

ECONOMIC POLICY NETWORK

Policy Paper 31

PROMOTING NEPAL AS A MANUFACTURING HUB

Min Bahadur Karki

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Prepared for:

Economic Policy Network
Government of Nepal/ Ministry of Finance
Singha Durbar, Kathmandu, Nepal
Tel: 977-1-4211353
E-mail: epn@mof.gov.np
Website: www.mof.gov.np

and

Asian Development Bank
Nepal Resident Mission
Srikunj, Kamaldi, Ward No. 31
P.O. Box 5017, Kathmandu, Nepal
Tel: 977-1-4227779
Fax: 977-1-4225063
E-mail: adbnrm@adb.org
Website: www.adb.org/nrm

This report has been prepared by Mr. Min B. Karki, Trade and Investment Specialist.

Inputs from various stakeholders during interactions at the Advisory Committee meeting, and the regional workshop in Birgunj, Parsha District organized by the EPN Focal Unit have been incorporated in the report.

Foreword

Economic Policy Network (EPN) initiated in August 2004 is an undertaking of the Government of Nepal with an Asian Development Bank (ADB) Technical Assistance (TA) to develop and institutionalize an open, responsive and result oriented economic policy formulation process based on sound economic analysis and dialogues with the partnership of public and private sector, academia, and independent professionals, to support and consolidate the Government's economic policy reforms on poverty reduction strategy. The initial focus has been in the areas of macroeconomic management; trade, investment and employment; infrastructure development; and tourism, agriculture, and regional development through four thematic advisory committees chaired by the secretaries of the respective implementing ministries, and guided by a high-level steering committee. The present study is an outcome of the initiative under the Advisory Committee for Economic Policy on International Trade, Investment, and Employment chaired by the Secretary of the Ministry of Industry, Commerce, and Supplies.

This report has reviewed the present status of sector-wise investment, both FDI and domestic, in the manufacturing sector. It has identified legal, economic and policy related problems in attracting significant investments in Nepal. The study has also attempted to make suggestion to effectively harness some comparative analysis is also done with respect to present status of investments in China, India, Bangladesh, Pakistan and Bhutan and a suitable framework for Nepal is also recommended. The recommendations are the outcomes of consensus reached among major stakeholders through various consultations and the EPN workshop. I hope the findings and recommendations will be helpful for policy makers for future reforms.

I would like to thank Mr. Min B. Karki for carrying out the study. I also thank all those who have provided inputs for the report during the interactions, the advisory committee meetings, and the EPN technical workshop held in Nepal Administrative Staff College, Jawalakhel, Lalitpur. The work of the Advisory Committee for Economic Policy on International Trade, Investment, and Employment is to be commended for selecting the issue and for following through with the study. I would also like to appreciate the entire EPN team for their hard work. Last but not least, I would like to thank the ADB for supporting this initiative.



Dr. Posh Raj Pandey
Member
National Planning Commission
Government of Nepal
[Chairman—EPN Steering Committee]

Abbreviations

ADB	Asian Development Bank
BIMSTEC	Bay of Bengal Initiative for Multi Sectoral Technical and Economic Cooperation
BIT	Bilateral Investment Treaty
BOO	Build, Own, Operate
BOOT	Build, Own, Operate and Transfer
DOI	Department of Industry
EPN	Economic Policy Network
EPZ	Export Processing Zone
FDI	Foreign Direct Investment
FEZ	Free Economic Zone
FTA	Free Trade Agreement
FTZ	Free Trade Zone
GON	Government of Nepal
IPR	Intellectual Property Rights
IT	Information Technology
MIGA	Multilateral Investment Guarantee Agreement
MW	Mega Watts
NRB	Nepal Rastra Bank
NTA	Nepal Telecommunication Authority
OPIC	Overseas Private Investment Corporation
PPP	Public Private Partnership
R&D	Research and Development
SAFTA	South Asia Free Trade Arrangements
SEZ	Special Economic Zone
UNCITRAL	United Nations Commission for International Trade Law
USD	United States Dollars
VAT	Value Added Tax
WCT	World Copyright Treaty
WIPO	World Intellectual Property Organization
WPPT	WIPO Performances and Phonograms Treaty
WTO	World Trade Organization

Table of Contents

EXECUTIVE SUMMARY	i
Chapter I: Status of Investment in the Manufacturing Sector.....	1
Chapter II: Review of Policy, Institutional and Legal Provisions	2
2.1 Open to Foreign Investment.....	2
2.2 Institutional Arrangements.....	2
2.3 Conversion and Transfer Policies	2
2.4 Expropriation and Compensation	3
2.5 Dispute Settlement	3
2.6 Performance Requirements/Investment Incentives.....	4
2.7 Right to Private Ownership and Establishment	5
2.8 Protection of Property Rights.....	5
2.9 Transparency of the Regulatory System	6
2.10 Efficient Capital Markets and Portfolio Investment	6
2.11 Labour Act	6
2.12 Free Trade/ Export Processing/ Special Economic Zones.....	7
2.13 Nepal India Treaty of Trade.....	8
2.14 Time for EIA.....	8
2.15 Holidays	8
2.16 Trade Treaty and Agreements.....	8
2.17 Duty Draw Back System.....	9
2.18 Repatriation.....	9
2.19 Patent, Trademark, Know-how	9
2.20 Legislative.....	9
Chapter III: Strength, Weakness, Opportunities and Prospects for Making Nepal a Manufacturing Hub.....	11
3.1 Strengths	11
3.2 Weaknesses	11
3.3 Opportunities.....	13
3.4 Prospects	14
Chapter IV: Recommendations on What Needs to be Done to Establish Nepal as a Manufacturing Hub	16
4.1 What Attracts Investments to a Country:.....	16
4.2 Nearness to a Large market:	17
4.3 Creating a Promising Manufacturing Environment:.....	17
4.4 Major Challenges in Making Nepal a Manufacturing Hub:	22
4.5 Conclusion:	23
Chapter V: POLICY ACTION MATRIX.....	27

EXECUTIVE SUMMARY

The first and second part of the report reviews the status of investments in Nepal and also the Policy, Institutional and Legal Provisions pertaining to investments in Nepal.

The next section discusses the Strengths, Weaknesses, Opportunities and Prospects for making Nepal a manufacturing hub.

This is followed by the section on what needs to be done to establish Nepal as a Manufacturing Hub.

The next section highlights the major challenges in making Nepal a manufacturing hub followed by a conclusion highlighted by a well formulated strategy for overcoming the set of inherent and generated obstacles for hosting footprint migration in Nepal.

Statistics on FDI in Nepal produced by the Department of Industries shows that in F/Y 2062/63 there were 1093 units with FDI registered with the Department. The total Authorized Capital of these units was NRs. 93312 million out of which the manufacturing sector accounted for NRs. 38,186.54 million or a measly sum of around USD 500 million. In addition, two other important points must also be kept in mind while looking at these statistics. The first is the fact that the amount shown is the Authorized Capital and not the actual inflow of investments and the other is that these statistics refer to companies registered in DOI and not the actual number of projects that have been implemented. In addition, if Indian Joint - Ventures and some projects in the Hydropower sector are not taken into account it is difficult to come across a unit with substantial FDI. This is not a very encouraging scene.

Nepal has always been highly receptive to unhindered investment inflow and has made attempts to put in place legislation and policies for the purpose of attracting FDI into the country. Then what is the reason for the dismal failure in attracting external investments into the Country.

In the past, perhaps the natural and other constraints like those mentioned below, were some of the reasons for lack of flow of external investments into Nepal:

- a. A small and scattered domestic market
- b. Low purchasing power of the consumer
- c. Landlocked and a harsh and unfriendly terrain
- d. Raw material not being available in abundance in the local market
- e. Low labour productivity – in fact it is one of the lowest in Asia
- f. Comatose business sector policies
- g. Lack of business related legislation that would help build the confidence and comfort level of the investing community
- h. A weak capital market that does not support inflow of investment other than FDI, i.e. Portfolio Investment
- i. A labour force hopelessly divided along political party lines

- j. An inflexible Labour Act that does not reflect the current international sentiments, norms and practices.
- k. Infrastructure bottlenecks.
- l. Continuous political instability of the last decade and half.

The above problems are further compounded by the fact that there are inadequate laws, policies and incentives to inspire and excite the potential investor to invest in Nepal. Whatever few laws and policies (Economic, Fiscal, Monetary) were put in place, were unfortunately formulated according to the perspectives of the Nepalese decision makers and planners and did not factor - in the perspective of the investors. As a result these instruments became more of a regulatory mechanism than a promotional instrument. The environment further deteriorated due to the insurgency and the resulting adverse business environment.

However, now the scenario is dramatically different.

- a. True, Nepal is still landlocked, but fortunately it is landlocked by China and India which are two of the largest and fastest growing markets in the World and whose markets the whole world is vying for.
- b. Both these markets are slowly dismantling trade barriers. In addition, India is building a network of roads in the Terai region of Nepal and upgrading custom points along the border. China is building a railroad upto the Northern Border with a possible extension upto Kathmandu.
- c. Nepal has now become a member of several international/regional trade regimes like WTO, SAFTA, BIMSTEC.
- d. The net effect of all these will further facilitate access to these markets and at the same time will help develop a working integration of the Nepalese market with these markets. This will mitigate the effect of the smallness of the Nepalese domestic market.
- e. Nepal has a huge potential Hydropower resource base that could be a major attraction for industries looking for energy to drive their growth. However, due to non - business issues associated with the development of Hydropower in the past Nepal could never capitalize on this huge nature gifted free resource. Even if Nepal had been able to develop only 25,000 MW of its potential Hydropower for use in driving its own industrial growth and for feeding a regional power grid the present Per Capita Income would have been more than double of what it is now. However, now due to democracy being put back on track, the maturing of the political players and the system and changing global and regional realities this vast natural renewal energy resource can be put to use to help attract industrial investments to Nepal.
- f. In the previous decades most of the global companies were vying to set up bases in either India or China. 125 of the Fortune 500 companies have already set up operation in India and China attracts more than USD 55 Billion as FDI every year. However, those companies that had set up operations to manufacture their products in China are now slowly setting up operations elsewhere also in order to remain competitive. India is fast become a high wage economy and so companies may move to a location that is a lesser-cost economy and yet close enough to the huge market that India is.

- g. In Nepal more than 60% of today's population is below 25 years. This huge segment of the population is educated and full of energy and would be a huge pool of manpower for mid - level management purposes.
- h. Nepal is a Least Developed Country and as a member of the LDC it will be the recipient of special package of concessions which will further enable it to enhance its market access and competitive capability.
- i. The cost of labour is low. True, many workers of the blue-collar segment have gone abroad; however, with the entry of women into the workforce there is no shortage of workforce.
- j. Inflow of over one billion USD as remittances from Nepalese working abroad that could help boost the local economy and growth.
- k. After the economic liberalization of the 90s, banks and financial institutions have mushroomed resulting in more funds for viable projects.
- l. A high quality communication network and infrastructure is in place now. This has been further strengthened by the laying of an East - West Optical Fibre Cable network by India and another one along by Kodari Rajmarg by China.
- m. Nepal has an ideal climatic condition for manufacturing activities.

Therefore, given the changed ground realities and a better & positive environment there are enough reasons to be excited about the possibility of Nepal turning into at least a regional manufacturing hub.

What are some critical factors that really influence inflow of investments:

- a. Those that impede investments:
 - 1. Red Tapeism
 - 2. Comatose policies
 - 3. Infrastructure bottlenecks
- b. Indifferent
 - 1. Micro issues
 - 2. Political systems
 - 3. Business risks
- c. what encourages
 - 1. Economic growth rate
 - 2. Sector growth rate
 - 3. Market volume
 - 4. skilled and trained manpowe
 - 5. Abundant energy to drive growth
 - 6. Investment security

- d. Some issues that could make a country competitive and hence support investment inflow
 1. Aspect that contributes to direct costs
 - Import tariff
 - Taxes
 - Cost of capital
 2. Indirect issues
 - Infrastructure
 - Transaction cost
 - Those that hamper productivity

History has shown that nearness to a large, attractive and a sustainably growing market and the existence of a very promising manufacturing environment are some of the more important and critical considerations in establishing a particular location as a manufacturing hub.

The two issues in relation to Nepal:

- a. Large Market:

Nepal has as its neighbours two of the most attractive , largest and fastest growing markets in the World. Therefore, even if it is not a big market in itself, it is attached to such large markets.
- b. A Promising Manufacturing Environment:

Nepal has several inherent and developed strengths, opportunities and prospects for promoting itself as a regional manufacturing hub. Therefore, since Nepal already has an advantageous geographical positioning, if Nepal can now just formulate and put in place a set of legislative and policy reforms in line with the sentiments, norms and practices of the international market place as well as implement new initiatives to enhance the comfort and confidence level of the global investing community and demonstrate the Government of Nepal's strong commitment to encourage and facilitate manufacturing activities and if the decision makers and planners start thinking big, out of the box and forward looking and change their mind set to function more as a promoter rather than a regulator and controller, there is no reason why Nepal cannot be transformed into a vibrant regional manufacturing hub.

Recommendations for creating/enhancing a promising manufacturing environment:

- I. Immediate Legislative and Policy Reforms:
 - a. A minimum set of the following business sector related Acts has to be immediately put in place
 - A Company Act that over - rides all other related Acts
 - Globally compatible Intellectual Property Laws and regulations
 - Bankruptcy Laws and Regulations for easier and painless exit
 - Competition laws to ensure a level playing field for all the players

- Clear cut Acquisition, Merger and Takeover laws for the industrial sector
- b. Encouraging and promoting R&D activities to enable the production of cost competitive, high quality products in Nepal.
- c. Financial Sector Reforms:
- Making of tax administration simpler and more compliance oriented
 - Elimination of discretionary power in the decision making process so that there is less scope for distortion through misinterpretation.
 - Rationalizing and reducing Cost of Capital to make it more competitive
 - Making available a mechanism for easy funding of Mega Projects.
 - Rationalizing taxes and duties to reflect regional ground realities
 - Strengthening Stock Exchange to make the Capital market more vibrant
 - Putting in place other Funding Instruments like off -shore banking and Venture Capital to help build companies in Nepal
 - Allowing the corporate sector to raise financial resources from abroad through various Debt and Equity instruments.
- II. Formulating and implementing a limited sector focused FDI policy that addresses only those areas/products that Nepal could be country competitive in.
- III. In order to supplement FDI investments, allow Portfolio Investments as another means of attracting foreign investments to Nepal.
- IV. Formulate and implement a clear cut Industrial Policy that would provide a set of incentives, protection and facilities comparable to what the other countries of the region are offering and also ensure continuity of the policies contained therein.
- V. Unless quality goods at competitive costs are produced, Nepal can never hope to penetrate the international market and consequently never hope to become a manufacturing hub. The ground reality is that due to several reasons the whole of Nepal can never be promoted as a manufacturing hub. Therefore it is necessary to identify, designate and segregate such special areas and build them up as special areas of excellence through implementation of a special package of incentives, facilities, provisions and Special Labour Laws so that quality goods at competitive costs can be produced there.
- VI. Electricity supplies in Nepal are expensive, in short supply, erratic, and of low quality. Therefore, unbundling of NEA should be carried out immediately and the three separate companies to be set up to handle the Generation, Transmission and Distribution should be privatized.
- VII. Connectivity will have to be further introduced and improved. Building of roads/railways through systems such as PPP, BOOT, BOO etc with the leadership and participation of the private sector should be encouraged. Two other Dry Ports, one in the East and the other in the Mid - West should be built through the participation of the private sector. Early integration with the Asian Highway Network is also desirable to achieve a better regional connectivity.

- VIII. To make movement of people in and out of Nepal easier, quicker and more convenient it is necessary to introduce and implement an Open Sky Policy.
- IX. Residential Visas should be gratis and easily & conveniently made available for the investors and their management team.
- X. Too many Bodies/Agencies have a hand in inward investment flow activities. As a result of the difficulties in achieving cross - agencies coordination, promotion activities are overlooked, diluted and loose focus. Therefore, an independent, high - powered statutory body dedicated exclusively to investment, like a Board Of Investment that exists in other countries with a success story of attracting investments, has to be created so that it can singularly focus - on promoting and facilitating investments into Nepal.

Conclusion:

- a. Nepal is endowed with a huge potential renewable energy base in the form of Hydropower for fueling and driving industrial activities and growth; it has a sound and high quality communication infrastructure network; it has an extremely large pool of educated, young people; it has a large pool of low wage - cost blue - collar workers including a large women workforce; it has a salubrious climate that is extremely favourable for a working environment; it has as its next door neighbours India and China, which are two of the fastest growing markets in the World, and has good connectivity and infrastructure for easy access to these markets; it is a member of several international and regional trade regimes which makes it easy and simple for accessing these markets as well as other regional markets including Bangladesh, which has a huge population.
- b. Now, if Nepal can just formulate and put in place a set of legislative and policy reforms in line with the sentiments, norms and practices of the international market place as well as implement new initiatives to enhance the comfort and confidence level of the global investing community and demonstrate the Government of Nepal's strong commitment to encourage and facilitate manufacturing activities and if the decision makers and planners start thinking big, out of the box and forward looking and change their mind set to function more as a promoter rather than a regulator and controller, there is no reason why Nepal cannot be transformed into a vibrant regional manufacturing hub.
- c. However, at the practical level it is easier said than done. It will be extremely difficult to implement the necessary and required reforms, particularly the ones on the labour related issues, to help supplement , compliment and enhance the strengths, advantages and positive aspects that Nepal has recently acquired or developed for turning it into a regional manufacturing hub. But, this does not necessarily mean that it is not possible to overcome these issues. **China faced land and labour issues and Malaysia faced the 'Bhumiputra' issue in their quest for attracting external investments.**
- d. In order to overcome some of the seemingly insurmountable difficulties that countries like China, Malaysia and even India faced in generating an environment that would be conducive for attracting external investments, they adopted the idea of segregating

pockets or parcel of land where special laws, regulations, facilities and incentives would be applicable which would help enhance the competitiveness of the industries hosted there and at the same time keep them immune from the other laws of the country that could have impeded the flow of external investments. These special areas termed as SEZ/ FTZ/ FEZ, which for all practical purposes were virtually isolated from other parts of the country in terms of application of regular laws and rules of the countries become special areas of excellence which succeeded in attracting large volume of external investments.

- e. Therefore, taking into consideration the changed context, ground realities and environment, what further needs to be done to improve the manufacturing environment in Nepal as well as our country - specific constraints and problems and keeping in view the experience of other countries in solving their similar type of problems, it is recommended that Nepal should also adopt the following three - pronged strategy for promoting Nepal as a regional manufacturing hub and attracting external investments.

1. Legislative and Policy Reforms.

Formulate and implement all legislative and policy reforms that are not categorized as sensitive to the sensitivity of the various sectors of the Stakeholders.

2. Creating Special and Segregated Areas of Excellence.

Create isolated areas that can be turned into areas of excellence the following way:

Identify and segregate large tracts of land in the Terai region, possibly attached to the present Dry Port or those to be built, that will host investments into Nepal. Special laws, rules, regulations and policies that may be sensitive for implementation in other parts of the country will be made applicable in only these areas. These areas could be designated SEZ/FTZ/FEZ or any other name and would provide the following facilities:

- a. The Government of Nepal would acquire land, develop it and set up high quality physical infrastructure like wide roads both internal as well as those connecting it to the rest of the country, information superhighway, water supply, adequate and continuous supply of electricity, a 132 KV transmission line to feed power to the zone, industrial waste management.
- b. This land should be leased out to the potential investors at a very nominal rate for a period of 99 years under a special contract.
- c. Negotiate the extension of an Indian railhead right into this zone.
- d. The lessee will have the right to build any structure conforming to Nepalese building code within the land leased out to him.
- e. A branch of a Foreign Bank would be allowed to be set – up and operate within this special area

- f. Foreign Insurance and Consultancy companies, Venture Capital Firms will also be allowed to set up shop there and operate
- g. Special labour laws with provisions like those stated below to be formulated and implemented specifically for these zones:
 - Productivity linked system of wages
 - the cost of labour in Nepal has become a fixed cost for the industry whereas in other parts of the developed World it is a variable cost where the number of people hired can fluctuate with the business status and condition of the industry. This flexibility is essential for the corporate sector to stay competitive. Therefore, the laws must have flexibility in allowing the industry to hire and release workers as per the needs of the industry.
 - The Zones will provide the following incentive package to attract investments and help them remain cost competitive:
 - i. All plant, machinery, instruments, equipments and spares to be allowed to be imported duty free.
 - ii. 100% repatriation of profits and capital
 - iii. A 10 year tax holiday
 - iv. From 10 to 15 years income tax will be free on all profit ploughed back as capital investment into the existing units.
 - v. R & D Costs can be written off against future payments against VAT/income tax payments.
 - vi. For captive power generation, duty free import of capital goods and subsidy on fuel necessary to run extremely large generators will be provided
 - vii. No export duties will be levied on export of production
 - viii. 20% of production can be sold in the local market; however, duties will be levied as per local rules.

3. Establishing an exclusive Board of Investment.

Set - up a very high powered, independent body (could be called the Board of Investment) BOI, with all the necessary over-riding authority, as referred to earlier in the report, to exclusively promote investments and undertake all necessary coordination as well as all other activities related to inward investments to Nepal.

Chapter I

Status of Investment in the Manufacturing Sector

There were a total of 3302 number of industries registered under Department of Industries (DOI) up to F/Y 2062/63. Out of which, the manufacturing sector accounted for 1753 number, approximately 53.09% of the total. Similarly, the project cost of these industries has been recorded at Rs.225,055.70 million. Out this, the manufacturing sector accounted for Rs. 104,477.50 million, which is approximately about 46.42% of the total authorised capital.¹

Similarly as of F/Y 2062/63, there were 1093 industrial units, registered under the DOI, with foreign direct investments (FDI). The total authorised capital of these units was Rs. 93312.07 million out of which the manufacturing sector accounted for Rs. 38186.54 million which is approximately 40.92%.²

The total FDI in these 1093 industrial units, as of F/Y 2062/63, was Rs. 28885.06 million, which is approximately 30.96% of the authorised capital. Similarly, the FDI in the manufacturing sector was Rs.12534.30 million, which is approximately 32.82% of the authorized capital in industries with FDI in this sector and approximately 43.39% of the total FDI in the industrial sector of Nepal.³

The FDI in industries, registered under the DOI, recorded an all time high of Rs.3102.56 million in the F/Y 2057/58. Likewise, FDI in the manufacturing industries also peaked in the same fiscal year when it recorded Rs. 1816.01 million, approximately 58.53% of the total FDI in industries granted registration by the DOI. During the period, end of F/Y 2046/47 to end of F/Y 2057/58, FDI in the industries, registered under the DOI, grew at an annual rate of approximately 20.51%. Thereafter, up to the end of F/Y 2062/63, FDI in the industrial sector had in fact declined at an annual rate of 9.64%. Likewise, a similar trend also prevailed in the manufacturing sector during these periods with the annual growth of 32.33% percent and an annual decline of 12.63%.

Chapter II

Review of Policy, Institutional and Legal Provisions

2.1 Open to Foreign Investment

Government of Nepal (GON) is open to foreign direct investment, though implementation of its policies is often distorted by bureaucratic delays and inefficiency. Government policy changes have signaled to foreign investors that Nepal is open for business. Nevertheless, significant problems remain. They include lack of direct access to seaports (currently all products imported by ship from third countries enter through Kolkata, India's inefficient river port), difficult land transport, lack of trained personnel, scarce raw materials, inadequate power (especially outside the Kathmandu Valley), non-transparent and discretionary tax administration, inadequate and obscure commercial legislation, and cumbersome labour laws. Policies intended to establish a "one window system" and simplify necessary interactions between investors and the host government have produced few results. Furthermore, there is often a wide discrepancy between the letter of the law and the law's implementation. Foreign investors constantly complain about complex and opaque government procedures and a working-level attitude that is more hostile than accommodating.

The Government has realized the need to attract foreign investments to drive industrial growth in Nepal and is slowly moving toward establishing a more investor-friendly climate. However, even these efforts have not addressed the basic issues of what really would attract foreign investment into any country.

2.2 Institutional Arrangements

The Department of Industry is designated as the "one window servicing agency" with the Industrial Promotion Board as a focal point for foreign investment under the Foreign Investment and Technology Transfer Act. Current administrative procedures do not allow for automatic approval of foreign investments. Foreign investors are required to obtain licenses for manufacturing sector investments, and each license request must be considered individually. Although investments below NRS 1 billion (approximately USD 14 million) are referred to the Department of Industry for action without the involvement of the IPB, in reality, such investment proposals invariably go to the IPB. Foreign investors frequently complain about bureaucratic delays and lack of transparency in procuring investment licenses. In most cases, one to six ministries other than the Ministry of Industry review the business proposal and provide input prior to consideration by the IPB.

Licensing of new investments can be time-consuming. Some foreign investors have reported that the licensing process requires a good lawyer and great patience. The law mandates, however, that the IPB make a licensing decision within 30 days of submission of application, provided all necessary information has been submitted.

2.3 Conversion and Transfer Policies

The Foreign Investment and Technology Transfer Act of 1992, permits foreign investors to repatriate all profits and dividends, all money raised through the sale of shares, all payments of principal and interest on any foreign loans, and any amounts invested in transferring foreign technology. However, convertibility is difficult and not guaranteed. Repatriation of any funds needs approval from the concerned GON department and Nepal Rastra Bank, which regulates foreign exchange. In most cases, approval must be obtained from the Department of Industry. In other cases, such as telecommunications, the Nepal Telecommunications Authority (NTA) must approve the repatriation. In joint venture cases, NRB and the Ministry of Finance must approve. Because commercial banks process only the applications but do none of the oversight, the process slows down when it reaches the NRB, which must verify the authenticity of all requests. In the end, an overworked and inefficient banking system is to blame for slow approval of foreign exchange facilities. The actual experience of American and other foreign investors suggests that there are discrepancies between the government's stated policy of repatriation and its implementation. To repatriate funds from the sale of shares, foreign investors apply to the Nepal Rastra Bank. For repatriation of funds connected with dividends, principal and interest on foreign loans, technology transfer fees, expatriate salaries, allowances, and emoluments, the foreign investor applies to the Department of Industry, and then to the Nepal Rastra Bank. At the first stage of obtaining remittance approval, foreign investors must submit remittance requests to a commercial bank. Generally, foreign investors rated services provided by private banks as satisfactory. However, final remittance approval must be made by the NRB foreign exchange department, at which stage the process slows down significantly. For this reason, foreign investors rated the Nepal Rastra Bank's administration of exchange regulations as unsatisfactory.

2.4 Expropriation and Compensation

The Industrial Enterprise Act of 1992 states that "no industry shall be nationalized." Nepal constantly reiterates this point in negotiations with private-sector firms interested in the hydropower sector. There have been no cases of nationalization in Nepal, nor are any anticipated. Companies can be sealed or confiscated if they do not pay taxes in accordance with Nepali law. There are no official policies either existing or planned that suggest official expropriation should be of concern to prospective investors.

2.5 Dispute Settlement

In the event of a dispute with a foreign investor, the concerned parties are encouraged to settle it through consultation in the presence of the Department of Industry. If the dispute cannot be settled in this manner, cases involving investments less than NRS 500 million (approximately USD 7 million) in value will be referred to arbitration in Nepal according to the Arbitration Rules of the United Nations Commission for International Trade Law (UNCITRAL). For investments that exceed this amount, the government of Nepal will permit stipulation of legal jurisdiction other than Nepal in shareholder agreements and contracts.

The Government is currently considering permitting stipulation of legal jurisdiction other than Nepal in share - holder agreements and contracts involving larger foreign investments, particularly in the hydropower and tourism sector.

There is an effective means of enforcing property rights as all such transactions must be registered and property holding cannot be transferred without following procedures. Even so, property disputes account for half of the current backlog in Nepal's court system and such cases can take years to be settled. Judgments from foreign courts are not accepted as all judgments must be made in Nepali courts.

There is a provision for liquidation in the Company Act. Claimant priorities are: 1) government revenue, 2) creditors, and 3) shareholders. Monetary judgments are made in local currency. Secured interest in property is secured in the Department of Revenue. Machinery collateral is valid in the courts.

Arbitration must be carried out in accordance with UNCITRAL rules. Nepal is a member of the Multilateral Investment Guarantee Agreement (MIGA). Nepal does not accept international arbitrators. Nepal is not a member of nor does it plan to become a member of the International Center for the Settlement of Investment Disputes (ICSID - also known as the Washington Convention) and/or the New York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards

2.6 Performance Requirements/Investment Incentives

The Nepal Laws Revision Act of 2000 has eliminated most tax incentives, regardless of whether they were connected with performance requirements. There is no discrimination against foreign investors with respect to export/import policies or non-tariff barriers. There is no local content or export performance requirement. There is no requirement that nationals own shares that the share of foreign equity is reduced over time, or that technology is transferred. On the other hand, Nepal does employ tax incentives to encourage industries to locate outside the Kathmandu Valley due to pollution and overpopulation and an interest in developing poorer parts of the country.

In general, there is no income tax on profits from exports. Customs, value added tax (VAT), and excise duties are to be reimbursed within 60 days on raw materials used in the production of export items. In practice, however, these duty paybacks are often extensively delayed.

Foreign investors are not required to disclose proprietary information to government agencies as part of the regulatory approval process. There are no restrictions on participation by foreign firms in government-sponsored research and development programs; however, depending upon the nature and expertise required for the job, government agencies sometimes limit such programs to participation by Nepali nationals only.

Beyond fulfilling legal requirements as to minimum investment amount, pollution parameters, restricted sectors, etc., no performance requirements are imposed on foreign investments in Nepal. There is no local content or export performance requirement.

In the case of foreign investments, there is no requirement that nationals own shares, that the share of foreign equity be reduced over time or that technology be transferred on certain terms.

In general, there are no conditions on investment imposed by the Government. However, industries are being encouraged to locate outside the Kathmandu Valley due to concern regarding growing pollution and over population in the capital. The Government expects that most employees will be Nepalese, but managerial, supervisory, and advisory positions can be filled by expatriates. Employment of foreigners must be approved by the Department of Immigration.

Investors are required to disclose proprietary information to the Government only if they wish to register patent rights.

2.7 Right to Private Ownership and Establishment

Foreigners are free to establish and own business enterprises and engage in all forms of business activity with the exception of a few industries. The GON is moving slowly toward open competition in most sectors of the economy.

Nepal does not have a law to guarantee free competition or to restrict unfair forms of competition. However, competitive equality is the official standard applied to private enterprises in competition with public enterprises with respect to market access, credit, and other business operations. That said, there are special subsidies and preferred credit arrangements for individual public and private companies in select sectors, such as rural electrification, fertilizer importation, and the provision of agricultural credit. In a joint initiative of the private sector and the Ministry of Industry, Commerce and Supplies, a new "Competition Law" is being drafted. Although Nepal committed to the enactment of the Competition Law during the negotiation process for its entry to the World Trade Organization (WTO), Nepal missed the July 31, 2004 deadline for its enactment.

2.8 Protection of Property Rights

The Contract Act of 2000 incorporates many new features, including provisions recognizing mortgages, sales, appointment of agents, and shipment of goods as contracts. Protection of intellectual property rights is inadequate. Patent registration, according to the 1965 Patent Design and Trademark Act, is only valid for seven years and can be extended twice for a total period of twenty-one years. In addition, Nepal does not automatically recognize patents awarded by other nations. The Copyright Act of 2002 is similar in that it does not recognize foreign patents; these must be re-registered in Nepal. As per the commitment made by the country on its accession to the World Trade Organization, Nepal must enact new legislation on trade-related intellectual property rights to bring the country into compliance with international norms. Nepal has not yet signed the World Intellectual Property Organization (WIPO) Copyright Treaty (WCT) and the WIPO Performances and Phonograms Treaty (WPPT).

The legal system protects property rights. According to Government officials, patent rights are also protected but the same cannot be said in general of intellectual property rights in that existing rules are not effectively enforced.

The Copyright Law is 30 years old and does not mention modern forms of intellectual property such as computer software. The country is not a party to any major IPR international agreement so foreign works are not protected unless they have been registered in Nepal.

Trademarks can be registered first for seven years and be renewed thereafter. There is no obvious problem with trademark infringement. Original formulas can be patented. Protection of trade sectors is informal at best.

2.9 Transparency of the Regulatory System

Foreign investors in Nepal face a non-transparent legal system. Firms complain that basic legal procedures are neither quick nor routine. The bureaucracy is generally reluctant to accept legal precedents. As a consequence, businesses are often forced to re-litigate issues that had been previously settled. Furthermore, legislation banning foreign investment in financial, legal, and accounting services has made it difficult for investors to find help cutting through regulatory red tape. Labor, health, and safety laws exist but are not properly enforced. Some companies report that the process of terminating unsatisfactory employees is cumbersome and that protective labor laws make it very difficult to bring skilled foreign-national specialists into Nepal.

2.10 Efficient Capital Markets and Portfolio Investment

Credit is allocated on market terms. Foreign-owned companies can obtain loans on the local market. The private sector has access to a variety of credit instruments. Legal, regulatory, and accounting systems are not fully transparent and consistent with international norms. Though auditing is mandatory, professional accounting standards are low.

There is no regulatory system to encourage and facilitate portfolio investment in the industrial sector. Only direct investment is permitted. Stocks of a few industrial firms are listed on the Nepal Stock Exchange, but foreign individuals and institutions are yet permitted to purchase these. There are no legal provisions with respect to private firms defense against hostile take-over.

2.11 Labour Act

Nepal lacks a large labor force of skilled and educated workers. The overall literacy rate is only 40 percent, and only 25 percent for females. Vocational and technical training is poorly developed, and the national system of higher education is overwhelmed by large enrollments. Many secondary and college graduates are unable to find employment in positions commensurate with their education because most of the schools and institutions do not provide job related training. The employment of foreigners is also severely restricted. Under current law, the Department of Immigration must approve the employment of foreigners for

all positions except those at the very top of a company or project. In private organizations, however, a significant number of professionals from India may be found in mid-level managerial positions.

The Constitution provides for the freedom to establish and join unions and associations. It permits restrictions on unions only in cases of subversion, sedition, or similar conditions. Despite the institution of parliamentary democracy in 1990, trade unions are still developing their capacity to organize workers, bargain collectively, and conduct worker education programs and embrace a work culture. The three largest trade unions are affiliated with legal political parties; the Maoists also have an active affiliate trade union. Excluding agriculture labor, a much higher percentage of the formal sector participates in unions.

In 1992, Parliament passed the Labor Act and Trade Union Act, and formulated enabling regulations. The laws permit strikes, except by employees in essential services such as water supply, electricity, and telecommunications. The laws also empower the government to halt a strike or suspend a union's activities if the union disturbs the peace or adversely affects the nation's economic interests. Under the Labor Act, 60 percent of a union's membership must vote in favor of a strike in a secret ballot for the strike to be legal. The government does not restrict unions from joining international labor bodies. Several trade federations and union organizations maintain a variety of international affiliations. While officially there is no government interference in union registration, unions have complained of difficulties in registering members when opposing political parties are in power.

While industrial actions are infrequent, politically motivated actions do sometimes take place. Unrealistic laws, such as the Bonus Act of 1974, which provides that workers must receive 10 percent of yearly profits in bonuses regardless of improvements in productivity, often hamper efforts at collective bargaining. In the past, labor strikes, transporter strikes and other political actions have closed all business and transport operations in major cities, sometimes for days at a time. Such strikes have severely damaged Nepal's business climate. Strikes are unpopular, but are widely viewed as the only available means of political or labor protest.

The Child Labor Prohibition and Regularization Act of 2000 prescribes conditions for 14- to 16-year-old laborers, and prohibits employees under the age of 16 from work in dangerous industries. This act has not been strictly followed.

2.12 Free Trade/ Export Processing/ Special Economic Zones

Nepal has not established any FTZ, EPZ or SEZ. However, any industry exporting 90% or more of its products is entitled to enjoy certain extra facilities. Export-oriented industries may also enjoy bonded warehouse facilities. Raw materials can be imported via entry in a passbook without paying any custom duty or sales tax but bank guarantee has to be provided. The same value of raw materials is deducted from the passbook upon export of the finished product. The industry must also submit a bank guarantee which must be sufficient to cover applicable duties.

2.13 Nepal India Treaty of Trade

The Nepal-India Treaty of Trade signed in 1997 provides free access to India for almost every product with "Made in Nepal" label. The treaty was regarded as a major breakthrough for the virtually India-locked Nepali economy. It was expected that with the treaty foreigners would flock into Nepal to locate their manufacturing facilities here to cater to the Indian market that was till then very much closed to outside world. But this did not really materialize as anticipated because the opportunity was not publicized enough in the initial years among the would-be investors. And the advantage the treaty gave Nepal in 1997 has now substantially reduced for two reasons.

First, India has been increasingly opening its economy to outside world and second, India has also been going on signing treaties with other neighboring countries allowing their products similar concessional entry into India as enjoyed by Nepali products. India already has similar special trading relations with Bhutan as with Nepal. On top of it, India has already signed a Free Trade Agreement with Sri Lanka and is said to be preparing to sign similar one with Bangladesh. These developments indicate that Nepal is fast losing time in capitalizing on the opportunity provided by the Nepal-India treaty.

However, Nepal still has one advantage, which has to be marketed vigorously right now. Whatever foreign investment flows into India, the manufacturing units are most unlikely to be located in the Northern Indian states like Bihar, UP or West Bengal, thanks to the situation there. To cater to these markets, even Indian companies would like to set up their factories in Nepal if they are convinced that the facilities here are better. Another, but a bigger factor, is the fact that India is fast developing into a high cost economy which would encourage the industries intending to move to India to move to Nepal.

2.14 Time for EIA

The initial bad experience is related with the Environmental Impact Assessment (EIA), which is said to take over one year to complete for a company already existing here. For an outsider it would take even more than that, point out some foreign investors calling for some rethinking about the procedures in this regard.

2.15 Holidays

Foreign investors have complaints about frequent strikes and, similarly, frequent holidays. The government announces national holidays for one reason or the other, but it is not made clear whether these holidays are for the industrial units as well. This uncertainty has been resulting in frequent disputes between the management and workers, which can be easily avoided if the authorities just bothered to make it clear in their announcements whether these holidays are also for the industrial workers or not. Some foreign investors also demand that the number of such holidays be fixed quite in advance.

2.16 Trade Treaty and Agreements

Nepal and the United States signed a Bilateral Investment Treaty (BIT) in 1960 which was amended in 1963 to permit extended risk investment guaranties to be provided by the Overseas Private Investment Corporation (OPIC).

2.17 Duty Draw Back System

It takes a long time to implement duty draw back from the government. The law says that the exporter has to apply for duty drawback within a year of the export. In trying to lodge the application within the stipulated time, the bureaucrats create so many problems complaining inadequacy of all the required documents. But the process can be speeded up with possible improvements. To make it simpler, a flat rate for export items should be incorporated.

2.18 Repatriation

As per the Foreign Investment and Technology Transfer Act, 1992, a foreign investor making investment in Nepal shall be entitled to repatriate amounts from Nepal:

A foreign national working in any industry with prior approval of the Department of Labour and who is from a country where convertible foreign currency is in circulation may repatriate salaries, allowances, emoluments etc. in convertible currency in an amount not exceeding 75% of such salaries, allowance and emoluments as well as equity investment.

To obtain the repatriation facility, the foreign investor or the technology supplier or the foreign expatriate or the concerned company must obtain a recommendation from the Department of Industry.

2.19 Patent, Trademark, Know-how

Foreign equity investment does not come alone - it also brings technical support along with it. The term 'technical support' varies in its meaning from industry to industry. For a manufacturing unit, it could be a formulae, patent, trademark, know-how, technical expertise etc. The existing act does not clearly spell out provisions regarding the above matter.

2.20 Legislative

The judiciary has an important role to play in the economic development of the country, particularly in terms of the volume of foreign investment that comes in. Because of weaknesses in the judiciary, many companies have left the country. Many companies want to settle legal complications offshore.

It seems that Nepalese judiciary does not particularly encourage foreign investment, as it does not set a timeframe to end such disputes. The time has come to review the judicial system in order to make it at par with international standards and practices.

Apart from political stability and proper policies, foreign investment depends on the strength and independence of the judiciary. Nepal needs to demonstrate that its judiciary is independent and capable enough of guaranteeing the basic legal requirements of foreign investors.

The Nepalese judiciary has a five-decade-long history and has been people friendly. The courts have upheld the rights of the people, which have helped to instill faith in the masses. The courts need to set similar standards for foreign investors, especially at a time when many multinational companies are knocking its doors.

The judicial system can strengthen the investment climate of the country if its decisions are perceived to be fair. If the local legal system is found to be ineffective, the parties concerned will opt for offshore countries in case of legal problems.

There must be a firm system to show foreign investors that they will receive equal treatment during the period of investment and when pulling out. If there is a hostile situation in withdrawing investment, it will send a negative message to all would-be investors.

Nepal contains several risk factors for foreign investors. The country is vulnerable in terms of geography, market and labor law, power, and lack of work culture of the work force. When the local courts deal with cross-border business issues, they have to follow the norms and principles set and accepted in developed legal systems and the decision should be made under the established principles of such law. If the local court takes a decision on its own, foreign investors may list the judiciary as another risk factor while assessing the viability of any project in Nepal. If that happens, it would spell economic disaster for the country.

Chapter III

Strength, Weakness, Opportunities and Prospects for Making Nepal a Manufacturing Hub

3.1 Strengths

- One of the first countries in South Asia to liberalize its economy.
- Strong and rapidly growing capital flow into the country through off shore remittance from Nepalese working abroad. The current estimate of remittance inflow is estimated to be over Rs. 100 billion.
- A high quality communication infrastructure and network in place. This has been further strengthened with the laying of an East - West Optical Fibre Cable network by India and one along the Kodari Highway by China.
- A large pool of young work force. It estimated that the population below 25 years has now reached 60% of the total population.
- An increasing pool of English speaking educated young work force in the urban area which could support sectors like knowledge based industries.
- Low cost labour force
- Large number of financial institutions and banks sitting on a huge capital that can be used by the viable manufacturing units.
- The building of a network of roads in the Terai region by India coupled with the existing road network and the linking up with the Asian Highway network will enhance transportation connectivity within Nepal as well as with the regional countries including India.
- The building of a railway line upto Nepal's northern border by China and possible future extension upto Kathmandu will enhance market access to Chinese markets.
- A well equipped and modern Dry Port in Birgunj connected by rail to the seaport in India and the upgradation of major custom points along the border will further make trade facilitation easier, quicker and more cost effective.

3.2 Weaknesses

- Poor investment climate and business environment
- A small and scattered domestic market.
- Low purchasing power of a large proportion of the population.
- Political instability and fragile law and order situation.
- Raw materials not available in abundance domestically.
- Low labour productivity
- Labour force divided along political party lines

- Open border with India which encourages informal trade
- Government Bureaucracy acting as a regulator rather than a facilitator on account of and/or resulting in:
 - Excessive government delays in provision of government services
 - Poor administration of tax laws impose unnecessary burden on manufacturing units
 - Poor delegation of authority
 - Inadequate dissemination of information
 - Lack of clarity, consistency and simplicity of laws and regulations
 - Absence of accountability
 - Weak tax administration: too much discretion to tax officials in tax assessments and absence of workable system in resolving tax disputes.
 - Weak customs administration: procedural delays and complicated documentation, inaccurate classification of goods causing arbitrary decisions, delays and unnecessary rental charges, inaccurate valuation of goods, delay in duty drawback scheme and VAT refunds, lack of enforcement and smuggling.
 - Frequent changes in Government policies and regulations, including changes in tariff rates, incentives and facilities (Eg. Introduction of 5 years tax holidays to newly established industries in 1992 and its subsequent removal).
 - Lack of special zones for hosting industries
 - Lack of export houses. Export Houses would help even smaller players to enter the export market which in turn would increase Nepalese exports thereby helping to increase activities in the industrial sector.
 - Restrictive labour legislation and administration such as:
 - Labour Law stipulates that permanent workers cannot be dismissed without prior approval of the Department of Labour which can take months even years
 - Labour regulations have achieved neither their aim of protecting the labour nor attracting investment.
 - Politicization of trade unions has caused industrial disputes, unrest and closure.
 - The employment of foreigners is also severely restricted. Under current law, the Department of Immigration must approve the employment of foreigners for all positions except those at the very top of a company or project.

Lack of Inter Agencies coordination:

Lack of effective and the desired level of coordination amongst various Government Agencies which has rendered even mechanisms like the One Window Committee ineffective.

Inadequate infrastructure:

According to the FNCCI & World bank Survey (2000) about 10% and 15% of industries faced severe or general problems respectively with waste disposal, the respective figures for telecom and air freight were also 10% and 15%, water availability and road access were more severe problems with respective figures 20% and 30% while the case of electricity problem was the worst with respective figures as high as 45% and 75%.

Low Productivity:

With regards to labour productivity, manufacturing value added per employee in Nepal is the lowest in South Asia.

Lack of Research and Development Facilities:

In order to produce cost effective and high quality products for competing in the global market a country has to have a very strong Research and Development base. R & D at the corporate level under the present environment and support is simply unaffordable and public technology institutes such as NAST, RECAST, Food Research Laboratory, universities and academic institutions in Nepal have negligible role in industrial research and development

Weak Capital market:

Under - developed and a weak capital market especially the stock exchange.

High cost of Energy:

Cost of energy is one of the highest in the world and the highest in south Asia.

Dispute settlement:

Long delays in resolving disputes by the judiciary.

3.3 Opportunities

- India is slowly becoming a manufacturing hub of the world. Already 125 of the Fortune 500 countries have set up shop in India and every day more are flocking in. However, India is fast developing into a high wage cost country. Since low cost labour is available in abundance in Nepal it could prove to be a viable alternative industry-hosting zone.
- It is predicted that in the next decade China is going to be the number one economy in the World and India is going to be the fourth. Even today both these countries are the fastest growing markets in the World. Therefore, even though Nepal itself is a small market, since it has common borders with India and China a large market is easily accessible from Nepal.
- Nepal has China, India and Bangladesh as neighbours. The combined population of these countries is extremely large so a huge market is available in Nepal's immediate neighbourhood.
- Nepal has become a member of international/regional trade regimes such as WTO, SAFTA, BIMSTEC etc. which increase its reach and access in the international

market place very substantially. Plus the special trading arrangement with India and offer of duty free access to China for Nepalese products enhances the prospects of Nepal to be a desirable zone for setting up an operation base for businesses and industries wanting to be nearer to such large markets.

- Nepal is a Least Developed Country and as a member of the LDC it will be the recipient of special package of concessions which will further enable it to enhance its market access and competitive capability.
- Nepal has a salubrious climate which could be useful in attracting manpower to operate industries here.
- Nepal also has abundant water resources and hydro-power potential to fuel the desired growth of the industries.

3.4 Prospects

- Special Manufacturing Zones near the Southern border with incentives that match those offered by the North - Eastern States, Himanchal Pradesh etc in India would be a lucrative proposition for setting up industries that would cater to the UP, Bihar and West Bengal markets in India.
- The Special Manufacturing Zones could also host Chinese industries focused on catering to the South Asian markets.
- Similarly, a Special Manufacturing Zone near our Northern border could host Indian as well as other international industries focused on catering to the South China market, particularly the Tibet Autonomous Region of China market. With China offering duty free access to a host of Nepalese products this zone should be a highly attractive one for setting up operating bases.
- Because of the educated and large young workforce industries would find a large pool of manpower resource to man their mid - level management operations, which should reduce their overall cost of operations.
- Because of the large number of English speaking workforce without a local accent plus the fact that India is fast becoming a high wage zone should make Nepal an attractive destination for setting up IT related industries and businesses.
- The huge hydropower resource of the country that could theoretically meet the unlimited energy demand of industry to fuel and drive its growth should prove to be a powerful motivator for setting up industries in Nepal.
- Future promising industries such as hydro-power development, electric & electronic assembly industries, semi conductors, food products, jewelery and handicrafts
- Non - High Tech., labour intensive, locally available know - how and expertise, distinctly Nepalese flavoured products with possibility of backward integration to enhance its competitive strength like Carpets, Thankas, Jewelery, organic food products etc.

- Vast flora, fauna and aromatic & medicinal herbs that provide immense prospects for manufacturing industries catering to focused market groups and natural products market segment.

Chapter IV

Recommendations on What Needs to be Done to Establish Nepal as a Manufacturing Hub.

4.1 What Attracts Investments to a Country:

History and experience has shown that:

- a. The following impede the flow of investments
 - Red Tapeism
 - Comatose Policies
 - Lack of Business - Friendly Policies
 - Uncertainty of continuity of policies
 - Infrastructure bottlenecks
- b. Movement of investments are indifferent to the following:
 - Micro issues
 - Political systems
 - Business risks
- c. What investors look for while considering a country as an investment destination:
 - Economic growth rate
 - Sector growth rate
 - Market volume
 - Abundance of skilled and trained manpower
 - Abundant energy
 - Investment security and certainty & continuity of policies

Therefore, keeping in view the above factors, the following would be some of the key factors in attracting investments to a country:

1. Nearness to a large, attractive and a sustainably growing market for finished products.
2. A very promising manufacturing environment.

Therefore, the recommendations for making Nepal a manufacturing hub are primarily focused on these two observations.

Furthermore, the paper also focuses on the following issues relating to making a country competitive, which would help support the inflow of investments into a country:

1. Aspect that contributes to direct costs.
 - Import tariff
 - Taxes

- Cost of capital
2. Indirect issues:
- Infrastructure
 - Transaction cost
 - Those that hamper productivity

4.2 Nearness to a Large market:

- a. Nearness to a large market cannot be designed or created. However, Nepal is fortunate to be sandwiched between two of the fastest growing markets in the world. It is close to three densely populated countries of the world - China, India and Bangladesh. Therefore, in terms of location it is perfectly situated to be a manufacturing hub to cater to the regional market.
- b. Of course, trade facilitation, unhindered access to these markets, possibly under special facilities, must be negotiated by the Government of Nepal. It must also ensure that:
1. Whether they are called FTAs or Special Trade Agreements, bi - lateral Trade agreements must be signed with major countries of the South Asian region like India, China, Bangladesh and Pakistan.
 2. Negotiate with countries of this region that are members of regional trading arrangements like SAFTA, BIMSTEC etc for reducing their negative list for Nepalese products.
 3. Try to increase the number of products for duty free access to Chinese markets.

4.3 Creating a Promising Manufacturing Environment:

A. Immediate legislative and Policy reforms.

- a. Effective Company Act.

First of all formulate a practical, forwarding looking and implementable Company Act with a provision of ensuring its supremacy over other related Acts

- b. Business - related critical Legislations:

In order to enhance the comfort level of the international investors and the level of their confidence in Nepal as a good place to do business in, it is necessary to put in place, at the minimum level, the following legislations:

- Effective Intellectual Property Laws and Regulations
- Bankruptcy Laws and regulations for easier and painless exit
- Effective Cyber Laws and regulations
- Competition laws to ensure a level playing field for all the players.
- Clear-cut Acquisition and Merger Laws focused at the industrial sector.

In this age of acute competitiveness, leveraging size for being cost competitive at the corporate level is a very critical strategy. Therefore, we need to encourage and promote rightsizing through acquisitions and mergers. There are a few provisions in the banking sector for mergers; however, we need clear Acts and regulations to acquire and merge corporates in the industrial sector as well as promote and incentivize these activities.

c. Encouraging and Promoting R&D.

In order to be cost competitive, besides leveraging size it is also equally important that corporates are encouraged and incentivized to undertake Research and Development in order to stay ahead of competition. However, R & D costs are huge and corporates cannot sustain this cost. Therefore, the Government must devise a system for lessening the burden of the R & D costs on the corporate sector. For a front loaded depreciation system could be introduced or write – off 50% of the costs against future payments to be made against VAT/Income tax etc.

d. Financial sector reforms:

1. Make Tax Administration Simpler:

Make tax administration process transparent and simple. This could be done by enacting simple laws (for example, the present Income Tax Act is a major work of puzzle even to so called tax experts) that even the small businessmen and ordinary citizen can understand. In the tax administration and assessment reduce minimum person to person contact by making maximum use of the electronic media in making available assessment forms and accepting self assessments electronically.

2. Remove discretionary powers:

Ensure elimination of the discretionary decision making powers. This can be achieved if clear, simple and unambiguous laws and regulations that leaves little room for interpretations can be formulated and implemented.

3. Correction of uncompetitive cost of capital issues.

The bank spread in Nepal is quite large which makes the cost of borrowing quite high. There is an immediate need to rationalize this structure. Since the banks cannot be dictated by the central bank the commercial banks must be incentivized and motivated to work within a smaller spread band. The larger the banks the lower will be their fixed costs, as a result of which the spread band can be reduced. Therefore, it is essential to encourage banks to merge in order to create larger banks. As an incentive to merge, Banks with an

equity base of over 3 billion rupees could be given a discount of around 2% in its income tax rate.

4. Setting up a mechanism capable of funding Mega Projects:

It is essential to set up lending mechanisms in Nepal that would help finance mega projects. Therefore, Foreign banks should be allowed to open Branch Offices in Nepal, if not, at least in the Special Economic Zones that are to be created. On one hand, this would help solve the single borrower limit problem being faced by the Nepalese banks currently and provide a mechanism for funding Mega projects and in the other it would help push the amalgamation of Nepalese banks in the process of creating bigger banks

5. Rationalizing tax and duty rates to reflect regional ground realities:

Rationalize tax and duty rates and structures in line with, if not better than what is in place in the region, particularly what the North - East States and Himanchal Pradesh in India are offering.

6. Strengthening the Capital Market:

It is necessary to enhance the strength of the capital market. This could be done in the following way.

- a. Incentivizing all companies registered in Nepal to be listed in the Stock Exchange. This could be done by providing a 2% income tax rebate for a period of 5 years for companies that list with the Stock Exchange.
- b. In order to promote Nepal as a manufacturing hub liquidating equity instruments in the secondary market in a speedier way must exist. This could be done through a working integration of the Stock Markets of the countries of the South Asian region at least. Nepalese Companies should be allowed to be listed in the Stock Exchanges of other countries of the region and similarly they should be allowed to be listed in Nepal's Stock Exchange also.

7. Putting in place other Funding instruments.

- a. Off shore banking like that in place in Mauritius should be encouraged
- b. In order to help companies build themselves up, particularly in Greenfield and high-risk sectors, Venture Capital firms should be encouraged and incentivized to set up operation bases in Nepal.

8. Raising resources abroad:

Corporate should be allowed to raise financial resources from abroad through various debt and equity instruments.

B Limited sector focused FDI Strategy:

Several attempts have been made to bring in laws that would attract Foreign Direct Investment. FDI is demand driven which will come in naturally if there are business opportunities. Therefore, instead of trying to frame a policy and a strategy to attract FDI to all the sectors across the economic spectrum in Nepal, select a few sectors that Nepal could be country competitive in, like Hydropower, Tourism, Herbs and Herbal Products, High Value Agriculture and Forest Based Products, Educational Outsourcing, Medical Outsourcing, IT and IT enabled services and enact laws and regulations designed specifically to promote external investments in these sectors.

C Availability of Portfolio Investment instrument:

In addition to the FDI policies it is also a good strategy to try to encourage, promote and incentivize Portfolio Investments for inward flow of foreign investments. A vibrant Stock Exchange is the appropriate and effective medium for this.

D Practical and implementable Industrial Policy:

Bring out a clear cut Industrial Policy. It is absolutely necessary to spell out in clear terms in the Industrial Policy what is offered to the potential investor and stick to them for the duration of the period guaranteed so that the international investors confidence is revived.

E Creating Special Areas of Excellence for hosting industries:

Call it SEZ, EPZ, FTZ, Industrial Estates or by whatever name but what is required are special areas in Nepal to exclusively host industries. The Government or for that matter even the Private Sector can be given the responsibility of setting up these special areas. Main features of these areas will be:

- a. The government will acquire necessary land, develop it and set up necessary physical infrastructure like roads, utilities like water, power, telecommunications, banking facilities etc.
- b. The owners of the area will not put up any buildings to house industries but will lease out the required amount of land to the industrialists who will build the buildings as per their requirements and needs.
- c. The land will be leased out to the industries for a period of 99 years in order to make large investments feasible and attractive.
- d. Special labour laws will be promulgated by the Government for these areas which will reflect and be in tune with global sentiments, norms and practices

particularly in productivity linked wages, hiring practice norms and labour exit policies, as well as providing no scope for strikes and lockouts.

- e. A special incentive package will be made available for industries setting up operations in these Areas. The special package should at least match if not be better than incentives available around the region.

F Energy to Drive Industrial Growth:

One of the main pre-requisite for a manufacturing hub is availability of power in abundance to meet the demands of the industries in the foreseeable future.

However, in addition to quantity of power the cost must also be competitive in relation to what is available around the region. It does not look like the present set – up in Nepal in the Hydropower Sector will be able to deliver energy at lower costs than what is available at present. Therefore, NEA should be immediately unbundled with three separate companies being set up for Generation, Transmission and Distribution purposes and they should be privatized as soon as possible. In case it cannot be unbundled special laws with electricity wheeling facilities should be enacted to promote the setting up of hydropower projects by the private sector to meet the corporate needs of itself or others that it can share power with. For those not wishing to do so, special incentives should be provided like duty free import of capital goods and a subsidy on fuel necessary to run large generators that the industries may wish to set up.

G Better Connectivity infrastructure:

Better connectivity within the country, with the Indian and regional market as well as the international market must be put in place. For better connectivity within the country, the building of more and better roads/railways through systems such as PPP, BOOT, BOO etc should be encouraged and incentivized so that there is no paucity of funds for building as well as maintenance.

For connectivity with the international market there is one dry port in Nepal which can take care of exports from the Birgunj area; however, one such port is not enough and two other dry ports with all relevant facilities must be built. Ensuring the timely integration into the Asian Highway Network system is also essential in order to capitalize on the opportunity that this road network would provide for integrating the Nepalese markets with the regional as well as other global markets.

For better connectivity with the Indian markets usage of the dry ports as well as extending Indian railheads up to all the dry ports in Nepal and using these railways to transport goods to Indian markets also is highly desirable.

H Open Sky Policy:

If Nepal is to be turned into a vibrant regional manufacturing hub it is necessary to focus on making traveling to and from Nepal easy, quick and convenient. For this an Open Sky Policy has to be in place so that available traveling options to the business community are abundant, varied and wide.

I Residential Visas:

Residential Visas should be provided gratis, easily and conveniently to investors and their top management team so that they can have in place a team of their choice.

J Setting up a 'Board of Investment'

There are a few major drawbacks in Nepal for encouraging Footprint Migration as well as Investors. Some of these are:

1. Several different Ministries/ bodies/ organizations are involved in Foreign Investment related activities which makes coordination work very difficult as well as time consuming.
2. There are several business sector related laws and regulations that overlap one another creating confusion as well as not being able to deliver the provisions in an Act.
3. Nepal has been a victim of political instability. This makes investments in Nepal very risky in terms of not being certain of the continuity of what had been promised or guaranteed at the time of entry of investments into Nepal.

Therefore, in order to address the above mentioned issues it would be appropriate to set up a powerful, independent statutory body under the Chairmanship of the Prime Minister of Nepal that would exclusively look after investment promotion in Nepal, undertake inter-ministerial coordination work, function as a one stop organization for advising, assisting and facilitating the setting up of projects in Nepal. It would also ensure continuation of the project as well as the provisions guaranteed by the state regardless of the political set up later on. This would go a long way in enhancing the confidence of the investors which is a must if Nepal is to be promoted as a regional manufacturing hub.

4.4 Major Challenges in Making Nepal a Manufacturing Hub:

1. Overcoming impression that Nepal cannot become a manufacturing hub:

At first glance Nepal does not seem to be an ideal location to host "Footprint Migration"

However, observation has shown that an ideally perfect environment for attracting investment does not exist in reality in any country and history has shown that FDI flows into a country despite existence of factors that are ideally not conducive for

attracting investments. In spite of India's infamous red tapeism, bureaucracy and a labour force hopelessly divided on the lines of the political parties, more than 125 of the Fortune 500 companies have already set up base in India.

China, in spite of a non - democratic political set up attracts more than USD 55 billion per year, which is one of the highest FDIs in the World. Germany, in spite of its strict labour laws is an industrial power - house. Availability of raw material is also not a major criteria; Japan imports very long staple cotton from Maharashtra and Karnataka in India, manufactures in Japan and sells them worldwide. Given these facts, there is no reason why Nepal cannot become a regional manufacturing hub, riding on its strength of being neighbours to two of the fastest growing markets in the world.

2. Overcoming conflict of interest:

Looking from a practical point of view and keeping in mind the interest of different groups in the spectrum of the Nepalese society, making the whole of Nepal a manufacturing hub will not be possible; in fact trying to do so would only bring about a state of stagnancy. Therefore, the best solution would be to set up special areas as free trade zones or off - shore areas that would have their own set of labour laws and other set of incentives that would be independent of what is available in the rest of the country.

3. Changing the mind set of the Bureaucracy:

In fact the biggest challenge to setting up Nepal as a manufacturing hub would be selling the idea to the bureaucracy. What the decision makers must understand is that these days practically every country in the World is trying to attract investments into their country. Therefore, in this extremely competitive global environment, unless the Government Bureaucracy starts thinking of promotion rather than regulation, unless it starts thinking of long term rather than short term, it will be a near impossible task to transform Nepal into a vibrant regional manufacturing hub.

4. Private sector involvement:

If the concept of making Nepal a regional manufacturing hub capable of hosting "Footprint Migration" is to be a reality, the private sector must be taken into close confidence and be made a part of the process because this is the sector that would know best what it would take to attract investments.

4.5 Conclusion:

- a. Nepal is endowed with a huge potential renewable energy base in the form of Hydropower for fueling and driving industrial activities and growth; it has a sound and high quality communication infrastructure network; it has an extremely large pool of educated, young people; it has a large pool of low wage - cost blue - collar workers including a large women workforce; it has a salubrious climate that is

extremely favourable for a working environment; it has as its next door neighbours India and China, which are two of the fastest growing markets in the World, and has good connectivity and infrastructure for easy access to these markets; it is a member of several international and regional trade regimes which makes it easy and simple for accessing these markets as well as other regional markets including Bangladesh, which has a huge population.

- b. Now, if Nepal can just formulate and put in place a set of legislative and policy reforms in line with the sentiments, norms and practices of the international market place as well as implement new initiatives to enhance the comfort and confidence level of the global investing community and demonstrate the Government of Nepal's strong commitment to encourage and facilitate manufacturing activities and if the decision makers and planners start thinking big, out of the box and forward looking and change their mind set to function more as a promoter rather than a regulator and controller, there is no reason why Nepal cannot be transformed into a vibrant regional manufacturing hub.
- c. However, at the practical level it is easier said than done. It will be extremely difficult to implement the necessary and required reforms, particularly the ones on the labour related issues, to help supplement , compliment and enhance the strengths, advantages and positive aspects that Nepal has recently acquired or developed for turning it into a regional manufacturing hub. But, this does not necessarily mean that it is not possible to overcome these issues. **China faced land and labour issues and Malaysia faced the 'Bhumiputra' issue in their quest for attracting external investments.**
- d. In order to overcome some of the seemingly insurmountable difficulties that countries like China, Malaysia and even India faced in generating an environment that would be conducive for attracting external investments, they adopted the idea of segregating pockets or parcel of land where special laws, regulations, facilities and incentives would be applicable which would help enhance the competitiveness of the industries hosted there and at the same time keep them immune from the other laws of the country that could have impeded the flow of external investments. These special areas termed as SEZ/ FTZ/ FEZ, which for all practical purposes were virtually isolated from other parts of the country in terms of application of regular laws and rules of the countries become special areas of excellence which succeeded in attracting large volume of external investments.
- e. Therefore, taking into consideration the changed context, ground realities and environment, what further needs to be done to improve the manufacturing environment in Nepal as well as our country - specific constraints and problems and keeping in view the experience of other countries in solving their similar type of problems, it is recommended that Nepal should also adopt the following three - pronged strategy for promoting Nepal as a regional manufacturing hub and attracting external investments.

1. **Legislative and Policy Reforms.**

Formulate and implement all legislative and policy reforms that are not categorized as sensitive to the sensitivity of the various sectors of the Stakeholders.

2. Creating Special and Segregated Areas of Excellence.

Create isolated areas that can be turned into areas of excellence the following way:

Identify and segregate large tracts of land in the Terai region, possibly attached to the present Dry Port or those to be built, that will host investments into Nepal. Special laws, rules, regulations and policies that may be sensitive for implementation in other parts of the country will be made applicable in only these areas. These areas could be designated SEZ/FTZ/FEZ or any other name and would provide the following facilities:

- a. The Government of Nepal would acquire land, develop it and set up high quality physical infrastructure like wide roads both internal as well as those connecting it to the rest of the country, information superhighway, water supply, adequate and continuous supply of electricity, a 132 KV transmission line to feed power to the zone, industrial waste management.
- b. This land should be leased out to the potential investors at a very nominal rate for a period of 99 years under a special contract.
- c. Negotiate the extension of an Indian railhead right into this zone.
- d. The lessee will have the right to build any structure conforming to Nepalese building code within the land leased out to him.
- e. A branch of a Foreign Bank would be allowed to be set – up and operate within this special area
- f. Foreign Insurance and Consultancy companies, Venture Capital Firms will also be allowed to set up shop there and operate
- g. Special labour laws with provisions like those stated below to be formulated and implemented specifically for these zones:
 - Productivity linked system of wages.
 - the cost of labour in Nepal has become a fixed cost for the industry whereas in other parts of the developed World it is a variable cost where the number of people hired can fluctuate with the business status and condition of the industry. This flexibility is essential for the corporate sector to stay competitive. Therefore, the laws must have flexibility in allowing the industry to hire and release workers as per the needs of the industry.

- The Zones will provide the following incentive package to attract investments and help them remain cost competitive:
 - i. All plant, machinery, instruments, equipments and spares to be allowed to be imported duty free.
 - ii. 100% repatriation of profits and capital
 - iii. A 10 year tax holiday
 - iv. From 10 to 15 years income tax will be free on all profit ploughed back as capital investment into the existing units.
 - v. R & D Costs can be written off against future payments against VAT/income tax payments.
 - vi. For captive power generation, duty free import of capital goods and subsidy on fuel necessary to run extremely large generators will be provided
 - vii. No export duties will be levied on export of production
 - viii. 20% of production can be sold in the local market; however, duties will be levied as per local **rules**.

3. Establishing an exclusive Board of Investment.

Set - up a very high powered, independent body (could be called the Board of Investment) BOI, with all the necessary over-riding authority, as referred to earlier in the report, to exclusively promote investments and undertake all necessary coordination as well as all other activities related to inward investments to Nepal.

Chapter V

POLICY ACTION MATRIX

S.N.	Constraints	Recommended Policy Improvement	Indicators of Achievement	Time Frame	Responsible Agencies
1.	Lack of necessary business supporting legislations to address the needs of the investing community	Revisit Company Act to make it an over-riding Act Revisit Bankruptcy Act, Intellectual Property Act, Competition Act to make them more effective Enact effective Cyber Laws and an Acquisition, Merger and Takeover Act	Enhance the comfort and confidence level of the investors " "	Immediate Immediate Immediate	MoICS " "
2.	Lack of R&D activities does not support the production of high quality and cost effective goods	The Nepalese corporate sector cannot afford R&D costs, therefore, incentive and subsidy schemes must be put in place	High quality cost effective goods will be produced which will help enhance market access and penetration	Immediate	MoICS/ MoF
3.	Tax laws are very complicated and non-transparent which reduces scope for compliance and encourages distortions	Make Tax Laws simple and easy to understand even by the lay man Introduce digital system of self assessment and handover so that there is a minimum level of person to person contact	Will improve self compliance	Immediate	MoF
4.	Discretionary powers of the officials increases distortions and increases Transaction Costs	Make Laws clear-cut, simple and easy to understand so that there is no scope for interpretations	Will reduce Transaction Costs and reduce sense of harassment	Immediate	MoF
5.	Cost of Capital is high which increases cost of production	Incentivize and motivate Banks and financial institutions to work within a smaller spread band	will reduce cost of production and hence reduce the possibility of being priced out of the market	Immediate	MoF/NRB

6.	Due to single burrower limit Nepalese Banks and other funding agencies are unable to fund large projects which does not excite the international investing community	Allow Foreign Banks to set up Branch Offices in Nepal for banking operations	Would provide a good tool to support large projects in Nepal	Intermediate	MoF/NRB
7	Due to a weak Capital Market in Nepal equity instruments held by the investing public cannot be easily liquidated	Make it mandatory for all companies to be registered as public companies and incentivize them to be listed in the Stock Exchange In order to have a vibrant Capital Market which could support international investments, companies of other countries should be allowed to be listed in Nepal's Stock Exchange and vice versa	Capital markets in Nepal will be strengthened and become vibrant which would help enhance foreign investments	one year	MoF/NRB
8	Lack of alternate funding mechanism to fund high risk and other Greenfield projects also limits the flow of external funds	Allow Off - Shore banking like what exists in Mauritius Encourage Venture Capital firms to set up operations here	would increase flow of investments as high risk and Greenfield projects could be set up because of the scope of availability of even equity injection	2 years	MoF/NRB
9	An FDI policy trying to encompass all possible sectors across the spectrum of the Nepalese economy has not be able to attract substantial investments in any sector	Formulate and enact an FDI policy that would be exclusively designed to focus on attracting investments to only those sectors/products that Nepal can be country competitive on	with concentration only on country competitive sectors/products investment in these sectors on a competitive basis will flow in	Immediate	MoICS
10	Not opening up Portfolio Investment to foreigners has deprived Nepal of attracting investments through another form besides FDI	Appropriate laws need to be implemented to allow Portfolio investments At the same time the National Stock Exchange must at least be integrated to the regional Stock Exchange network to provide a greater market	would supplement FDI flows into Nepal	one year	MoF/NRB

		for debt, equity instruments.			
11	An Industrial Policy that does not reflect regional realities in this age of globalization will not help attract FDI	Draft and implement a forward thinking Industrial Policy that would keep in view policies enacted by regional competitive countries and ensure that continuity of policies is assured by the Policy document	would help Nepal be regionally competitive in attracting investments	Immediate	MoICS
12.	Shortage of electricity, irregular, erratic and low quality of supply of electricity and no policies to address this situation impedes flow of funds into Nepal	Unbundle NEA into three companies to carry out the function of Generation, Transmission and Distribution and privatize them	More projects will come up for Generating, Transmitting and Distributing electricity as the private sector will be demand driven. Regular and ample supply of electricity will help bring in investments	one year	MoWR
13	Non effective instruments for Public Private partnerships for taking forward transportation and other physical infrastructure has impeded the development of better connectivity.	Revisit various instruments like PPP, BOOT etc to make them more attractive and saleable. Let projects be run by the private sector for upto 50 years as infrastructure projects are very expensive and allowing more years for receiving cash flow would encourage investments in these sectors Let the private sector choose the projects that they wish to develop, provided it falls within the broad policy frame work of the Government.	connectivity within Nepal as well as the region.	one year	MoPPW
14	Lack of an open air policy severely limits the easy and convenient access to the country which does not encourage investors	Implement an Open Sky Policy as it would help not only the investing community but would help economic revival through increased earnings through Tourism	The easy, quick and convenient air connectivity would help create a more favourable business climate	Immediate	MoCTC

Institutional

1	Because of the inability to implement business related legislations and policies in line with the sentiments, norms and practices of Nepal's competitors in the international market place, Nepalese products and services can never be cost competitive and efficient; this helps drive away investors from Nepal	A way out could be to implement these necessary laws, rules and regulations in certain areas of the country only. Therefore, special areas, possibly designated as SEZ/FTZ should be set up with special laws and facilities for housing industries	Because of the globally competitive environment that these areas would provide, investors would be willing to set up operations in them	Two Year	MoICS
2.	Too many Government agencies/departments/authorities are involved in foreign investment related activities. As a result cross - agencies coordination is difficult to achieve, promotion activities become overlooked and neglected,	So an independent, high- powered body armed with adequate authority should be created and set - up to focus exclusively on promoting and facility investments in Nepal. Something like the Board Of Investment In Sri Lanka	The success story of Sri Lanka's BOI is a sure indicator that such bodies will be able to bring in investments to Nepal	Immediate	MoICS