red-book-28.html

judicial system (or, lack of a strong reward-punishment mechanism) could be one of the contributing factors leading to weakened judicial independence.

2. Impartial Courts & Contract Enforcement

The sub-component 'Impartiality of Courts' in the Economic Freedom of the World Report is based on the Global Competitiveness Report. It is a measure of how efficient a country's legal framework is for private businesses to settle disputes and challenge the legality of government actions/ regulations. A score of mere 3.3 in this sub-component is a clear indication that the legal framework that prevails in Nepal is not conducive for private businesses. There are government and non-government-imposed challenges to the success of a private enterprise. The settlement of disputes thus becomes a mammoth task, stretching for years on end with no resolution in sight. The following sub-sections will look into some of the policy and implementation hurdles that bear a direct impact on the impartiality of courts, as they were brought to light during the consultation meeting.

> "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)

2.1 Adjudication of commercial contract disputes and enforcement

Adjudication of commercial contract disputes has been one of the weaknesses of the Nepalese court system, lacking both technical expertise and resources (Krishnan, Connelly & Giri, 2013). Currently, there are no separate commercial courts in the country and commercial disputes are handled by the commercial benches set at select Courts of Appeal.

Challenges in terms of settling commercial disputes start from the commercial bench itself. Firstly, since there is no commercial court, there is also no specialized state-institution to deal with the cases. The commercial bench, which then fills in, is comprised of judges who are transferable. As already discussed in the previous sections, this practice deprives them of the opportunity to focus on a specific kind of case and build sectorial expertise. The experts in the consultation meeting expressed their concern over the lack of capability of our court system to even fathom some of the commercial cases, especially ones pertaining to large scale commercial undertakings, subjecting the contract interpretation to the personal views of the judges, based on their limited understanding. In addition to this, conventional adjudication is a lengthy and expensive process in Nepal. As per the World Bank's Ease of Doing Business Report, 2015, it takes 910 days on an average to enforce a contract in Nepal [4].

When businesses and entrepreneurs seek a more efficient, quicker and low-cost alternative to this kind of conventional adjudication, arbitration can be a very practical option – "a more flexible and adaptable process, capable of accommodating the particular needs of the disputants, the business community and society at large" (Krishnan, Connelly & Giri, 2013).

However, even if the disputants opt for third party arbitration, even with its pronouncements being legally binding, the enforcement still relies on the courts – the same courts which are: a), overburdened with backlogs, and b) lack technical expertise and resources.

When the government is also involved in the dispute, things get even worse for the plaintiffs. The Nepalese government has earned some infamy for being a defector of contracts (Krishnan, Connelly & Giri, 2013). This can be seen most visibly in the construction industry. Public construction projects are guided by Public Procurement Act, and Regulations, 2007, which mandate Alternate Dispute Resolution (ADR) mechanisms, for dispute settlement. Mediation and arbitration are the popular ADR mechanisms. Arbitration offers the final and binding pronouncement, in case the disputants fail to resolve their dispute through other amicable means. However, the public (government) employers neither prefer the amicable mechanism, nor do they abide by the arbiter's pronouncement (Niraula, n.d.).

"Public employers" in Nepal do not recognize the arbitration award until they are forced to do so by a competent court (Niraula, n.d.). This gives rise to a new litigation altogether, just to have the arbitration award enforced. These litigations reach as far as the Supreme Court. The plaintiffs are thus led back to square one, with low prospects of the contracts being enforced.

2.2 Lack of predictability in judiciary

The issue of the judiciary making pronouncements that are contradictory to each other was raised as a major concern when it came to discussing the

4 With this, 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.

impartiality of the court system in Nepal. The experts identified two major issues leading to the lack of predictability in the judiciary:

- There is no consistency in upholding the precedents set by competent benches,
- There is no follow-up of the precedents

A very recent case in point would be that of the Supreme Court issuing a stay order over the implementation of a 16-point deal struck among the four major political parties of Nepal (Jhangnam, 2015). The 16-point deal struck by the parties on the 8th of June, 2015 stated that Nepal would be federated into eight provincial states and the provincial assemblies would be assigned the responsibility to name the states. It further stated that a Federal Commission would look over the matters relating to the delineation of the states. On June 19, 2015 the Supreme Court ordered the government to not implement the deal, citing that it contradicted with articles 138 and 82 of Interim Constitution of Nepal (Khatiwada, 2015).

> Orders and decisions of the Courts to be binding:
>
> (1) All shall abide by the orders and decisions made in the course of hearing a lawsuit by the Courts.
>
> (2) Any interpretation given to a law or any legal principle laid down by the Supreme Court in the course of hearing a lawsuit shall be binding on the Government of Nepal and all offices and courts."
>
> - Article 116 of the Interim Constitution of Nepal, 2007.

When in 2008, a petition was filed at the Supreme Court seeking the interpretation of Article 138 of the Interim Constitution of Nepal, 2007, to set up a High Level State Restructuring Commission (SRC), the Court, without even issuing the show-cause notice to the respondents dismissed the petition at the first hearing (Acharya, 2015). The Court ruled that the issue was one of political nature with the Constituent Assembly having the power to make final decision on similar cases. Any active involvement of the court in the decision-making pertaining to the formation of the commission would be interfering in something that fell within the jurisdiction of another tier of the government – Constituent Assembly.

Given this background, the issue immediately came under heavy criticism by constitutional experts (Khatiwada, 2015) and the Nepal Bar Association (Jhangnam, 2015). It was criticized as having been against precedents set by the court itself, citing examples from the 2008 case on the same issue. Constitutional experts also say the event was guided by political will and against the Principle of Judicial Restraint (Dr. Bhimarjun Acharya, as cited in Khatiwada, 2015).

The stakeholders present at the consultation opined that such behaviors from the Judiciary erode predictability, and subject political as well as economic players to uncertainty and insecurity. When the court system gives contradicting pronouncements on similar cases, the fundamental principle of precedent is broken. Furthermore, there is an uncommon practice (putting things in international best practices perspective) in Nepal where a pronouncement made by a single judge in the Supreme Court is taken as the verdict of the Supreme Court itself if approved by a combined bench of two other judges (Upreti, 2014). The very fact that one judge makes an interim ruling and a combined bench of two judges makes the final ruling on the issue gives rise to unpredictability in terms of what kind of ruling to expect from the judiciary (Upreti, 2014).

2.3 People's confidence in judiciary eroded

Table 2: Case Processing in the Courts (as of 2014/14)

Court	Pending cases at previous year's end	New cases registered in the year	Total number of cases	Cases finalised in the year	Clearance rate(finalised cases/ total cases)	Pending cases at year's end
Supreme Court (1)	16451	8284	24735	5946	24.04	18789
Courts of Appeal (16)	15246	26606	41852	19070	69.46	12782
District Courts (75)	45664	64965	110629	68048	61.51	42581
Other courts/ tribunals	1896	914	2810	814	28.97	1996
Total	79257	100769	180026	103878	57.7	76148

Source: Annual Report, Supreme Court of Nepal, 2013/14

On one hand, concerns are growing about the problems of commercial cases being handled by a commercial bench within the courts in the absence of a commercial court itself, which renders it inefficient (as aforementioned), along with a growing sense of unpredictability about the judiciary's interpretation of similar situations/cases (as evinced by cases like the one discussed earlier). ,On the other hand, the reports from the Supreme Court itself show disturbing figures concerning the number of cases pending in the court system. In other words, if these numbers are anything to go by, the court system in Nepal is just not able to catch up with the demands placed on it. Every year, the court system creates more and more backlog for itself, at an increasing rate almost every year.

Table 3: Pending cases in the Court System as of 2013/14

Court / Fiscal Year	Supreme Court	Court of Appeal	District Court	Other courts/ tribunals	Pending cases at the end of the year
Until 2006/07	135	0	0	0	135
2007/08	196	0	1	0	197
2008/09	364	0	5	0	369
2009/10	778	0	30	12	820
2010/11	2373	22	175	27	2597
2011/12	3772	356	1026	309	5463
2012/13	4638	2634	8968	857	17097
2013/2014	6533	9770	32376	791	49470
Pending cases in a court	18789	12782	42581	1996	76148

Source: Annual Report, Supreme Court of Nepal, 2013/14

The World Bank's Doing Business Report, 2015 notes that it takes 910 days to enforce a contract in Nepal, including 365 days to impose the judgment once it has been made.

As the dockets of the courts get crowded beyond the capacity of the court system, it not only becomes time-consuming to resolve a dispute through the judiciary but also results in the parties having to bear additional costs to resolve their disputes. The transaction costs of the service are manifest in the forms of bribes, or even social detriment in escalating disputes given that the Nepalese society still views having to report to the police or the court system as a moral stain on an individual's character (Krishnan, Connelly & Giri, 2013). This has, consequently, led to people losing confidence in the judiciary and beginning to raise questions about its capability in its current state – viewing it as just another layer of hindrance in terms of doing business. The following remark, which is from a stationery owner who has been in the business for over a decade, adds perspective to the general public's perception of the court system:

"Who would want to run to the courts for breach of contracts? Courts take a long time to sort things out. Courts are nothing but a hassle and I have a business to run." - Osho Rai, as quoted in Krishnan, Connelly &Giri, 2013.

3 Protection of Property Rights

Comparatively, Nepal performs better in terms of property rights than both 'judicial independence' and 'impartiality of court' sub-components, and has managed to maintain that position for a few years in a row now (Figure 3). That said, Nepal only scored a 4.10 in the year 2012, and has historically hovered very close to that score, which puts it well below the world average, the landlocked countries average, and South Asian countries average (Table 1).

Given that the 'protection of property rights sub-component is scored based on how well the property rights are defined in and protected by the law, the experts present in the consultation meeting were asked to specify some of the aspects of Nepalese property rights system that render Nepal's performance in this category a dismal one when compared to the countries that rank higher up in the index. They were further asked to make suggestions that could strengthen the protection of property rights in Nepal. This section elaborates on some of the issues identified by the experts during the session.

3.1 Inaccurate and ineffective property (land) recording

Experts identified lack of a central registry, scientific survey, measurement mechanism, and digitization as some of the major reasons leading to the ineffectiveness of the property-record system (especially with regards to immovable property like land, more than movable ones) of Nepal.

Cadastral mapping of all 75 districts was last done in 1997/98. Out of these 75, mapping in 38 districts was done without National Control Network, hence requiring re-mapping (Department of Survey, n.d.). Problems with the property recording system in Nepal began right from the cadastral surveying process. Due to technical deficiencies and human factors, these processes end up being "inaccurate" and "ineffective" (Bhatta, 2006).

In a paper titled "Technical Deficiencies and Human Factors in Land Disputes: in the Context of Nepalese Cadastral Surveying," Ganesh Prasad Bhatta, Deputy Director General of Survey Department, identifies the following fifteen categories of land disputes arising from deficiencies in cadastral surveying and other factors in Nepal:

1. Improper demarcation of parcel boundary on the ground.
2. Errors in trace copy of original cadastral maps and wear and tear of documents.
3. Errors in file maps prepared in larger scale from original maps.
4. Displacement in the location of features, natural as well as cultural, with respect to existing maps.
5. Implications due to impractical legal provisions.
6. Inaccurate representation of reality at the margins of island maps.
7. Problems with ownership in the land distributed by special commissions.
8. Wrong survey of reality.
9. Wrong marking of parcel subdivision on cadastral map.
10. Wrong interpretation of the agreement mentioned on the deed document prepared at the time of transaction
11. Encroachment of public lands.
12. Transfer of ownership over public land by local authority beyond the legal provision.
13. Mismatching of existing maps with new maps prepared by cadastral resurveying.
14. Lack of proper coordination between the District Land Revenue Office and Survey Party/Office.
15. Mistakes in documentations during cadastral surveying.

Box 1: Problem with current property recording system

One classic case highlighting the problem area of a proper property recording system is the legal case between Deepak Ranjit (the then Inspector of Nepal Police) and Jeevan Ratna Sindhurakar (a local of Kathmandu) over the title of a piece of land in Kathmandu. In 2022 B.S, the Survey Department, under the then Ministry of Land Reform had registered the property under the ownership of Mr. Najarman Tamrakar. In 2030 B.S, Mr. Tamrakar died. Since he had no children, Ms. Dilshova Tamrakar, the sister of the deceased, acquired the property. After issuing a 35-day notice in the year 2044 B.S, the Land Revenue Office issued the Land Ownership Certificate to Ms. Tamrakar.

In 2049 B.S, Mr. Deepak Ranjit claimed that the property belonged to his mother and subsequently went to the Kathmandu District Court. The District Court decided in favor of Ms. Tamrakar. The plaintiff then went to the Court of Appeal, to which, in 2053 B.S, upheld the verdict of the district court. Mr. Ranjit again went to the Supreme Court, this time, to have the verdict made on his side. Following the verdict, Mr. Jeevan Ratna Sindhurakar, son of Ms. Dilshova Tamrakar began making rounds to the Supreme Court to get the verdict in his favor. As of 2009, the disputed property had two certificates of land ownership, under two different owners i.e, the records were showing that there two different owners of the same property.

Source: Kantipur TV

Inability to conduct a scientific survey and digitize the information has not only meant that it is a challenge to store, access, update and disseminate the real-time and accurate data pertaining to land ownership, but also that people with access to the limited information have been able to partake in otherwise unofficial transactions, jeopardizing citizens' property rights (Please refer to Box 1 for an example of a similar case.) Some district land reform offices are dilapidated to the point that one might not find any record of a property at the district land revenue office (News24, 2012). Furthermore, there are cases where the government has distributed land to the people but has neither offered the land ownership certificate, nor kept any record of the act (Bhatta, 2006), which is a property ownership dispute waiting to happen.

3.2 Violation of Property Rights

The Interim Constitution of Nepal 2007 has made certain provisions for the protection of an individual's property. The constitutional provision (article 19: right to property) reads,

"(1) Every citizen shall, subject to the existing laws, have the right to acquire, own, sell and otherwise dispose of property.

"(2) The State shall not, except in the public interest, acquire, or create any encumbrance on the property of any person. Provided that this clause shall not be applicable to property acquired through illegal means.

"(3) Compensation shall be provided for any property requisitioned, acquired or encumbered by the State in implementing scientific land reform programmes or in the public interest in accordance with law. The amount and basis of compensation, and relevant procedure shall be as prescribed by law."

"If there is no right to property, there will be terror of the state."
- Yubaraj Ghimire, Senior Journalist

Staying true to the constitutional provision of protecting private property, the Land Acquisition Act 1977 has set a due process that the state needs to follow in order to acquire somebody's private property. The Act also requires the state to pay due compensation to the private owner of land.

In practice, however, the state has not been able to protect this fundamental right of the people, going as far as violating the rights of people in some cases. In 2011 the government, under the premiership of Dr. Baburam Bhattarai, did not follow due procedure while carrying out its 'Road Expansion Drive.' To add to the woe of the victims, no compensation was paid to landowners when their lands were acquired for the purpose of the expansion drive. Government, however, did commit to paying compensation if the acquired land also housed a physical property right over it (Republica, 2012). The amount of this compensation (which takes into consideration only the damage done to the physical property and not the land) was also determined by the state. The compensation was paid after the demolition, and based on the report of the road expansion project, which is against the due process (as provisioned by the Land Acquisition Act) of compensating at least 50% of the damage in cash, before the acquisition.

As of September 7, 2015, the draft constitution, as posted on the official website of the Constituent Assembly, consists of provisions that further weaken the protection of property rights of the Nepalese people. Article 25, the Right to Property reads,

"(3) … when the state acquires private land for purposes relating to public interest, the basis and process of compensation will be as per the law.

"(4) Nothing … shall be deemed to prevent the State in enforcing land reform, management and regulation for the purpose of increasing production and productivity of land, modernization and commercialization of agriculture, environment preservation, organized housing and planned urbanization.

"(5) As per the sub-article 3, when the state acquires any individual's private property for public interest purpose, nothing shall prevent the state from using the property in any other public interest purpose than the one cited at the time of acquisition."

Note: The above text is an unofficial translation by the author.

The draft constitution, as aforecited, 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, should the Acts that follow (or the Acts that will be amended in the coming days) empower the state to acquire property without any compensation at all.

Going back to the interim constitution, the very use of the term "public interest" can be used by the state to expropriate property under private ownership, though it requires compensation before expropriation. First, the public interest can be subject to political interpretation. Using such a phrase can effectively mean that somebody else, other than the private owner of the property, gets to decide what the best use of the property is. Also, since the interim constitution stipulates that the compensation be designed as prescribed by the law, the private owner does not get a say in setting the value of his own property. Some experts expressed great concerns about such provisions and pointed out that it still gives the state the power to acquire somebody else's private property, as and when it deems necessary, without the owner's full consent, in which case, it is against the fundamentals of private property. They argued that in the case of expropriation, there needs to be a very narrow and well-defined reason for it, and the compensation should be made before expropriation.

Section IV: Recommendations

When a country is near the bottom of an economic index it definitely means that it has policies and institutions that are not conducive to fast-paced economic growth. However, equally-importantly it also means that marginal reforms can yield huge relative returns. China and India bear witness to the fact.

Judicial Independence

1. The Judicial Council, in its composition, suffers from various flaws. With the existing composition of two judges from the judiciary itself in a body that is responsible for appointment of judges, and oversight of the activities of the judges that they appoint, the Council fails to guarantee an independent performance and punishment mechanism. Furthermore, the presence of members of the executive in the Council subjects the judiciary to political interference.

Against this scenario, **one way to guarantee judicial independence would be to reform the composition of the Council.** The members of the Judiciary and Executive in the Council could be replaced by independent juries and professional experts.

2. 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.** Otherwise, when the posts become vacant, the Judicial Council can choose to just keep it that way and wait for the opportune moment to bring in a favored judge.

3. **Clear criteria for the appointment of judges need to be laid down in the Constitution.** Appointment of judges on the basis of competence, and zero-influence of political recommendations, both need to be guaranteed. The Constitution should further guarantee equal promotion of professional and cadre (employees of the judicial service) judges.

4. **The provision to appoint provisional judges in the courts should be removed.** Considering the fact that the provisional judges would naturally aspire to become permanent judges (which automatically brings along the prospect of great scales of professional gains, getting as high as the position of the Chief Justice), the current system can compromise the professional integrity of the temporary judges.

5. **Financial autonomy of the judiciary should be guaranteed.** Budgetary dependence, resource inadequacy and lack of incentives and benefits for the practitioners within the judicial system (or, lack of a strong reward-punishment mechanism) could otherwise lead to weakened judicial independence.

6. A parliamentary oversight body, with powers only to oversee the activities of the judiciary and make necessary recommendations to the Council, and none whatsoever to influence the judicial independence, could be created by the Constitution.

Impartial Courts

1. **Judges in the commercial bench should be declared non-transferable.** In the absence of a commercial court, this practice would enable the judges in the commercial bench to focus solely on commercial cases and build sectorial expertise. In the Federal District Courts in the U.S., for example, there are insolvency benches that have judges instated for a period of 15 years. This, not only allows them to concentrate on a specific kind of case and build an expertise in that field, but also allows the judges to practice their profession independently.

2. **The existing Contract Act, 2000 could be amended to include a special provision for disputes relating to commercial cases.** Nepal already has a Summary Procedures Act, 1972 that allows for certain cases to be sped up and be decided within 90 days. A similar provision of 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 complement 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, so that more cases are handled and the entire adjudication process becomes much shorter.

3. **Only the full bench of the Supreme Court should be allowed to make precedents.** As seen in case of Nepal, having no such guarantee has violated the fundamental rule of precedents. Having Supreme Court verdicts made only through the full bench can guarantee consistency and predictability.

4. A mechanism should be created whereby the pronouncements of third-party arbitrations are enforced without having to rely on courts. Arbitration cases having to rely on the Supreme Court for the enforcement of the arbiter's pronouncement despite their being legally binding only adds to the cost of doing business in Nepal, discouraging investors.

5. **Commercial courts should be established and given responsibility to deal with all commercial cases.** Given that adjudication of commercial contract disputes has been one of the weaknesses of the Nepalese court system without a commercial courthaving specialized commercial courts would mean that:

a) It is easier and cheaper to settle commercial disputes in Nepal, making it more favorable to doing business,

b) The conventional court system has a lesser burden (none relating to an area in which it does not hold any expertise), and provides a substantial opportunity to enhance its own efficiency.

Protection of Property Rights

1. **Nepal should continue to recognize and uphold property rights as fundamental 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.

2. **The existing provision pertaining to compensation for acquisition of privately-owned property should be amended and it should be guaranteed that the private owner is fully compensated before the state acquires his or her property** (as opposed to the current provision of partial compensation before acquisition). It should be guaranteed that expropriation is only allowed after complying with due process, including a just, fair and reasonable compensation.

3. Cadastral mapping of the districts requiring re-mapping should be expedited and completed as soon as possible. However, no compromises should be made regarding the science and accuracy of the survey and subsequent documentation.

4. **A proper central registry should be developed for the registry of immovable property.** A digital property recording system covering records of all districts in the country is extremely important, especially considering that it would aid access, update and enable dissemination of real-time and accurate data pertaining to property entitlements, ease coordination among government departments and reduce cases of disputes over property ownership.

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PART III

COUNTRY AUDIT OF AREA

FREEOM TO TRADE INTERNATIONALLY

Abbreviations

EFW	Economic Freedom of the World (report)
NRB	Nepal Rastra Bank
WTO	World Trade Organization
MFN	Most Favored Nation
ODC	Other Duties and Charges
SPS	Sanitary and Phytosanitary (requirements)
NBSM	Nepal Bureau of Standards and Meteorology
LDC	Least Developed Country
BIS	Bureau of Indian Standards
FGD	Focus Group Discussions
JV	Joint Venture
NPC	National Planning Commission
GoN	Government of Nepal
FDI	Foreign Direct Investment
FITTA	Foreign Investment and Technology Transfer Act
FIP	Foreign Investment Policy
NTFP	Non Timber Forest Products
CRO	Company Registrars Office
DoI	Department of Industries
FAO	Food and Agricultural Organization
DFO	District Forest Office
CFUG	Community Forest User Group
DDC	District Development Committee
FNCCI	Federation of Nepalese Chambers of Commerce and Industry
NCC	Nepal Chamber of Commerce
DPR	Department of Plant Resources
DoF	Department of Forests
SMFE	Small and Medium Forest Enterprises
TBT	Technical Trade Barriers
DoI	Department of Industries
ASYCUDA	Automatic System of Customs Data management
RA	Road Agencies
RBN	Roads Board Nepal
DoR	Department of Roads
RTGS	Real Time Gross Settlement System
ICT	Information and Communication Technology
GDP	Gross Domestic Product
DoLIDAR	Department of Local Infrastructure Development and Agriculture Roads
DoC	Department of Customs
DoTM	Department of Transport Management

Section I: Economic Freedom and Freedom to Trade Internationally

Trade is an integral aspect of a modern economy. One of the important contributions of modern economics has been the recognition of trade as a positive sum game. It is now generally accepted that trade betters both the recipient and supplier of the traded goods/services. The Economic Freedom of the World (EFW) report attempts to "measure the degree to which the policies and institutions of countries are supportive of economic freedom" where the "cornerstone" of economic freedom is considered to be a combination of personal choice, voluntary exchange, freedom to enter markets and compete, and security of the person and privately owned property (EFW, 2014). Of the five areas which comprise the EFW measurement, "Freedom to Trade Internationally" is an important one.

Below is the description of the indicators used by the Economic Freedom of the World Report to assign scores in the Freedom to Trade Internationally category. It has been taken from the Economic Freedom of the World, 2014 report.

A. Tariffs

i. Revenue from trade taxes (% of trade sector)

This sub-component measures the amount of taxes on international trade as a share of exports and imports. The formula used to calculate the ratings for this sub-component was: (Vmax – Vi) / (Vmax – Vmin) multiplied by 10. Vi represents the revenue derived from taxes on international trade as a share of the trade sector. The values for Vmin and Vmax were set at zero and 15%, respectively. This formula leads to lower ratings as the average tax rate on international trade increases. Countries with no specific taxes on international trade earn a perfect 10. As the revenues from these taxes rise toward 15% of international trade, ratings decline toward zero.

Sources International Monetary Fund, Government Finance Statistics Yearbook; International Monetary Fund, International Financial Statistics.

ii. Mean tariff rate

This sub-component is based on the unweighted mean of tariff rates. The formula used to calculate the zero-to-10 rating for each country was: (Vmax – Vi) / (Vmax –Vmin) multiplied by 10. Vi represents the country's mean tariff rate. The values for Vmin and Vmax were set at 0% and 50%, respectively. This formula will allocate a rating of 10 to countries that do not impose tariffs. As the mean tariff rate increases, countries are assigned lower ratings. The rating will decline toward zero as the mean tariff rate approaches 50%. (Note that except for two or three extreme observations, all countries have mean tariff rates within this range from 0% to 50%.)

Sources World Trade Organization, World Tariff Profiles.

iii. Standard deviation of tariff rates

Compared to a uniform tariff, tariff rates with wide variations indicate greater efforts to centrally plan the economy's production and consumption patterns. Thus, countries with a greater variation in their tariff rates are given lower ratings. The formula used to calculate the zero-to-10 ratings for this component was: (Vmax – Vi) / (Vmax– Vmin) multiplied by 10. Vi represents the standard deviation of the country's tariff rates. The values for Vmin and Vmax were set at 0% and 25%, respectively. This formula will allocate a rating of 10 to countries that impose a uniform tariff. As the standard deviation of tariff rates increases toward 25%, ratings decline toward zero. (Note that except for a few very extreme observations, the standard deviations of the tariff rates for the countries in our study fall within this 0% to 25% range.)

Sources World Trade Organization, World Tariff Profiles.

B. Regulatory trade barriers

i. Non-tariff trade barriers

This sub-component is based on the Global Competitiveness Report survey question: "In your country, tariff and non-tariff barriers significantly reduce the ability of imported goods to compete in the domestic market. 1-7 (best)" The question's wording has varied slightly over the years. Note, notwithstanding the sub-component's title, this indicator captures both tariff and non-tariff barriers.

Source World Economic Forum, Global Competitiveness Report.

i. Compliance cost of importing and exporting

This sub-component is based on the World Bank's Doing Business data on the time (i.e., non-monetary) cost of procedures required to import a full 20-foot container of dry goods that contains no hazardous or military items. Countries where it takes longer to import/export are given lower ratings. Zero-to-10 ratings were constructed for (1) the time cost to export a good (measured in number of calendar days required) and (2) the time cost to import a good (measured in number of calendar days required). These two ratings were then averaged to arrive at the final rating for this sub-component. The formula used to calculate the zero-to-10 ratings was: (Vmax – Vi) / (Vmax – Vmin) multiplied by 10. Vi represents the time cost value. The values for Vmax and Vmin were set at 62 and 80 days (1.5 standard deviations above average in 2005) and 2 days (1.5 standard deviations below average in 2005) and 0 days, respectively. Countries with values outside of the Vmax and Vmin range received ratings of either zero or 10 accordingly.

Source World Bank, Doing Business.

C. Black-market exchange rates

This component is based on the percentage difference between the official and the parallel (black) market exchange rate. The formula used to calculate the zero-to-10 ratings for this component was: (Vmax – Vi) / (Vmax – Vmin) multiplied by 10. Vi is the country's black-market exchange rate premium. The values for Vmin and Vmax were set at 0% and 50%, respectively. This formula will allocate a rating of 10 to countries without a black-market exchange rate – i.e., those with a domestic currency that is fully convertible without restrictions. When exchange rate controls are present, and a black market exists, the ratings will decline toward zero as the black market premium increases toward 50%. A zero rating is given when the black market premium is equal to, or greater than, 50%.

Source MRI Bankers' Guide to Foreign Currency.

D. Controls of the movement of capital and people

i. Foreign ownership/investment restrictions

This sub-component is based on the following two Global Competitiveness Report questions: "How prevalent is foreign ownership of companies in your country? 1 = Very rare, 7 = Highly prevalent"; and "How restrictive are regulations in your country relating to international capital flows? 1 = Highly restrictive, 7 = Not restrictive at all".

Source World Economic Forum, Global Competitiveness Report.

ii. Capital controls

The International Monetary Fund reports on up to 13 types of international capital controls. The zero-to-10 rating is the percentage of capital controls not levied as a share of the total number of capital controls listed, multiplied by 10.

Source International Monetary Fund, Annual Report on Exchange Arrangements and Exchange Restrictions.

iii. Freedom of foreigners to visit

This component measures the percentage of countries for which this country requires a visa from foreign visitors. It reflects the freedom of foreigners to travel to this country for tourism and short-term business purposes. The formula used to calculate the zero-to-10 ratings was: (Vi – Vmin) / (Vmax – Vmin) multiplied by 10. Vi represents the component value. The values for Vmax and Vmin were set at 47.2 (1 standard deviation above average) and 0. Countries with values outside of the Vmax and Vmin range received ratings of either zero or 10 accordingly.

Note This sub-component was not updated for the 2014 Annual Report.

Source Robert Lawson and Jayme Lemke, Travel Visas, Public Choice 154, 1–2 (2012): 17–36.

This paper will now attempt to examine some of the reasons behind Nepal's low score in the "Freedom to Trade Internationally" aspect of the Economic Freedom of the World report. As part of the EFW country audit report, 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. The meeting served two purposes: It provided an opportnity to understand the views of major players from Nepal's trade sector, and invited recommendations, suggestions, and processes required to increase Nepal's openness to trade.

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 brought forth.

Section II: Analysis of Nepal's Performance in this Category

In the "Freedom to Trade Internationally" aspect, in the Economic Freedom of the World 2014 report, Nepal received a score of 6.4 and ranked 117. The scores are broken down as follows:

Table: Nepal's score in the Area Freedom to Trade Internationally

SN	Year	2010	2011	2012
	Freedom to Trade Internationally	**6.43**	**6.35**	**6.40**
A	**Tariff**	**6.29**	**6.25**	**6.36**
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	**Regulatory Trade Barriers**	**4.72**	**4.44**	**4.58**
i	Non-tariff Trade Barriers	4.9	4.52	4.94
ii	Compliance cost of Importing and Exporting	4.54	4.35	4.21
C	**Black-market exchange rates**	**10.00**	**10.00**	**10.00**
D	**Controls of the movement of Capital and People**	**4.69**	**4.71**	**4.65**
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: EFW Report, 2014

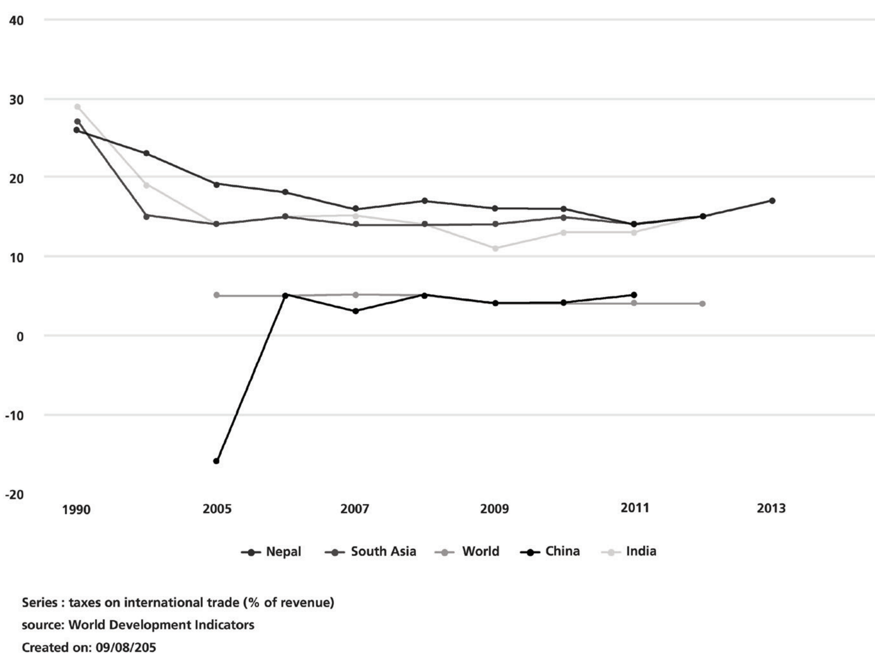
According to the table, Nepal performs poorly in the categories of tariff rates, regulatory trade barriers and control of movement of capital and people. Poor performance in these areas may be contributing to difficulty in conducting trade in Nepal. Owing to controls placed by the Central Bank of Nepal on capital movement, Nepal scores a zero in the capital controls category. The controls placed on foreign ownership over the years also have increased, thereby reducing the score on the 'Foreign ownership/investment restrictions' category.

A) Tariff

I. Revenues from trade taxes

Nepal generates about one third of its revenue from taxes on international trade. This is a significantly high portion of the revenue compared to the world average and that of Nepal's neighboring country, China. China's growth can be largely explained by its exposure to international trade, as depicted by the Figure 1 below:

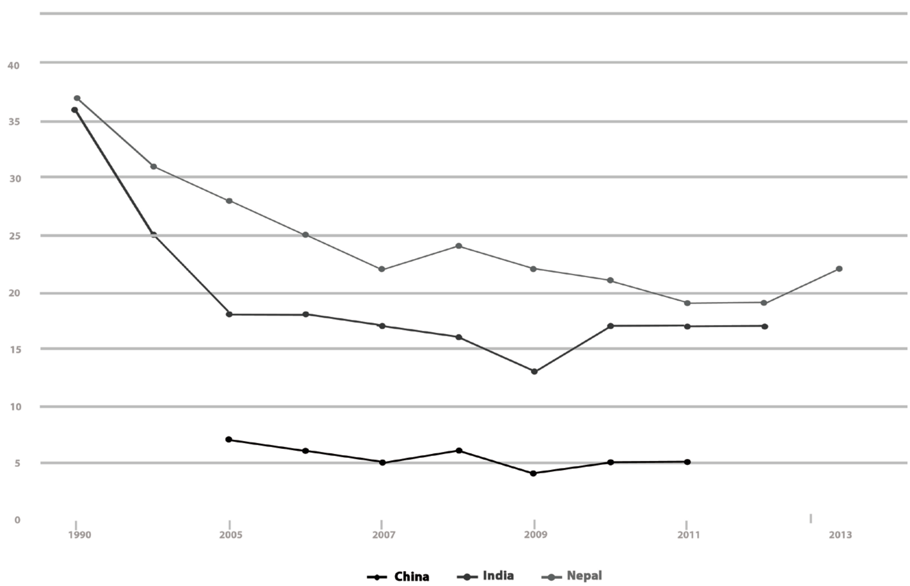
Figure 1: Taxes on international trade (% of revenue)



Nepal's revenue collection from trade is higher than the South Asian average as well as that of India. One of the primary reasons for growth in emerging markets is interaction with the rest of the world and openness to international trade. Taxing international trade discourages it. For a poor economy like Nepal, this is a counter-productive, since international trade can be the engine of growth..

A closer look at Nepal's customs charges and other duties also reveals a picture similar to that shown above. Nepal is relying on taxing international trade to generate much of its revenue while India and China have both moved away from such measures. Figure 2 gives us a clearer indication of this:

Figure 2: Customs and other import duties (% of tax revenue)



Series: Customs and other import duties (% of revenue)
Source: World Devlopment Indicators
Cretaed on: 09/08/2015

As can be seen in the above, Nepal still relies largely on taxing imports for its revenue. At the same time, both India and China, which have succeeded in establishing themselves as world players in international trade, are moving away from relying on custom and other import duties as a major source of their revenue.

Despite taxing imports heavily and discouraging them, Nepal still routinely records trade deficits, with imports consistently larger than exports. According to the Trade Policy Review, which is a report published by the World Trade Organization (WTO) along with the participation of the member state: "The total volume of trade doubled in 2009/10 in comparison to that of 2004/05. In the total trade volume, export share decreased drastically from 28.2% in 2004/05 to 14.1% in 2010/11 and import share increased from 71.8% to 85.9%." The decreasing share of export in total trade, the report says, is because "the average growth rates of export and import are 1.0% and 20.4% respectively from 2004/05 to 2010/11." An interesting insight noted in the report is that "after the accession of Nepal to the WTO, the share of exports in total trade decreased from 28.2% in 2004/05 to 14.5% in 2010/11 in comparison to the increase in imports from 71.8% to 85.9% during the same period." The fact that Nepal's membership in the WTO correlated with growing trade deficits may be highlighting the fact that Nepal lacks the mechanisms to become more competitive in global markets, and it may also underscore the need for large structural overhauls to remove artificial and/or structural barriers.

II. Tariff Rates

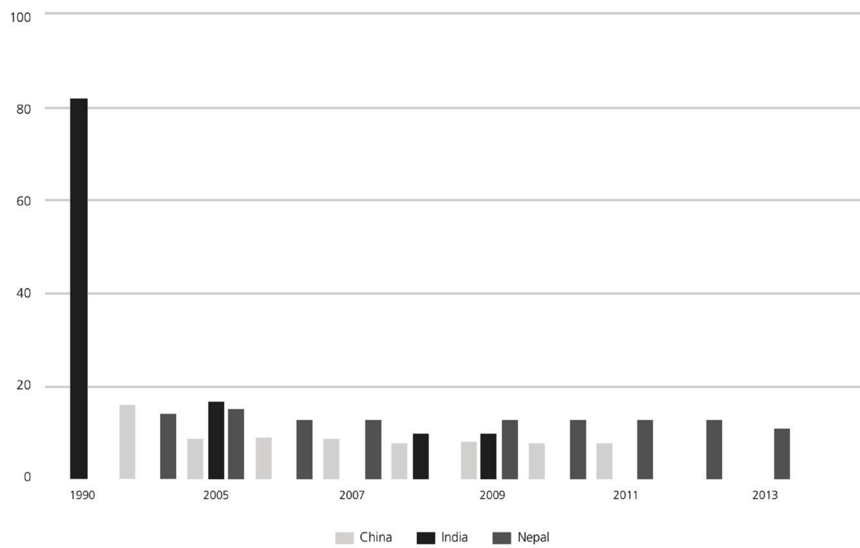
Tariff wise, Nepal imposes duties on both imports and exports. Import duties can run as high as 80 percent of the value of the products in the case of automobiles. Besides duties and tariffs, a variety of "Other Duties and Charges" (ODC) like Pollution Fee, Road Maintenance Fee, Agriculture Development Fee, Cigarettes and Alcohol Fee and Alcohol Control Service Fee are levied on a number of goods that are imported to Nepal (Pandey et al. 2011).

Export duties on forest related commodities and products are as high as 200 percent of the value of the products. One argument for the high export duty on timber product may be the perceived need to conserve such resources. However, when the cost of doing business through official channels is high, it is likely that unofficial ways will be used and business may be conducted under the radar. Such "under the radar" activities, then, may be even more likely to occur when the cost of punishment is relatively low or when the chances of getting caught are slight.

Nepal shares an open border with India and there are 22 "agreed routes for mutual trade" along the 1751 km of the eastern, southern and western border that Nepal shares with India, according to Indo-Nepal Treaty of Trade published by the Ministry of Commerce and Industry Government of India, New Delhi. This suggests that illegally acquired logs can be transported to India in clandestine ways. In the illegal logging business, however, transportation is not only carried out via roadways. A BBC news article by Navin Singh Khadga reports that rivers that flow from Nepal to India are also used to float logs to the hands of receivers (Khadga, 2010).

A comparison of Nepal's mean tariff rate with two of its neighbors – India and China – both of whom have benefitted greatly from liberalization of international trade – shows there is much room for improvement in rationalizing our tariff structure.

Figure 3: Tariff rate, applied, simple mean, all products (%)



Series: tariff rate, applied, simple mean, all products (%)
Source: World Development Indicators
Created on: 09/08/2015

Both India and China have demonstrated tremendous progress in reducing their mean tariff rates since 1990, and there is much to be learned from their experience as we seek ways to rationalize Nepal's tariff structure.

Besides government tariffs and duties that directly influence trade,, several other trade related issues are at odds with globally competitive business practices.

B) Regulatory Trade Barriers

Sharma, Bhusal, and Adhikari conducted research on the barriers impeding the growth of Nepalese exports to India, and they concluded that procedural, institutional, policy, and structural barriers to Nepalese trade exists (Adhikari et al, 2014). They argue that, on the procedure side, provisions related to "providing trade related approvals such as certificate of origin, quality test certificates, quarantine approvals, permission for financial transactions, foreign exchange provision … transportation, etc." are inadequate. Of the listed procedural problems, their research points out, "congestion at the exit border point causing problems in parking… and problem of collection hub especially for agricultural products" as being other major issues to consider.

"Provision of Certificate of Origin, quarantine certificate, transportation and export tax" are also highlighted as being areas needing attention (Adhikari et al., 2014). In case of institutional barriers, the authors decry the "lack of clarity of roles and responsibilities between ministries, departments and implementing agencies" as the central reason for the existence of this (institutional) barrier (Adhikari at al., 2014). For the political barriers, the authors identified the lack of clarity in communication among various departments and ministries as a reason for the existence of such barriers. Based on the authors' research and various Focus Group Discussions (FGD), they found that policy barriers were worst in case of forestry related products while the policy regime was rather straightforward in case of other manufactured products (Adhikari et al., 2014).

In the Minutes of the meeting of the Nepal-India Inter-government Committee (IGC) on Trade, Transit and Cooperation to Control Unauthorized Trade, which was held in Kathmandu in 21-22, 2013, it was noted that Nepalese labs, which test under mandates of the Nepal Bureau of Standards and Meteorology (NBSM), are not accredited by the Indian side, namely by the Bureau of Indian Standards (BIS). This issue was raised by Sharma, Bhusal, and Adhikari, in their paper *An Assessment of Export Barrier of Nepalese Products to India*, where they acknowledge the lack of adequate laboratory testing of locally produced products as a barrier to trade.

In his presentation on the topic *Public Private Dialogue on Enhancing Export Competitiveness of Nepalese Honey*, Pandey argues for the accreditation of existing and independent laboratories (Adhikari et al, 2014; Pandey, 2014). Such inadequacies lead to unwanted increases in time and in the cost of doing trade, as the samples have to be sent abroad to labs abroad for approval.

C. International capital market controls

Nepal's finance sector is at an early stage compared to those in markets of economically advanced nations. Excess liquidity has been a regular phenomenon since liberalization reforms started in the 1990s. One of the contributing factors is also the Government's own liquidity position, since it has been active in collecting revenue but has not been able to spend that revenue – especially the funds related to capital expenditure. The 2014/15 Monetary Policy of Nepal acknowledges one of the government's priorities is managing the excess liquidity, and, therefore argues for a "tight" monetary policy. Excess liquidity occurs when deposits increase at a higher rate than the demand for loans. The monetary policy suggests that the high remittance inflow is contributing to excess liquidity.

Clearly, for a country that is classified as a Least Developed Country (LDC), the availability of funds should be a welcome opportunity to invest. Unfortunately for Nepal, investments are not taking place and, clearly, a lack of resources is not the cause of this problem. The country cannot attain prosperity without significant investments. This report charts out reform measures that can help Nepal increase the level of investment in the economy both from domestic and international sources.

On one hand, avenues of investment in the domestic sector are in short supply, and on the other there are restrictions in place on investing abroad. Current regulations restrict the movement of capital to and from Nepal. The capital account is highly regulated in Nepal while there is a relatively open regime in the case of the current account.

Nepal Rastra Bank (NRB), the central bank of Nepal, argues that the conditions required for convertibility of the capital account do not exist in Nepal. A study titled Capital Account Convertibility in Nepal: A Feasibility Study, conducted by NRB's Institute for Sustainable Development, reports that prerequisites such as reduction in fiscal deficit, tax reforms, control of inflation, and financial sector reforms need to be initiated to make capital account convertibility feasible and beneficial for the country (NRB, 1994).

Besides a non-convertible capital account, there is also an act in place that restricts Nepalese nationals from investing abroad. The Act Restricting Investment Abroad, 1964 has not yet been repealed and it is still in force. The act restricts Nepalese citizens or corporate bodies residing inside or outside Nepal from investing in shares of a foreign firm, from forming partnerships, purchase of real estate, and the like in foreign markets. This policy contradicts other existing policies such as the Foreign Investment and Technology Transfer Act, 1992 and the Foreign Investment Policy, 1992, that aim to encourage the competitiveness of Nepalese industries in the international market.

There are also restrictions in place of the size of businesses that can be established through FDI. Foreign investors are required to invest at least Rs. 5 million (investnepal.gov, 2015). Similarly, a foreign owned company can only be set up as a "Private Limited Company" or as a "Public Limited Company" and businesses cannot be established (by foreign nationals) as a "proprietorship" or as a "partnership" (investnepal.gov). The foreign entities or individuals are allowed to have a Joint Venture (JV) with Nepali nationals or entities, or to establish entities with full (100percent) ownership in most of the sectors of the economy. On the labour front, foreign nationals are allowed to work in Nepal only when their particular skill set is not available in Nepal as per the Labour Rules, 2050 based on the Labour Act, 2048.

D. Other Major Barriers to Trade

Nepal's weak position in trade is also affected by its overall economic policy and business environment. This report examines various other factors that affect the business environment, and also outlines recommendations that can help Nepal improve its economic policy regime and pursue the path to prosperity. Some provisions that are directly affecting trade are outlined in this section. Provisions related to hiring and firing are tedious for entrepreneurs in Nepal, and essential inputs such as energy and water are supplied intermittently. Foreign owned companies are not allowed to trade – either by export or import – except when they are dealing with their own products or inputs for their own products.

While such factors have contributed to a loss of competitiveness of Nepalese goods in international markets, other actions taken by the government in pursuit of protection or promotion may have exacerbated Nepal's failing ability to trade internationally and/or even antagonized foreigners who wish to trade with Nepal. The fact that Nepal lies between two manufacturing powerhouses – India and China – and has no access to the sea puts up structural barriers to trade. Meanwhile the country's tedious trading processes, along with inadequate infrastructure to produce quality products, reminds us that artificial barriers to trade also exist.

Labour related disputes are a frequent occurrence for Nepal. Recently, Devyani International, an India based company that introduced international fast food chains KFC and Pizza Hut, shut down because of "dispute(s) with the labour union on May 11," as per a local daily (The Himalayn Times, 2014). In 2012, Surya Nepal Private Limited also shut its garment production wing citing problematic labour relations and a difficult regulatory environment (ekantipur, 2014).

Trade unions in Nepal are associated with political parties and at times, labour problems occur not because of troubled industrial relations at the enterprise level but because of the program of the political party with which the unions are affiliated (Upadhyaya, 2011). Acharya, Nepal, and Neupane also find a high correlation between political transition and strikes and forced closures by labour unions (Acharya et al., 2013). While labour relations may not be directly related to trade, they play a pivotal role in creating either a favorable environment or a disruptive one. The politicization, and sometimes militancy, of labour unions has made the general industrial environment of the country poor.

E. Trade Liberralization Slow Despite WTO

The book Understanding the WTO, which is published by the World Trade Organization, states that membership in the WTO allows member nations to talk and sort out issues related to trade. While the underlying agenda of the WTO is trade liberalization, issues related to protection of consumers and the welfare of less developed nations are also part of its mandate. “Principles”, such as Most Favored Nation (MFN) status and national treatment — which means treating imported goods (after duty) on par with domestically produced goods — indicate the WTO”s intention of creating a level playing field. Allegorically, one may be able to say that while the WTO has leveled the playing field and the game can run very smoothly, the Nepalese team is so weak that the outcome of the game is rarely in its favour.

A matter of discussion between trading partners, which is in harmony with WTO’s vision, is regarding setting Sanitary and Phytosanitary (SPS) requirements. The WTO recognizes an SPS as “an agreement on how governments can apply food safety and animal and plant health measures” in order to ensure that the country’s consumers are being supplied with food that is safe to eat (wto.org, 2015).” Due to its Least Developed Country (LDC) status, Nepal is allowed a “transition period” before adoption of such practices by the WTO, but bilateral or regional agreements may hinge on the SPS and other such matters.

Section III: Policy Implementation and Challenges

Policies on trade, investment and industrialization are linked with each other and must be complementary in order to achieve sustainable and inclusive growth. Studies have shown strong positive and self-reinforcing relationships between bilateral trade and FDI flows with trade "causing" FDI as well as FDI "causing" trade. Nepal's trade-related laws and regulations are illustrated below:

Table2: Trade Related Legislations in Nepal

Customs	• Customs Act (2006 and Regulations 2006) • Customs Rules (2007)
Export and import licensing	• Export and Import Control Act (1958, as amended in 2006) • Export and Import Control Regulation (1974)
Technical barriers to trade	• Nepal Standards (Certification Mark) Act (1980, as amended) • Nepal Standards • (Certification Mark) Regulations (1982, as amended) • Drugs Act, (1978, as amended in 2000) • Drug Registration Rules, (1981, as amended in 2001)
Sanitary and phytosanitary measures	• Nepal Seeds Act, 2045 (1988) • The Seeds Regulation, 2054 (1997) • Plant Protection Act, 2064 (2007) • Plants Protection Rules, 2066 (2010) • The Food Act, 2023 (1966) • Food Regulation, 2027 (1970) • Feed Act (Animal Concentrate), 2023 (1966)
Competition policies	• Animal Health and Livestock Services Act (1998) • Competition Promotion and Market Protection Act (2007) • Competition Promotion and Market Protection Regulation (2007) • Consumer Protection Act (1998)
Privatization	Privatization Act, 2050 (1993)
Investment regime	• Foreign Investment and Technology Transfer Act (1992, as amended) • Industrial Enterprises Act (1992, as amended)
Government procurement	• Public Procurement Act (2007) • Public Procurement Rules (2007)
Trade-related intellectual property rights	• Patent, Design and Trade Mark Act (1965) • Copyright Act (2002) • Copyright Regulations (2004)

Source: Trade Policy Review: Nepal, 2012; Ojha, 2012

In the following section, we take a look at policy and implementation challenges in the related sub-category of the Freedom to trade internationally category.

1. Tariff:

Nepal has an Overall Trade Restrictiveness Index (OTRI) score of 0.14 (on the MFN tariff base) and 0.13 (on the applied Tariff rate) measured by the World Bank (World Bank, 2015). This indicates that the overall tariff and non-tariff barriers in Nepal are equivalent to imposing approximately 15 percent duties on all of its imports without changing the volume of trade.

On the OTRI, the lower the score the better off the country is in terms of being less restrictive on trade. Nepal's score cannot be considered highly restrictive. It is, however, restrictive enough to have a negative impact on further international trade. This is evident from the fact that places that are doing well in terms of international trade have a much better score compared to Nepal. For instance, Hong Kong scores 0.017 on the OTRI and ranks number 1 while an emerging market economy like Indonesia scores 0.080 and ranks number 14.

There are certain issues that prevail in the tariff regime that have more to do with economic diplomacy and implementation. For instance, although the additional customs duty has been waived on 168 products between Nepal and India, such duty is imposed on other potential export products including ready made garments. Although Article V of Revised Indo-Nepal Treaty of Trade, October, 2009 states that other industrial goods will also be provided with duty free access, the annexure and sub-clauses of the article limit this to certain items with quota restrictions and other qualifications. This clearly shows problems with economic diplomacy in Nepal and the lack of negotiation skills for a better deal for Nepali products to access the Indian market (Kharel, 2009).

In addition to the tariff regime, Nepal has a para-tariff regime. The country imposes other duties and fees, such as excise duty, agriculture development fees, pollution control fees etc., on several import items. These taxes and fees represent the hidden cost of doing business in Nepal in terms of international trade. For instance, while the import duty on cars is already at a high 80 percent, other kinds of fees and duties imposed result in cars being taxed a total of 248% of its CIF price.

2. Regulatory Trade Barrier:

a. Non tariff trade barrier:

Nepal exports around 84 herbal products. Of these, only 16 can receive prevention of food adulteration (PFA) test certificates from Indian laboratories. PFA certificates and quarantine requirements (quarantine facilities are available in only 3 out of the 26 customs points) are among the key issues raised by Nepali exporters and cited as non-tariff barriers imposed by India. To ensure the compliance of agreed standards in fabric, Nepalese exporters of ready made garments and pashmina need to carry out tests at Indian laboratories or alternatively obtain a certificate from the Bureau of Indian Standards when exporting products to India.

Similarly, transportation and logistics have restricted Nepal's opportunities to explore regional and global markets. This has significantly increased the cost of doing business and adversely affected growth, employment and poverty reduction. Another major problem confronting Nepal, is difficulty in reducing transit time, pilferage and loss/damages. Pilferage and losses and damages add to the cost of doing business for Nepali exporters and make Nepali exports more expensive in international markets.

Besides the possible administrative shortcomings, WTO's Trade Policy Review on Nepal finds that Nepal's ability to trade is "severely handicapped by its limited human resources, institutional capacity, financial resources and understanding of complex dynamics of multilateral trade regime (Trade Policy Review body, 2012)." These points are underscored by the various SPS requirements and Technical Trade Barriers (TBT), which Nepal has not been able to overcome and which impede the ability to trade.

On one hand, policies relating to cargo transportation and cargo insurance are missing. On the other, competitively advantageous sectors such as forestry products are over-encumbered because they fall under the jurisdiction of several government bodies. The 1993 Motor Vehicles and Transport Management Act is also silent on the matter of insurance of goods being transported. Rajkarnikar, in his paper Adequacy and Effectiveness of Logistic Services in Nepal: Implication for Export Performance writes: "Nepalese transit cargoes are required to be insured against deflection in India at high bond prices fixed by the Indian customs. As Indian National Insurance Company has a monopoly in this business, the insurance premium is also very high. The shipping lines do not provide a through bill of lading to Nepalese traders. Nepalese importers have to separately arrange for the land transportation and this increases the overall door-to-door cost. Such a condition favors de-stuffing of containers in Kolkata/Haldia, rather than being carried through as full container loads to Nepal. Customs inflexibility regarding timing of clearance arrival of goods is also considered as a non-physical barrier. Nepalese customs offices do not process the cargo arrived after 15:00 hours on the same day. Indian regulations of quarantine have appeared as an additional non-physical barrier in case of export of foodstuffs and agro products from Nepal. It makes a delay of up to 10-12 days as India does not readily accept standards set by the Nepal Standard Bureau and samples have to be sent to Kolkata for testing (Rajkarnikar, 2010)."

In the case of landlocked countries, the goods to be received have to pass through a different country or several countries, and the inefficiency within one system may be imposed on another. However, the barriers imposed in another country do not negate the fact that adequate physical and institutional infrastructure would support trade. Since Nepal is a landlocked country, road transportation is vital to move goods from one point to another. However, the condition of roads and road network leaves much to be desired, thereby increasing the cost of doing business in Nepal.

Currently, 12 customs offices have installed Automatic Systems of Customs Data Management (ASYCUDA), according to the website of the Department of Customs (DoC) (customs.gov.np). However, this automated system is not fully utilized and a manual system is used along with the ASYCUDA system, leading to additional time-costs (Rajkarnikar, 2010).

Along with the increased time due to incomplete implementation of automated processes in the customs point, Nepal's trade performance is also hampered by uncompetitive practices in the transport sector. While transportation facilities are easily available to export goods from Nepal, freight syndicates are present and have contributed to higher prices for Nepalese goods. The section examining the business environment and legal system in this report makes some suggestions on how we could improve this situation. Likewise, while there is a shortage of adequate human resources in the customs offices for handling, unloading and loading of goods, a labour syndicate has made is difficult to hire other persons (Pohit, 2009).

Another disadvantage faced by Nepalese truckerss is that they are required to get a permit that lasts for 3 months, before they are allowed to move to the Indian side, but Indian trucks can come into Nepal for a period of 72 hours without any permit (Pohit, 2009).

b. Compliance cost of importing and exporting:

Owing to the inefficiencies associated with bureaucratic hassles and red tape, international trade in Nepal faces high transaction costs. These costs are associated with complex procedures and documentation, slow and inefficient customs clearances and inadequate transport infrastructure. Such constraints have made Nepal's exports non-competitive in international markets.

> Doingbusiness.org ranks Nepal 104 out of 189 countries for the "number of procedures, time and cost for a small and medium sized limited liability corporation to start and formally operate." The Doing Business Report's "Economy Profile" of Nepal for 2015 reports that: "exporting a standard container of goods requires 11 documents, takes 40 days and costs $2545.0. Importing the same container of goods required 11 documents, takes 39.0 days and costs $2650.0 (Doing Business Report, 2015)."

Cumbersome or lengthy processes for doing business in Nepal, which result in inefficiency, can be due to duplication of work by various agencies at the local and central level. Tamang and Malena find that there is "duplication and ambiguity in the division of responsibilities between local bodies and central government." (Tamang et al., 2011). They argue old acts, which "predate and contradict the Local Self-Governance Act" and are still not updated or phased out, may be leading to inefficiency (Tamang et al., 2011). For instance, exporting herbal and forest related products requires authorization from the Department of Plant Resources. To add to the procedures in case of Forest-Product export Ojha, Current Policy Issues in NTFP Development in Nepalargues that while no direct acts or policies have been formulated for Non Timber Forest Products (NTFP) export and extraction, several existing acts cover the topic. Besides the various steps the acts mandate, general business requirements such as incorporating the company with the Company Registrars Office (CRO), registration of industries with the Department of Industries (DoI), and registration with the Inland Revenue Office further complicate matters.

FAO's Challenges and Opportunities for Nepal's Small and Medium Forest Enterprises finds that, while the policy seems to favor forest product related enterprise development, the mechanisms designed by such policies "are tuned only to promote community-based conservation and the fulfillment of the communities' subsistence needs (FAO, 2009)." They cite "cumbersome bureaucratic process(es)" such as the forest-based enterprise registration, requiring three-party consensus among District Forest Office, Cottage and Small Industry Development Board, and Land Survey Office (FAO, 2009). "Table 1" below highlights the cumbersome "legal steps for collection and export (FAO, 2009)."

Table 3: Legal steps for collection and export of forest products

Requirement	Issuing Agency
Collection Permit	DFO/CFUG
Royalty Payment	DFO/CFUG
Issue (transit) Permit	DFO
Local Taxes	DDC
Certificate of origin	FNCCI/NCC
Product Certification	DPR/ DOF
Export License	Department of Industries
Export Duty	Customs office

Source: FAO, 2009, Challenges and Opportunities for Nepal's Small and Medium Forest Enterprises

As shown in the table, forest related enterprises, have to interact with many government agencies, including District Forest Office (DFO), Department of Plant Resources, Department of Forests, District Development Committee (DDC) and Department of Industries (DoI) for permits, royalty payments, fees and certification. Along with private stakeholders like the Federation of Nepalese Chambers of Commerce (FNCCI) or Nepal Chamber of Commerce that can provide the Certificate of Origin, Ministry of Finance and its Department of Customs and Department of Revenue Investigation, Ministry of Commerce and Supplies and its Department of Commerce and Supplies, and Ministry of Agriculture all take positions and decide on trade related matters.

Similarly, electronic payments and other ICT tools are not adequately used. However, a Nepal Payments System Development Strategy is being developed by NRB and envisages the application of a "Real Time Gross Settlement System (RTGS)". While some major commercial banks in the country have made electronic payments available for intra-bank transactions, there is no electronic system in place for inter-bank payments. Since, commercial banks are already present at the customs points located at various border crossing points in Nepal, implementing the RTGS will greatly speed up the payment processes that are associated with import and export.

3. Controls on Movement of Capital and People:

Nepal is not receptive when it comes to accepting foreign workers or foreign owned businesses. While the 1992 Foreign Investment and Technology Transfer Act (FITTA) and Foreign Investment Policy (FIP) are relatively open in terms of inward Foreign Investment and foreigners working in Nepal, there is a layer of bureaucracy in the form of additional permissions and procedures that foreign investors need to fulfill which have been detailed in the 'Investors Manual for Foreign Investors' produced by the Department of Industry. WTO membership requires that foreign nationals and companies be treated equally to domestic ones. However, it does not seem to be the case with FDI in Nepal.

Foreign investors, for instance, require approval for direct investments, technology transfers, or providing credit. Similarly, foreign individuals cannot own land in Nepal and have to go through lengthy immigration processes to acquire business visas for Nepal. Foreign investors further are required to have a minimum investment of USD $50,000 although this kind of restriction is not specified in FITTA, 1992. Foreign investors in Nepal face several regulatory hassles, including in remitting their income, hiring foreigners to work and dealing with the compliance aspect of administering foreign investment in Nepal (Chalise et all, 2014).

The Ministry of Labour of the Government of Nepal controls the terms and conditions under which foreigners are allowed to undertake foreign employment in Nepal. Several restrictions on employing foreign nationals exist. There are also restrictions on Nepalese going to foreign countries for employment, and terms and conditions under which foreign employment can be undertaken. Despite these controls, remittance forms almost 1/3rd of Nepal's GDP (Ministry of Finance, 2014/15).

Nepal Rastra Bank (Nepal's central bank) imposes controls on Nepalese investing abroad. Restrictions on the amount that Nepalese are allowed to carry with them while traveling abroad also exist. This has created a regulatory environment that does not garner much trust amongst foreign investors.

Section IV: Recommendations

A. Tariff:

1) **Nepal needs to rationalize its tariff regime and re-orient its revenue collection.** Tariffs cannot be a safe source of income for government in the longer run. This requires a systematic study into the contribution of tariffs on each commodity to the revenue source of Nepal. Alternative measures of revenue collection need to be explored such that the tariff regime can be brought down to the level that other countries levy. The concept of protection of 'own production' and import substitution is archaic in an increasingly interconnected world. If Nepal follows this policy, it might have to face consequences of additional measures against its exports from countries to which it wants to export.

2) Para-tariffs need to be revised as well. Excise duties and other fees collected for commodities like cars do not make sense, as there is no domestic production of such items. Owning a vehicle in the 21st century is more about improving an individual's standard of living, saving time and improving efficiency of the populace. Very high duty on such products only encourages illicit practices. **High tariff and para tariff barriers have encouraged informal trading and understatement of turnover by businesses. A rationalization of these issues will not only reduce costs to the consumers but also will increase economic activities and revenue in the longer run.** Similarly, other kinds of fees and duties imposed on imported goods need to be reviewed under the consideration that these products help improve the living standard of the Nepalese living in Nepal if availed cheaply.

B. Regulatory barriers to trade:

3) **The number of documents required, and the procedures for export and import, should be streamlined.** Electronic filing of documents and elimination of unnecessary processes can help lower the time and cost for international trade.

4) SPS barriers impede Nepal's competitiveness. However, rather than worry about such barriers, **Nepalese traders should see such standards as incentives to produce higher quality products.** The need to test such products

outside Nepal creates added and unnecessary costs. Therefore, Nepal should be open to having internationally accredited labs and encourage them to invest here so that testing can be carried out at much less cost.

5) Customs procedures and processes that impede trade are made worse by weak infrastructure. **Implementing a single window/single document procedural requirement would greatly improve efficiency and expedite import and export processes while, simultaneously, reducing rent seeking opportunities. For instance, the customs clearance process in Birjung, Nepal, requires 19 steps (Rajkarnikar, 2010)**. Currently, the ASYCUDA system in place has not contributed to increasing efficiency as the manual system of entry is used in tandem with the automated procedure (Rajkarnikar, 2010). Clearly, there is a need to move away from the manual entry method and make complete use of the ASYCUDA system.

6) Currently Nepalese and Indian systems are not linked, requiring filing of same documents to both sides. As much of Nepal's trade is either with India or goes through India, aligning the automated systems of Nepal and India is urgently required. In the longer run we hope the authorities in both countries will come to a mutual understanding that processing in one country will be enough for the traders.

7) While cartels and syndicates are illegal in Nepal, they exist in the freight and transportation systems. In the case of public transportation, for instance, the Department of Transport Management (DoTM) decides the routes on which public vehicles may run. This implies that the government is curtailing the number of vehicles that may, at any given time, run, since permits from DoTM are hard to obtain. This is effectively diminishing competition and increasing government responsibility in monitoring. Moreover, private entrepreneurs are not allowed to operate on a decided route without having full understanding with the local transport entrepreneur committee which acts as an effective local monopoly. These committees have good 'understanding' with local political leadership and have a significant clout in local decision-making. This arrangement is clearly fostering cartels and non-competitive practices. **In order to improve efficiency and to ensure that the most number of people have access to transport facilities, it is important to inculcate an environment of competition.**

8) The upgrading of infrastructure can help significantly reduce the cost incurred in import and export. Bad road conditions not only jack up transportation time and cost, but also lead to unwillingness of the insurers to

ensure goods on transit within Nepal. **Hence, priority should be given to the regular maintenance and repair of existing roads as well as construction of new and higher quality roads.**

9) Along with improvements in roads, improvements in other infrastructure like warehousing, cold storage, Safe vaults, weighing bridges and X-ray facilities need to be developed. Due to the absence of these facilities, trading in high value and perishable items is not viable.

10) Better storage and parking facilities should be developed at all the customs check points and border-crossings. Likewise, space for handling sensitive cargo and refrigeration units should be provided.

11) The processes of entry and exit from a business are challenging in Nepal and an overhaul is required to promote more entrepreneurship, thereby creating more employment opportunities in Nepal. For details on improving the entry and exit process, please refer to the recommendations section of the 'Business Regulation' chapter of this report.

12) Electronic transactions should be encouraged for the private sector and adopted by government agencies as this will greatly reduce cost to service seekers in terms of time and money. The payment system Nepal has been using is old. We still rely on L/C or advance payment for export. Use of plastic money and modern payment procedures could ease import and export, especially for SMEs.

13) **Nepal needs to strengthen its economic diplomacy and conduct more bilateral trade treaties with different countries.** Nepal's economic diplomacy is especially crucial to solve the problems related to transit that Nepali entrepreneurs face in India. Therefore, Nepal needs to make an investment in its diplomats and diplomatic missions to improve their economic negotiation capacity. This is especially crucial to promote forest based products trading, since herbs and non-timber forest products have the potential to give Nepal a competitive advantage in the international market. Therefore, increasing the number of forest products that can be traded with India, and the procedure for trading, needs to be well negotiated such that small scale Nepali entrepreneurs can enter the export market via India.

C. Control in the movement of people and capital:

14) Nepal needs to improve its foreign investment regime and remove the underlying regulatory hurdles that have been created for foreign investors, including:

- The minimum investment requirement,
- Requiring permits and authorizations of several different government agencies in running their business, and
- Remitting their earnings and capital.

15) Nepal needs to improve immigration procedures for foreigners willing to work in Nepal. This includes simplifying the business visa process and the process of hiring foreign nationals for their operations. Restrictions such as those now in place harm Nepali enterprises by restricting their ability to acquire competent people from the global marketplace.

16) The importance of developing the capacity of the people involved in regulating, as well as operating, international trade oversight cannot be overemphasized. We may not like regulations but they are not going to fade away. Therefore, in order to make regulations work we need competent people. HR development in this field is of extreme importance.

17) Capital controls need to be removed in a systematic manner such that Nepalese can freely compete for resources in the international market. Removal of capital controls would also increase Nepal's credibility with foreign investors.

18) Nepal needs to ease its controls on foreign employment of Nepali people since they are the primary revenue earners for Nepal at the moment. More importantly, Nepal needs to focus on improving its internal and external business environment such that more investors will be attracted to Nepal, creating new and exciting employment opportunities.

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PART IV

COUNTRY AUDIT OF THE COMPONENT
CREDIT MARKET REGULATION

Abbreviations

BAFIA	Banking and Financial Institution Act
BFI	Banks and Financial Institutions
ECB	European Central Bank
EFW	Economic Freedom of the World (Report)
FDI	Foreign Direct Investment
GTZ	German Technical Cooperation
ICT	Information and Communication Technology
IMF	International Monetary Fund
INCLUDE	Inclusive Development of Economy Programme
NBL	Nepal Bank Limited
NEFSCUN	Nepal Federation of Savings and Credit Cooperatives Union
NGO	Non-governmental organizations
NIDC	Nepal Industrial Development Corporation (Bank)
NPA	Non Performing Asset
NRB	Nepal Rastra Bank
RBB	Rastriya Banijya Bank
RSRF	Rural Self Reliance Fund
SFCL	Small Farmers Cooperatives Limited
WGI	Worldwide Governance Indicator
YSESEF	Youth and Small Enterprise Self-Employment Fund

Section I: Economic Freedom and Credit Market Regulations

All economies are unique in their own ways. Some economies are integrated with the world market while others are not; some economies are known for their reliance on natural resources while the identifying feature of another may be the entrepreneurship of its inhabitants. Similarly, the banking sector of a country creates a unique footprint for each economy.

Banks are not only saving institutions; they also actively mobilize the accumulated savings (Hicks, 1969). Since capital is scarce, capital owners charge interest on the mobilized capital and, thereby, set mechanisms to ensure that only those who are best suited for its utilization do so. Ross Levine finds that Joshep Schumpeter argues along the same lines. He cites Schumpeter in stating: "well-functioning banks spur technological innovation by funding those entrepreneurs with the best chance of successfully implementing innovative products and production processes (Schumpeter, 1912 cited in Levine, 1997)." Levine is also quick to point out that not all economists agree that financial institutions are directly responsible for inducing growth. He cites Robinson, who posits that: "Where enterprise leads, finance follows (Robinson, 1952, citied in Levine, 1997)." However, Levine assures the reader that a wide body of research now finds that banks and financial institutions (BFIs) play an important role in the "growth process" rather than as an "inconsequential sideshow, responding passively to economic growth and industrialization (Levine, 1997)." Again, it is important to realize that any "economic" growth attributed to financial institutions may have occurred in coordination with other mechanisms such as law and order, and well maintained property rights.

George Akerlof, in his paper *The Market for "Lemons": Quality Uncertainty and the Market Mechanism,* pointed out that information asymmetries exist in markets, and parties take advantage of this inequality to gain advantage in trade (Akerlof, 1970). These information asymmetries also exist in the case of lending and borrowing capital. An individual with capital to spare would face similar problems attributable to inadequate information. Capital owners have to take decisions based on the probability that the borrower will repay the debt. However, banks and financial institutions step in to alleviate this adverse environment by utilizing resources to scrutinize borrower characteristics and determine which transactions will yield adequate returns (Levine, 1997). Hence, banks save enormous costs to society by specializing in collecting information on borrowers, and saving each lender from having to spend resources on analyzing the returns from every transaction.

"Credit market regulation" is a sub-component under the "Regulation" heading and looks at possible regulatory hurdles affecting the market for credit. In Nepal, the Nepal Rastra Bank (NRB) is the central bank and issues regulations and directives to commercial banks, development banks, finance companies, micro-finance institutions, and permitted cooperatives and financial intermediary non government organizations (NGOs). While Central Banks are separate from the government, the fact that the central bank is the "banker of banks" and "government's bank" underscores the power the central bank wields to influence the market. Similarly, the government of Nepal may have the ability to influence the Central Bank's monetary policy while formulating economic policies.

One of the powerful tools in the central bank's arsenal is its legal power or control over the interest rate. Interest rates, in economic terms, can be defined as the payment for the use of capital. Since capital is scarce, parties interested in using it are expected to compensate others for its use. If the central bank issues a directive that sets up regulations fixing interest rates, it essentially prevents the lenders from behaving according to the information given by the market. Similarly, it undermines the ability of banks and individuals to make economically sound decisions. Likewise, regulations on credit markets may make it difficult for the private sector to participate in the credit market. For example, the Central Bank may set interest rates too low for private sector banks to sustain their activities.

The government has tools and mechanisms in place that can regulate the functioning of the credit market, labour market or businesses. The use, or lack thereof, of these tools serve as indicators to evaluate the overall regulations set in place in the country. While these markets may be interrelated, studying the regulations separately will help pinpoint areas for possible corrections that may lead to more economic freedom. Likewise, the topic of Credit Regulation is further divided into topics such as "Ownership Of Banks," "Private Sector Credit," and "Interest Rate Controls/Negative Real Interest Rate." These sub topics help to identify factors that may be leading to a particular country's underperformance in the "Credit Market Regulation" category. The EFW assigns scores to each of these three aspects and then takes the simple average of the scores to assign the country's ranking in the credit regulation sector.

Below is the description of the indicators used by the Economic Freedom of the World Report to assign scores in the Credit Market Regulation category. It has been taken from the Economic Freedom of the World, 2014 report.

i) Ownership of banks

Data on the percentage of bank deposits held in privately owned banks were used to construct rating intervals. Countries with larger shares of privately held deposits received higher ratings. When privately held deposits totaled between 95% and 100%, countries were given a rating of 10. When private deposits constituted between 75% and 95% of the total, a rating of 8 was assigned. When private deposits were between 40% and 75% of the total, the rating was 5. When private deposits totaled between 10% and 40%, countries received a rating of 2. A zero rating was assigned when private deposits were 10% or less of the total.

Note This sub-component was not updated for the 2014 Annual Report.

Sources: World Bank, Bank Regulation and Supervision Survey; James R. Barth, Gerard Caprio, and Ross Levine, Rethinking Bank Regulation: Till Angels Govern (2006).

ii) Private sector credit

This sub-component measures the extent of government borrowing relative to private-sector borrowing. Greater government borrowing indicates more central planning and results in lower ratings. If available, this sub-component is calculated as the government fiscal deficit as a share of gross saving. Since the deficit is expressed as a negative value, higher numerical values result in higher ratings. The formula used to derive the country ratings for this sub-component was $(-V_{max} - V_i) / (V_{max} + V_{min})$ multiplied by 10. V_i is the deficit to gross investment ratio, and the values for V_{max} and V_{min} are set at 0 and −100.0% respectively. The formula allocates higher ratings as the deficit gets smaller (i.e., closer to zero) relative to gross saving.

If the deficit data are not available, the component is instead based on the share of private credit to total credit extended in the banking sector. Higher values are indicative of greater economic freedom. Thus, the formula used to derive the country ratings for this sub-component was (Vi – Vmin) / (Vmax – Vmin) multiplied by 10. Vi is the share of the country's total domestic credit allocated to the private sector and the values for Vmax and Vmin are set at 99.9% and 10.0%, respectively. The 1990 data were used to derive the maximum and minimum values for this component. The formula allocates higher ratings as the share of credit extended to the private sector increases.

Sources: World Bank, World Development Indicators; World Economic Forum, Global Competitiveness Report; International Monetary Fund, International Financial Statistics.

iii) Interest rate controls/negative real interest rates

Data on credit-market controls and regulations were used to construct rating intervals. Countries with interest rates determined by the market, stable monetary policy, and reasonable real deposit and lending rates spreads received higher ratings. When interest rates were determined primarily by market forces as evidenced by reasonable deposit and lending rate spreads, and when real interest rates were positive, countries were given a rating of 10. When interest rates were primarily market determined but the real rates were sometimes slightly negative (less than 5%) or the differential between the deposit and lending rates was large (8% or more), countries

received a rating of 8. When the real deposit or lending rate was persistently negative by a single-digit amount or the differential between them was regulated by the government, countries were rated at 6. When the deposit and lending rates were fixed by the government and the real rates were often negative by single-digit amounts, countries were assigned a rating of 4. When the real deposit or lending rate was persistently negative by a double-digit amount, countries received a rating of 2. A zero rating was assigned when the deposit and lending rates were fixed by the government and real rates were persistently negative by double-digit amounts or hyperinflation had virtually eliminated the credit market.

Source: World Bank, World Development Indicators; International Monetary Fund, International Financial Statistics.

Section II: Analysis of Nepal's Performance in this category

Nepal has been an average performer in the category of Credit Market Regulation. Its rating in "Credit Regulation" was 8.2 in 2011 where the "Ownership of banks" was given a score of 8 out of 10, "Private Sector Credit" was awarded 9.7, and the "Interest Rate Controls/Negative Real Interest rate" was given a score of 7. In 2012, the overall score for "Credit Market Regulation" for Nepal was 7.3. While Nepal has been able to maintain its scores in the "Ownership of Banks" and "Private Sector Credit" categories, its performance in "Interest Rate Controls/Negative Real Interest Rate" seems to have dwindled significantly with a 3 point drop in scores. The table below shows the score Nepal received for various years.

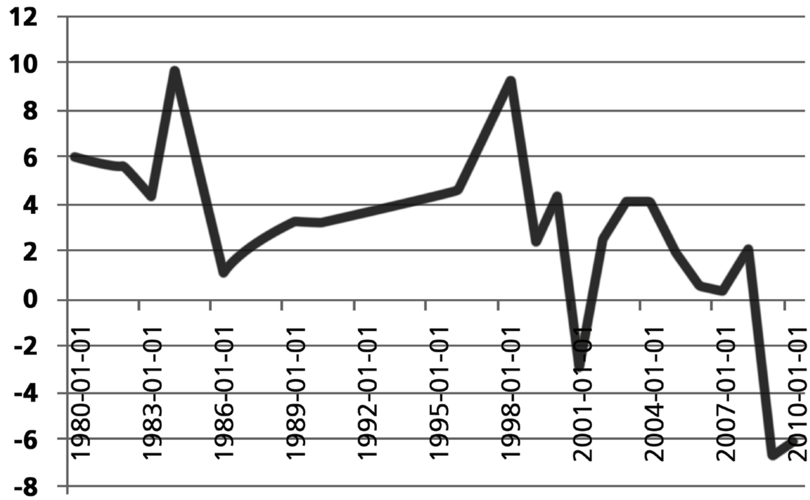
Table1: Credit Market Regulation Scores of Nepal

Year	Credit Market Regulation Score
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)

According to the Economic Freedom of the World, 2014, which looks at data from 2012, a rating of 4 is assigned to the "Interest Rate Controls/Negative Real Interest Rate" category when "the deposit and lending rates were fixed by the government and the real interest rates were often negative by single-digit amounts (EFW, 2014)." EFW gets its data for the "Interest Rate Control/Negative Real Interest Rate" indicator from the World Bank's World Development Indicator Report and the International Monetary Fund's International Financial Statistics (Gwartney, Lawson & Hall, 2014).

Figure1: Real Interest Rate for Nepal



Source: World Bank

A look at the "Money Indicators" section of the World Bank's World Development Indicator report from 2012 shows Nepal's real interest rate to be at -4.8 percent. A negative real interest rate implies that the inflation rate is higher than the nominal interest rate; hence, even with the interest accumulating in an individual's bank account, the value of their money erodes. Such conditions can compel individuals to spend rather than save and it may divert savings from the formal banking or financial sector to the informal banking sector or to alternate forms such as physical assets like precious metals, land or foreign currencies. The European Central Bank (ECB), for instance, is paying (charging) negative interest to banks in hopes that a negative interest on saving by the ECB will prompt the banks to invest or lend more (Randow, 2015).

The financial market of Nepal is relatively new, and it can even be considered to be in its infancy. The central bank of Nepal, Nepal Rastra Bank (NRB) was established in 1956. The public was introduced to the formal banking sector in 1937 with the establishment of Nepal Bank Limited (NBL) (Maskey et al. 2009). Prior to the establishment of NBL, the general populace had to rely on landlords and merchants for their credit related needs, and this market was completely off the grid. Until the 1980s the banking sector was closed to the private sector and it was the initiation of the liberalization process that saw private banks established in the country. Government owned banks such as Nepal Industrial Development Corporation, Rastriya Banijya Bank, and Agricultural Development Banks, along with NBL were the only banks available to the public until Nepal Arab Bank Limited was established in 1984 (Maskey et al. 2009).

Interest rate control is a sensitive issue because such regulation can diminish the ability of lenders and lending institutions to customize interest rates based on borrower characteristics. The inability to charge borrowers on the basis of the risk involved will encourage financial institutions to refuse to lend to high-risk individuals. When interest rate controls are absent, lenders who are able to distinguish between different kinds of borrowers will be able to charge different rates for people with different credit characteristics and, at least, provide access to finance to all qualified parties. Saving and credit cooperatives and financial NGOs, which cater mostly to the poor, are, ironically, known to charge much higher interest rate on loans than banks, After all, providing the poor with financial services is risky given their lack of collateral or savings or proper credit history. In the absence of regulations, which set limits for charging users of capital, the rate for the use of capital is determined by the market. Moreover, it is important for the market to play a major role in establishing the rate for the use of capital because charging money for the use of capital ensures that it is put to good use.

In Nepal, saving and credit cooperatives and financial NGOs were institutionalized after the promulgation of the National Micro-Finance Policy in 2005. These institutions are not governed by NRB and are essentially "deregulated" (Shrestha, 2009). However, there are 35 Microfinance institutions, 31 financial NGOs, and 16 saving and credit cooperatives that are licensed, permitted, regulated and supervised by NRB. So, in Nepal, Microfinance institutions such as saving and credit cooperatives and financial NGOs may be within or outside the jurisdiction of NRB. "D class" financial institutions such as microfinance development banks are also considered microfinance institutions.

The main objective of these institutions, as per the 2005 Microfinance Policy, is to provide means of financing to the "destitute class," encourage them to save, and provide access to insurance. The Micro-Finance policy refers to "destitute class" as the "class of people with a per capita income amounting to the annual average of Rs. 4,404, that is, about USD 60 (at 1995 prices) (Micro-Finance Policy, 2005)." In a primary survey done on 40 micro-finance institutions, it was found that the size of loans forwarded by these enterprises generally range between five and ten thousand rupees (Sharma, 2012). Most of the loans forwarded by MFIs are done on a non-collateral basis because the (destitute) clients may not have anything to offer as collateral, and, as a result most of these organizations use group security when endorsing loans to clients or require the clients to have saved for some time—in order to have a transaction history with the organization—before they are forwarded loans. It should also be noted that most of these loans are tied with interest rates ranging up to 25 percent while these institutions generally provide five to 8 percent interest on savings (Shrestha, 2009). Moreover, these institutions report a high degree of loan repayment. In the above survey of 40 MFIs, 85 percent of the respondents reported a 98 percent loan repayment rate (Sharma, 2012). Various Small Farmers Cooperatives Limited (SFCL) companies around the nation have disbursed over Rs. 4702.08 million and MFIs that follow the Grameen Banking model have disbursed more than Rs. 41508.5 million (Shrestha, 2009). For comparison, in 2012, the total amount of credit extended by commercial banks amounted to Rs. 600 billion or Rs.600000 million (Banking and Financial Statistics, NRB 2012). Similarly, the average interest rate charged by commercial banks such as Nepal Bank Limited (a government owned bank) and Prime Bank Limited range between 10 and 14 percent (Prime bank website; Nepal Bank Website). The information titled Interest Rate Structure of Commercial Banks for 2010, published on NRB website, shows similar statistics (NRB, 2015).

One of the “focuses” of NRB, according to its press release for the 2012/13 monetary policy, was “monitoring interest rate” and another was “stimulating interest to productive sector”. If one were to look at the rhetoric used by NRB regarding interest rates in Nepal, one would expect the commercial banks, due to their low interest rates, to eclipse Microfinance institutions’ lending ability. However, the above numbers show that this is not the case. Rather, it enforces the idea that people are willing to pay whatever price the market sets for the use of capital. The people who require money the most, i.e. poor people or people belonging to the destitute class, are paying the highest price for its use.

Another advantage of allowing markets to decide interest rates is that it encourages capital lenders to enter the market. The 2005 Microfinance Policy, for instance, cites the need of institutionalizing “organizations spontaneously formed at the local level” to justify its requirement. The microfinance movement itself was established in order to “bank the un-bankable,” i.e. the first customers of microfinance institutions were individuals that were being turned away by banks for their lack of collateral or due to lack of profit from the small sized loans they were demanding (Aghion, et al. 2007). In the presence of interest rate regulations, lenders may not be adequately compensated for the risks they take while letting others use capital. This inadequate rewarding mechanism may then deprive a market of lenders, as lenders need to be adequately compensated for the risks they take. The 2012/13 monetary policy recommends that short term interest be contained within a certain band to establish effectiveness of monetary policy. Similarly, the 2014/15 monetary policy has called for a 5 percent spread between interest on savings and loans for commercial banks.

Interest rates are not only a function of the borrower's characteristics. Environmental factors also play a deciding role in establishing the interest rates. Dooley finds that there is a negative relation between a "political risk premium" and capital flight (Dooley, 1986). This means that in a politically unstable climate, lenders would be willing to participate in the market if they have the ability to charge higher prices for the risks they are taking. According to the "Worldwide Governance Indicator," Nepal ranked 14.2 on the percentile scale on the "Political Stability and Absence of Violence" indicator for the year 2013 (WGI, 2014). This means that there is at least an 85 percent likelihood of finding another country that has a more stable political climate. Hence, following Dooley's reasoning, it is likely that financial institutions will charge the people of Nepal a higher interest rate for the use of capital since it would be safer to take their capital to a more politically stable economy.

There are other aspects besides interest rate regulations curbing entrance to the Nepalese banking market. Currently, there are six "foreign owned" banks of which one – namely Standard Chartered Bank – is a foreign bank. The other five are joint ventures established with an equity partnership in a local bank by a foreign bank. Foreign participants are only allowed to own 75 percent of the total equity as stated in Legal, Regulatory and Supervisory Provisions for Foreign Bank Branches in Nepal released by NRB Task Force on Foreign Bank Branches and the Health and Stability of Nepal's Financial System (NRB, 2006).

In accordance with the requirements proposed to allow Nepal's ascension to WTO, wholesale banking is allowed by foreign banks and in such cases, 100 percent ownership is allowed according to the Policy Provision for Opening Branch Office by Foreign Bank or Financial Institutions in Nepal, 2010. While the Policy Provision for Opening Branch Office by Foreign Bank or Financial Institutions in Nepal does not regulate the amount of equity that can be owned by the foreign entity, it states that "while granting the letter of intent, the Nepal Rastra Bank may specify terms and conditions (NRB, 2010)." The Banks and Financial Institution Act (BAFIA) of 2006 also does not have any extra requirements for foreign banks. However, it is partial towards banks that contribute to the "banking development of the state of Nepal."

Likewise, the BAFIA also reiterates that NRB may "prescribe necessary conditions" for the foreign banks. Since 2009, a moratorium has been in place for the registration of banks, according to IMF Country Report No. 10/185 (IMF, 2010). This restriction on bank licenses was instated to allow the NRB to monitor the health of the financial sector of Nepal and to facilitate a review of the then current licensing procedure (IMF, 2010). The ban on registration of microfinance banks was lifted in 2010 while the procedural requirements for the registration of development banks was eased at the same time, given the role such institutions can play in increasing access to finance among the rural poor (IMF, 2010).

It has been argued that government ownership of banks, or the government's control of banks, can lead to the politicization of resource use, or that the resources may be used to finance projects and enterprises which may not be otherwise funded in a free market condition (La Prota et al., 2000). It would be fair to argue that, with the government in control over the resources, it is likely that resources will be spent by incumbent political parties and bureaucrats to secure their position in office for a longer term or in order to curry favor with voters. On the other hand, with 1) selfless politicians or bureaucrats in office and 2) perfect foresight, it is likely that capital or other resource will be used to finance "long term projects" that are seen as being "socially desirable" (La Porta et al., 2000)." Funding socially desirable projects implies financing projects that may not be funded by private parties given the high spillovers which make it difficult for private actors to realize returns to the cost involved. However, even such projects that may have enormous social benefits beg the question: "With what cost?" It is unlikely that the above mentioned two conditions of having selfless politicians or bureaucrats in office and perfect foresight could ever be met.

There are currently four "government-owned" banks in the country according to NRB's List of Banks and Non-bank Financial Institutions. They are Nepal Bank Limited (NBL), Rastriya Banijya Bank (RBB), Agriculture Development Bank and Nepal Industrial Development Corporation (NIDC) Bank. The first three are classified as commercial banks or "Class A" financial institutions while the last one is a Development Bank or a "Class B" financial institution. In 2006, according to the Legal, Regulatory and Supervisory Provisions for Foreign Bank Branches in Nepal, published by NRB, the Non Performing Assets share of total loans for NBL and RBB stood at 49.64 percent and 52.99 percent respectively. These numbers support the suggestion that government banks may be quick to disburse funds without grasping the profitability or sustainability of these loans.

In order to increase the financial access of the rural poor and to encourage small scale saving and, hence, capital formation, the "Small Sectors Credit Program" or "Priority Sector Credit Program" was initiated in 1974 (National Micro-Finance Policy, 2005). This policy established a mandate that required commercial banks to invest 5 percent of all deposits in the "priority" areas designated by the government. These priority areas included "agriculture, cottage industries, and service enterprises" and destitute class—including low income households, socially deprived women, lower caste, blind and hearing impaired, disabled, craftsmen, artisans and small and marginal farmers including landless farmers— termed as "deprived sector" (National Micro-Finance Policy, 2005). While the (Priority sector lending) policy was phased out in 2007, commercial banks still had to allocate at least 3 percent of all investments in the deprived sector (National Micro-Finance Policy, 2005). However, the mandatory lending for deprived sector has continually increased and currently, banks are required to set aside 4.5 percent of their total loan portfolio for deprived sector lending, according to Bank Supervision Report 2014 released by NRB. Recognizing the need to make banking easier for rural inhabitants, and in order to increase their access to credit, in 2005, in correspondence to the Tenth Plan's identification of "micro-finance as a powerful means of alleviating poverty," the National Micro-Finance Policy, 2005 was implemented (National Micro-Finance Policy, 2005). This policy aims to formalize the micro-finance sector by instituting laws and regulations relating to the sector. The "Micro-Finance Development Fund" was developed with a view to increase these institutions' access to funds by making available wholesale credit to the Local and Rural Self-Reliance Funds.

However, even with the market's ability to provide financial tools that cater to different parties' needs, and with the recognition of microfinance as a "powerful means of alleviating poverty," other programs introduced by the government are still working in tandem to increase rural inhabitants' access to finance. For example, commercial banks, as noted above, are required to maintain at least 4.5 percent of their investments in deprived sectors and commercial banks can even provide wholesale funs to micro-finance institutions and have that amount be part of their deprived sector lending.

The Youth and Small Enterprise Self-Employment Fund (YSESEF), which was established in 2009 by the Ministry of Finance, is one such program that involves commercial banks, development banks and finance companies (Humagain et al., 2010). The main aim of the YSESEF is to establish a fund that can subsidize collateral-free loans of up to RS 200,000 to entrepreneurs in rural locales. A study, conducted by GTZ/INCLUDE, of the Banking and Financial Institutions (BFI) of Chitwan and Palpa participating in the Youth and Small Enterprise Self Employment program found that the banks were mostly unaware of the Fund, and in cases where they were aware, they were unclear regarding "how to invest and how to recover the loan (Humagain et al., 2010)." Interactions with the 33 banks that participated in the research showed that the recommendations or directives passed by the central bank were inadequately supported by the government through recommendation of loan receivers, proper monitoring and evaluation, and involvement of local governance bodies in the program (Humagain et al., 2010). Such findings lead one to conclude that the central bank may be quick to impose regulations and issue directives but fails to provide adequate support to facilitate the implementation of such regulations.

While MFIs and credit cooperatives are in essence deregulated, one can find interventions that have prevented even this market from freely exhibiting its traits. For example, the micro-finance interest rate in Nepal is low by international standards. The per annum interest rates range from 20-30 percent for microfinance institutions and can go up to 36 percent for cooperative bodies and self-help groups (Shrestha, 2009). In the case of South Asian countries, as reported by Rosenber, Gaul, Ford, and Tomilova, the interest rate for loans extended by Microfinance institution range up to 40 percent while throughout the world, similar interest rates may reach up to 70 percent (Rosenberg et al., 2013). While forwarding loans at a cheap rate is not a matter of concern, it should be noted that loans from microcredit institutions are naturally going to be more expensive. Small loans forwarded to many individuals or organizations—which in turn are derived from micro-savings from many individuals and organizations—are likely to be more expensive than large loans mobilized via large savings.

One of the reasons why MFIs in Nepal are able to afford loans at lower prices may be their access to cheap wholesale funds. MFIs and Credit cooperatives that fulfill a “set criteria” have access to wholesale funds at an 8 percent interest rate through the Rural Self Reliance Fund (RSRF). However, if the “interest and principal amounts are paid within the prescribed schedule” they get a rebate of 6 percent (Shrestha, 2009). This means that MFIs have access to funds, effectively, at a 2 percent interest rate. Moreover, the RSRF is “mobilized as per the decision of the RSRF steering committee (which is) headed by the Deputy Governor of NRB (Shrestha, 2009).” The appointment of a high level NRB staffer in the RSRF suggests that, while microfinance institutions are, in paper, deregulated, intervention may be occurring through other mechanisms.

Section III: Analysis of Nepal's Performance in this category

As part of the EFW country audit report, a series of meetings was 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. The meetings served two purposes :- They helped obtain the views of major players from the credit market, and invited recommendations, suggestions, and processes required to lift Nepal from its current position. 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 brought forth.

Currently, the NRB operates under the "Nepal Rastra Bank Act" of 2002 and has formulated an Umbrella act titled "Bank and Financial Institution Act" 2006 to harmonize regulations pertaining to the banking and financial sector.

Challenge: 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 per capita deposits, 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. It is no wonder, then, that by mid-July of 2011, there were only 1,425 branches of commercial banks operating throughout the country catering to about nineteen thousand customers per branch (NRB, 2012). If we consider all the branches of commercial banks, development banks, finance companies, and micro finance development banks, the number of clients served per branch amounts to 9,000 (Nepal Monetary policy, 2012-13).

The low rate of public participation in formal banking may also be symptomatic of Nepal's anemic growth rate. However, with the proliferation of Information and Communication Technology (ICT), particularly through cellular phones, banking can easily be integrated into these systems to encourage more people to enter the formal banking sector.

Challenge: Public bank vs. private banks

To validate the argument that government owned banks, or banks under undue government pressure, would be likely to use resources in ways that they would not be used in ordinary circumstances we can tally the performance of loans that are made by government owned banks against loans made by privately owned banks. The "gross NPA to gross advances" for the third quarter of the fiscal year 2014/2015 were 2.05 percent and 4.48 percent, respectively, for NABIL bank and Nepal Bank Limited. The former is a private joint venture bank while the latter is a government owned bank. The numbers show that the government owned bank has more principal from which it is not earning any income or interest. Looking at the NPA/advances ratio alone may not serve as an adequate representation of efficiency as we may be ignoring other factors such as the time the banks have been in business, the establishment of projects with high positive spillovers and the amount of capital that public banks are loaning out versus the amount that private banks lend out. However, we may still be able to conclude that private banks use funds with more prudence than government owned banks. This is a point to be noted because government owned banks still exist in Nepal. Still, the numbers regarding NPA/Advances also serve to remind us that public banks and private banks may be following completely different lines of thought and aiming for different ends (and it is not the scope of this paper to take a side or elaborate on the matter). In a report titled Banking Supervision prepared by the Bank Supervision Department of Nepal Rastra Bank, in the fiscal year 2001/02, we find, Rastriya Banijya Bank and Nepal Bank limited accounted for 44.27% of all deposits and 44.88% of all credit in the market (NRB 2002). Refer to the Table below for the gross NPA to gross advances percentage for some commercial private and government owned banks.

Table 1: Government and Private Banks and their
"Gross NPA to Gross Advances" (%)

SN	Name of Bank	Gross NPA to Gross Advance (%)	Ownership
1	NABIL	2.05	Private
2	Nepal Bank Limited	4.48	Public
3	Mega Bank Limited	1.64	Private
4	Rastra Banijya Bank	3.53	Public
5	Agricultural Development Bank limited	5.41	Public
6	Kumari Bank Limited	3.98	Private
7	Sanima Bank limited	0.1	Private
8	Standard Chartered Bank	0.18	Private
9	Nepal Commerce and Credit Bank	2.4	Private

Challenge: Fostering riskier investment through
a) government regulations mandating investment in certain sectors
b) government insurance of banks

Since banks provide a safe depository for peoples' money, it is natural to expect that banks will make investments in only the safest of projects. Financial markets in many developed countries consist of entities that specialize in riskier investments. Hedge funds, venture capital firms, and other forms of private equity lending are more than capable of catering to the needs of high-risk/high-return investments and projects.

Unfortunately, the Nepalese market's financial infancy and lack of government recognition of these instruments in policy creates pressure on banks to make riskier investments. Pressure from the government to provide low interest loans or collateral free loans to certain groups further exacerbates the 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 intervention from the government in the banking and financial sector in a bid to improve access to finance for 'deprived and marginalized groups. 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.

Regarding deprived sector lending, private banks in Nepal have raised their objections to NRB, urging the central banks to phase out the policy. After NRB made its monetary policy of 2014-15 public, the Nepal Bankers Association submitted a report to the central banks with a recommendation to reduce the mandatory deprived sector lending imposed by NRB (eKantipur, 2014). The association's rationale behind the recommendation was that the deprived sector does not have the capacity to absorb the influx of credit. It also argued that an adequate number of micro-finance institutions already exists and caters to the exact demography NRB aims to benefit (through commercial banks) with the deprived sector lending.

Since deprived sector lending in Nepal is nowhere near being phased out, the central bank has attempted to make it easier for banks, development banks, and finance companies to lend to the deprived sector. Because banks have to maintain a certain percentage of lending towards the deprived sector, arrangements have been made so that commercial banks can lend out the amount set aside for deprived sector through other means. The money can flow either to individuals who are deprived of banking facilities or those banks that can lend out the money to other financial organizations such as microfinance development banks or credit cooperatives whose expertise lies in lending to individuals belonging to the deprived sector (NRB country Report, 2013). This move has been touted by the central bank as an attempt to make it easier for banks to lend money to the deprived sector.

It seems that microfinance development banks and credit cooperatives emerge as the real winners because these institutions enjoy access to funds, possibly at a lower rate than the market would provide in normal circumstances. One commercial bank, Prime Bank Limited, on its website displays information regarding deprived sector lending. It states that, where Deprived Sector Loans are provided on an institutional basis—meaning to microfinance companies or saving and credit cooperatives— they are given out at an interest rate of 5 to 8 percent per annum, whereas deprived sector loans on an individual basis, such as through the "Prime Kaligadh Karja," for individuals involved in handicraft, is given out on 11 to 14 percent interest rate (Prime Bank Limited, 2014).

The microfinance sector is also subject to some influence by NRB. Commercial banks are to provide loans to deprived sector either through individual loans or through wholesale loans to MFIs or credit cooperatives. And the Rural Self Reliance Fund (RSRF) from which MFIs and credit cooperatives can draw wholesale funds at a subsidized rate is chaired by the deputy governor of NRB. There are many such funds that have been created by the government. The Youth and Small Entrepreneur Self Employment Fund (YSESEF), Local Development Fund, Town Development Fund, RSRF are some examples. These funds all have their own administrative arrangements and serve similar functions.

After the earthquake that struck Nepal on April 25, 2015, NRB drafted a "concessional scheme" to provide loans to earthquake victims for rebuilding houses that were damaged beyond repair by the earthquake, according to The Rising Nepal daily (The Rising Nepal, 2015). The scheme is to have commercial banks provide loans at only 2 percent interest. However, Dabadi (2015) points out that commercial banks usually forward similar housing loans at interest rates of 10 to 14 percent and 2 percent may not be enough to cover the operating costs of banks.

Challenge: Direct control of interest rates through spread

Banks and financial institutions are among 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.

There is evidence of other means by which banks and financial institutions – such as development banks and finance companies – have been regulated by the central bank. 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 percentage points (NRB, 2014).

The poor, like any individual or institution, require access to capital, and the market may be capable of devising alternative mechanisms to ensure that the poor can borrow to make investment and accumulate capital.

- 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. In the case of financing the Nepalese poor, a problem analogous to adverse selection exists. In insurance, adverse selection is the likelihood of those involved in dangerous professions to get insured. In our case, it is the rural poor, or those with the least likelihood of the ability to pay off their debts, who are most in need of financing. However, coercion and forcing institutions to provide to these individuals or groups is not the only answer, as the market may have solutions to such problems. The 2005 Microfinance policy of the government of Nepal itself, for example, justifies its existence because of the various organizations that have "spontaneously formed" to address the financial needs of marginalized and other fringe groups (Microfinance policy, 2005).

Examples of the market providing innovative solutions can be tied to various credit cooperative agencies that have emerged in the Nepalese credit market. In 2005, which was touted by the then government as the "Institutional Micro Finance Year" a Micro Finance Policy was formulated and put into practice (Micro finance Policy, 2005). The policy describes micro finance as "(the) financial business of providing institutional financial services to the destitute and low-income families desirous of operating self-employment opportunities (Microfinance policy, 2005)."

- One of the most important instruments for disseminating microfinance in Nepal is the credit cooperative. According to the Nepal Federation of Savings and Credit Cooperatives Union (NEFSCUN) website, there are an estimated 19,724 cooperative agencies, employing around 50,000 individuals, operating in sectors such as credit and saving, dairy, agriculture, science and technology, fruits and vegetables, bee keeping, tea, coffee, and energy, and providing services to more than 3 million people (NEFSCUN, 2014). One of the features of cooperatives is the emphasis they place on on and the way they mobilize according to the needs of the poor. Moreover, since these institutions deal with the poor and other marginalized individuals who are deprived of capital and need it to, usually, establish micro enterprises or for foreign employment related expenses, the funds are loaned out on a non-collateral basis. Thus, even the very poor are introduced to an opportunity to ensure their livelihoods.

Hence, we have an example of a system that has evolved through the adoption of foreign best practices, such as Grameen banking model, or devised indigenous approaches to help those in need. While a central agency may be able to stimulate a growing economy and protect it from shocks by ensuring checks and balances for those in power, it is not justified for the central banks to issues directives and orders that may affect banks, micro-finance institutions, and consumers while barely lifting the condition of the poor.

Challenge: Fostering alternative forms or channels of investment

The 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 funds specialize in making high risk/high return investments. Giving these entities a space in the market will create opportunities for those with surplus capital to invest instead of simply saving in banks or physical assets. The lack of these instruments may be stimulating a conflict of interest in the bank owners. Capital rich business persons may have large stakes at banks, with an aim of securing a safe avenue for loans. When alternative financial instruments are available, those who require capital will have more than one entity to turn to and may even be catered to, with various traditional and non-traditional methods of acquiring loans. This, in turn, will create competition to attract capital and create a vibrant market.

Given the large number of people seeking employment abroad in hopes for better wages and jobs and the important role these individuals are playing in the economy by sending remittance money back to their home country, or by learning about technology and other practices being implemented in other countries, the banking sector can play an important role in enticing these individuals to remain in Nepal and start their own enterprises. Similarly, the need to develop agriculture and manufacturing sectors by promoting commercialization and mechanization will only be possible when the players in theses field have adequate access to finances to fund expansions and advancements.

In this light, it is important to allow banks the opportunity to steer the economy towards profitable channels when appropriate, or be able to follow entrepreneurs and the economic opportunities they carve out through their own endeavors. However, this will not be possible when banks are antagonized, or when an atmosphere of mistrust exists between banks and their clients. Hence, it is important to enact laws that eliminate conflict of interest of bankers and other such institutional hazards. Similarly, indirect monetary instruments should be opted for in case intervention is required.

Section IV: Recommendations

- Since the era of liberalization started in Nepal in 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 making it compulsory to lend money in the 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 to create a larger fund that could be 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, more individuals would be encouraged 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 market, is increased competition. Liberally allowing foreign owned banks or their branches to enter the Nepalese banking sector would not only give consumers more choice, 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 the Nepalese banking sector.

- Opening the Nepalese market for foreign banks should be complemented by liberalizing the entry of foreign direct investment (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. This moratorium needs to be revisited.

- A liberal policy framework for opening alternative forms of channels of investment, such as hedge funds, mutual funds, and venture capital, should be established to offer predictability for investors.

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PART V

COUNTRY AUDIT OF THE COMPONENT
LABOR REGULATIONS

Abbreviations

ADB	Asian Development Bank
ADR	Alternative Dispute Resolution
APP	Agricultural Perspective Plan
CBA	Collective Bargaining Agreement
DOI	Department of Industry
DOL	Department of Labor
EFWR	Economic Freedom of the World Report
GDP	Gross Domestic Product
GEFONT	General Federation of Nepalese Trade Unions
ICT	Information and Communication Technology
ID	Identity Card
ILO	International Labor Organization
PRS	Political Risk Services
UNCITRAL	United Nations Commission on International Trade Law

The Nepali year is based on the Bikram Sambat Calendar and is approximately 57 years ahead of the Gregorian calendar. (2062/1/1=2005/4/14)
Therefore, fiscal year 2014-15 = Fiscal Year 2071/72

Section I: Economic freedom and labor regulation

The Economic Freedom of the World index, by the Fraser Institute, measures the degree to which the policies and institutions of countries are supportive of economic freedom. The cornerstones of economic freedom, as reported in the index, are personal choice, voluntary exchange, freedom to enter markets and compete, and security of the person and privately owned property. Forty-two data points are used to construct a summary index and to measure the degree of economic freedom in five broad areas:

1. Size of Government: Expenditures, Taxes, and Enterprises;
2. Legal Structure and Security of Property Rights;
3. Access to Sound Money;
4. Freedom to Trade Internationally;
5. Regulation of Credit, Labor, and Business.

The Economic Freedom of the World report in essence attempts to measure the amount of economic freedom a nation has and its implications for other social and political areas, by compiling data from the World Bank, International Monetary Fund, United Nations, European Bank for Reconstruction and Development, PricewaterhouseCoopers, World Economic Forum and the PRS Group, among a number of other sources.

The fifth area of the index focuses on regulatory restraints that limit freedom in credit and labor markets, and for business. When regulations restrict entry into markets and interfere with the freedom to engage in voluntary exchange, they reduce economic freedom. The Economic Freedom report thus lists a number of constraints to development of the labor market the world over. Among the more prominent are high minimum wages that prevent workers from entering formal employment, dismissal regulations, centralized wage setting, extension of union contracts to non-participating parties and conscription. The labor-market component (5B) is designed to measure the extent to which these restraints upon economic freedom are present.

Specific indicators of labor market regulation as indicated by the Fraser Institute in The Economic Freedom Report 2014 and their means of calculation and data sources are given below. The indicators and their explanations are from the 2014 Economic Freedom Report:

i. Hiring regulations and minimum wage:

This sub-component is based on the World Bank's Doing Business "Difficulty of Hiring Index", which is described as follows: "The difficulty of hiring index measures (i) whether fixed-term contracts are prohibited for permanent tasks; (ii) the maximum cumulative duration of fixed term contracts; and (iii) the ratio of the minimum wage for a trainee or first-time employee to the average value added per worker.

ii. Hiring and firing regulations

This sub-component is based on the Global Competitiveness Report question: "The hiring and firing of workers is impeded by regulations (=1) or flexibly determined by employers (=7)."

iii. Centralized collective bargaining

This sub-component is based on the Global Competitiveness Report question: "Wages in your country are set by a centralized bargaining process (= 1) or up to each individual company (= 7)"

iv. Hours regulations

This sub-component is based on the World Bank's Doing Business "Rigidity of Hours Index", which is described as follows: "The rigidity of hours index has 5 components: (i) whether there are restrictions on night work; (ii) whether there are restrictions on weekly holiday work;(iii) whether the workweek can consist of 5.5 days; (iv) whether the workweek can extend to 50 hours or more (including overtime) for 2 months a year to respond to a seasonal increase in production; and (v) whether paid annual vacation is 21 working days or fewer. Countries with less rigid work rules receive better scores in this component.

v. Mandated cost of worker dismissal

This sub-component is based on the World Bank's Doing Business data on the cost of the advance notice requirements, severance payments, and penalties due when dismissing a redundant worker with ten years tenure.

vi. Conscription

Data on the use and duration of military conscription were used to construct rating intervals. Countries with longer conscription periods received lower ratings. A rating of 10 was assigned to countries without military conscription. When length of conscription was six months or less, countries were given a rating of 5.

Based on these indicators, the economic freedom report scores how much labor regulations impede a country's development. Labor markets are a significant component of the economic freedom of the world for a number of reasons. Firstly, labor markets are explicably linked to one's ability to work, earn a livelihood and enjoy a certain standard of living. Thus the ease by which a worker can enter and exit an enterprise, as dictated by hiring and firing regulations; whether the minimum wage is set at a level that prices lower skilled workers out of the formal labor market; and the structure of collective bargaining are all essentials when determining one's economic freedom. Since economic freedom, by definition, deals with one's right to earn and keep one's private property (Economic Freedom Report, 1996), labor market regulations indicate the ease or difficulty in doing so. Thus, labor market regulation is an important criterion for measuring economic freedom.

Going by specific indicators, hiring and firing regulations outline the ease with which a person can enter and exit an enterprise for work as previously stated. The minimum wage indicates whether workers and employers can freely negotiate pay or whether they are bound by a minimum wage that may limit employment that would otherwise be voluntarily entered into (discussed in more detail in the following report). The report provides data on whether collective bargaining, for example, forces wage structures across sectors that may be ill-suited to particular businesses and workers and if working hours are flexible. The 'cost' of firing a worker and what procedures need to be followed in addition to whether a nation has conscription (compulsory enlistment in national service, typically military service) are additional indicators to determining economic freedom in labor markets. This report thus aims to examine labor regulation in Nepal and put forward policy recommendations that will lead to an overall improvement in the economic freedom of Nepalese.

Section II: Analysis of Nepal's performance in Labor Regulations in the Economic Freedom report

Nepal's unadjusted score of economic freedom as reported by the index in 2012 is 6.16, out of 10, where lower ratings reflect harsher obstacles to economic freedom. Amongst the five indicators, Nepal has a score of 6.41 in overall regulation, with a score of 5.82 in labor regulation. The labor regulation score includes 6 variables, which have been described in previous pages from the Economic Freedom of the World Report.

Nepal's score under sub-headings of labor regulation for the year 2012 are as follows:

(i) Hiring regulations and minimum wage (3.33)
(ii) Hiring and firing regulations (3.73)
(iii) Centralized collective bargaining (5.25)
(iv) (Working) Hour regulations (10.00)
(v) Mandated cost of worker dismissal (2.60)
(vi) Conscription (10.00)

Nepal's performance in this category for the year 2012 (as mentioned in the 2014 report) with other selected economies is depicted in Table 1.

Table 1. Labor Market Regulation, Economic Freedom of the World Report 2014

Countries	5Bi Hiring regulations and minimum wage	5Bii Hiring and firing regulations	5Biii Centralized collective bargaining	5Biv Hours Regulations	5Bv Mandated cost of worker dismissal	5Bvi Conscription	5B Labor market regulations
Hong Kong	10.0	8.0	8.4	10.0	9.5	10	9.3
United States	10.0	6.5	7.5	10.0	10.0	10	9.0
New Zealand	8.9	5.2	8.1	10.0	10.0	10	8.7
Jordan	8.9	5.0	7.0	10.0	10.0	10	8.5
Canada	8.9	6.1	7.5	10.0	8.3	10	8.5
Switzerland	10.0	7.7	7.9	10.0	10.0	5	8.4
Unit. Arab Emirates	10.0	6.1	8.4	6.0	10.0	10	8.4
Rwanda	10.0	5.4	7.1	10.0	7.8	10	8.4
Japan	8.9	3.2	8.1	10.0	10.0	10	8.4
Bahrain	8.3	5.4	8.2	8.0	10.0	10	8.3
Top 10 average	9.2	5.9	7.4	9.0	8.6	7.6	8.6
World average	6.5	4.8	6.5	8.1	6.6	6.6	6.5
Landlocked countries' average	7.5	4.9	6.8	8.4	6.5	5.3	6.5
South Asia	7.0	5.0	6.7	9.0	2.6	10.0	6.7
Nepal	3.3	3.7	5.2	10.0	2.6	10.0	5.8

As the table above demonstrates, Nepal does worse than the South Asian standard in both hiring regulations and minimum wage and hiring and firing provisions. Both these categories are important indicators of labor market flexibility.

Even those who might prefer a highly regulated labor market must recognize that it reduces the wellbeing of Nepalese. These myriad and confusing regulations reduce formal employment in Nepal forcing millions of workers into the informal labor market or to other nations to find work, where regulations protecting workers are often non-existent or ignored. By creating a more flexible labor market, millions of workers can, over time, be brought into the formal economy and offered at least some level of worker protection.

Labor market regulation is a relatively new indicator on the index for Nepal, with data available only from 2002 onwards. In 2005, Nepal scored 5.91

in this category and had an infinitesimal drop to 5.90 in 2010. The score in 2011 was 5.83 and by 2012, it stood at 5.82. These scores can be understood as we examine its sub-categories. In 2005, hiring regulations and minimum wage scored 4.40 and declined to 3.33 in all the remaining years up to 2012.

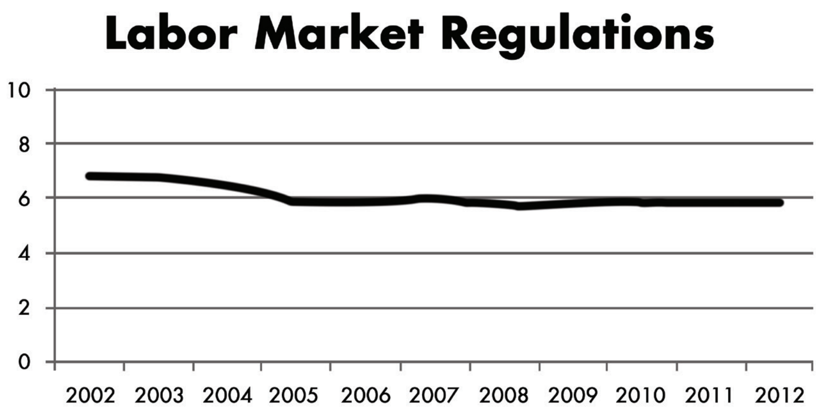
In 2005, the government revoked the rights of government workers to engage in trade union involvement during the continuance of the civil war (Socioeconomic and Labor Market Trends, 2009). Ironically, because many trade union activities were deemed illegal, the minimum wage during 2003 to 2005 stagnated, hence leading to more compliance with minimum wage laws. The negotiations were infrequent and therefore, employers could follow through on a stable law. However, once the 2007 Civil Service Act restored the workers' rights to re-engage in trade unions and bargain collectively, minimum wage negotiations picked up pace once again and Nepal saw a notable rise in minimum wage, thereby reducing compliance.

Nepal scores a 10.00 on both hour regulations and conscription as Nepali workers in the formal economy do not face restrictions on work hours, and conscription, which is involuntary enrollment of workers in the national services, is non-existent in Nepal.

In examining other trends, hiring and firing regulations began with 3.56 in 2005, climbing to 4.13 in 2010, with 4.09 in 2011 and 3.37 in 2012. Centralized collective bargaining was at 5.86 in 2005, dropping to 5.35 in 2010, further dropping to 4.37 in 2011 and then to 5.25 in 2012. The mandated cost of worker dismissal begins at 1.66 in 2005 and then stays at a steady 2.60 until 2012.

Nepal's performance in the labor market regulations category (with data from the Economic Freedom of the World Report 2014) over a period of time is depicted by the chart below:

Figure 1. Labor market regulations trend of Nepal



As shown by Figure 1, Nepal has faced a decline in the labor market regulations score making it more restrictive over a period of time. Its overall score has declined owing to a higher minimum wage and increasing difficulty in firing workers. Nepal has a very high minimum wage ratio over value added per worker in 2015. In fact, Nepal's minimum wage was the highest in South Asia in 2012 as a ratio of value added per worker. Currently, India has a higher absolute minimum wage than Nepal but lower than Nepal's as a ratio to value added per worker. In comparison, economies like Bangladesh and Bhutan in South Asia (both of which are doing better in terms of GDP growth rate and per capita GDP) have lower minimum wage than Nepal.[1] Nepal's current minimum wage stands at US$ 95.03 while its GDP grew by 5.2% (ADB, 2015) due to a good monsoon season. The industrial sector and service sectors, which employ a large portion of the formal labor force, grew only by 2.7 % and 6.1 % respectively (ADB, 2015) while the minimum wage grew by 25 percent in the same time period from US$75.9 to US$95.03 (World Bank, 2015).

Similarly, Nepal requires third-party intervention when a firm wishes to dismiss even 1 employee when most other South Asian Nations and a number of others do not have this requirement as evidenced by Table 2:

1 Refer to Doing Business, 2015 published by the World Bank for details (World Bank, 2015). Nepal's minimum wage stands at US $95.03 per month while that of Bhutan is at US $66.98. Bangladesh recently raised the minimum wage for its garment factory workers to US $68. Bhutan's GDP growth rate in 2014 stood at 6.9% and its GDP per capita in 2014 stood at US $2379.2 while Bangladesh's GDP growth rate in 2014 was 5.6% and its GDP per capita was US $1096. Nepal's ratio of minimum wage to value added per worker stands at 0.94, the highest in South Asia (the higher this ratio, the lower the productivity of the worker).

Table 2. Selected countries and their corresponding requirement of third-party approval when dismissing one worker.

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

Source: Doing Business Report 2015

A recent study found that the cost of firing an employee in Nepal hired at minimum wage can range from Rs.2, 93,000 – 3, 02,000 (approx. USD 2935.87 – 3026.05 at the rate of $1 = Rs.99.80 on 07/04/2015), notwithstanding compensation that may need to be paid if the employer is charged with wrongful firing (Samriddhi Foundation, 2015). A myriad of issues contribute to this high cost including a lethargic judicial system that takes approximately 910 days to enforce a contract (World Bank, 2015), a confusing system of resolving industrial disputes marred by lack of capable institutions and a regulatory environment that does not reflect the reality of the Nepalese economy and the labor market (Samriddhi Foundation, 2013).

Section III: Policy and implementation challenges

1. Hiring and firing regulations:

The Labor Act of 2048 BS (1992) is still the governing labor act of Nepal, along with its 2054 BS (1998) amendment. An examination of the Labor Act reveals a number of policies that need to be reassessed in order to ensure higher overall economic freedom. Nepal scores a mere 3.73 in hiring and firing regulations, indicating stringent measures that do not allow easy entry and exit for laborers from one enterprise to another. Beginning with Sub-section 2 of Section 4 of the 1992 Labor Act, Appointment of Worker and Employee, which states that a worker/employee shall be kept on a probation period unless he/she completes the continuous service period of one year (240 working days) and then based on his/her efficiency, sincerity discipline, diligence towards works, punctuality, etc. in this period, he/she shall be appointed permanently.

In practice, workers who work for the given time period irrespective of their capability or employer's willingness to retain them, are considered 'permanent workers' by the Nepalese legal code. Termination is only possible either through retrenchment or through a dismissal based on misconduct on the employee's part. The difficulties in the process of dismissing an employee and the obligation of making employees permanent after the 240 days employment, increases the cost for employers with additional security benefits obligations. Therefore, most enterprises/industries choose to remove an employee before the 240 day mark and replace him or her with another worker, thereby not having to incur additional costs of making them permanent.

In addition, the law has restrictions on hiring 'temporary' or 'contractual' workers. Due to this, most employers refrain from giving employees their due 'letter of appointment'. This then becomes one of the primary issues of contention between the employers and employees. This cycle is harmful to both employees and employers. It hampers the enterprise's productivity when having to continually replace workers and reduces stability that a worker looks for in his/her job. In addition, not having the 'letter of appointment' or a legally binding 'contract' leaves the employee in an even more vulnerable position.

In other words, a regulation meant to protect employees has the perverse effect of preventing workers from obtaining jobs in the formal sector.

1.1 The procedure of dismissal

Worker dismissal is a complex process in Nepal. Though the labor act lists a number of offences for which one could categorically be punished – being reprimanded, remuneration being withheld, suspension and finally dismissal – the process is long and arduous, which naturally makes for hesitant employers.

Grounds for dismissal, as dictated by the Labor Act under section 51, are as follows:

- In case of any bodily harm or injury or fetters or detains to the Proprietor, Manager or Employee of the Enterprise, with or without use of arms, (the person) causes any violence or destruction or assault within the Enterprise in connection with the labor dispute or on any other matter;
- In case (one) steals the property of enterprise;
- If (one is) absent from the Enterprise for more than a consecutive period of thirty days without notice;
- In case (one is) imprisoned on being convicted of a criminal offence involving moral turpitude;
- In case (one) performs any activity with a motive of causing damage to secrecy relating to special technology of the Enterprise or production formula

A person may also be dismissed from service if he/she has been punished twice already for a listed offence within a period of three consecutive years. Though it may seem like firing is as clear cut as hiring on paper, the procedure dictates otherwise.

In order to dismiss an employee, 'a notice of at least seven days setting forth in an obvious manner the fact of the misconduct and the punishment as may be imposed if such fact is proven, shall have to be given to the worker or employee in question for him/her to submit his/her clarification thereof' (Labor

Act, 1992). This is followed by a waiting period of two months within which the worker/employee is supposed to furnish clarifications for his/her actions. If the worker fails to acknowledge the receipt of the notice, which is a likely scenario, there are additional procedures whereby one can 'assure' that the worker can be notified of the decision, stretching an already overlong process.

A major problem with firing in Nepal, on top of the arduous procedure, is the fact that when an employer, citing legitimate reasons, wishes to dismiss a worker or employee, third party involvement is required by law. This usually comes in the form of labor officers. However, as previous research shows, Nepal's labor offices fall far short of the required capacity to handle industrial conflicts and the volume of work that comes their way (Samriddhi Foundation, 2014). Similarly, a dismissal always involves the Trade Union in one form or another. As soon as any form of third party is involved, it further complicates the process and increases the cost to employers. The individual level conflict can sometimes turn into a full-fledged labor problem. The difficulty of firing workers thus lies not only in the lengthy procedures, but with the cost associated with third party intervention as well.

1.2 Retrenchment and enterprise dissolution:

The Labor Act 1992 does allow for a company to retrench, or cut back employees, when curtailing production or closing down the enterprise wholly or partially for more than three months. **Once again the procedure is so lengthy and, as revealed in consultation meetings, so entrenched in corruption that it is ironic that the employer shall be asked to furnish more money simply in order to close the factory when funds are precisely what he/she lacks.** One has to first ask for approval from the Department of Labor for retrenchment, which legally takes at least two months. In practice, this approval often takes years as the decision for retrenchment ultimately reaches the Ministry of Labor and the approval often has to come from the Minister of Labor (in order to deal with the resistance from politically aligned trade unions). The retrenchment approval process therefore is rife with rent seeking opportunities. This is in addition to the lump sum compensation in terms of retrenchment pay and severance pay that the employer has to pay to his/her workers. Trade unions often want to stop the process of retrenchment and/or enterprise dissolution – understandably because it will mean the taking away of a workplace that pays. However, an employer engaging in retrenchment has to keep paying wages even when production has been curtailed.

Our consultation with experts also revealed that it is commonly perceived that hiring/firing regulations are much simpler in the developed world. This is partly because employers in developed nations usually maintain good records of all their employees. In Nepal's case, proper records of a worker's skills and counts of disciplinary actions are hard to come by from the management side. Because the task of hiring and firing is in the hands of the employer, it makes natural sense for them to keep active records of all workers in order to be able to execute their ability to hire and fire when needed. But due to lack of such monitoring, employers often find it difficult to meet conditions as set by the labor law.

2. Multiple trade unions in a single enterprise (more than mandated by the law):

One of the major constraints to economic freedom as highlighted in the discussion was that there are too many trade unions operating in a single enterprise. Labor laws have mainly differentiated among three levels of labor unionization, namely at the establishment (enterprise), the association, and the federation. As of 2012, there were 104 newly registered enterprise-level unions, in addition to the 323 existing enterprise-level trade unions (DoL, 2012 as cited in Nepal, Acharya & Neupane, 2013). This has to be seen in juxtaposition with the fact that trade union members make up only 8% of the total labor force (NLSS, 2008). This naturally begets the question of whether labor unions really are representative of those they say they represent.

The other primary problem with many trade unions in a single enterprise is inter-union rivalry. As new unions keep being registered, often under different political affiliations, the chances for conflict and dispute rise exponentially. Nepal's democratic process has been closely associated with the Trade Union movement. Most of the top-level leaders of political parties of Nepal have a background of Trade Union engagement. Owing to the political instability facing Nepal, any kind of political issue therefore provides space for disrupting enterprise-level activity (even when the issue is not related to workers welfare).

In addition, every time a political party splits, all its associated sister organizations split. This naturally affects the Trade Unions as well. When a Trade Union is split along party lines, the smaller of the offshoots needs to assert its identity in the Trade Union movement. This political instability and the desire of the smaller Union to assert its identity often leads to strikes. These patterns become clear if we analyze the rise in industrial relations disturbances and correlate this with the political evolution of Nepal (Samriddhi Foundation, 2013).

The Trade Union Act, 1992, allows for a maximum of 4 Enterprise level trade unions in any single enterprise. However, in practice, up to 6 Enterprise level trade unions have been registered for a single enterprise. This poses considerable challenges in the collective bargaining process. The employers often have to deal with multiple union representatives who may not agree on the terms and conditions among themselves. Similarly, a Collective Bargaining Agreement (CBA) conducted with one union may not be acceptable to another. This creates further avenues for disputes. The existence of multiple unions also poses a problem in dispute resolution. An employee may take membership in multiple unions. Therefore, when a dispute arises with an employee, the employer has to deal with representatives of multiple unions simply to resolve one case.

3. Problems in dispute resolution institutions:

3.1. Presence of only one labor court and lack of equipped labor inspectors:

The Department of Industry (DoI) reports that 440 large, 1113 medium and 2999 small scale industries exist in the country and employ a total of 412,813 people (DoI, 2011 as cited in Nepal, Acharya & Neupane, 2013). One would think that there are a number of state mechanisms to handle likely disputes in such a scenario. However, there are only 10 labor offices across the nation in total and 1 labor court, mired in pending cases. Also, the labor court is only present in Kathmandu, making it burdensome for disputing parties outside the valley to travel all the way to the capital (Nepal, Acharya & Neupane, 2013).

Additionally, although the Labor Act 1992 stipulates provisions for labor officers (in charge of labor relations) and factory inspectors (in charge of examining machinery and other technical aspects), in practice, the two roles have merged and only a single labor/factory inspector exists in many of the labor offices. **With only 12 labor inspectors in the country as of 2012, with one responsible for 1,380,000 workers and equipped with only technical knowledge and with no background in conflict resolution, these inspectors are ill-equipped when it comes to handling labor disputes and contentions, a situation with which most of consulted labor experts agreed.** The merging of roles makes it even more confusing for a labor inspector to understand the boundaries of his/her role.

3.2. Lack of enterprise level grievance handling mechanisms:

The Nepalese labor act has provided enterprise level authorized trade unions with authority to handle disputes and engage in collective bargaining. But due to the lack of skilled conflict handling mechanism on the part of the union, and the employer's hesitance in engaging with lower level staff for trivial matters, the authority rests only in theory. According to a 2009 ILO report, '… with regards to the bargaining, one of the reports states, due to a combination of worker inexperience, employer reluctance and barriers to strikes, there is little collective bargaining in practice. The report further presumes that the large number of unions also reduces workers' bargaining power' (Socioeconomic and Labor market trends, 2009).

In practice, if and when there is a problem in the workplace, employers often try and engage higher-level politicians to address their labor problems (since all the unions are politically affiliated to one party or the other). Splits in political parties also ultimately cause splits in existing labor unions. The distinct problem here is the unwillingness of both parties to cooperate with each other, despite the fact that their cooperation would yield better results rather than constant doubting of each other's intensions, much like the Flood and Dresher's classic prisoner's dilemma problem. Because the chain of command follows a hierarchy in most enterprises in Nepal, much of the information is either distorted or absent by the time it reaches the worker. Thus, it is natural for the lower-level staff to feel unimportant within the enterprise and react with solidarity with the union rather than the enterprise itself. This is because they are rarely ever consulted or given direct information on changes if any, that the organization will undergo. In the absence of a more inclusive communication procedure and grievance handling mechanisms at the enterprise level, enterprises suffer as employees and workers fail to navigate the important territory of communicating well.

3.3. Floating and/or ghost members of unions

The formation of an enterprise level union demands endorsement by at least 10 persons from the trade union as designated by the working committee (Trade Union Act, 1993), and at least 25% of the labor force (or 5000 members) of the enterprise in question have to sign up as members of the union. Considering this, no more than 4 enterprise level unions can be registered within an enterprise. However, as one of our experts revealed, time and again newer trade unions emerge as they 'pen in' non-existing names for registration, i.e., to get to the stipulated 25%, new trade unions continually 'make up' new names of workers for their registration and because of a lack of an electronic record keeping mechanism, there is no way that this forgery can be pinpointed. Workers too register themselves under multiple trade unions in order to gain from the membership of each or from pressure from the to-be-registered trade union.

4. Non-recognition of those in the shadow economy:

Of 151 economies, Nepal ranks at 91 out of all international shadow economies with a share of 37.5% and growing as of 2007 (Schneider, Buehn and Montenegro, 2010). Most of the country's labor is employed in subsistence agriculture, which is not recognized formally. Female labor force participation in Nepal is much higher than other South Asian countries, (namely, Pakistan, India, Sri Lanka and Bangladesh) at 80.1% as of 2008, which is mostly concentrated in the informal sector of subsistence agriculture (Nepal Labor Market Update, 2014).

As claimed by Schneider, Buehn and Montenegro (2010), 'Shadow economy growth can lead to reduced state revenues, which in turn reduce the quality and quantity of publicly provided goods and services. Ultimately, this can lead to an increase in the tax rate for firms and individuals in the official sector, often combined with a deterioration in the quality of the public goods (such as public infrastructure) and of the administration, resulting in even stronger incentives to participate in the shadow economy'. Nepal, as a transitioning economy, has significantly higher participation in the informal economy because of complex regulations and higher tax rates in formal job-holdings, the costs of which pushes employers and employees into the informal market.

The Labor Act 1992 had been formulated in order to grant recognition, official benefits and maintain standards of work hours among other things to those working in formal sectors. However, Nepal is home to a growing shadow economy that the law does not recognize. The existing Labor Act thus caters to only a minority of workers in the country and seems to ignore the vast majority of workers.

The complications of the Labor Act 1992 further discourage Small and Medium Enterprises (SMEs) from participating in the formal economy. Owing to the high cost of compliance with the Labor Act, many enterprises choose to hire workers informally and operate in the informal economy themselves. This further weakens the position of the workers in these SMEs. Once in the informal economy, they do not have access to a legally binding contract that could protect them in case of harassment and unfair behavior.

5. Industrial action and disruption in enterprise operations

As noted in one of our informal consultation meetings with experts, if there is an increase in the minimum wages then even the employees working above minimum wage demand the same level of increment in their wages. If demands such as these are not met, the enterprise will likely suffer industrial action.

In 2009, the Maoist-Aligned All Nepal Trade Union Federation (Revolutionary) demanded that salaries be increased by 40 percent and dearness allowances by 100 percent. This is in line with the fact that the Maoist faction, in consultation with the private sector, had already negotiated increases in the minimum wage that year. **Another of their demands was to increase workers' wages regardless of their work hours put in, productivity, qualifications and efficiency, though their wages were supposed to be increased or decreased in light of their marginal productivity of labor (Republica Daily, 17/12/2009).**

The Labor Act has given workers the right to strike if unhappy with the decision made by the Labor Office and, subsequently, involving the Labor Court when it comes to conflict handling and resolving issues between workers and the employers. The Act specifies that in order to go into strike, a notice claiming their cause and rationale, including endorsement of the act by 60% of the workers via a secret ballot, must be presented to the concerned proprietor, the Department of Labor, appropriate labor office and local administration before a strike is called. However, in common practice, this procedure is rarely followed. The Proprietor may be notified a few days in advance at most. In addition to this, as noted in a 2009 ILO Nepalese labor market report, 'Although the legislation denies the right to strike to employees providing essential services, the assessment of recent years shows strikes being organized everywhere (water supply, electricity, road, air and sea transport, the print industry, the government, press, and hotels and restaurants) by stepping outside the ILO mandate by violating the definition of essential services…..Although stringent conditionality, the unions at their end are not found to have received 60 per cent vote either by their members to launch illegal strike'.

This is not to say that unions do not always have justified rationale for strikes. They may. However, in light of their abuse of procedures, their rationales may be further diluted. The collapse of numerous factories and industries in this millennium in Nepal is not too hard to explain in light of strikes that further disrupt production, resulting in failure of industries and in unemployment.

Forty factories were shut down in the Sunsari-Morang corridor over the last five years primarily because of problems such as political instability, energy crisis, and frequent labor disputes (National Census of Manufacturing Establishment 2011-12 as cited in The Kathmandu Post, 27/09/2014). If these concerns are not addressed, it would not be farfetched to say that Nepal may lose more than half of its existing industrial sector to such issues, triggering mass unemployment and subsequently pushing more people below the poverty line.

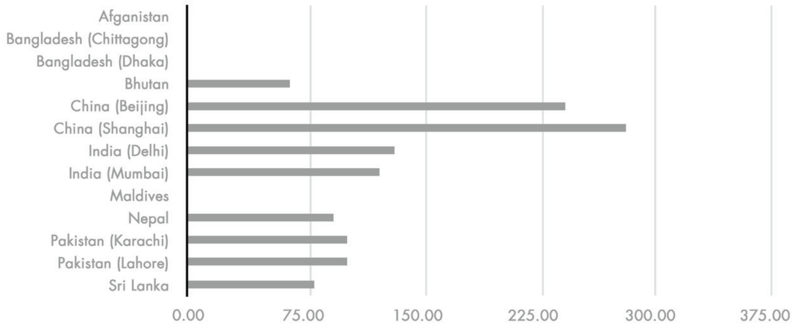
6. Minimum wage: boon or bane?

The Minimum Remuneration Fixation Committee in Nepal is responsible for fixing the minimum wage and dearness allowances for workers in Nepal. The Committee constitutes an equal number of representatives of workers/employees, managers and representatives of the Government. In 2013, the minimum wage was increased to Rs.8000 (Rs.5,100 as basic pay and Rs.2,900 as dearness allowance per month) from the previous Rs.6,200 (basic salary of Rs.3,550 and dearness allowance of Rs.2,650) (The Kathmandu Post, 13/06/2013). A common argument for the minimum wage is to ensure that workers are not exploited and have the means to enjoy an acceptable standard of living to stay above the poverty line. But since it has already been established that, proportionately, the number of workers in the informal sector is significantly larger than those employed in the formal sector, the set minimum wage serves barely a fraction of the working population.

In fact, labor economics gives us ample evidence that, if the minimum wage rate does not follow labor productivity, then it only pushes more people into informal employment where they are even more susceptible to exploitation. 'If the wage rate is pushed above its equilibrium level, then job losses follow so as to restore the equality between the wage rate and the marginal revenue product of labor. Workers whose productivity is below the minimum wage are priced out of work. As a result, the minimum wage set above the equilibrium level causes unemployment among the affected workers' (Rutkowski, 2003). Now those driven out of the formal economy have no choice but to join ranks with those in the informal sector, thereby driving down wage rates of the informal sector as well. In the case of Nepal, unemployment has continually forced workers into moving to the Middle East and East Asian countries for better employment opportunities. The continuing movement of Nepalese youth to countries abroad in search of employment and better pay should be an eye-opener. While Nepal's productivity level declines, the minimum wage is on the rise (Doing Business, 2015) [2].

2 Nepal's Ratio of Minimum wage to average value added per worker measured under the 'Labor Market Regulations' category in the Doing Business Index developed by the World Bank shows a steady decline in labor productivity especially in comparison to South Asian Standards (For details refer to: http://sapkotac.blogspot.com/2014/11/minimum-wage-and-productivity-in-nepal.html)

Table 2. Minimum wage for a full-time worker (USD/month)



Source: Doing Business Report, 2015.

Case Study: Surya Nepal Pvt. Ltd.

On August 18, 2011, The Kathmandu Post reported that Surya Nepal Private Limited had shut down its garment factory in Biratnagar that manufactured popular labels Springwood and John Players. This move was made following an unresolvable labor dispute that lasted for months.

The shut-down did not come as a surprise, considering that the factory had already been closed for two months, beginning June 15 of the same year. As reported by numerous media houses during the crisis, the situation between the workers and the employers was frequently marred with tensions, particularly on demands of wage increases by the workers. In mid-April of 2009, the workers at the factory staged a six-day protest against existing wages and demanded increased wages. Surya Nepal refused to do so, citing their 'no work-no pay' policy, which, as the name suggests, means there is no payment if the assigned job is not done. Court rulings around the world accept this principle.

Recently India's 2012 Madras High Court case wrote: "The principle of 'no work, no pay' will not apply to employees who were willing to work but not allowed to work by the employers despite valid judicial orders in favor of the workers'" (The Hindu 15/09/2012). This ruling supports the simple principle that, if you do not work, you do not get paid, unless you are prevented by the employer from working when the employer was legally obliged to offer work.

The situation worsened when protesting workers locked up 42 members of the management team and began threatening them with physical abuse and even death. The police were also prevented from entering the factory premises. The factory employed almost 700 people, of whom more than 90% were women.

The protests and events that led up to the shutdown provided no room for resuming production, causing the factory to lose out on existing and future markets. Surya Nepal supplied clothing to India, North America and countries in Europe. The company in August of 2011 also decided to pay lump sum compensation to workers until June 14, the day before the protests began.

The management blamed militant trade unionism for the decision. Random demands of wage increases and the abject rejection of the 'no work, no pay' policy was one of the main problems leading to the factory shutdown. The company, a subsidiary of ICT Company of India, had been established with investment of 700 million in 2004.

Section III: Recommandations

1. Hiring and Firing made easier

One of the essential aspects of improving economic freedom is decreasing regulations on the labor market. A flexible labor market works in favor of both the employers and employees. With a flexible labor market, employers can adapt their enterprises to changing times and better respond to market dynamics. Employees, meanwhile, are easily able to move between jobs that provide the best remuneration for their effort and they do not have to stick to obsolete jobs that waste their capacity to upgrade their skills according to changing dynamics of the market.

In essence, a flexible labor market facilitates what the 19th century economist, Joseph Schumpeter, termed as a 'creative destruction'. The process of creative destruction not only facilitates an economy to rapidly respond to changing times but also fosters the spirit of 'innovation and entrepreneurialism' since people have to find better ways of doing things instead of stagnating at the status quo.

The Department of Foreign Employment (DoFE) of Ministry of Labor and Employment claims to have issued a total of 2.2 million Foreign Employment Permits for the period of 2008/2009 to 2013/2014. This represents about 8 percent of the total population of Nepal (DoFE, 2014). If Nepal wants to retain its economically active population at home then it needs to take a close look at its labor market and the reforms required. The young population that is leaving Nepal for employment opportunities abroad requires a flexible labor market that allows them space to find employment in Nepal or move from employment that does not suit their capabilities or skills. This calls for reforms in our own hiring and firing laws. Some of these reform measures are outlined below:

1.1 Removing the mandatory permanence rule

The Labor Act of 1992 currently requires an employer to make an employee permanent after s/he has worked in the enterprise for 240 days. This kind of rule deters entrepreneurs from hiring, since it is very difficult to fire permanent employees. This essentially increases the cost of doing business. We see two kinds of implications of this rule. Firstly, employers hesitate to provide a 'Letter of appointment' to employees they hire and therefore, employees are left vulnerable in their jobs and susceptible to exploitation. Secondly, employers fear to hire in the formal market since they are unable to adjust their workforces to market demands or deal with problematic employees. This suppresses job creation in Nepal, leading to a situation where far too many Nepalese are forced to go abroad to seek work. Thirdly, due to the increased cost implication of this rule, employers try and make do with the available labor or switch to labor saving technology (even when it is expensive to do so) to avoid costs associated with firing a labor. This eventually results in less job creation in the economy.

Therefore, one of the first reform measures should be to remove this clause for making employees permanent compulsory. Employers should have the flexibility to choose the number of permanent staff they would like to retain since this number and type of labor required differs in every enterprise.

1.2 Firing at will with adequate notice and due compensation

The Labor Act of 1992 only opens two avenues for firing an employee in Nepal. An employee can either be fired for misconduct or can be fired when the enterprise is downsizing through retrenchment. This limits the employer's flexibility to respond to market conditions. It can be the case that an employer may not find the attitude of the employee suitable to his/her enterprise. In a case like this, it is likely that, if the employer cannot fire the employee, the employee will not have opportunities for career advancement at the enterprise. This is harmful for both the employer and the employee.

The process of firing thus needs to be simplified. **An employer should be able to fire at will. The only conditions that need to be stipulated in the law are in regard to adequate notice and due compensation. If the firing is deemed unfair then the decision can always be challenged through the legal system.** The law can provide the specifications of the kind of firing that is invalid (essentially the ones that do not provide adequate notice and due compensation). This kind of simplification gives employers the confidence to hire more people, thereby helping create more job opportunities.

Firing can be done two ways – with cause and without cause. The compensation category of firing can be determined by the law. Initial hiring contracts between the employer and employee could state that the employer reserves the right to terminate employees with and/or without cause. Firing 'without cause' should be combined with a severance pay that ensures the employee's welfare.

While the law is made to deter bad behavior, the current Labor Act 1992, through its assumption that all employers could demonstrate bad behavior on the part of a worker, increases the cost of firing in such a way that even the ones that are not prone to bad behavior will not be hired easily. This is a cost that is borne by the unemployed.

Since the provisions for Social Security measures are well spelled out in law, employees that don't receive their due compensation will be able to take this decision to the court and challenge the employer. Enforcing the judgments of the court would help improve the credibility of the law as well as deter employers from making unfair decisions.

1.3 Reducing the red tape on retrenchment

If an enterprise begins to steadily decline in terms of net gain and worth, and is subsequently unable to retain all its workers, it has the ability to close down or retrench in accordance to the existing labor laws. However, the process is not only long but requires a lot of money to change hands while the company has to appease line ministries and Trade Unions in order to 'allow' the retrenchment. The burgeoning number of trade unions and pressure from workers blocks easy exit from the market.

Enterprises are more inclined to enter a market when they understand that entering and exiting the market is easy and straightforward. Although the law stipulates a maximum of two months for a retrenchment decision to be processed by the Government agency, in practice, this process can translate to years. As the process of retrenchment stretches on, the enterprise suffers from further losses and the entrepreneur has a huge debt to pay in closing down an unsuccessful enterprise. This provision of the law and its execution implies that Nepal encourages sick industries to function for a long period of time even when they are occupying labor and capital that could be productively used elsewhere to boost the economy. Therefore, one primary reform measure is needed to reduce the regulatory burden on retrenchment.

Employers should be able to retrench at will with minimum processes to follow. Retrenchment also implies that employers have to give adequate notice and due compensation to the retrenched employees. If this is not done

properly then the law can specify the punishment that befits this kind of transgression.

1.4 Removing mandatory third party approval rule

As per the Doing Business survey of 2015, Nepal and Sri Lanka are the only countries in South Asia that have a mandatory third party approval rule when dismissing an employee. Requiring third party approval is problematic on two levels. Firstly, it creates opportunities for rent seeking at the approval-granting agency. In a country like Nepal, where bureaucratic transfers and promotion are dependent on political loyalties, and with trade unions that profess political allegiance to one party or the other, this creates a vicious cycle where, despite paying extra rents, an employer may not be able to dismiss an employee. Secondly, this process of seeking approval (even without the rent seeking scenario) increases the cost of doing business in Nepal.

Therefore, the provision of having to seek third party approval (the Labor Office in Nepal's case) to dismiss an employee needs to be removed. The concerns regarding unjustified dismissal could be addressed by challenging the decision in a court. A look around South Asia (given our similar history and cultures) tells us that even without the mandatory third party approval, workers do not get unfairly dismissed in large numbers. There can be exceptions and that is why our emphasis needs to be on maintaining the rule of law and enforcing decisions granted by the court – not punishing everybody.

2. Handling disputes better

One key to having a productive work environment is to be able to handle industrial disputes better. Industrial relations in Nepal have been strained at best for over two decades now. As our labor productivity falls , it becomes imperative for Nepal to review its dispute handling mechanisms and make improvements accordingly. Following are some reform measures for improving industrial relations in Nepal.

2.1 Possibility of Alternate Dispute Resolution mechanisms including arbitration

Allowing an environment for the growth of private arbitration service providers could prove to be a useful alternative. Nepal Mediators Society is one of the few non-governmental non-profit mediation service providers that boasts of trained lawyers and mediators. Private mediators demand a fee for their services, because conflicting parties feel more bound to the outcome when mediators are involved. In the long run, allowing private mediating bodies to develop in the nation may prove useful for Nepal, and the country could even grow as a regional hub for mediation. This would be similar to how the Africa ADR, initially managed by the Arbitration Foundation of Southern Africa, has now become an independent cross-border ADR servicer. Looking at the increasing number of migrant workers leaving the country every day for opportunities abroad, Nepal will need cross-border mediation service providers, and private mediators could play a key role in the establishment of such.

The Arbitration Act 1999 of Nepal does in fact present a module as to how an ADR mechanism could be implemented. However, the arbitration mechanism in Nepal is devoted to commercial corporate practice and does not include labor disputes. Though Nepal has been host to mediation and conciliation practices, these are not binding in nature and can be contested in court, adding an additional court proceeding. Arbitration is, by definition, 'a system whereby the parties make presentations to a mutually agreed neutral party and commit themselves to abide by that person's decision, recognizing it as final and binding' (Okharedia, 2011). Mediation and conciliation are recognized procedures in the existing labor law, but the law does not recognize arbitration as another option. Arbitration, as stated above, is binding and final, thus putting a stop to the continual contestability of all decisions that come from either mediation and/or conciliation. Commercial disputes, including labor disputes, can also be addressed by arbitration for reasons inclusive but not limited to:

a. Arbitration is a less time, effort and money consuming mechanism
b. The non-stigma that a court case represents
c. It's a final and binding decision
d. Deliberate and consensual agreement

The simplicity of the Arbitration Tribunal: Lessons from Bosnia and Herzegovina

Bosnia and Herzegovina, a country of mountainous terrain like Nepal, on the Balkan Peninsula of southeastern Europe, scores a 7.01 on labor regulations in the Economic Freedom of the World Index as of 2012. A comparison of Nepal's scores and those of Bosnia and Herzegovina begs the question, what does the other country do differently? In short, one major distinction between the two is that Bosnia and Herzegovina recognizes arbitration as a valid tool for ADR of labor disputes in its labor law of 1999.

The arbitration rulebook is implemented by a body known as the Bosnia and Herzegovina Arbitration Court. It sets out guidelines for arbitration, its scope and the implementation of these decisions. Bosnia and Herzegovina's arbitration rulebook has been standardized and harmonized in line with the UNCITRAL (United Nations Commission of International Trade Law) Arbitration Rules, whose text has been used by half the world in making or remaking their arbitration laws. Nepal's Arbitration Act of 1999 also borrows heavily from the UNCITRAL Arbitration Rules.

However, Labor Law 1992 of Nepal does not note arbitration as a policy alternative when it comes to labor disputes, and the Arbitration Act of 1999, in practice, encompasses commercial disputes other than labor Instances of arbitration of labor disputes are rare if not impossible to find. **The simplest recommendation that one could borrow from the Bosnia and Herzegovina model would see Nepal allow arbitration to become a policy alternative in the new labor law and let it come under the jurisdiction of the existing Arbitration Act.**

The existing Arbitration Act, like the UNCITRAL Arbitration Rules, calls for appointment of arbitrators as per previous agreements (if any) or the appointment of one arbitrator based on a joint decision by two parties. In the absence of a consensus on arbitrator appointment, each party decides on one arbitrator and then the chosen two select a third arbitrator, making up a panel of three. This Arbitration Council/Tribunal then moves on to an examination of previous agreements and current topics of dissent to come to a decision.

One of the most significant aspects of arbitration is that it avoids the contentious procedure of litigation. Making every ADR mechanism eventually contestable in court undermines the purpose of the arbitration process, when the entire point is to engage in an out of court settlement. Mediation still allows decisions to be contested, but the arbitration council should be able to enforce its decision based on consensual discussion.

Arbitration allows for a more informal face-to-face discussion among the parties and the arbitrator, and provides room for compromise based on both parties' interests. Labor courts are important and necessary, but so is enforcement of an arbitration contract. Arbitration decisions should be final.

2.2 More and better equipped labor courts

Nepal currently has only one labor court with a mandate to deal with all conflicts related to labor issues. Currently, the head of the labor court is appointed by the Nepal Government from a pool of First class gazette officers from the Judicial Service (Reliance, n.d.), who are not seen as powerful as other civil or district court judges. A large part of other regulation consultations also agreed with the fact that the responsibilities of the labor court were blurred at best.

Conflicts related to labor are specialized issues and therefore require specialized knowledge in labor law and international conventions related to labor. Therefore, it is important to have a special track for judiciary focused on labor issues. These judicial appointments should be non-transferable. This kind of system would provide stability to the interpretation of the law and allow judges the time to develop an expertise on labor issues. The appointments at the Labor court can also be carried out by the Judicial Council and labor courts should be granted the same status as the Appellate court level. This would increase confidence in the judicial system.

If new labor courts are to be set up, they should be done so primarily in areas where industry is concentrated such as Biratnagar, Janakpur and Birgunj. This would ensure easier access to justice for both employers and employees. At the same time, **specifying the jurisdiction of the labor courts (on handling interest-based or right based-disputes) further as well as dividing its current burden with an arbitration council would significantly help improve the efficiency of labor courts.**

2.3 Minimizing the number of labor unions at the enterprise level

As mentioned in the analysis portion of this report, having multiple labor unions/trade unions in one enterprise has become a huge problem. Due to their political affiliation, an enterprise is often shut down because of political feuds between groups rather than on labor issues. Even on labor issues, having multiple unions poses a problem. Which group is the authorized union that represents the workers? Which group should negotiate collective bargaining agreements? Which group's demands should be given priority by management? One solution posed by many trade unions is to have elections for the authorized trade union at the enterprise level. However, elections of this scale impose a huge cost and it is unclear who is to bear this cost.

Owing to the various problems that multiple unions pose at the enterprise level, many countries have opted for having only one union per enterprise. This union represents all the workers of the enterprise and negotiates with the management on various issues. The fact that many trade unions already exist at the enterprise level may make this reform a challenge. Therefore, **Nepal could have a joint union at the enterprise level comprised of the representatives of all the unions present at that enterprise. However, this union would be required to function as a single union. The various trade unions could exist outside the enterprises and engage in larger policy debates about labor welfare and safety in Nepal.**

3. Minimum wage – how to follow marginal productivity of labor?

Though the rationale behind setting a minimum wage is well understood, setting too high a minimum wage ultimately causes an increase in unemployment, particularly when it is based only on worker demands (as seen in Nepal) and not on a thorough survey and examination of the labor market to establish whether the rise in wages is following the marginal productivity of labor.

Nepal has one of the highest minimum wages, as explained in the analysis section. At the same time, labor productivity is declining in Nepal. If the minimum wage laws continue to increase the minimum wage every two years (the committee sits every two years at the moment) and disregard productivity completely, then more and more workers will be pushed to the informal economy due to lack of employment opportunities in the formal economy. Therefore, removal of the national minimum wage will in fact allow more low-skilled workers to come into the market, and thus let them have at least some standard of living rather than none at all.

In fact, Scandinavian countries such as Sweden, Norway and Denmark do not have national minimum wage rules. As noted in the British Journal of Industrial Relations, 2006: "Finland does not have statutory minimum wage laws. Instead, minimum wages are determined separately in each industry in the contracts between the unions and the employer organizations. These contracts are extended to all workers in each sector and are therefore also binding for non-union workers. The union contracts specify a set of task-specific minimum wages. In addition to varying across sectors, these minimum provisions vary across regions and seniority.

Collective bargaining and negotiations in each enterprise or firm set a minimum wage for that particular firm/enterprise, as unions recognize that a national minimum wage will interfere with collective bargaining and even bring down the price of labor (Forbes, 2009); a model that could possibly be replicated in Nepal.

4. Better enforcement of labor law and improving the rule of law

With appropriate reforms in the existing Labor Act, 1992, and a significant reduction in the cost of firing and hiring, more people from the informal economy can transit to the formal economy. The reform measures outlined above also reduce the list of things that the state has to ensure in terms of labor rights.

Given Nepal's state of affairs, reducing the regulatory burden would free up the state to concentrate on enforcing a limited set of clearly defined rights as well as focusing on punishing people who violate these rights. If the labor law includes a gamut of rights that the state cannot enforce, then this fosters a situation of impunity, which is detrimental to the overall rule of law situation of the country. Therefore, **Nepal needs to limit the scope of its labor law and concentrate on key issues that can ensure the workers' welfare while not burdening the employers with additional cost of doing business. Only with an improved rule of law and a fair and efficient judiciary can we truly protect the rights of workers in Nepal.**

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PART VI

COUNTRY AUDIT OF THE COMPONENT
BUSINESS REGULATIONS

Abbreviation and Acronyms

ABBS	Any Branch Banking System
BIMSTEC	Bay of Bengal Initiative for Multi-Sectoral Technical & Economic Cooperation
BoP	Balance of Payment
DOI	Department of Industry
GDP	Gross Domestic Product
IMF	International Monetary Fund
IFC	International Financial Corporation
IRD	Inland Revenue Department
NARC	Nepal Agricultural Research Council
SAWTEE	South Asia Watch on Trade, Economics and Environment
SAFTA	South Asian Free Trade Area
WEF	World Economic Forum

Section I: Economic Freedom and Business Regulation

Components of Business Regulation

The cost of doing business cannot be improved until and unless there is improvement in the six different components in business regulation, which have been identified in the Economic Freedom of the World report. As per the initial draft constitution, Nepal may become a federal nation with 8 states. It is expected that the overall need and thrust of development will be identified better by the federal structure than a unitary system of governance. However, if complex tax laws, a rigid bureaucratic system, and conflicting clauses are upheld in the constitution, it will further increase the cost of doing business and make domestic products uncompetitive. Therefore, in order to increase the cost competitiveness of business, the following six different components of business regulation should be improved.

The components have been calculated as such in the Economic Freedom of the World Index:

i. Administrative requirements

This sub-component is based on the Global Competitiveness Report question: "Complying with administrative requirements (permits, regulations, reporting) issued by the government in your country is (1 = burdensome, 7 = not burdensome)."

Source: World Economic Forum, Global Competitiveness Report.

ii. Bureaucracy costs

This sub-component is based on the Global Competitiveness Report question: "Standards on product/service quality, energy and other regulations (outside environmental regulations) in your country are: (1 = Lax or non-existent, 7 = among the world's most stringent)".

Source: World Economic Forum, Global Competitiveness Report.

iii. Starting a business

This sub-component is based on the World Bank's Doing Business data on the amount of time and money it takes to start a new limited liability business. Countries where it takes longer or is more costly to start a new business are given lower ratings. Zero-to-10 ratings were constructed for three different variables: (1) time (measured in days) necessary to comply with regulations when starting a limited liability company, (2) money costs of the fees paid to regulatory authorities (measured as a share of per-capita income) and (3) minimum capital requirements, i.e., funds that must be deposited into a company bank account (measured as a share of per-capita income). These three ratings were then averaged to arrive at the final rating for this sub-component.

Source: World Bank, Doing Business.

iv. Extra payments/bribes/favoritism

This sub-component is based on the Global Competitiveness Report questions: "In your industry, how commonly would you estimate that firms make undocumented extra payments or bribes connected with the following: A – Import and export permits; B – Connection to public utilities (e.g., telephone or electricity); C – Annual tax payments; D – Awarding of public contracts (investment projects); E – Getting favorable judicial decisions. Common (= 1) Never occur (= 7)"; "Do illegal payments aimed at influencing government policies, laws or regulations have an impact on companies in your country? 1 = Yes, significant negative impact, 7 = No, no impact at all"; and "To what extent do government officials in your country show favoritism to well-connected firms and individuals when deciding upon policies and contracts? 1 = Always show favoritism, 7 = Never show favoritism."

Source: World Economic Forum, Global Competitiveness Report.

v. Licensing restrictions

This sub-component is based on the World Bank's Doing Business data on the time in days and monetary costs required to obtain a license to construct a standard warehouse. Zero-to-10 ratings were constructed for (1) the time cost (measured in number of calendar days required to obtain a license) and (2) the monetary cost of obtaining the license (measured as a share of per-capita income). These two ratings were then averaged to arrive at the final rating for this sub-component.

Source: World Bank, Doing Business.

vi. Cost of tax compliance

This sub-component is based on the World Bank's Doing Business data on the time required per year for a business to prepare, file, and pay taxes on corporate income, value added or sales taxes, and taxes on labor.

Source: World Bank, Doing Business.

Section II: Analysis of Nepal's Performance in the Category

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 (Economic Freedom of the World: 2014, p.10). The expanded use of regulation in key growth sectors has been an important factor contributing to the low ratings in the business regulation category of the report.

After the restoration of democracy in 1990, a series of business and private sector friendly policies were promulgated and this led to increased contribution by private enterprises in the Nepalese economy. However, the high potential for growth in sectors like education, tourism, hydropower, agriculture and infrastructure is yet to be tapped in the absence of a favorable business environment in the country. The Gross Domestic Product (GDP) of Nepal was a mere USD 19.64 billion in 2014 (World Bank, 2015) and the annual economic growth rate was just 3 percent in FY 2014/2015 (Economic Survey, 2015, p. 28). The final figures of economic growth rate for FY 2015/2016 may be even lower due to damage caused by the two major earthquakes that shook Nepal on 25th April and 12th May, 2015 and a series of landslides triggered by the earthquakes and aftershocks that followed.

As previously mentioned, the overall score of Nepal in Business Regulation category is 6.07 out of 10 in the EFW Index of 2014 (EFW, 2014, p. 124). The scores Nepal has obtained in the past three years are shown in the table below:

Table 1. Nepal's scores through the years on business regulation on the EFWR index

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

Source: Gwartney, Lawson & Hall (2014)

Similarly, Nepal's performance in this category vis-à-vis world average, landlocked countries' average, South Asia Average and some selected countries are presented below:

Table 2. A compilation of selected countries' scores on subsects of the business regulation category for the year 2012

Business Regulation							
Countries	5Ci Administrative requirements	5Cii Bureaucracy costs	5Ciii Starting a business	5Civ Extra payments/ bribes/ favoritism	5Cv Licensing restrictions	5Cvi Tax compliance	5C Business regulations
Unit. Arab Emirates	6.5	3.0	9.7	8.6	10.0	9.9	7.9
Singapore	7.4	2.2	9.9	8.9	10.0	9.1	7.9
Qatar	7.0	2.1	9.5	8.9	9.9	9.5	7.8
Hong Kong	6.5	3.1	9.9	8.0	9.7	9.1	7.7
Finland	6.6	1.5	9.5	9.1	9.8	9.0	7.6
Georgia	5.6	6.4	9.9	7.0	9.7	6.9	7.6
Rwanda	6.6	4.0	9.9	7.5	8.5	8.7	7.5
Bahrain	5.7	3.2	9.0	7.1	9.9	9.6	7.4
New Zealand	5.5	2.0	10.0	9.2	9.3	8.3	7.4
Estonia	5.6	3.3	9.7	7.3	8.5	9.1	7.2
Top 10 average	4.1	3.4	9.3	6.1	7.3	7.8	7.6
World Average	4.1	4.8	8.8	4.9	7.6	7.0	6.3
Landlocked	4.8	5.6	8.8	4.6	7.4	6.6	6.3
South Asia	3.8	5.5	9.1	3.3	6.4	6.3	5.7
Nepal	3.5	6.7	9.1	3.0	8.1	6.3	6.1

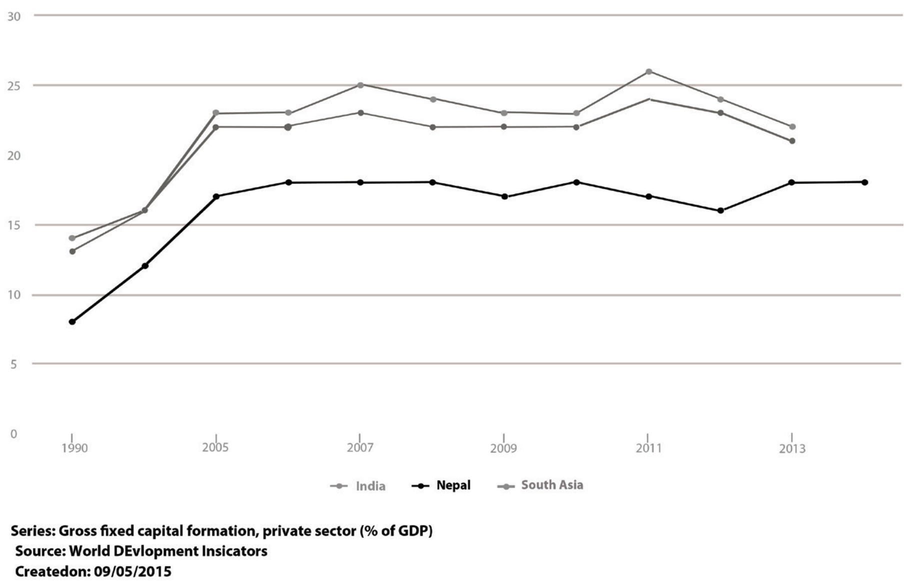
Source: Gwartney, Lawson & Hall (2014)

In the comparison demonstrated in the above table, Nepal performs relatively well in this category compared with other aspects of Economic Freedom. Its average score is closer to the world average as well as the average score of landlocked countries. Similarly, it scores relatively higher than the South Asian average score. However, a look at the disaggregated data in the column above presents a troubling picture. While Nepal seems to do exceptionally well in the categories of 'Starting a Business' and 'Licensing Restrictions', its abysmal performance in 'administrative requirements' and 'extra payments/ bribes' categories pulls down its overall average.

The wave of liberalization that opened up the Nepalese economy to domestic and foreign private sector participation was initiated in the mid-1980s and took the form of several new acts and regulations in 1992. Key legislative changes amongst these reforms were the Industrial Enterprise Act, 1992, Electricity Act, 1992, and Foreign Direct Investment and Technology Transfer Act (FITTA), 1992. These acts paved the way for more economic freedom in Nepal and all these acts were, indirectly or directly, related to overall business regulation. The idea behind the promotion of economic freedom in Nepal was to have a democratic and liberal society that would deliver for the common person as opposed to the system that benefited only the elites prior to the 1990 democratic movement.

While these were the first step in reforming the Nepalese legislative and regulatory environment, , these reforms unfortunately could not gain momentum. Instead, many of these reforms were back-tracked as can be seen by the state of affairs today. For instance, although FITTA 1992 does not require and specify any regulatory burdens as such for foreign investors, and has a relatively small negative list, foreign investors that subsequently came to Nepal were handed an incredibly long 'Foreign Investment Procedural Manual' that detailed numerous permits they have to obtain and forms that they have to fill. Similarly, although the Electricity Act 1992 opened up private sector participation in all aspects of electricity generation, transmission and distribution, investors discovered that they had to follow numerous regulations in order to secure their investments, particularly in electricity transmission. Nepal's business environment is home to many opaque areas that can baffle any investor. Therefore, despite Nepal's above average performance in this category in comparison to South Asia, the size of the private sector as well as its contribution to the GDP in Nepal is considerably lower in comparison to other South Asian countries (WB, 2015) as demonstrated by the chart below:

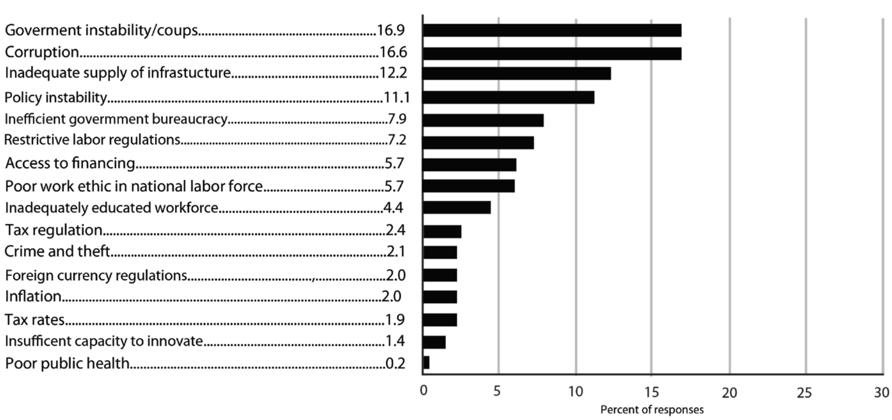
Figure1: Gross fixed capital formation, private sector (% of GDP)



Nepal falls significantly behind the South Asian average and India on the private sector contribution to fixed capital formation. This implies that while Nepal may rank above in business regulation category in comparison to rest of South Asia, the score is not yielding results as expected.

The Global Competitiveness report of 2014/15 flows from annual surveys amongst enterprises to identify problem areas. The following chart gives a brief description of some of the problem areas for Nepali enterprises:

Figure2: The most problematic factors for Doing Business in Nepal



Note: From the list offactors above, respondents were asked to select the five most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

Source: Global Competitiveness Report 2014/15, World Economic Forum.

As reported by Nepali enterprises, political instability and an inadequate supply of infrastructure are significant problems of operating in Nepal. However, not far behind are regulatory issues such as an inefficient bureaucracy, tax regulations, corruption and policy instability. Therefore, it becomes imperative to analyze Nepal's policy and implementation challenges in each category and especially in those categories where Nepal is not performing well.

Section III: Policy and Implementation Challenges

1. Administrative Requirements

Nepal has created a cumbersome system of regulations for running an enterprise. Permits, administrative authorizations, and periodic reporting are all unfortunate realities of doing business in Nepal. 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 companies and increasing the cost of doing business in Nepal.

Nepal scored 3.1 out of 7 in this category (WEF Global Competitive Report 2013-14, p. 418). Easy administrative procedures with transparent rules allow entrepreneurs to concentrate their time on real business issues and reduce the cost associated with meeting administrative requirements. Additional administrative requirements create rent seeking and extra payment opportunities further increasing the cost of doing business (Aterido, R., Driemeier, M. & Pages, C., 2007).

In a developing country like Nepal, that has many rules and regulations for conducting a business, entrepreneurs have to go to numerous civil servants with several documents for authorizations. These 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).

There are many instances that indicate the onerous administrative requirements in Nepal. For instance, in order to register a mom and pop store (Kirana Pasal), an entrepreneur has to head to 4 different government agencies before he or she is formally recognized (Samriddhi Foundation, 2013). Similarly, every public or private company needs to submit annual financial statements certified by the auditor to the Office of Company Registration (OCR) within six months of the completion of the financial year. Failure to do so results in hefty fines.

All companies also have to submit their Annual General Meeting minutes to the OCR. Any change in the Company's Memorandum of Association (MoA) and Articles of Association (AoA) has to be approved by the OCR before it becomes applicable (Company Act, 2006). These are simply administrative requirements associated with opening any kind of company in Nepal.

However, in order to become fully operational, companies have to pass additional hurdles which include tax registration and registration or obtaining a licence/permit from the relevant government agency. This implies that if anyone wishes to open a company that trades in agricultural products then it needs to fulfill the required registration and permit acquisition requirements laid out by the Ministry of Agriculture as well as Ministry of Commerce and Supplies. Similarly, if one wishes to set up a company to enter the agro-processing industry then the administrative requirements of the Ministry of Agriculture as well as the Ministry of Industry needs to be adhered to before one can begin operation.

For importing raw materials or exporting the final products, there are several additional layers of administrative requirements that need to be fulfilled.

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. Both these processes are unclear and many administrative requirements regarding these are subject to the arbitrary authority of the tax and labor officials.

Owing to the administrative complications, almost all enterprises in Nepal fulfill their regulatory requirements through agents who are specialized in navigating the opaque bureaucracy. This further adds to the cost of doing business in Nepal.

2. Bureaucracy Costs

When administrative requirements are numerous, it increases bureaucratic costs. Similarly, when unnecessary documentation and procedures are put in place, it increases the cost of doing business (Cochrane, 2014). The lack of transparency in rules, laws and procedures also creates a suitable environment for corruption and financial embezzlement. Bureaucrats have opportunity for rent seeking if there is room for arbitrary decisions when the clauses are not clear in policy and acts. Additionally, when the rules are confusing or not publically available, and change without proper prior notice to the public, it gives ground for various interpretations (Tanzi, V., 1998, p. 20).

Delaying 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.

3. Starting a Business

Nepal's position is 104th out of 189 economies in starting a business. Nepal has made the process of establishing a firm easier by minimizing the time previously required for administrative procedures at the Office of Company Registrar. This was accomplished by introducing an automatic registrations system and by establishing a link between agencies involved in the incorporation process (Doing Business Nepal 2015, p. 19).

While Nepal does well in this category, there are numerous areas for improvement. Nepal can ease the process of doing business by setting up a one-stop shop to streamline procedures, making procedures simpler or faster by introducing technology and reducing or eliminating minimum capital requirements. As of today a company registration requires two documents – MoA and AoA – for incorporation, which could be combined into a single document. Similarly, the registration process is currently centered in urban areas. In order to ease the process of starting a business, given the online infrastructure at OCR, Nepal needs a digital signature and online payment system. 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. This requires entrepreneurs from outside the capital to travel to the capital to register their businesses.

4. Extra Payments/Bribes/Favoritism

Extra payments and bribes increase the cost of doing business, as payments are needed for getting service from government officials. These kinds of costs are even higher in a country like Nepal, where instability in governance and politics has led to weakened institutional structures.

Few people benefit through such abuse of public power. The majority of people are adversely affected by such practice and it erodes the competitiveness of the entire country. Corruption tends to reduce public revenue and increase public spending as the state begins to employ mechanisms to combat corruption (such as the Center for Investigation of Abuse of Authority in Nepal). Thus, it balloons fiscal deficits (Tanzi, V., 1998, p. 22). Similarly, extra payments and bribes distort the market as people who have better connections with politicians have great advantages while the rest are excluded from economic opportunities. This gives rise to crony capitalism.

In most developing countries, small and medium enterprises are the main engine of growth. These countries cannot prosper without the growth of such enterprises. However, corrupt practices hamper the growth of these businesses, as the majority of small and medium enterprises do not have enough resources and access to deal with bureaucratic hassles. This kind of practice, then, encourages the Small and Medium Enterprises (SMEs) to operate in the informal economy to bypass the burdensome regulatory framework. Rent seeking behavior also opens up space for big organizations to influence crucial policy decisions. Transparency of public institutions is crucial for increasing the business confidence level in the country.

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.

One case in point is the existence of special agents called ‘brokers’ who can be found outside almost any public-service government agency in Nepal.

The administrative requirements are so hazy and create so many rent-seeking opportunities that these 'brokers' facilitate the process of getting a government service through 'extra payments'. This is a well-known fact of the business regulatory environment in Nepal. All process, right from 'Starting a Business' to 'Exiting an Industry', require the help of these 'brokers'. This is an indicator of why Nepal scores so low on the corruption perception index.

5. 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 licences issued by 41 institutions in Nepal. Out of these, more than half (67 out of 125) of the business licenses are pre-operational licences.** 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.

Agro-entrepreneurs who need approval from Nepal Agricultural Research Council (NARC) for new varieties of seed must wait for at least two years. Such a long duration for approval is not suited for entrepreneurs, who conduct business on a rather small scale, or for newcomers, because they cannot bear the overhead cost for such a long period of time (Adhikari et, al., 2013, p. 8).

Likewise, foreign individuals are not allowed to open educational institutes at primary and secondary school level. This provision has hindered innovations in the field of education at lower levels. Manipal Group, one of the leading private sector educational service providers in South Asia, has pulled out its investment from school and college levels in Nepal, as it was not allowed by law to engage in these areas. The private sector in Nepal requires a licence from the Ministry of Education to open an educational institution.

Similarly, in Nepal, people are not allowed to open a private university as The University Grants Commission Act, 1993 allows open public universities (Chalise & et.al, 2013, p. 38). Therefore, many colleges have become affiliated with foreign universities and as a consequence, a large sum of money flows outside the country. The aim should instead be in attracting international students to our own domestic universities. Additionally, many colleges, which have the potential to grow into a full university cannot expand, although these institutions fulfill all necessary requirements to open a university.

In the case of Nepal's hydropower sector, there is a dual licensing system that requires developers to have a survey and generation licence before starting their business. Most of the survey licences were given immediately after 1992 at a very low price and the majority of them were taken by people with links to the licence issuing authority. Most of these people had no intention of investing in hydropower themselves but took licences so that they could profit from the sale of the licence to actual developers. Consequently, a large portion of the investment meant for hydropower generation plants was spent on obtaining licences (Dhungel & Rijal, 2012, p. 50). Furthermore, there is a tendency to hold the licence for a long period without following the terms and conditions of the agreement (CIAA, 2015, p. 7). Government officials also seek their 'cut' while awarding licences (CIAA, 2015, p. 8). As a result, the real developer's cost goes up. On top of this, it is uncertain whether the party that has obtained the survey licence will get the generation licence due to provision of dual licensing system.

> 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 licences are limited to a small elite thereby marginalizing large groups of people in terms of economic opportunities. A 'licence raj' in essence does not complement the vision of 'inclusive growth' that Nepal has undertaken.

6. Cost of Tax Compliance

The redundancies and legalities of tax regulation in Nepal have 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 his or her budget. Therefore, most SMEs choose to function in the informal economy. The lengthy process involved also increases the 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 expect 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. The recent earthquake may have aggravated the situation. As the government's efforts will have to be concentrated in rehabilitation and reconstruction, the reforms in regulation will not get due attention.

Section IV: Recommendations

The reform measures in the 'Business Regulation Category' need to focus in the following areas:

A. 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.

B. Simplify the Process of Exit

It is very cumbersome for firms to exit from a business as no company can commence insolvency without the permission of the court, and it takes normally two years to complete the liquidation procedure. Therefore, 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.

C. Remove certain licences and simplify the 'absolutely necessary' ones

Agriculture, education, energy, and infrastructure are major growth sectors of the Nepalese economy. However, the growth of these sectors is hindered by licensing and lengthy approval system. An overhaul of the licensing system needs to be undertaken. This is also important from a viewpoint of curbing corruption and extra payments. Licences 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 licence that has been created to limit 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.

D. Curb Corruption and Culture of Favoritism

One way of curbing corruption is to simplify the administrative requirements and eliminate many requirements that simply provide 'approval authority' to certain government agencies. This can be done by amending laws that grant 'arbitrary power' to government agencies. Similarly, the language of legalese that leaves laws open to various interpretations needs to be simplified such that those in authority cannot use them for rent-seeking. Nepal has, so far, introduced many oversight agencies to 'eliminate' corruption, but the popular wisdom of adding one more agency does not curb corruption. In fact, one more agency adds another 'cost' of doing business. Corruption cannot be eliminated by employing additional inspectors, but by eliminating the need to have 'an inspection'. Introduction of modern information technology, use of automatic procedures in regulatory agencies and measures to ensure their independence through institutional checks and balances can significantly minimize corruption. Corruption control will also require reviewing Nepal's Civil Service Act and redesigning the incentive system for bureaucrats.

E. 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 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.

F. 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 payments from any commercial bank, eliminating the need to go to the tax office for a tax clearance certificate, making tax administrators liable for their actions/inactions and employing mechanisms to administer tax clearances to large number of people who fulfill broad requirements. Taxpayers should be treated with respect rather than be treated with suspicion. There is no doubt that some reform in the taxation system has 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.

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Annex

Annex I: Country Audit Report preparation team

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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
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