PRIVATE SECTOR ASSESSMENT (SUMMARY)¹

A. Overview

1. Liberal economic policies established by Nepal's government in the early 1990s provided a significant growth opportunity for the country's private sector. Before much could be achieved, however, an armed civil conflict began in 1996. By the time the conflict ended in 2006, the private sector, though resilient, had lost some of its vibrancy, and Nepal's economy, particularly in relation to those of neighboring countries, was falling behind. With the restoration of peace, investor confidence was renewed, which led to increased private investments. The private sector since 2001 has been contributing to about 80% of the country's gross fixed capital formation, which is equivalent to about 17% of its gross domestic product (GDP). There is potential for and interest in further private sector investments—from both domestic and foreign sources—especially in such sector of Nepal's comparative advantage as hydropower, agriculture, and tourism. The increase in foreign direct investment (FDI) from $38.42 million in fiscal year (FY) 2009 to $113.92 million in FY2012 is an indication of this.² This was only 0.27% of the total FDI inflow into South Asia, which leaves much room for further increases.

2. Nepal's private sector is dominated by small- and medium-scale enterprises, which comprised more than 90% of the total registered businesses and accounted for about 22% of GDP in FY2012. The World Bank's Nepal Enterprise Survey 2009 shows that about 60% of the formal nonagricultural private sector is in wholesale and retail business, followed by 15% in hotels and restaurants, and 12% in manufacturing. These sectors contribute 13%, 15%, 2%, and 7% to GDP, respectively.³ Construction activities have greatly increased and now account for 6% of GDP.⁴

B. Critical Constraints to Private Sector Development

3. Numerous studies have indicated that the prolonged political instability that has weakened the country's governance has been a critical constraint on private sector investment.⁵ The political uncertainties following the dissolution of the country's constituent assembly in May 2012 have disrupted the formulation and implementation of policies conducive to private investment. Of particular importance is the delay in amending the Private Financing in Build and Operate of Infrastructure Act—popularly known as the build–own–operate–transfer (BOOT) act—which governs public–private partnership (PPP) investments and currently lacks clarity. For example, the government's ability under the current act to cancel concession agreements without effective compensation for the concessionaire in FDI and BOOT projects heightens the risk profile in the view of private investors and discourages them from investing in Nepal.

4. Another critical constraint identified in a study supported in part by the Asian Development Bank (ADB) is a severe infrastructure deficit.⁶ Public investment in basic infrastructure in key areas such as energy and transport continues to be low (2.5% of GDP in

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¹ This analysis is a summary of the private sector assessment for Nepal undertaken by the Nepal Resident Mission in 2013 as part of the background studies for preparation of the new country partnership strategy.
² Nepal's fiscal year runs from mid-July to mid-July
This limits the ability of the private sector to perform well and to scale up investments. The country’s inadequate and unreliable supply of electricity is repeatedly noted as having a crippling effect on economic growth. Although Nepal is endowed with the potential to generate huge amounts of hydropower, it suffers long scheduled power cuts due the fact that the current installed capacity falls an estimated 448 megawatts short of demand during peak periods. Demand, meanwhile, is increasing by more than 10% every year. Businesses must often rely instead on expensive diesel power generation, resulting in higher operational costs. Nepal’s potential to earn revenue by exporting energy to neighboring markets is also hampered by the lack of the necessary cross-border transmission infrastructure and the appropriate power trade arrangements. The government is aware that it has limited ability to provide the investments needed to develop the country’s hydropower resources and has been attempting to promote private investment in electricity generation since 1992. It has now expanded this effort to power transmission. Independent power producers currently contribute about 30% of the total electricity supply, and there is significant interest from domestic and foreign investors to add to this capacity. Opportunity also exists to tap investments from nonresident Nepalese, through creation of a consortium of financiers from domestic and international finance institutions, or cofinancing of projects under PPPs. Faster development of the sector, however, will require a strong government commitment to comprehensive and strategic planning and to critical regulatory and institutional reforms. These reforms include a pending Electricity Act and Electricity Regulatory Commission Act and the financial restructuring of the Nepal Electricity Authority (NEA) to enhance the efficiency of the sector and attract private investment.

5. Road transport is the predominant mode of transport in Nepal, accounting for 90% of passenger and goods movement. However, Nepal has the lowest road density in the region, with 14 kilometers (km) per 100 square km and 0.9 km per 1,000 people. The condition of these roads is also poor. Of the 25,115 km of the Strategic Road Network as of FY2013, 7,474 km were paved, 6,077 km graveled, and 11,565 km unpaved. The network is concentrated mostly in the Terai lowland region of the country. Transport difficulties are also frequently exacerbated by disruptions in traffic along the major highways. The government is making efforts to promote private sector participation in the maintenance and upgrading of some roads. Meanwhile, reliance on air transport in Nepal is on the rise, with annual growth rate in air passenger movement varying from 7%–17%. This growth has followed the increased availability and affordability of air transport services that resulted from a liberal aviation policy adopted in the early 1990s to allow the entry of private operators. While the government-owned Nepal Airlines Corporation has seen a decline in profitability, private operators are doing well enough to warrant expansion of their services. As a result of the rise in domestic and international air traffic, the Tribhuwan International Airport in Kathmandu is operating over its capacity. The government is considering suitable PPP modalities for the construction and management of certain airports and their terminal buildings, including Tribhuwan airport.

6. Nepal’s urban centers provide the critical population mass needed for many private sector enterprises to invest. These centers support economic and business activities and ultimately drive economic growth. The country’s urban population increased sharply from 8.3% of the total population in 1990 to 17.3% in 2012. Failure to manage this expansion can impact the growth of private sector and the economy, and migration is already putting immense pressure on limited urban infrastructure. Without a proper strategy or the resources to invest, the lack of the necessary cross-border transmission infrastructure and the appropriate power trade arrangements, the government is aware that it has limited ability to provide the investments needed to develop the country’s hydropower resources and has been attempting to promote private investment in electricity generation since 1992. It has now expanded this effort to power transmission. Independent power producers currently contribute about 30% of the total electricity supply, and there is significant interest from domestic and foreign investors to add to this capacity. Opportunity also exists to tap investments from nonresident Nepalese, through creation of a consortium of financiers from domestic and international finance institutions, or cofinancing of projects under PPPs. Faster development of the sector, however, will require a strong government commitment to comprehensive and strategic planning and to critical regulatory and institutional reforms. These reforms include a pending Electricity Act and Electricity Regulatory Commission Act and the financial restructuring of the Nepal Electricity Authority (NEA) to enhance the efficiency of the sector and attract private investment.

9 The government adopted a more liberalized policy framework through the Hydropower Development Policy in 1992.
the government has been unable to keep up with the increasing demand. The government and the private sector have made several attempts at PPPs in the delivery of basic services, including the creation of the Kathmandu Upatyaka Khanepani Limited to provide water supply in Kathmandu, but this has had mixed results.

7. Labor unrest has been a difficult challenge for private sector development (PSD) in Nepal. Despite many increases in the minimum wage, which is now the highest in South Asia, the influential, politically affiliated labor unions have gone on strike repeatedly for higher wages and other benefits. The high number of registered trade unions in the industrial sector has not only discouraged new investment, but also forced the closure of some domestic and foreign firms. However, labor relations is improving modestly as indicated by a 2012 nationwide Federation of the Nepalese Chambers of Commerce and Industry’s survey, which showed that only 6.3% of respondents considered labor issue a critical challenge. Much improvement is still needed, as is a revision of rigid labor regulations, if Nepal is to become more investor-friendly. In addition, the government lacks the capacity to enforce and monitor compliance with agreed arrangements or to resolve disputes. Enforcement of provisions in industrial and trade policies and better communication between employers and employees is required. Skills enhancement and training of workers are also needed.

8. The competitiveness of Nepal’s private sector in today’s global economy is limited, given its small size, large degree of informality, and lack of innovation. Most firms are small, operate in the informal market space, and have limited economies of scale and profitability. Dominant large firms are generally family-run and have survived mostly due to a lack of competition. This is changing, however, with market liberalization allowing foreign investment and increasing internal capacity due to the influence of and exposure to such investments.

C. Government’s Sector Strategy

9. The government recognizes the private sector as one of the three pillars of the economy and considers its role crucial to achieving higher growth. The government is now promoting private sector participation in infrastructure development of hydropower plants, irrigation, roads, and airports and has begun creating an enabling environment for private investment. In 2011, the Investment Board of Nepal was established to facilitate investments of more than NRs 10 billion in priority sectors by mobilizing domestic and foreign investments through PPPs and other funding mechanisms. The government has initiated several legislative reforms, including amendments to the Industrial Enterprise Act (1992) to promote export-oriented and domestic consumer-oriented industries. It has also begun consultations to draft a PSD policy and published a white paper on PPPs to provide better clarity about its intentions to engage with the private sector.

10. The limited capacity of the bureaucracy and its weak governance have meant that a comprehensive strategy to deal with the exigencies of PSD is lacking. Among other obstacles to business, the private sector must deal with slow bureaucratic procedures, weak enforcement of contracts, a cumbersome tax regime, and inconsistent policies. In 2010, the government set up the Nepal Business Forum to address these issues; facilitate a national platform for public–private dialogues; and establish a structured, transparent, and results-oriented mechanism through which the public and private sector could collaborate in identifying solutions.

10 According to Nepal Labor Force Survey 2008, about 70% of nonagriculture employment is in the informal sector.
11 Other legislative efforts include the Banks and Financial Institutions Act 2006 and the Private Financing in Build and Operation of Infrastructure Act 2006.
D. **ADB’s Sector Experience and Assistance Program**

11. ADB has been helping to create an enabling business environment in Nepal by supporting policy, institutional, and regulatory reforms. This has included strengthening the capacity for PPP undertakings by assessing the scope for PPPs in energy, road and air transport, and urban services development. ADB is also helping to develop a PPP policy and regulatory framework and to formulate viable PPP projects. To promote private sector investment in infrastructure development, ADB is supporting important regulatory and institutional reforms to improve public debt management and thereby develop the country’s rudimentary capital (bond) market. Going forward, these reforms will be deepened to create the necessary conditions for private sector investment in the development of key infrastructure facilities through PPP modalities.

12. ADB will also redouble its efforts to promote private sector investment in the sectors it operates in. In the energy sector, which holds the greatest potential for private investments, ADB has been helping to strengthen the regulatory mechanism, undertake institutional and financial restructuring of the NEA, and pilot private sector participation in power distribution. Under the new country partnership strategy, ADB will continue to support critical regulatory, policy, and institutional reforms needed to create the necessary conditions for private sector investment. In addition, ADB will catalyze private investment in hydropower generation, transmission, and distribution based on suitable PPP modalities. This will help fill the deficit in domestic power demand as well as generate electricity for export to potential markets. In this regard, ADB will conduct feasibility assessment of large-scale projects and provide transaction advisory services to formulate and implement PPP projects.

13. In the transport sector, assessments are underway to involve the private sector in the maintenance of the country’s strategic road network and the potential for PPP in air transport. ADB will provide necessary capacity building support to introduce performance-based management contracts for the maintenance of the road network and to upgrade and manage airports through PPP. PSD initiatives in urban infrastructure include a pilot industrial park development through a build–operate–transfer modality, and capacity building for the government’s Town Development Fund to mobilize municipal and private sector funds for building sustainable water supply systems. These pilots will be replicated through appropriate PPP modalities under ADB projects. In the agriculture sector, experience from two ongoing value chain projects, which have been providing promotional grants to tap private investment in various agribusinesses, could present business opportunities for direct investments through ADB’s private sector window.

14. ADB will also explore new private sector business opportunities for direct and innovative investment and lending products through ADB’s private sector window in all these sectors, as well as in others (e.g., tourism, health, and manufacturing). ADB’s viable private sector investment activities will be coordinated with its ongoing efforts to support the issuing of local currency bonds and lending in the Nepalese currency.

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