E-Seminar Title: First NSC E-Seminar No 1, 2007: The State's Role in Private Sector Development in New Nepal
Subject: Designated Discussant's Comment on Ms. Mallika Shakya's Paper
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Many minds in Nepal are occupied, and rightly so, with the question of how to reorient political structure in the country. Sustained economic development requires a stable political system. Meanwhile how to create a durable basis for development in the new Nepal must also be thought through. It is refreshing to see Ms. Shakya thinking about development of the private sector in new Nepal in this context. There is a serious concern in some quarters that the Maoists might succeed in acquiring much of political power after a new constitution is written and a new election held. In that case, the argument goes, the role of the private sector will be severely curtailed. We continue to hope, on the other hand, that democracy is here in Nepal to stay. What role should the private sector then have in development? In particular, how should things change from the way they are now?

There is a lot in this paper with which I agree. Here, however, I focus more broadly on a few things that I think need further elaboration and emphasis. Is the model of development Nepal has been trying to follow since 1991, for instance, an appropriate one for future or does it need a major change? In the dimension of private sector economic activity, I do not think that the broad contours of the existing model need a fundamental transformation. This includes the rights to private property. A new model will have to change, however, in the way it addresses gross inequality of political and economic power existing today. The heightened awareness of the plight of the poor and underprivileged makes it almost mandatory for the state to provide them some support and enable them to exercise their political rights.

The paper proceeds with the presumption that the new government will drop all hostilities to the private sector. During the period of transition to an evolving new order, I feel it needs repeating that having too many regulations and controls will stifle private business. Nepal made major advances in the early 1990s to emphasize clearly that it is individuals and businesses rather than the government that would serve as the engine of growth. Reducing the regulations and protection of inefficient import-competing industries were some good examples of the policies taken at that time. Carrying this perspective forward would seem to be essential.

As an example, greater labor market flexibility may be required to boost growth of private investment. Yet it may be particularly difficult to relax labor laws in Nepal if social demands to protect poor workers from "unscrupulous" businesses are carried too far. This is one of the important issues that policymakers in India have also not been able to resolve. To get around the prevailing labor and tax regulations, many developing countries have set up free trade zones (FTZs) or export processing zones (EPZs). Malaysia, China, and Kenya are but a few good examples of significant growth through

EPZ manufacturing. Development of infrastructure and accumulation of human capital in local labor are some of the prerequisites for attracting foreign direct investment (FDI) in EPZs and, more strongly so, elsewhere in the country. Nepal may have a long way to go in that direction. But sooner the country realizes that a thriving industrial sector is not feasible without FDI in the country's low cost resources, the better. One can simply look at Mauritius, a country that was termed a case of Malthusian trap at the time of independence. By early 1980s, the open trade and investment policies, and tax preferences were combined with the maintenance of near equilibrium exchange rate and the removal of special favors given earlier to public enterprises. By the mid-1990s, Mauritius had emerged as the seventh in a group of 15 consistently growing exporters of manufacturing among low and middle income countries, outperforming such stellar exporters as Thailand and Portugal.

Going back to basics, a problem that must be tackled by the new government in Nepal is how to reduce uncertainty and encourage risk-taking. Much of institutional evolution necessary for efficient management of risks is a slow process. For example, breaking the status quo can be difficult in any regime including democracy. Indeed, windows of opportunities for a rapid change may be available sometimes. A new government formed after a large victory in elections can often go in that direction. Yet political leadership may be loath to make such a move. The people that advocate transparency in government during elections may fall for personal gains to be made from the continuation of old policies. The problem is that situations like this can create or sustain uncertainty that becomes hard to remove for a long time.

Uncertainty dooms growth by constraining investment. It is usual for firms to work with risks in business because often the probability distribution of returns is known or can be estimated. Uncertainty, however, takes away much of the basis on which decisions can be made. During Panchayat, removal of uncertainty in industrial and commercial policy was a regular demand of the business community. Yet the groups that controlled political power had no incentive to remove the status quo. This shows once again that we must start raising transparency in government to align the private incentives of rulers with public interest. Once again, we must reform institutions to emphasize administrative and legal efficiency to go along with the soon to be established political superstructure.

The paper indicates how Nepal can profitably concentrate on the production of "smart" goods such as specific types of garments. The need is to identify many more of the goods that reflect current comparative advantage, either based on an abundance of specific resources such as unskilled labor or some natural resource. A WTO study describes how a recent experience of a herbal medicine company in Nepal, Gorkha Ayurved, has shown a critical need for quality assurance which the government regulatory bodies must establish to increase access to export markets. As is well known, Nepal should have a clear relative advantage in medicinal and aromatic products because of its rich biodiversity. Improvements in quality standards and FDI inflows in this industry could help to capture a share of the rapidly growing world demand in this market.

For long-term development of the country, however, what matters is the emergence of new products and processes that indicate dynamic comparative advantage. Such products are hard to predict years in advance. Thus, rather than intervening in the product markets directly, policy should be geared to creating an environment where the risk-taking ability of entrepreneurs and the productivity of workers can increase on a sustained basis. That probably is the only way to escape productivity stagnation that is bound to set in gradually in many of the goods in which the country has comparative advantage today.

Attracting large FDI is difficult in Nepal in the short run. Why not invest more in exploring large FDI inflows from India? Of all the foreigners, the Indians are in the best position to take advantage of opportunities offered by Nepal's economic and noneconomic resources and policy. Investors from India will also have easier access to the vast Indian market for Nepal-made products. Finally, FDI from India should also help in giving signals to third country investors about good investment prospects in Nepal.

Turning inward, what can the country do in its domestic sectors? The services have grown much more rapidly in Nepal than sectors producing goods. Expansion of finance, health, and education mainly in the urban areas has been a leading factor in the growth of services. Though hit sharply by political instability, tourism still holds immense potential for growth once lasting peace returns. The poor investment climate in industry has made trade more lucrative than manufacturing where investments are lumpy and returns may be uncertain. This is not, however, a problem because if growth through private investment is a main strategy of development, funds will flow to wherever the expected return is high. It is the job of policy to reorient the incentive structure, and to reduce the risks involved, if possible. But the policy should reflect long-term development priorities and should only change when such priorities do.

Can Nepal arrive at a political consensus on pro-business policy that consistently encourages the use of abundant national resources? Malaysia, Thailand, South Korea and Indonesia prospered since the 1960s not because they all adopted authoritarian regimes for decades. Their progress owed much to a powerful hand of the state that provided basic infrastructure, and guided and nurtured private investments.