The State's role in Private Sector Development (PSD) in New Nepal

(Not for citation)

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The April 2006 movement is one of the three major popular movements Nepal has undergone in just over half a century. The cumulative transformation it brings to Nepal's political landscape is only the beginning of a long and winding road to peace, which at some stage will have to engage with apolitical elements within the State-building process to be able to deliver on the popular demands of sustainable peace, reconstruction, and a rise in the living standards. This has three mutually interlinked components to it: First, the recently secured political solution will have to be sustained through a thorough rehabilitation program. Second, the local economy must grow in the short run in order to be able to absorb the large number of people who are likely to return and rejoin the post-conflict civil economy.[2] And third, the economic growth must be sustained in the long run for the average Nepali to see a concrete rise in his/her living standards so as to save being disillusioned by the historic political transformation that has occurred. While all these issues are equally important, this paper will exclusively focus on the third issue.

Private sector development (PSD) is central to securing and sustaining of economic growth in post-conflict Nepal. The aim of this paper is NOT to offer solutions for PSD in Nepal, but to identify pertinent issues that must be addressed for a PSD strategy to be conceptually sound and pragmatically doable at this transitional situation. This paper will signpost a number of specific policy measures and programmatic interventions that have been adopted in other countries under similar circumstances so as to provide food for

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[2] This population will involve: (i) people from the conflict-ridden regions whose direct or indirect engagement with the conflict-economy comes to an end; (ii) the rural diaspora who returns in attempts to join a post-conflict local economy; and (iii) some members of the former militia and armed police force if the State initiated a policy to trim the security force as the security threat has largely ended.

thought in initiating a dialogue in this direction. I hope that the discussants who bring with them deep insights and long experiences in this field, will share their opinions and experiences on this pertinent topic.

A discussion on PSD can be approached in a number of ways. This paper will take a three-dimensional approach. The first section will introduce and contextualise the Nepalese private sector in the rapidly changing domestic and international contexts. The second section will engage in a more in-depth discussion on the nature and construction of the two pillars of Nepalese economy [(i) the labour-intensive industries including the micro, small and medium enterprises (MSMEs), and (ii) the capital-intensive large sectors) vis-à-vis public policy measures essential for their well-being. Section 3 will discuss the missing links between Nepal's currently largely agrarian rural sectors and the rapidly industrializing urban sectors. The last section will summarise the discussion.

Nepal's private sector development at the crossroads

<u>At a national level</u>, Nepal is at the outset of a historic transformation. Following the April movement, we are already witnessing a steady emergence of important political, social and economic outcomes: The first session of the reinstated parliament called for an ambitious social/gender inclusion program in favour of the marginalized ethnic, regional and gender groups. Outside the parliament, the Maoists have called for a draconian redistribution of national resources (e.g. land ownership) and private sector opportunities (e.g. renewed emphasis on micro, small and medium enterprises) in favour of the marginalized groups. As the Seven Party Alliance (SPA) and the Maoists proceed towards a constituent assembly amidst intensifying demands for restructuring of the governance structure – including possibilities of regional autonomy, speculations are high that the currently formed interim parliament and the soon to be elected constituent assembly might both evolve as vehicles intensifying actions in these areas.

Affirmative action and redistribution of resources are not crises in themselves. Actually they can turn out to be unique opportunities for much needed change. For example, the post-apartheid government led by the African National Congress (ANC) in South Africa implemented a draconian Black Economic Empowerment (BEE) program, which successfully accomplished an ambitious housing and land redistribution program towards inclusion of the black people. The BEE program mandated that all economic enterprises must ensure that a significant share of economic interests are owned by the black people, and this was achieved relatively efficiently – in consultation and participation from the private sector – maintaining a fine balance vis-à-vis the trade-off between efficiency and equity. In contrast, the land reform program in Zimbabwe has instigated wide international criticisms and reports of misallocation of resources and provocations that are destructive to local harmony.

After the spates of rebellion and reconciliation, both of which signal clear gender/ethnic nuances, it is not too early for Nepal's PSD *gurus* to proactively strategize on these fronts. We have witnessed that Maoists' 'leap of nationalism' in their third wave translated into ultra-leftist labour movement, which for the first time, differentiated the labour union treatment of factory owners as per their ethnicities (Shakya, forthcoming). The Maoist propositions of resources redistribution and affirmative action are bound to exert direct or indirect impacts on PSD in the coming months and years. It is important that a discussion on PSD strategies in New Nepal explores a 'middle ground' where popular concerns about ethnic and gender inclusion are well addressed without self-destructive compromises on the market rigor.

<u>At an international level</u>, China and India are emerging not only as the roaring and shining giants who have begun to flex their muscles in the global economy; increasingly their interrelationship is taking form of an alliance than rivalry. This has a number of implications for Nepal: First, Nepal's role in the new global order might be that of a *jholunge* between the two economic giants as opposed to its conventional *dui dhungako tarul* politico-economy where its perceived security threats encouraged Nepal to maintain an exaggerated 'neutrality' with both the giants. Second, as the financial boom in China and India are increasingly accompanied by booms in technology and knowledge, it makes more plausible that Nepal's quest for FDI and technology transfer can be quenched within

the Asian boundaries than by turning to far-away Western multinationals. Third, as both Indian and Chinese economic booms are rapidly trickling down to its vast middle class in the form or rising disposable incomes, Nepal now potentially has access to a vast international market within the continental thresholds.

This precisely marks the symbolic crossroads Nepal is currently standing at. On one hand, Nepal is caught in a dilemma between a potential reversal of liberal economic policies and a proactive governance restructuring that might open new doors for an economic revival. On the other hand, it also has the possibility of choosing between a doomsday of being the dumping site for its giant neighbors or evolving as a primary beneficiary of the regional knowledge and capital boom.

Differentiating the 'big' pillar of the private sector from an equally important 'small' pillar

PSD wisdom is a story of never-ending metamorphosis. The 1980s and 1990s were the decades of economic liberalization where economies removed entry/exit barriers, deregulated their markets, and liberalized their current and capital accounts . The new millennium now makes the case for the role of 'new industrial policies' that should work to enhance innovation and quality in industries so as to become and remain competitive in the global market once it has opened up. The new industrial policy also makes the case for a dichotomous approach to industries. For the sake of simplicity, I define my dichotomy as the 'big' and 'small' pillars of the private sector.

The 'big' pillar of Nepal's private sector includes components that have to do with infrastructure, energy, banks, universities, etc. It is often the case that Nepalis play more the role of consumers of the products and services of these industries than that of the producers, for the simple reason that these ventures directly or indirectly call for foreign investment, technology and operations systems, and knowledge. In such cases, the onus on Nepal's PSD policymakers is to usher in foreign capital, either in the form of foreign aid or FDI, but in such a way that they are cost-effective, market-friendly, and are not the pricedistorters. First, foreign direct investment (FDI) must not displace local investment but accommodate them. Second, foreign aid must facilitate and complement foreign/local investment rather than displace them. It often works better if the foreign aid funds the on-site public goods with long gestation periods which cannot be funded by private investment due to coordination failures. And third, which is often the biggest challenge, foreign investment must usher in technology and knowledge transfer, which is not always guaranteed unless the policymakers especially factor this into account from the very outset of project conception. More importantly, Chandra and Kolavalli (2005) argue that FDI will lead to technology transfer only if this is combined by a rigorous national learning system in less developed countries. Let's compare the case of blood diamonds of Sierra Leone on one hand and the techno-savvy China on the other hand. The lessons become clear that FDI is a good servant but a bad master. While restraining the temptations to patch every problem with a cheap nationalism slogan, policymakers must prevent FDI turning into an uncontrollable monster.

The 'small' pillar of Nepal's private sector is often a more important one since it concerns the livelihoods of a larger number of people. The role of globalization is important even in this strictly 'local' pillar of the private sector because the MSMEs are increasingly serving their global clients because domestic markets are simply not large enough for a country like Nepal, especially in the niche areas; and that technology and liberalization has made global integration much a 'local' reality like never before. The new industrial policy claims that the 'new' market is increasingly beyond the national borders. Nepal can either run the risk of being inundated by cheap foreign goods from the northern or southern neighbours who have a much better comparative advantage when it comes to scale economies (Smith, 1776) or geography economics (Krugman and Venables, 1995), or it can proactively distinguish its products and seek competitiveness in selected global niche markets. For example, we cannot produce garments cheaper than India or China, but we can produce garments that are smarter. Again, we cannot produce contemporary garments that are smarter than the West, but we can produce ethno-contemporary designs that have a Nepali symbolic fashion touch. What we need to do is that we need to pursue areas of comparative advantage.

The writing on the wall seems to be: Quality, Innovation and Export Competitiveness. With this conviction, this paper appeals for a case for a timely union between 'new' industrial policy and economic liberalism. Nepal has worked relentlessly in the early and mid-1990s towards a sound macro policy. Growth has not followed. It is perhaps now time for the second leg, getting our industrial policies and institutions right.

First, a recent World Bank study (2007) on access to finance shows that household's access to banks and credit agencies compares well with the neighbouring countries, the problem area is that of MSME finance. Entrepreneurs who want faster and easier credit, opt for informal finance even at much higher costs. Then comes the issue of availability of tailor-made financial instruments which would accelerate the spirit of entrepreneurship (venture capital, matching grants), increase the speed of monetary churning (factoring and captive finance), and spread out transaction risks to level the playing field to some extent (shipment finance and insurance).

New Industrial Policy: Ingredients for Export Competitiveness

Preconditions: trade & industrial liberalization; infrastructure; human resources

1. Access to finance and financial instruments
   (SME finance, venture capital, pre- and post-shipment finance, export insurance, factoring and captive finance tools)
2. Brand economics (promotion agencies, quality and MSTQ)
3. Collaboration economics (consortia, clusters, EPZs)
4. Incentives (trade promotion agencies, matching grants, duty drawbacks)
5. Supply and value chain
6. Business enabling environment (red tape, tax and property rights)

That Nepal has better comparative advantage in niche products than scale products needs no elaborate arguing. On one hand is the argument for a 'Gulliver effect,' referring to the relationship between a small country and large neighbours (Blejer and Szapary, 1991). On the other hand is the argument for commercial capitalization of its rich and diverse ethnic and geographic legacies to produce 'distinction' goods and services (Bourdieu, 1984). Several booms and busts in our export portfolio have largely involved niche products such as carpets, handicraft and pashmina. The booms and busts within an industrial sub-sector – of the readymade garments – has inferred Nepal's failure in scale economics on one hand (Shakya, 2004) and emerging success in niche ethno-contemporary manufacturing on the other hand (Shakya, forthcoming).

Cultural capital for Nepal's industrial awakening

The resurgence of ethnic identities might be a blessing in disguise if Nepal's PSD strategy utilizes it creatively. If ethnicity-based institutions strengthen in the coming years, instead of futilely fuelling fragmentation politics, the PSD strategy could utilize the new energy to: (i) develop internationally accredited export promotion agencies (EPAs) that would develop market-savvy brands based on ethnic and geographic heritages. The informal ethnic/geographic networks can be mobilized to link the ethnic/geographic history, culture and icons to further promote cultural brands in the international market; and (ii) develop vocational institutions which would codify ethnic histories and heritages, and develop internationally accredited modules through which the skills and knowledge is made open for any Nepali national who is dedicated to learning them. Some of the Nepalese products which would benefit from such a strategy might include not only heritage tourism, mountain sports industry and ethno-contemporary art, but also a whole range of consumption commodities such as fusion fashion designing, Himalayan honey, mustard, cheese tea and coffee. There are several business models dealing with the cultural capital not only in Europe but also in India (Sen, 2001).

Little effort is made in Nepal to identify which areas have been less effective in integrating domestic production with global markets. The literature deems contributions of export promoting agencies and local collaboration institutions particularly important in higher innovation sectors. Globally, every dollar invested in a sound export promotion agency (EPA) is estimated to generate over 300 dollar worth of export. But this is going to occur only if they effectively engage in core binding constraints holding export back. In case of Nepal, development and marketing of culture- and geography-based brands for the global markets could be an area the EPAs can effectively work on.

The literature on collaboration economics suggests that industrial clusters push incumbents to upgrade to higher level of quality, innovation and technology faster by offering solutions to the coordination failures (Humphrey and Schmitz, 2000). Clusters are concentrations of firms in one or few industries, benefiting from synergies created by a dense network of competitors, buyers, and suppliers. They also include prodders of complementary products, specialized infrastructure providers, institutions providing specialized training, education, information, research and technical support (such as universities, think-tanks, vocational training providers) and standards-setting agencies. Such clusters make investment, as has been seen in the cases of leather and garment clusters in various parts of India, salmon cluster in Chile, technology clusters in Taiwan and Korea, etc. A similar structure to clusters but more commonly used are the EPZs, which are more formalized and controlled institutions facilitating inter-firm collaboration, but they also focus more on regulatory and policy rebates. The EPZs can be developed as the experimentation ground for new policies and packages for market products with greater potentials.

The generic well-being of the private sector will depend largely on the overall climate for doing business. Nepal ranks 100 out of 175 countries in the Ease of Doing Business index (World Bank, 2006). Within this, a best practice it follows is that it has not set a minimum capital requirement to start a business. Through the deregulation measures of the early 1990s and especially the New Industrial Policy 1992, Nepal has significantly dismantled the Panchayati License Raj and has improved its procedures for starting a business and enforcing contracts. The bottleneck lies, however, in the rigid labor regulations which prevent the industrialists from approaching a flexi-policy to suit the seasonality of his business. It ranks 150 out of 175 countries in an index measuring labor flexibility.

An exodus from agriculture to industries:
Are co-operatives the missing link?

Over 80 per cent of the Nepalese population derives their livelihoods from agriculture while contributing to about 40 per cent of the GDP. The agricultural dominance leaves little space for industrial sophistication and diversification on one hand, and denies a supply chain that is necessary for profitably processing and marketing agricultural products for a rise in productivity on the other hand. Asia as a whole earns only 6 per cent of its GDP from agriculture because it has migrated well to better yielding sphere of industries. As we renew the discussion on the need of a sustainable post-conflict construction, time is ripe to reinitiate the discussion on how could we bridge the gap between agriculture and industries to ensure a sustainable growth rate. What role do micro-credit and co-operatives have in establishing a link between the rural and urban population?

Studies show that the lack of formal capital and infrastructure in the rural areas can be partially compensated by creatively utilizing their rich social capital. The success of collateral-free lending to rural women in Bangladesh and the success Nepal's community forestry model has shown that co-operatives and micro-credit are instruments that have excellent potentials. One does have to remember, however, that Nepal does carry a long list of donor- and indigenously-led cooperative programs that have miserably failed not only to sustain but even to take off. Nepal might consider a scrupulous examination of its past cooperative schemes and renew the rigorous debate among the local, national and international stakeholders before conceptualizing a new strategy in this area.

Concluding remarks

The April 2006 people's movement is the first step in a long process. For private sector development, this can be taken as a shrill wake-up call pledging departure from a bureaucracy-laden 'business-as-usual' to adaptation of a 'new' and rigorous strategy which would construct the basis on which the State can effectively lay out its instruments exercising equity and inclusion economics without compromising on what might bring the average Nepali the best chance for a rise in living standards. In a largely capitalistic global economic order, the private sector development remains at the core of any discussion on equity, inclusion and growth.

The April revolution can also be a unique opportunity for the Nepalis to break the vicious cycle of fatalism and cynicism that has long dominated Nepali political and economic history. Capturing this opportunity will require a vision for greasing the nuts and bolts of PSD on various fronts of: finance, promotion and incentives, logistics and regulatory environment. Capturing this opportunity will also require a vision for creative use of the country's social, cultural and geographic capital in addition economic. This essentially means brining depth and precision in the application of policy interventions: In addition to broad macro policies, PSD also needs sound and effective meso policies and institutional establishments to achieve the goals in especially challenging circumstances. The time is ripe for the PSD policymakers to develop a strategic grand vision tackling the nexus between the new and the old wisdom on the making of industrial policies.

This paper has attempted to offer some food for thought for a discussion on Nepal's PSD agenda. It began by conceptualizing the contours of Nepal's private sector against a broader politico-economic situation as well as the regional dynamics. It then identified a number of structural and sectoral components which form the eclecticism inherent within Nepal's private sector development, such as the issue of access to finance and financial instruments, promotion and incentives, logistics and regulatory environment. Finally, the paper pointed out the urban-rural gap that continues to gasp within its private sector, calling for an in-depth deliberation.

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