Economic Reforms for Economic Prosperity: There is no Alternative to Speedy Reform

ASIA’S PATH FORWARD

By Sujeev Shakya | 23 September 2020
SUMMARY

The post-pandemic recovery will require large sums of investment that will not be met through interventions from development partners. Nepal will have to open itself to foreign investments by competing with other countries to attract investments and technology to push growth along with crafting a good policy around foreign assistance that keeps it focused. There has to be a shift from myopic inward-looking policies that promote crony capitalism to ensuring opening up of the economy, loosening bureaucratic hurdles and dismantling private sector cartels. These, in conjunction with an innovation-promoting environment, young entrepreneurs pushing start-ups, women-led enterprises, geographical inclusion focusing on rural areas, facilitation of different fund structures and pushing sub-regional partnerships will help Nepal to get back to building a prosperous Nepal.

BACKGROUND

The formal Nepali private sector is less than a hundred years old. Before the restoration of multiparty democracy in 1990, the private sector was closely linked to the aristocracy via the caste system. Only privileged individuals could start a businesses and governing regulations unconditionally favored them. This patronage system posed a barrier to new entrepreneurship. Only those with the royal connections could start a business in partnership with the palace members. The private sector growth during this time was, therefore, sluggish.

Various market-oriented reforms were implemented after the 1990 Jana Andolan (People’s Movement I), which saw the establishment of constitutional monarchy. Various sectors were deregulated, including finance, tourism, aviation, insurance, and power development; the industrial licensing system was also scrapped. This period also witnessed a significant inflow of FDI. However, businesses established during the Rana and Panchayat regimes exerted power and utilized their political and governmental patrons to preclude many such reforms from taking place; rampant lobbying by the private sector also limited the market access of international investors. Consequently, during this period the culture of forming business associations thrived as a means to garner group power to impede reforms.

The Second People's Movement of 2006 saw the end of the 240-year-old monarchy. However, it was not until 2015 that a new constitution could be ratified and only in 2018 that Nepal officially became a Federal Democratic Republic. Despite these drastic changes in the government and governance structure, the private sector became more used to rent-seeking on uncertainty using political connections to restrict reform. After the protectionist measures in US and India, they further found excuses to restrict reforms, bring in FDI and ensure ease of doing business.
Cartels Proliferate Impending reforms: As Nepal looks to become a middle-income country by 2030, it faces major challenges with regards to foreign investment and the continuing dominance of the ‘cartelpreneurs.’ Nepal’s economy is plagued by cartels in practically all sectors, leading to substandard services, higher prices and overall economic inefficiency while breeding unethical practices such as creating artificial shortages, etc. Cartels have become a way of life in Nepal. They are all-pervasive and present in some form or another throughout the economy. Consumers in the lower income bracket face the brunt of this cartel economy. As consumption spending increases for even the most basic goods and services needed for survival, spending capacity for other requirements decreases, lowering the overall standard of living.¹

Competition is seen as one of the major drivers for economic growth and for firms to become more efficient and productive. It raises the chances of producing quality goods and services and also makes room for consumer choice and therefore innovations. Liberalization encourages competition, as seen when the government converted state owned Nepal Telecom into a public limited company selling its shares to general public, allowed private companies and opened up to increasing mobile technology activities. However, the government still has a monopoly over many utilities such as transportation, petroleum products and to an extent, electricity. Business sectors where the government is not a monopoly have developed anti-competitive behavior in the form of cartels, price fixing and barriers to entry. These anti-competitive practices negatively affect the growth of all sectors.²

Businesspeople Do Politics and Politicians Do Business: There are over 200 associations in Nepal, between those registered under Federation of Nepalese Chamber of Commerce and Industries (FNCCI) and the Nepal Chamber of Commerce (NCC) as well as unregistered associations. These associations have strong ties to political parties and lawmakers thereby giving them leeway to push for policies that give them maximum advantage and make it easier for them to further status quo. Occasionally, when the government undertakes regulatory initiatives like inspections, associations block the initiative by

¹ “Understanding the Cartel Economy”, Nepal Economic Forum, 10 January 2018
Shakya, Sujeev. “Cartels against Reform”, The Kathmandu Post, September 2, 2014
threatening to strike. In this sense, the associations have become above the rule of law, taking the role of the regulator.\(^3\)

**Foreigners Don’t Invest: the Nepali Definition of FDI:** Nepal has an unwelcoming attitude towards foreign investment, prompting some to speculate that the Nepali definition of FDI is really “foreigners don’t invest.” In addition to legal issues, the Nepali government harasses investors through procedural obstacles. With low domestic capital formation, only foreign investments can provide much-needed impetus to economic growth. The government hypocritically attempts to attract investment as a matter of policy while frustrating it in through regulation in practice. Nepal’s outlook remains fundamentally protectionist. The distributive and protectionist policies of the current Communist government and previous socialist governments have only hindered the growth of FDI. Nepal has yet to grasp that it must compete for foreign investment with hundreds of countries — there are no investors queueing up to come to Nepal.

The private sector acts as the biggest impediment to reforms by resisting legislative reform. For instance, construction companies have cooperated as a cartel (registered as an association) to block the promulgation of a law requiring construction to follow international standards. Similarly, sugar producers successfully lobbied for a ban on the import of sugar. Dairy companies pushed the government to put agriculture on the prohibited list for foreign investment, blocking international agribusiness companies from entering Nepal.

In many countries, the private sector drives the agenda for economic reform as it is believed that an opening up to foreign investments and integrating with the global economy brings about newer opportunities. Nepal’s private sector, on the other hand, is largely inward-looking and does not want to compete with the globalized world. Private sector associations therefore spend more time blocking the entry of international firms to sectors they operate in, rather than acting as a driving force for positive economic reform. They would like to trade in foreign manufactured goods, but are uncomfortable with anything beyond that.

**One Step Forward, Two Steps Backward:** When Nepal’s Prime Minister, KP Sharma Oli, finally made it to the World Economic Forum in Davos in January 2019, it seemed that the communist government was considering opening Nepal for foreign investment. The Nepal Investment Summit was held in March 2019 and a buzz arose in the international media as many foreign investors thought Nepal was

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\(^3\)“Political Economy Analysis (PEA) of Business Houses in Nepal”, Nepal Economic Forum, 17 November 2017
now ready for investment. But less than a month later, the government put agriculture on the restricted list for foreign investments. Then, the government decided to increase the minimum threshold for foreign investments to US$500,000 at the behest of protectionist business associations. The government refuses to upset its source of political funding the Nepali business community. By the end of 2019, the government had made many economically nonsensical decisions, including the Central Bank's decision to restrict access to foreign exchange.

MAKING REFORMS HAPPEN

After attending the Nepal Investment Summit 2019 and covering side events, Sheetal Kharka of Business World wrote:

“For over few decades when you heard the country's name Nepal- the episodes came into the global minds was the massive hijack, the massacre of the royal kingdom, the Maoist insurgency and the most recent earthquake with the blockade that almost destroyed beautiful Nepal - a destination for mountaineers & holidaymakers in the world! Somehow it always was in news for its political shift and for being a poor & low-income economy - Nepal as of today has moved forward of its conflicting past to a stable government and has made itself identified as a new Investment hub to watch-out for – for the global economy.”

She also wrote about projecting Nepal as a major investment destination: “Nepal is targeting to get 20 billion USD a year – government spends 5 billion dollars a year and they need another 15 billion to become double-digit growth – domestic and private sector can take another 5 or 6 billion so we need almost 10 billion dollars of foreign investments to promote us to double-digit growth and become middle-income economy.”

Planning for Transformative Reform: Nepal needs transformative reform. The recalibration of thinking is a big exercise; we need to start. Nepal’s formal economy is valued at US$30 billion, up to US$75 billion when factoring in the informal economy. We need to be able to think like a $75 billion economy, with government spending of $7-8 billion dollars each year, but planning is alien to our day-to-day life in Nepal. So how can a country whose citizens do not plan, or do not believe in planning, plan for its

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5 Ibid [4]
government? We have not been able to use the money that is available due to poor planning. The more than $4 billion pledged after the earthquake was never even budgeted. Up to thirty percent of the budget has come from international aid in recent years. More aid has never led to improved economic growth. If a country’s development strategy is not right, aid will flow to the wrong places. Nepal’s future transformation will depend on whether we can learn to ‘walk the talk’ and question each aspect of our everyday life.

With the aid of a strong private sector, the government needs to work on six areas of reform to ensure Nepali economy integrates with the global economy: land reform, tax reform, capital market reform, financial sector reform, labor reform and fiscal reform. CIPE and other international organizations can work with key private sector think tanks in Nepal to draw on existing institutional knowledge.

The cause of reform can be taken up by policy institutions that have a sustainable source for their existence. The Nepali private sector needs to learn to support policy institutions that are working towards building the right frameworks for policy, institutional structures, and legislations. For these institutions to succeed, we need more people that can analyze global practices and Nepali pragmatism. Perhaps for Nepal to embrace a narrative of transformation, it needs more people studying business and economics to start off as reporters, investigative journalists, and columnists to provide stories that are backed by data.

The change has to be driven by global ambitions, a moving away from mediocrity and breaking away from a protectionist mindset and a willingness to compete with global firms. Everyone must have realized that money is not the problem. Rather, it is the recalibration of the mindset of people in politics, bureaucracy, business and professional organizations. There must be a transformation in the way we talk about Nepal, and the way we sell Nepal as an investment destination. Also, we have to improve our record of implementation. CIPE and other global institutions can bring knowledge transfers to make this happen through exchange programs as well as focused interventions.

Facilitating FDI: The word choice in naming the ‘Foreign Investment Technology Transfer Act’ instead of ‘Foreign Investment Facilitation Act’ is wrong in itself. This shows that amendments are not as progressive as they should have been. The objective of amending these acts is to ease business and facilitate investments. But our focus has always been on regulation and control, which makes conducting business full of hassles and uncomfortable for businesses. For instance, the government

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has recently introduced new regulations to govern private equity and venture capital, but the document is in Nepali. This shows the narrow vision of Nepali stakeholders. We cannot dream of large scale FDI if we continue to have every document written in Nepali. To kickstart post pandemic economic growth, there is an urgent need for foreign capital and technology.

Fostering Entrepreneurial culture: On the positive side, more start-up entrepreneurs emerged and Nepalis are traveling like never before, exploring their own country and beyond. Art, music, literature, and other forms of creative voice remain strong. There are more young people returning after studies abroad. These are opening cafes and businesses supported by technology platforms and building a foundation that will help to unleash Nepal’s potential. The pandemic also saw many new businesses emerge, and young people starting different platforms to make buyers and sellers meet. This needs to be institutionalized. Similarly, as in the aftermath of the earthquake, there is an opportunity to create institutions that will train people, since people will need money to restart their lives, be it for building their livestock inventory or a seed bank and agricultural inputs. Fostering entrepreneurial culture will lead the way for this. It will also have direct influence on the internationalization of technology, human resource and capital and information flows. It is very important to have a well-educated labor force and a flexible labor market that puts productivity and merit above privilege and protection. Institutions like CIPE can through, through their networks, bring in global institutions to kick-start Nepali ones.

This Asia’s Path Forward paper addresses Restarting Economies. Visit CIPE.org for further Asia’s Path Forward papers on the six essential themes for an economic recovery roadmap:

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