



## Dispatches from The Hall of Ideas!

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### NEPAL'S ECONOMIC REALITY\*

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In the early 1990s Nepal initiated a series of reforms. Many know of it as the first generation of reforms, and many are still unaware. The story of SUJAL foods best captures what these reforms entailed. Before the first generation of reforms, Nepal had many regulations in place; together, these regulations established an architecture aptly termed the License Raaj. The core of our business has always been manufacturing confectionaries; to that extent, sugar is our primary raw material. Such was the system back then that a particular company was only allowed to import a certain quantity of sugar<sup>1</sup>. My family had found a way to work around the matter by incorporating several companies to import higher amounts of sugar. It was only after the first-generation reforms that these companies were merged to form a single entity—SUJAL Foods<sup>2</sup>.

Prior to the first generation of reforms, business regulations were feudalistic. Numerous licenses were in place, and one had to be closer to the state, i.e., the monarch, to successfully obtain a license. It should then not be surprising that only a

- 1 There was quota on the amount of sugar that could be imported. In addition, any importer would require the permission of the Chief District Officer and would also have to ensure that all other formalities have been completed.
- 2 The name SUJAL is also an amalgamation of the names of the different companies.

\* The text is an abridged and translated version of the February 2025 edition of Sambaaad @ Samridhi. Sambaaad @ Samridhi is a monthly discussion on contemporary issues held on the last Friday of each month. In this edition, Niranjan Shrestha shares his insights on Nepal's Economic Reality. The discussion was moderated by Robin Sitoula.

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handful of businesses were successful. While many found a way to work around these regulations, the existence of stringent licensing mechanisms meant that growing a business was nigh on impossible. But all this changed when the licensing mechanisms were dismantled. Nepal was open for business; consequently, many businesses that had earlier found it difficult to expand grew rapidly. SUJAL was also one of these businesses. Foreign Direct investment was permitted, financial access grew as more banks started their operation, and electricity was cheaper because of investments in generation. The results were also apparent; in 1994, our GDP grew by 8.22 per cent. Further changes were also made, including the introduction of Value Added Tax in 1996 and the revision of custom slabs.

But this momentum could not be sustained. I would argue that this happened for two reasons. First was the Civil Conflict in Nepal, and second was the failure to start the Arun Hydropower project. On the first cause, operating a manufacturing business became difficult in Nepal. Factories could no longer operate for more than 8 hours, and labor-industry relations became increasingly hostile. On the second cause, the Arun Hydropower project would have improved the competitiveness of the Nepali manufacturing sector by making electricity cheaper. At one period of time, Nepal had a more favorable business environment than India. The cost of doing business was lower, given road connectivity and cheap electricity. Arun would have brought down the costs even more, but for many reasons the project was never started.

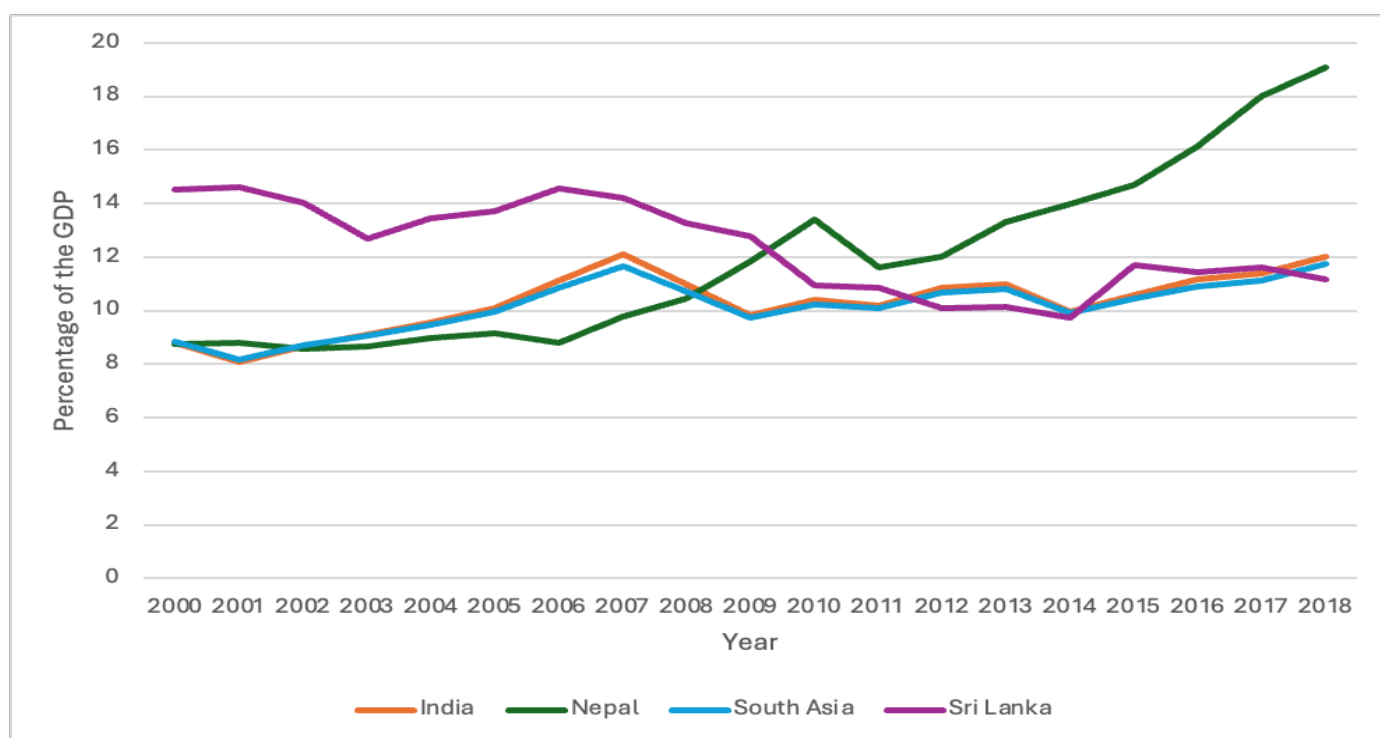
When the peace agreement was finally signed in 2006, the Nepali private sector was slightly hopeful. It felt that survival was finally possible. But the damage had already been done. Remaining competitive in the manufacturing sector was no longer possible given the leaps that our neighbors had made. Thus came the shift from manufacturing to the trading sector. We also followed suit by venturing into trading cars. The institutional memory of the reforms similarly waned. The political landscape was dominated by parties that were left of the center, and this was reflected in the policies as well.

The biggest damage to our economy came in 2008. The state increasingly pursued a policy of higher taxation. Whereas every other country in South Asia has more or less decreased or maintained a consistent level of tax-GDP ratio, Nepal has since 2008 increased its Tax-GDP ratio by 7.5 percentage points. In 2022, Nepal's tax-GDP ratio was 17.5 percent, and the South Asian average was 11.7 percent. The average Nepali disposable income is lower today, the result is thus a lower demand and consequently shrinking business activity. Consequently, private sector gross fixed capital formation has not increased substantially, in fact between 2008 and 2023, it has declined by 1.18 percentage points. I would also argue that outward migration is driven by Nepal's taxation policy than anything else. Since 2008, Nepal has increasingly taxed the middle-class. That economic activity has remained stagnant since then and outward migration has increased should not be surprising.

What is worth noting is that within the same period, domestic credit to the private sector increased by 20.5 percentage points. The obvious question then is where has the money gone? Nearly everyone would agree that the money has been invested in the real estate sector. Absent any sector for investment, the obvious choice has been real estate. The fact that our GDP growth rate within the same period has been minimal further substantiates the claim that investment has largely been made in the unproductive sector.

There is an additional factor worth noting here which I will explain through a personal anecdote. Every month when the interest on the loan my company has taken is due, I gather all the staff from my finance department and ask them a simple question—Who is the risktaker, us or the banks? The answer is always us; if businesses are the ones taking greater risks, then what should happen naturally is that the return rate for businesses should be more than the rate of return for banks. What happens in Nepal is the opposite. Banks average a profit of around 18 per cent, businesses average around 3-4 per cent. It thus does not make sense to invest in businesses by availing of lending facilities. Banks today operate in the most risk-free environment, and as a result, the private sector has also lobbied for a risk-free environment. Its manifestation has been in the form of a protectionist policy since 2019. Earlier, only three slabs of customs existed. Today, there are seven slabs, and they offer protection to the domestic industry from competition. I distinctly

**Figure 1: Tax-GDP ratio in select South Asian Countries**

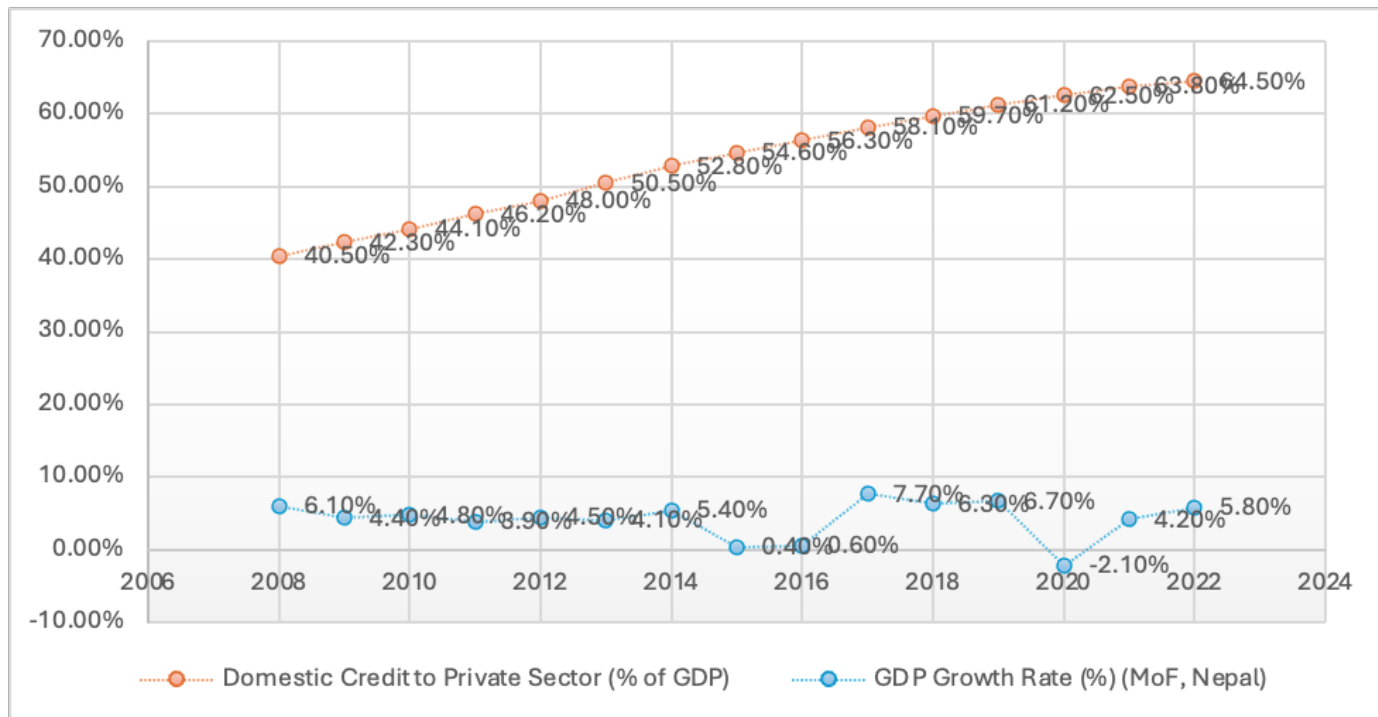


Source: World Bank

remember the situation being very different. The first generation of reforms offered minimal protection, the outlook was always “compete or shut down”. The highest rate of customs then was just 20 per cent. Today the rate ranges from anywhere between 0-80 per cent.

the size of informal economy has only increased. I would argue that informal trading activities then provided a modest sum of seed money to engage in other forms informal trade. The second incident was the import restrictions imposed in 2022. Together, these two incidents fueled informal

**Figure 2: Domestic Credit to Private Sector and GDP Growth Rate**



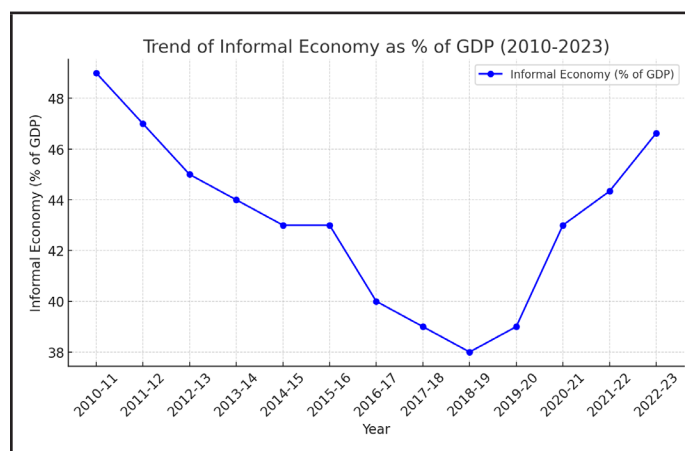
Source: Nepal Rastra Bank

Furthermore, Nepal practices a mortgage-based lending system. The most predominant form of mortgage is land. To that extent land is most sought-after asset. Consequently, the price of land has doubled every 3-4 years. By and large the investment in land together with the increase in prices has created a real estate bubble. I would argue that the bubble would have burst in 2015, the earthquake and the resulting investment in reconstruction and the Covid-19 postponed the real estate crisis. What we see today i.e. excess liquidity and rising proportion of Non-Performing assets is merely the bubble bursting.

The private sector often laments that the economy is in a crisis. Economists often argue that because business activities as observed through common market place activities has remained the same, the economy is doing well. What economists often forget is the size of informal activity in Nepal. There are two events worth highlighting. The first is the 2015 blockade. When the borders between India and Nepal were shut down in 2015, informal activity increased. Petroleum shortage across the country provided bootleggers the opportunity to engage in cross border informal trade. Since then,

trade, as a result the service sector in Nepal still operational and profitable. It is money from the informal trade that has cushioned the economy to a larger degree.

**Figure 3: Informal Economy as a percentage of GDP**

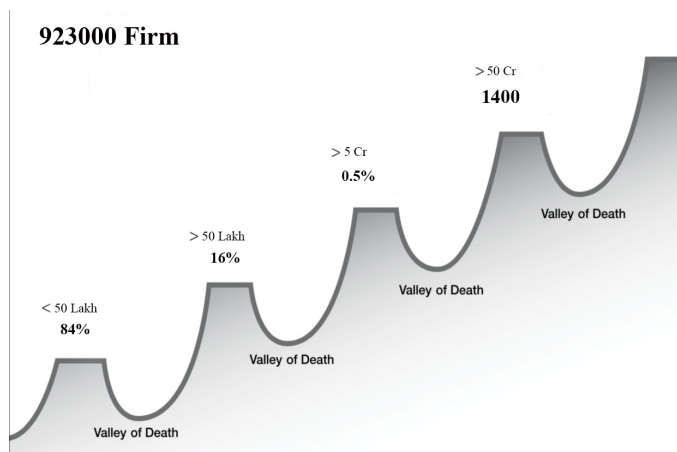


Source: Nepal Rastra Bank

The structure of the economy is such that we have a large share of micro enterprises, of the 923000 firms in Nepal 84 percent of the firms have fixed capital worth less than NPR 5,000,000, only 0.5

per cent of the firms have fixed capital worth more than NPR 50,000,000. Medium-sized enterprises in Nepal are limited, for any country to have a robust ecosystem, it needs medium-sized enterprises across the value chain. But Nepali firms cant scale up, micro-enterprises remain micro and rarely do they transform into medium-sized enterprises.

**Figure 4: Number of Enterprises by size of capital**



Source: National Economic Census

Nepal’s economy is not doing fine. We have another three years to fix it, but if we don’t then we will have missed the window of opportunity. We are already an ageing society, the average age right now is 25, our population has already witnessed a negative growth rate and first generation of reforms can only sustain the economy for a limited time. Rent-seeking and kleptocracy has increased in Nepal and absent a strong focus on correctional measures, business-as-usual is no longer possible. The ordinance has made the private sector hopeful, more reforms in that direction is needed and urgent.

