Leveraging Entrepreneurship for Advancing Prosperity (LEAP)

LIBERATING MANUFACTURING SECTOR

Photo: Amit Banmala

SAMRIDDHI FOUNDATION

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Published by
Samriddhi Foundation
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ACKNOWLEDGEMENT

We take this opportunity to acknowledge various parties who have made this research a success. Firstly, we would like to express our sincere gratitude to our research co-ordinator Mr. Akash Shrestha who have helped and guided us throughout the course of this research. We are also extremely grateful to the fellow researchers Ranju Bista and Samar Rana at Samriddhi Foundation for their valuable inputs to complete this research.

We would like to thank Mr. Chudmani Bhattarai from FNCSI for providing us with the contacts details of micro entrepreneurs. Similarly, our sincere gratitude also goes to all the entrepreneurs for sharing their experiences and knowledge about running micro, small and cottage enterprises in Nepal. Lastly, valuable insights and information from Ministry of Industry (MoI), Department of Cottage and Small Industries (DCSI), Federation of Nepal Cottage and Small Industries (FNCSI), National Micro Entrepreneurs Federation Nepal (NMEFEN) and Federation of Handicraft Associations of Nepal (FHAN) were also equally important to prepare this research paper.

We thank our colleagues from at Samriddhi Foundation, specifically Mr. Akash Shreshta. Mr. Jai Vanaik and Ms. Ankshita Chaudhary who constantly provided us with their inputs and editorial support to help build this report. We would also like to extend our credit to Mr. Roshan Basnet for his efforts to give the paper its final design and layout.

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Table of Contents

LIST OF TABLES

ABBREVIATIONS AND ACRONYMS

AusAID	Australian Agency for International Development
CCIA	Central Carpet Industries Association
DCSI	Department of Cottage and Small Industries
DFQF	Duty Free Quota Free
FHAN	Federation of Handicraft Association of Nepal
GAN	Garment Association Nepal
GATS	Generalised Agreement in Trade in Services
GDP	Gross Domestic Product
GoN	Government of Nepal
GSP	Generalised System of Preference
IEA	Industrial Enterprise Act
ILO	International Labour Organization
MEDEP	Micro- Enterprise Development Programme
MEDPA	Micro-Enterprise Development for Poverty Alleviation
NBSM	Nepal Bureau of Standards and Metrology
NCEA	Nepal Carpet Exporter Association
NMEFEN	National Micro Enterprise Federation Nepal
NPC	National Planning Commission
NRs.	Nepalese Rupees
NS	Nepal Standard
PAN	Permanent Account Number
UNDP	Unites Nations Development Programme
USA	Unites States of America
USD	Unites States Dollars
WDR	World Development Report

PAPER AT A GLANCE

According to the National Accounts of Central Bureau of Statistics (CBS) for the fiscal year 2016/17, the contribution of manufacturing sector in the Nepalese GDP is 5.67 percent. It is regarded as one of the major sectors that could help boost the Nepalese economy. With the development of manufacturing sector, it will not only increase national output and create more employment opportunities but will also complement agricultural and service sector through backward and forward linkages respectively. Therefore, the support it provides to the other economic sectors further necessitates its growth.

There are a lot of microenterprises engaged manufacturing sector in Nepal. Out of these micro manufacturers, many of them have not even been formalised and many of them have not been able to grow to become medium and large-scale enterprises due to various problems/ challenges faced by them. This paper has selected five of the growing manufacturing sub- sectors, namely handicrafts, textile and readymade garments, iron and related, woollen carpet, and food and beverage and has analysed the problems that micro- entrepreneurs in these manufacturing sub- categories are currently facing. The paper has also tried to propose some potential solutions to the identified problems.

Many of the microenterprises in the handicraft sector are operating informally. The entrepreneurs perceive formalisation will only increase the cost of doing business as it comes with having to pay taxes, meeting various regulatory compliances, and yearly renewal of the registration, among others. Therefore, they are reluctant to get formalised.

The major problem faced by the iron and related enterprises is getting 'no objection commitment' from the neighbours. These enterprises are mandatorily required by the law to obtain a 'no objection commitment' from the neighbours before establishment of the industry. But, because of the negative externality (sound pollution) produced by these enterprises, it is very difficult to get the commitment from the neighbours. Therefore, the microenterprises in this sector are being forced to operate informally and they are not being able to upscale their operations.

The major problems faced by woollen carpet manufacturers are the lack of clear set of standards that comply with the international standards and lack of standard testing mechanism inside the country. Because of these factors, there have been instances when the exported carpets had to be withdrawn as they could not pass the standard test in international market. Nepalese manufacturers not only stained their reputation but also had to withdraw their products incurring huge loss.

In Food and Beverage industry, we have found that a standard mark is very important to reach out wider markets. Many retailers and traders do not accept the food and beverages without a standard mark. But, the procedure of getting license for Nepal Standard (NS) mark is very difficult and costly, due to which many micro entrepreneurs are not being able to expand their business.

Textiles and Readymade garments industries specifically face problem while exporting their products. The border as well as documentary compliance to export a consignment takes as long as 100 hours and costs 398 USD, which is more than 50 percent of the GDP per capital of Nepal. Moreover, various monetary incentives provided to boost up exports do not seem to have benefitted micro and small manufacturers as they are not directly involved in international trade.

In addition to these, the paper explains various other challenges faced by microenterprises in manufacturing category and also proposes potential solutions to these problems.

1 INTRODUCTION

1.1 Background

The liberalization momentum post-the transformation of Nepal into a constitutional monarchy with multi-party democracy ushered an era of growth fueled markets. However, the case for microenterprises per say did not feature in the Industrial Enterprise Act of 1992. The earliest evidence of a separate policy solely oriented towards the development of micro enterprises can be traced to the Micro- Enterprises Development Programme (MEDEP) initiated by His Majesty's Government and United Nations Development Programme (UNDP). The same was also incorporated and prioritized in the 9th Five-year plan of the National Planning Commission (NPC), the apex body for planning and development in the country. Subsequent policy additions garnering more attention were articulated in the Micro enterprise Policy 2008 while the Industrial Policy (2010) recognized and defined the micro enterprises for the first time in Nepal. Following suit, the Industrial Enterprise Act (IEA) that passed in 2016, legislated on the creation of industry status for micro-enterprises in Nepal.

In the current legal framework, micro enterprises are defined on the following parameters:

1. Fixed capital of Rs. 5 Lakhs or less, not including land or building
2. The owner himself/herself is operating or managing the business
3. Employs 9 people or less including the owner
4. Annual transaction of up to Rs. 50 Lakhs
5. Electricity consumption by engine, equipment and machine of 20 KW or less, if applicable

Prior to the definition in this Act, all the micro enterprises had to be registered as cottage or small-scale enterprise. Although there were differences in the categorization of the enterprises as cottage and small in the previous act, the policies, regulations and rules adopted by the Department of Cottage and Small Industries (DCSI) - the regulating body for both the cottage and small-scale industries - were the same. The IEA 2016 has taken a few initiatives to ease up the business operation for micro enterprises such as free registration and tax exemption till five years from the date of establishment.

Micro enterprises are normally found to be a startup, family business, a partnership firm or an enterprise run by a group of people co-operatively. As identified by Samriddhi Foundation (2013), the micro-enterprises cover large part of the informal economy in Nepal. Furthermore, they are characterized by the following traits.

- Largely family run enterprises that are set up with family savings and are supported by friends and family
- A single individual often plays both the role of owner and manager and makes all the key decisions
- Low credit worthiness

- Enterprise relies largely on the skills of the founder and managerial competence requirements are not perceived to be of importance
- Staffs are recruited often without job analysis or job description and are rarely delegated authorities to make decisions.
- Technology used is locally innovated and is often limited in capacity and efficiency
- Largely cater to local markets
- Poor access to institutional credit for SMEs. Recently, due to the influx of remittance, people are coming in possessions of capital that they lacked before. Hence, Nepal has witnessed an increase in the number of people getting involved in micro enterprises.

1.2 Developments in Microenterprise sector in Nepal

The Government of Nepal (GoN) announced a Micro, Cottage and Small Industry Fund via the budget speech of the financial year 2004/05 in addition to the MEDEP Programme that has been running since 1999. On the data published by MEDEP, up till 2011 a total of 53,345 micro enterprises with a total employment of 54,240 was achieved. These were concentrated in 38 districts of Nepal. For the fiscal year 2012/13, the government extended the MEDEP in 45 districts and expanded it to 5 more districts in 2013/14. The Council of Ministers recently approved (on July 17, 2013) the operational guidelines of Micro- Enterprise Development for Poverty Alleviation (MEDPA) that establishes a plan to advance MEDEP and expand throughout the country. The government will contribute 33% of the total budget of 4,100 million Nepalese rupees (NRs.) from the central government's fund with a commitment of 67% from the donors and development partners (Australian Agency for International Development (AusAID)/ UNDP). Consequently, in the fourth phase of the MEDEP expansion (August 2013 - July 2018), the government's MEDPA program will gradually take control of MEDEP and expand it into a national program covering all 75 districts. MEDEP facilitated the approval of a series of policies and guidelines at the national level to create an enabling environment for the development of microenterprises. In 2013, the GoN approved the five-year Strategic Plan of MEDPA (2070/71 - 2074/75) and the document MEDEP IV Phase (2013/14 - 2017/18). With these resources, the government has focused on creating 73,000 new micro entrepreneurs while also providing expansion support for the 40,000 existing micro entrepreneurs. The GoN reviewed and finalized the Industrial Law, which includes the perspectives of microenterprises, and is drafting its Regulation. Other policy-level initiation worth mentioning is the development of the Operational Guide of MEDPA, which mainly includes five components: Sub-contracting Directive, CFC Directive, MEDF Directive, Fiduciary Risk Directive and M & E Directive.

Given that the Government is internalizing the MEDEP model in its own Program for the Development of Microenterprises for the Mitigation of Poverty (MEDPA) and implementing the program in all 75 districts of Nepal, the role of MEDEP has changed. Finally, during the fourth phase (August 2013 - July 2018), the government's MEDPA program will gradually take over MEDEP's role of creating and sustaining entrepreneurs and MEDEP will focus more on capacity building of government agencies and private organizations for sustainable delivery of microenterprises development services. Therefore, during the period of the fourth phase (August 2013 - July 2018), the role of MEDEP will change with a more specific focus on the development of an enabling environment and institutional capacity building of the Ministry of Industry and other partners. With this, it aims to contribute in reducing poverty through the transfer of knowledge and skills for the development of entrepreneurship; create, promote and maintain microenterprises, and generate self-employment and employment opportunities for the rural poor.

1.3 Contribution of Informal Sector

The informal economy provides employment to 69.7 percent of the total economically active population in non-agricultural sector according to the Labor Force Survey (2008) of the International Labor Organization (ILO). ILO also estimates the contribution of informal economy in the Gross Domestic Product (GDP) of Nepal to be 51.5 percent. Similarly, World Development Report (WDR) 2011 estimates that informal sector covers about 37.5 percent of the national GDP for South Asian countries. Therefore, even if we take the minimum of the two, 37 percent is a significant portion of GDP that can be overlooked.

Out of the total contribution of the informal sector, micro- enterprise has a huge role to play. The micro- enterprises can be broadly categorized into Manufacturing, Service and Trading enterprises. In this report, we will specifically focus on micro-enterprises in manufacturing sector and will identify the hurdles that have hindered the growth of these enterprises. In doing so, first of all, we focus on the informality status of these enterprises and the reasons behind their informality.

1.4 Reasons behind existence of Informal Microenterprises

There are various explanations provided as to why micro enterprises remain in the informal economy. Loayz and Rigolini (2008) identify excessive regulations as the main hindrance to formality. The regulation costs are fixed and sometimes sunk cost to the businesses. Djankov et al (2000) concluded that the official cost of registration, excluding bribe and administrative delays, is 34 percent of the GDP per capita and that in average, involves 10.17 steps and 63.05 business days in a developing country. Likewise, due to lack of expertise in accounting and transferring VAT amount to customers as final product/service price, micro entrepreneurs view the need to keep accounts for all the financial transactions as a discouraging factor to formalization. However, Lagos (1995) explains that with relatively small transactions, for micro entrepreneurs, the obligation to pay taxes have a small impact on formalization.

Apart from the contribution to the GDP, informal economy is important for the formal economy as well. According to the structuralist perspective of informal economy, the informal economy is subordinate to the formal economy. The subordination reduces the input and labour costs and increases the competitiveness of the large firms (Castells and Portes, 1989). The Stucturalists maintain that the nature of capitalism drives informality; the attempts by larger firms to reduce costs and increase their competitiveness, ability of these firms to react against the organized labour, state regulation especially, regulatory compliances and taxes and global competition.

Similarly, the legalist perspective of informal economy states that the informal sector comprises of micro entrepreneurs who deliberately choose to operate informally as a rational response to avoid costs, time and effort of formal registration due to the hostile legal system (Hernando de Soto 1989,2000). As a result, informal economy has cost advantage that the formal economy does not enjoy.

2 How we approach this paper

Micro enterprise, introduced in the new IEA, 2016, is relatively new among other enterprises in Nepal. As mentioned above, prior to this Act, micro, cottage and small were treated from the same lens and did not have any specific provision only for micro. The process to start a business, payment of taxes, conforming to the standards, procedure to comply with other legal obligation for all these three enterprises are same even after the formulation of the Act. Likewise, the other problems and challenges faced by micro, cottage and small industries are also similar in nature. So, in this paper we have also incorporated the inputs from cottage and small industries apart from micro sector to dissect the hurdles faced by them while running their enterprises.

The paper is also a collaborative deliberation held with multiple stakeholders which includes formal manufacturing enterprises, authorities from respective federations and government. Also, the secondary publications and researches which are related to this paper are taken into consideration.

Key informant discussion with formal entrepreneurs was conducted as the respondents have already passed each and every stage that is required to qualify them as a 'formal' entity. In addition, series of individual interview were also conducted with the formal enterpreneurs as they are well aware of all the governmental provisions that need to be complied in the due process. So, drawing lessons from their experience in this sector makes it easier for those currently in the informal sector to formalize their business. Additionally, we have also included other problems faced by them while doing business which have inhibited their growth.

In order to identify the problems, we also conversed with the concerned officials from the umbrella organizations such as National Micro Enterprise Federation Nepal (NMEFEN), Federation of Handicraft Association of Nepal (FHAN). These interviews produced valuable insights regarding the problems and difficulties of complying with laws and regulations whilst suggesting solutions to the aforementioned problems. Likewise, we had consultation with concerned government authorities about their efforts to motivate enterprises to formalize along with their future plans and programs to facilitate their growth.

According to *'Audhyogic Tathyanka 2072/73'* (Industrial Statistics 2016/17) published by Department of Cottage and Small Industries (DCSI) there are currently 107,231 micro, cottage and small manufacturing industries registered till 2072/73. These industries are categorized under 133 different categories.

Table 1: Year-wise registration of Manufacturing Industries

Industry	2068/69		2069/70		2070/71		2071/72		2072/73		Total industries till 2072/73
	New registration	Growth %	New registration	Growth %	New registration	Growth %	New registration	Growth %	New registration	Growth %	
Mill	325	1.35%	279	1.14%	136	0.01%	70	0.28%	202	0.81%	25122
Wooden furniture	89	1.28%	96	1.27%	126	1.77%	487	6.71%	4	0.05%	7746
Food processing	189	3.74%	358	6.83%	359	6.41%	123	2.07%	116	1.91%	6195
Iron and related	325	12.83%	400	10.37%	198	6.08%	46	1.33%	268	7.65%	3769
Dhaka & readymade clothes	120	5.45%	211	9%	496	19.60%	102	3.37%	432	13.81%	3562
Steel & related	45	1.81%	57	2.25%	237	9.16%	131	4.64%	170	5.75%	3125
Cement & related	102	4.82%	332	14.96%	83	3.25%	129	4.90%	32	1.16%	2795
Handicrafts (gold & silver)	302	19.52%	148	8.00%	36	1.80%	175	8.61%	142	6.43%	2350
Carpet	5	0.25%	74	3.66%	126	6.01%	0	0	121	5.45%	2343
Saw mill	82	7.13%	156	12.66%	302	0.22%	98	5.80%	86	4.81%	1874

Source: Industrial Statistics,2016/17 Department of Cottage and Small Industry (DCSI)

After assessing these industries, the top ten industries which have the major contribution in the manufacturing sector have been shortlisted. Among these, five industries that have exhibited promising growth percentage in the last five years have been selected. A minute study of these five sectors has been conducted in this paper to find out their contribution to national economy and export as well as to identify potential problems and suggestions to ease their business. The following is the list of sectors:

1. **Handicrafts (gold, silver and metal)**
2. **Textiles and readymade garments**
3. **Iron & related**
4. **Woollen carpet**
5. **Food and Beverage**

3 Handicraft

3.1 Overview

The statute of FHAN in its article 1.4 (i) has defined "Handicraft Industry" as "an industry that manufactures a product reflecting the country's tradition, art and culture, and/or uses labour intensive specialized skills, and/or uses indigenous raw material and/or resources". Due to wide range of people inhabiting in diverse topographic setting, Nepal is blessed with rich handicrafts.

According to FHAN, there are around sixteen hundred firms associated with the Federation. Among them, around twelve hundred are formal firms while the remaining still operate informally. As compared to other industries, more number of firms, associated with the Federation, in the Handicrafts industry are operating formally; reason being most firms are export oriented which requires formalization from their end.

According to official data from FHAN, Nepal's handicraft sector has been providing direct employment to 916,852 people. But Rishi Raj Subedi, Deputy Director of FHAN believes that as many as 1.5 million people are being employed in this sector both formally and informally. He further states that the handicraft industry employs an even larger number of people because a fair amount of manufacturers who are home and/or cottage based have other family members directly engaged in production.

Market of traditional handicraft products has expanded with the rise in interest of foreigners in the recent years. As a result, handicraft sector has evolved as one of the major sources of foreign currency in Nepal. It contributes about 5-6% of the total export of Nepal. Handicrafts worth NRs 4.8 billion were exported from Nepal in the fiscal year 2014/15. But exporters claim that handicraft items worth around Rs. 7 billion went outside the country including those going through informal channel (Karobar, 2014). Although 1,500 entrepreneurs are affiliated to the Federation, only around 400 entrepreneurs have been exporting handicrafts (The Himalayan Times, 2017).

FHAN has listed a wide range of products under the handicraft industry. From woollen carpet and Dhaka products to metal craft and bamboo products, all the products that are made from human effort rather than modern machinery are recognised as handicrafts by FHAN.

Table 2: Handicraft exports (Amount in NRs.)

S.N.	Description	F/Y 2013/14	F/Y 2014/15
	A Textile Products :		
1	Pashmina Products	793,632,764	517,757,266
2	Woollen Goods	619,446,798	593,017,238
3	Felt Products	738,566,740	916,565,389
4	Silk Products	48,870,008	49,351,465
5	Cotton Goods	230,968,293	190,767,074
6	Hemp Goods	30,614,742	22,230,063
7	Allo Goods	1,739,589	2,056,974
8	Dhaka Products	1,197,932	1,378,701
9	Misc.Textile Products	18,558,436	13,913,933
	Sub Total :	**2,483,595,301**	**2,307,038,103**
	B Non Textile Products :		
1	Silver Jewellery	198,498,016	164,314,900
2	Metal Craft	1,105,184,488	1,091,948,843
3	Handmade Paper Products	414,727,980	404,697,041
4	Wood Craft	112,110,663	111,963,523
5	Glass Products	201,718,293	217,936,278
6	Bone & Horn Products	85,449,484	62,385,086
7	Crystal Products	1,864,246	2,852,543
8	Ceramics Products	36,769,077	21,910,521
9	Leather Goods	12,772,024	23,122,241
10	Incense	33,389,932	33,122,472
11	Plastic Items	19,341,520	20,397,967
12	Paubha (Thanka)	15,357,176	19,472,930
13	Beads Items	172,833,422	114,087,190
14	Stone Craft	8,229,721	11,997,076
15	Bamboo Products	12,404,746	3,258,722
16	Miscellaneous Goods	121,711,213	174,970,864
	Sub Total :	**2,552,362,003**	**2,478,438,197**
	Grand Total	**5,035,957,304**	**4,785,476,300**

Source: Yearly Comparison Data of Handicraft Goods Exported 2013/14 and 2014/15, FHAN

Due to availability of diverse range of products that are associated with handicrafts, we have taken at hand, gold, silver and metal craft to narrow down our study.

3.2 Major problems/challenges

i. In Nepal, several handicraft firms are family owned enterprises. The members of the family acquire the skill of craftsmanship from the elderly members and this skill is thus, passed from generation to generation. In such family owned enterprises, members of the family produce the final goods by themselves but rely on the large manufacturers and trading companies for purchase orders as well as a market for their products. These sort of enterprises in handicraft sector still remain informal as they do not think it is necessary to register their home-based enterprise. People are still unaware about the advantages associated with business registration and perceive that formalization will only increase their production and compliance cost. Likewise, myriad entrepreneurs opined that the formalization process requires visiting various government agencies. However, at the same time, they are unaware about exactly what are the agencies they need to encounter in the process of formalization. This demonstrates ignorance from the entrepreneurs' end. Furthermore, formalization comes with tax compliance and orderly payment of taxes. Given the vulnerability of the market demand, entrepreneurs are reluctant to formalize their entities and pay taxes on a regular basis.

ii. The "Public Procurement Act" of Nepal government has set Value Added Tax (VAT) registration as a mandatory provision for any firm that wishes to supply goods to the government. But the majority of the firms in the handicraft industry are cottage based and are registered under DCSI and have acquired only Permanent Account Number (PAN). So, this clause has barred most of the handicraft industries especially micro, cottage and small from enjoying the benefits of selling their product to the government.

iii. With the purpose to motivate the manufacturers to export their products, the government has been providing various incentives on exports. According to IEA, 2016, if the manufacturing industries export their products, such industries can get a discount of 10 percent on the total income tax payable. Similarly, on the basis of total volume of exports, the manufacturing industries are liable to get a VAT refund that is levied in the manufacturing process. Additionally, duty drawback facility is available on the imported raw materials, provided that the final output made by processing the imported raw materials is exported.

   When it comes to Micro-enterprises they neither export their goods nor import raw materials directly. They export their products through third party and hence, have not been benefitted by the export incentives provided by the government. It shows that the government initiative to promote the manufacturing sector has not penetrated a great deal of manufacturers. Also, unclear processes and lack of information have made entrepreneurs reluctant to claim duty drawback.

iv. The handicrafts products dealing with metal crafts have been impaired by the absence of clear set of standards. There is no mechanism in place to check whether the quality of products that are sold in the market or exported to a foreign country comply with the international standards or not. This dearth of trademark that proves the products' compliance with the standards, is considered to be one of the major areas of issues for the manufacturers. So, their products which deal with valuable metals like gold and silver have been the victim of forged quality. The use of cadmium (white metal like silver which is toxic to human health) was found used instead of silver on the exported silver jewellery forcing which has caused the downfall of the articles of jewellery exported from Nepal.

3.3 Recommendations

i. The micro entrepreneurs working in the manufacturing of handicrafts are unaware about the benefits of formalization and they lack information about the same. Therefore, in order to bring them into the formal sector, information/ assistance desk pertaining to registration of their industry and registration with tax authority should be established at the municipal/ ward level. This will solve the problem of information gap faced by these businesses.

ii. VAT registration is mandatory for any firm to sell their products to the government. However, most of the handicraft businesses fall under the category of micro and cottage industries and therefore, are not required to get registered in VAT. On one hand, by making the VAT registration optional for these enterprise, the government seems to have made formalization process easy. On the other hand, mandatory requirement of VAT for public procurement has barred them from selling their products to the government, inhibiting their growth. Therefore, VAT registration should be made optional, for supplying the products to the government.

iii. The government on the basis of the requirement of the handicraft importing countries should make clear set of standards. Also, there should be mechanism by which quality of these products could be checked to see whether these products meet the standards or not.

4

Iron and Related

4.1 Overview

Iron and iron related is one of the major micro and small level manufacturing industry. According to the DCSI, it is the fourth largest cottage and small industry in terms of the number and there are 3,769 industries registered under iron and related items till 2072/73 B.S. Additionally, more than four thousand are operating in the informal channel according to the President of Federation of Grill & Fabricators, Mr. Mohan Katuwal. He also added that these formal and informal industries are responsible for an annual transaction of around NRs. 40 billion and for creating more than one hundred sixty thousand direct employment in the economy.

Table 3: Export of Iron and Steel

Fiscal Year	Total export of iron & steel (in 000' Rs)
2011/12	10,784,009
2012/13	11,637,554
2013/14	11,831,564
2014/15	10,276,634
2015/16	4,666,974

Source: Trade and Export Promotion Centre

The iron industries mainly rely on the imported raw materials. But by exporting the finished products, these industries have been successful in making net additions to the currency flow into the country. So this industry has the potential in both domestic and foreign market.

4.2 Major problems/challenges

i. One of the most complained problems of this sector is to get sadiyar, which is a no objection commitment/ consent from neighbours and is considered as a mandatory document while registering the business. All industries including micro and cottage are obliged to present this approval. However, neighbours in this industry are reluctant to give their consent due to the excessive disturbance created by such firms. As a result, myriad firms in this sector are being forced to operate informally.

ii. Similarly, due to the cumbersome process to obtain a no objection commitment approval, iron and related industries are forced to operate in the hinterland, away from the human settlement. But due to rapid urbanisation and increasing migration, the vicinity where industries are operating gets crowded in a short period of time. So, the increasing human settlement in and around the industry is forcing them out of their place as the residents want to get rid of noises that iron industries produce.

iii. The employee turnover in this industry is yet another serious challenge faced by the entrepreneurs. Employees visualise this industry as a getaway route to Gulf countries and consider the skill learned in the domestic iron industries to be beneficial in the global marketplace. Hence, most of the employees work for a very short period of time and seek their future elsewhere. This trend has not only hampered the smooth functioning of their operations but has also barred the entrepreneurs from enjoying the economies of scale in the long run.

4.3 Recommendations

The fact that domestic iron industries create negative externalities in the surrounding cannot be discredited. But simply pushing these industries out of the market because of the noise they produce would be unjust. So, in order to resolve this issue, the government must find a middle ground between the entrepreneur and the surrounding neighbours. One solution could be to levy Pigouvian tax, i.e. the tax on the basis of the negative externalities they produce. This tax money should only be used for the benefits of the local people and their surrounding so that they can directly realize the contribution made by the industries which operate in that locality. By doing so, both industries and people can benefit and can peacefully co-exist in a single society. This process would deem to be highly effective if the local government were to take charge of the tax collection. This would create a conducive environment for the local people to pay tax and access information whilst saving time and money.

i. The lack of incentives and benefits as demanded by labourers are the major reasons for the volatility of labour turnover in this industry. Small and micro iron firms, even though operating for number of years, have not been able to grow to medium and large ones. The main reason behind this is that these firms constantly have to change their operative locations as the neighbours oppose their presence for the negative externalities produced by them. As these firms are not growing, labourers are forced to work with low wages. Hence, the root of this problem is associated with the first problem. If only the first problem could be taken care of, this issue would automatically resolve.

5

Woollen carpet

5.1 Overview

According to Central Carpet Industries Association (CCIA), the art of weaving is an old tradition in Nepal, especially in the mountainous region of the country. Radii, Pakhi, Bakkhu, Darhi (with pile) are well-known Nepalese products produced in these regions using indigenous wool.

Initially, the marketing of these products was confined to the domestic market. The development of an export quality carpet was initiated with the influx of the Tibetan refugees in the early sixties. Credit goes to the Swiss Agency for Technical Assistance (SATA) for their contribution in the development of the carpet industry in Nepal through financial & technical support to the Tibetan refugees' re-settlement programs. In the beginning, the marketing of carpets was limited to tourists visiting the country. Efforts to gain access in the international market arena paid-off in 1964 when the first commercial shipment left to Europe, namely Switzerland. With a good vision and the skills of entrepreneurs, woollen carpets transformed into a nationally recognized commercial commodity and till date remains the most important export product from Nepal.

Table 4: Total export of Woollen Carpet

Fiscal Year	Quantity (sqm)	Value 000'Rs
2011/12	684,455	6,001,657
2012/13	528,611	5,660,341
2013/14	607,431	7,384,950
2014/15	625,437	6,943,061
2015/16	605,294	8,061,417
2016/17*	459,639	6,725,518

*first eleven months of fiscal year

Source: TEPC

In 2000s, Nepalese carpet industry was hit hard when the international community refrained from importing good produced by using child labour. Subsequently, the recession in Europe and United States of America (USA) also affected the exports of woollen carpets. But despite these two big hurdles, carpet industry is slowly picking up its pace in the recent years.

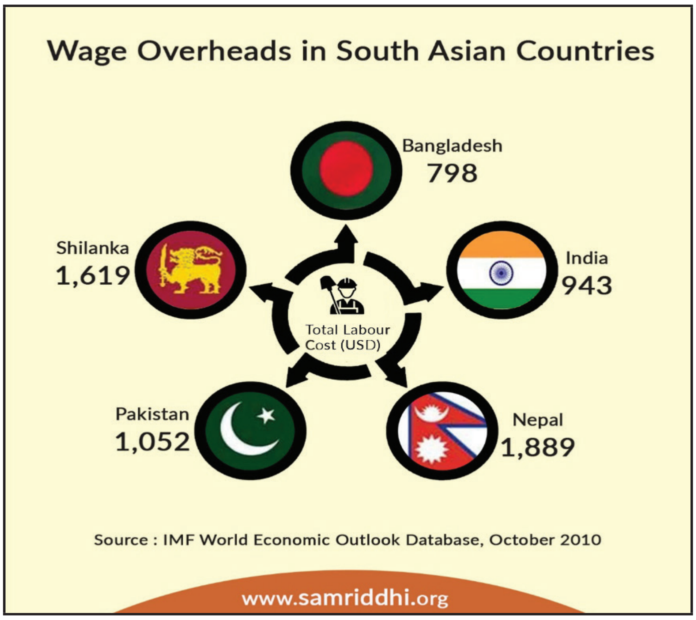
USA has emerged as the largest market for the Nepalese carpet industry, courtesy to the Trade Preference Act of the government of USA. The meeting, led by the Commerce Secretary Naindra Prasad Upadhyay from the Nepal government, and Mark Linscott, Assistant Trade Representative from the United States Trade Representative Office, discussed on a wide range of areas. These included better utilisation of the duty-free quota-free (DFQF) facility for 66 Nepali items in the US market, policy reforms in the intellectual property rights, bringing investment and easing visa process for skilled Nepali labour to the US under mode IV of General Agreement on Trade in Services (GATS) (Shakya, 2016).

The United States, through the Trade Preference Act, has extended DFQF market access to 66 Nepali products that include luggage, handbags, pocket goods, travel bags, carpet, shawls, blankets and headgears, among others, in addition to the regular facility of Generalised System of Preference (GSP). Due to this provision, several Nepalese goods including the handmade carpet have been able to find a market in the US soil. As a result, carpets and other textile coverings worth USD 43 million were exported to USA from Nepal in the year 2016 (The Himalayan Times, 2017).

These products are handmade in nature and can be produced by micro and small enterprises in rural areas as well. Thus, these products have high potential to contribute to poverty reduction as envisaged in the Trade Preference Act of the United States.

5.2 Major problems/challenges

i. While conversing with the carpet entrepreneur about the challenges they encounter, labour related issues topped the list. Firstly, due to the sectorial bargaining of the trade unions, the wage rate of labour has increased manifolds in the past. This sectorial bargaining which increased the wage rate is binding to all the firms in the industries including cottage and small. So, the wage rate of the labourers has been increasing in a regular time interval but labour productivity has remained the same. This trend in the carpet industry has made many cottage and small firms to employ the labourers informally as they are unable to pay this increased wage to the formal labourers. Labour costs in Nepal are the highest in all of South Asia, with a total annual cost per worker of U.S Dollar (USD) 1,889, compared to a cost in Sri Lanka of USD 1,619, Pakistan of USD 1,052, India of USD 943, and Bangladesh of USD 789[1]. Between October of 2010 and October 2011, labour costs have increased by 35% for carpet manufacturers in Nepal.



1 IMF World Economic Outlook Database, October 2010

ii. The micro and cottage carpet manufacturers do not possess the facilities like colouring and washing which is essential to give finishing touch to the carpets. These services require skilled manpower and advance technology which many of the small manufacturers cannot afford. As a result, these manufacturers have no option rather than relying on bigger manufacturers. This semi-production nature not only has compromised a good share of revenue of micro, cottage and small enterprises but also has limited their claim over Government's facilities like income tax exemption, export incentive, duty draw back etc.

iii. Raw material is one of the key factors of production of any good. Likewise, thread extracted from the wool and colours required for dye are the major components to produce a carpet. But Nepal only produces wool, that too, the production does not suffice the actual need. So, in order to fulfill the demand of the carpet, most of the manufacturers have no option but to import the wool. Wools are mostly imported from Tibet and New Zealand. The costs of these imported raw materials are obviously higher than domestically produced raw materials as the cost of transportation and customs are added to them. Hence, insufficient production of raw materials is one of the major problems of carpet industry.

iv. As the major market of Nepalese carpet lies in the foreign countries, efforts to promote and advertise domestic carpet has not been satisfactory. Nepal government has been taking part in a single event known as 'Domotex Fair', held once a year, where only limited numbers of exporters are given the opportunity to endorse their carpets. In order to promote Nepalese carpets in the international market, a single promotional activity cannot be adequate. The Government, CCIA as well as Nepal Carpet Exporter Association have to make necessary efforts to promote Nepalese carpets internationally.

v. The carpet industry, due to absence of any standard related mechanism and unavailability of standard checks, has been hurt numerous times in the past. One fine example is the use of eso element in the dyeing (colouring) process of carpets. This eso element is considered as cancer causing element and has been banned in many countries. But due to lack of knowledge, Nepalese carpet manufacturer have used this chemical in the past.

The exported carpets had to be withdrawn as they could not pass the standard test. Due to absence of standard checks inside the country, Nepalese manufacturers were forced to withdraw their carpets. Not only did these manufacturers incur huge amount of loss but it also tarnished their reputation in the international market. Besides, many countries impose a ban on imported goods that have been produced using child labour. This regulation has refrained Nepalese manufacturers, who employ child labourers to manufacture the goods, from selling their products in the international market. Also, the manufacturers are unfamiliar with the international standard testing mechanisms. Due to this, Nepalese manufacturers are producing low quality carpets with less knot per square inch than specified by international standards, thereby hindering their ability to export.

5.3 Recommendations:

i. With the series of interviews, we came to know that around 80-90% percent of the total carpet produced in Nepal is exported to countries such as USA, Germany, Belgium along with other European countries. This shows high demand for carpets in international markets. However, government does not seem to have done much for the advertisement of Nepalese carpets internationally. To improve that, the government should focus on mobilizing Nepalese Embassies in various countries to advertise and promote Nepalese carpets. Generally, the embassies are only focused on promoting tourism and not in advertising Nepalese products in the foreign market. With proper advertisement, export of Nepalese carpets can be significantly increased.

ii. Due to the lack of standard testing mechanism in Nepal, it cannot be tested whether Nepalese carpets meet the standard set by other countries or not. Because of this, the carpets that have been exported have to be withdrawn, which in turn increases the cost for the manufacturers. Therefore, various standard testing centres should be established in order to test the standard of Nepalese carpets.

iii. Even though government provides duty drawback facilities and other incentives, the process of claiming those is very cumbersome. There are six documents to be presented while applying for duty drawback. They are:

- Custom declaration form for the import of raw materials
- Receipt of duty payment
- Calculation of raw material uses
- Sales invoices
- Certificate of receipt of payment
- Copy of agreement with the buyer

Through interviews with some of the entrepreneurs, it was identified that the entire process of getting duty drawback takes from 4 to 5 months. Given the amount of time taken and the number of documents required, entrepreneurs are reluctant to apply for duty drawback facility.

If only the process of obtaining duty drawback can be made easier by reducing the number of documents and the amount of time required, the entrepreneurs will be able to enjoy this facility provided by the government. This can compensate the cost the entrepreneurs have to bear while importing expensive wool from abroad.

6

Food and Beverage

6.1 Overview

Food and beverage industry is one of the growing subsector under manufacturing sector, in which apart from the big industries, there are a large number of micro, cottage and small industry engaged in processing of food and beverages. Out of the total contribution of 6.3 percent by manufacturing sector, the total value added by food and beverage industry is 34 percent in the fiscal year 2011/12. Even though the share of manufacturing sector has decreased from 9 percent in the fiscal year 2000/01 to 6.3 percent in the fiscal year 2011/12, the share of food and beverage increased from 22.8 percent in 1996 to 34 percent in 2011[2].

Apart from directly contributing to the GDP, food and beverage sector has indirectly supported the agriculture sector. The raw materials required by food industry are agricultural products. In a way, food and beverage industries are major customers of the agriculture sector. Hence, food and beverage sector has boosted the demand for agricultural products and has been a big market for the farmers.

Given the significant share of food and beverages in the total value added to the manufacturing sector, and its indirect contribution to the agriculture sector, it is imperative to promote this sector. Promotion of this sector will not only add more value in the national output but also indirectly contribute to the growth of agriculture sector. For the promotion of food and beverage industry, we first need to identify challenges that this industry is facing.

6.2 Major problems/challenges

As per the Food Regulation, 1970, enterprises who intend to produce or process any food are required to obtain a recommendation from the Central Food Laboratory prior to applying for the registration of industry. The entrepreneur who intends to obtain recommendation has to prepare a scheme setting out the following matters about the industry which he/she intends to establish and make an application to the central food laboratory:

1. Type of Industry
2. Machinery required for the industry
3. Technical skills
4. Provision of sanitation
5. Kinds of raw materials and source for the same

After the application is submitted, the Central Food Laboratory (CFL) makes necessary alterations in the scheme of the proposed industry and provides recommendations ensuring that

2 Development of Manufacturing Industries in Nepal, CBS, 2014

the industry is fit for operations. The entrepreneur can establish the industry only after receiving this recommendation by CFL. Once the industry is established, the entrepreneur has to go back to CFL to obtain a license by making a payment of two hundred rupees, prior to the commencement of production of food.

i. The first problem that we can recognize is the redundant process of getting the recommendation and going back to the CFL to obtain license. This not only increases the total time taken to complete the registration process, but also adds to the entrepreneur's cost, and labour that the entrepreneur could have invested elsewhere. This thus, increases the entrepreneur's opportunity cost. While talking to a few micro entrepreneurs working in food processing industries, we came to know that they were completely unaware about the fact of obtaining a license. These micro entrepreneurs have been operating locally and do not have the complete knowledge about registration of the industry and tax registration which are basic registration required by all kind of businesses in Nepal. Given this scenario we cannot expect micro enterprises to get recommendation from CFL.

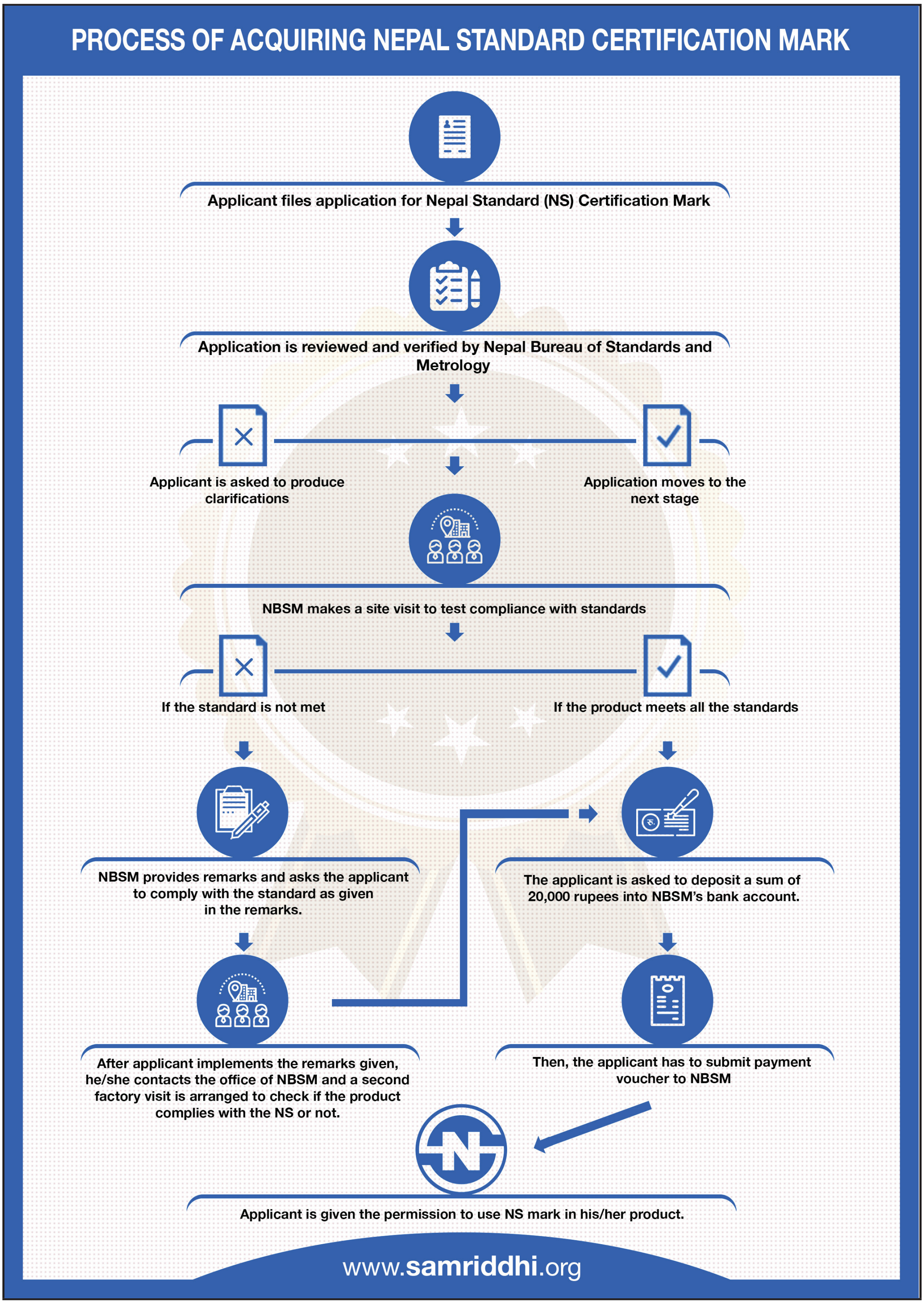
ii. Additionally, any person who intends to produce food in more than one place has to make a separate application and obtain the license for each of such places. Thus, the entrepreneurs who wish to expand their industry and establish industries in multiple places will have to make application multiple times which is very cumbersome. Again, meeting the license compliance multiple times comes with an additional cost in terms of time and labour. In order to meet these compliances, many entrepreneurs seek help from legal experts and have to pay for their service. This directly increases cost of doing business which to some extent has barred the micro enterprises from expanding.

iii. A standard mark is very important for the growth of micro enterprises because it has potential to increase the credibility of their products to reach out to wider markets. However, for getting license for using Nepal Standard (NS) marks provided by Nepal Bureau of Standards and Metrology (NBSM) in the product, there is a significant fee to be paid. Further, the NS mark can only be obtained at the regional and central level. A deposit of Rs. 20,000 and license fee of Rs. 2,000 has to be paid while applying for license to use NS mark. Additionally, after first three years of receiving the license, it has to be renewed every year by making a payment of Rs 1,000. Moreover, obtaining standard mark is very difficult because of bureaucratic hurdles. A box case has been presented where a micro-entrepreneur working in food processing business could not get the NS license despite her effort. As she did not possess the NS certificate she faced myriad hurdles while operating.

Box case.

Basumaya Tamang, Nepali Mann Udhyog, Tarkeshwor, Manmaiju, Goldhunga

Basumaya produces Timur Chhohp. They are a group of 15 women who make it at home. She feels that being registered gives the product an identity and it enables the producer to reach a wider market. She adds that one can only make profit after having access to a wider market. She wants to get the NS mark from NBSM but the cumbersome and lengthy processes have hindered her from doing so. She stated that bribing the officials would have been easier than going through the lengthy procedures; however, she did not opt for that. But all this deprived her from obtaining the NS license due to which she could not sell her product to a desired number of retailers and traders. Retailers and traders constantly refused to buy products from her because she did not have the NS license; Bhatbhateni being one of them. She finally had to sell her products through her networks/contacts.


PROCESS OF ACQUIRING NEPAL STANDARD CERTIFICATION MARK
Applicant files application for Nepal Standard (NS) Certification Mark
Application is reviewed and verified by Nepal Bureau of Standards and Metrology
Applicant is asked to produce clarifications
Application moves to the next stage
NBSM makes a site visit to test compliance with standards
If the standard is not met
If the product meets all the standards
NBSM provides remarks and asks the applicant to comply with the standard as given in the remarks.
The applicant is asked to deposit a sum of 20,000 rupees into NBSM's bank account.
After applicant implements the remarks given, he/she contacts the office of NBSM and a second factory visit is arranged to check if the product complies with the NS or not.
Then, the applicant has to submit payment voucher to NBSM
Applicant is given the permission to use NS mark in his/her product.
www.samriddhi.org

6.3 Recommendations

i. As the task of obtaining NS license is costly and arduous, the Micro enterprises opt for getting collective mark provided by the commodity associations. There are various such associations like FHAN, NMEFEN, etcetera who provide such collective marks to the entrepreneurs. In order to get the collective mark, the entrepreneurs have to get affiliated to these associations. Such affiliation with the association also comes with an annual (renewal) fee ranging from Rs 500 to Rs. 5,000. Dependence on the associations for standardisation can also lead to a compulsory sub-contracting, wherein the MEs lose their independence to reach out to markets on their own and have their unique identity.

   Thus, in order to let micro enterprises grow and reach out to the larger market, the fees to be paid while making application for obtaining license for the NS mark should be significantly reduced and the procedures of getting NS should be made easy. Additionally, NS license can only be obtained at Nepal Bureau of Standards and Metrology at Central level or at Nepal Standards Office at regional level. As the NS certificate can be obtained only through Central or regional offices, many micro entrepreneurs do not have easy access to these offices. Hence, these offices should also be established in at least district levels to increase the reach of the micro entrepreneurs.

ii. The redundant process of having to visit CFL twice- once to obtain recommendation before registration of the business and again to obtain permission after registration of business, can be curtailed to a single visit. A single visit either before or after the registration of business would suffice the purpose and at the same time save the valuable time of the entrepreneurs.

7

Textiles and Readymade Garments

7.1 Overview

The textile sector includes textile, yarn, jute, woollen carpets, garments and pashmina. However, we have looked upon woollen carpets separately, so it has been excluded here. Additionally, we have added garments made from Dhaka and Allo.

Textiles and readymade garments are one of the major sub-sectors of Nepalese Manufacturing sector. Apart from big enterprises producing textiles and readymade garments, there are many micro and small household level textile enterprises operating in Nepal. Nepalese textile industry has a major contribution in Nepal's total export. In the fiscal year 2014/15, the contribution of textile industry comprised of 48 percent[3] of the total exports of hand made goods. The annual average share of the readymade garments is about 20 percent[4] of the total exports. Nepal's total readymade garment exports in the fiscal year 2015/18 was Rs 5,884,597,000[5]. According to the report, Development of Manufacturing Industries in Nepal- Current Status and Future Challenges (2014), out of the total value added by the manufacturing sector in 2011, the share of textiles was 3.8 percent.

Given the export potential of the textiles and readymade garment industry, it is essential to promote this industry. However, there are some problems faced by this industry which are impeding its growth.

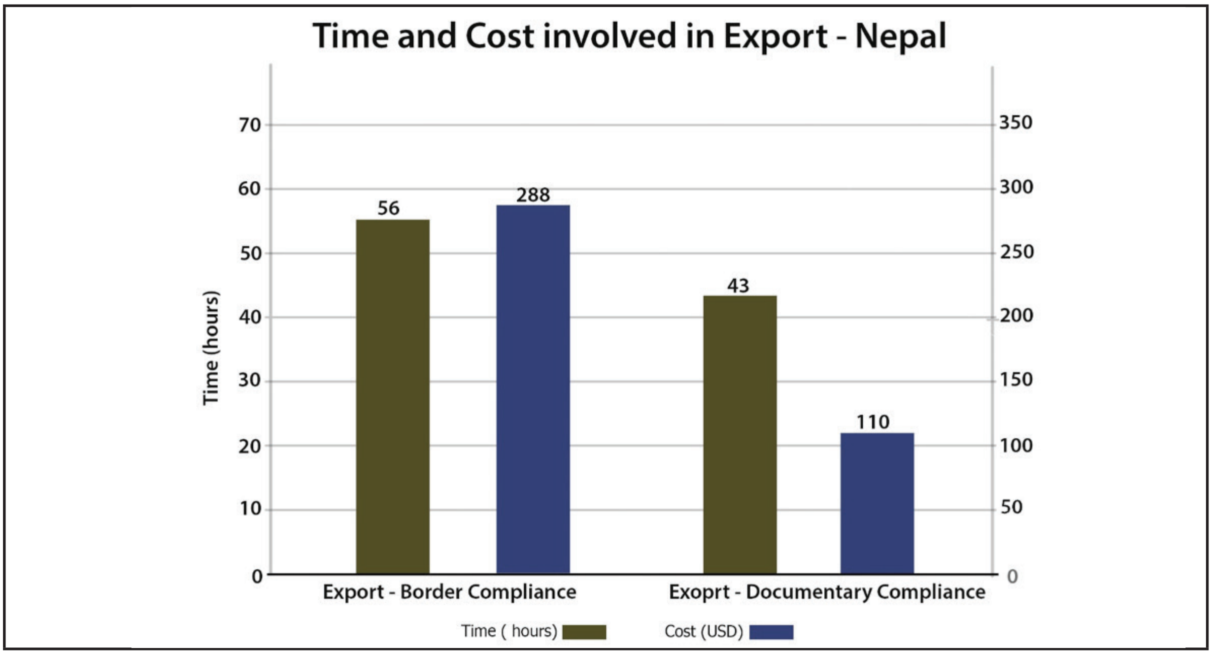
7.2 Major problems/ challenges

i. The taxes on import of raw materials are higher than taxes on import of the finished goods. Thus, for the consumers, the imported textiles are cheaper than the ones made in Nepal. This has served as a discouraging factor for the entrepreneurs producing textiles.

ii. The IEA, 2016 has made a provision of giving duty draw back on imports of raw materials to the industries who intend to use the imported raw materials to produce final goods for the purpose of export. As most of the entrepreneurs in this sector are small scale household manufacturers, they are neither directly involved in importing the raw materials nor are they directly involved in exporting the final readymade garments. Due to lack of information and technical knowledge about cross-border trade and economic infeasibility of exporting small volume of production directly, they are involved in imports and exports through third party. Hence, these small-scale manufacturers have not been benefitted by this policy at all.

3 Yearly Comparison Data of Handicraft goods Exported, Fiscal year 2014/15, FHAN
4 TEPC
5 Garment Association Nepal (GAN)

iii. Larger compliance cost and longer compliance time has also worked as a demotivating factor for exporting textiles and readymade garments. According to the World Bank's Doing Business Report of 2018, it takes 43 hours to meet the documentary compliance and 56 hours to meet border compliance. It costs 398 USD to export a consignment from Nepal. With this given compliance cost and time, Nepal ranks 105 out of 190 countries in trading across border category of Doing Business Index. The high cost of meeting compliance has hindered Nepalese from engaging in cross border trade in a free and easy manner, directly hampering the exports of textiles.



Source: Doing Business Report, 2018, World Bank

7.3 Recommendations

i. In order to promote the micro and small level enterprises, policies focused specifically to these types of enterprises should be devised. As mentioned above micro entrepreneurs cannot claim for duty drawback facilities as they are neither directly involved in importing raw materials nor are they directly involved in exporting the finished products. Therefore, instead of providing duty draw backs, if import duty can be reduced in first place, it will directly benefit small and micro-enterprises involved in manufacturing textiles and readymade garments.

ii. Given the export potential of textiles and readymade garment industry, it is very important to promote this industry to boost up Nepalese exports and reduce the widening trade deficit. But, with high cost of compliance and number of hours required to export a consignment, Nepal ranks low in Trading across Borders component of World Bank's Doing Business Index. The time and cost required to meet the compliances should be significantly reduced and customs procedures should be eased in order to promote the exports.

8 Conclusion

Manufacturing sector is undoubtedly a critical driving force for economic growth and employment generation in Nepal. Given the unskilled and semi-skilled characteristics of Nepalese labour force, the growth of manufacturing establishments can create employment opportunities in a large scale. Furthermore, the manufacturing sector also provides opportunities for micro and small entrepreneurs in self-generation of employment and engagement in entrepreneurial activities. But, as identified by the paper, there are various obstacles and challenges faced by these micro manufacturing enterprises, which have adversely affected their growth.

The micro manufacturing enterprises have reported various problems that they face. The formalization process involves various steps and requirement to visit multiple government agencies (because of which many micro enterprises opt to remain in the informal economy). Arduous process of getting license related to standards, difficulty in meeting export compliances, lengthy process of claiming duty drawback facilities and other export incentives, blanket policies for enterprises of all scale, among others have impede growth of microenterprises in Nepal.

In order to ease the formalization process for existing informal enterprises and to promote growth of the formal microenterprises, these issues and the sector- wise problems explained above should be taken into serious consideration. Without considering these problems which have been identified through direct interview with micro and small entrepreneurs, any attempt to promote microenterprises might not work in an efficient manner.

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