



CREATING MARKETS IN NEPAL

Country Private Sector Diagnostic

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Abbreviations and acronyms

ACAP	Annapurna Conservation Area Project	MCC	Millennium Challenge Corporation
ADB	Asian Development Bank	MCR	Minimum Capitalization Requirement
ADS	Agriculture Development Strategy	MFD	Maximizing Finance for Development
BPO	Business Process Outsourcing	MICE	Meetings, Incentives, Conferences and Exhibition Tourism
CAN	Computer Association of Nepal	MIS	Management Information Systems
CEM	Country Economic Memorandum	MOUS	Memorandum of Understanding
CF	Community Forest	NABIC	Nepal Agribusiness Innovation Centre
CTVET	Council for Technical and Vocational Education and Training	NEA	Nepal Electricity Authority
CPSD	Country Private Sector Diagnostic	NGOS	Non-Governmental Organizations
DFID	Department of International Development	NVQ	National Vocational Qualifications
DMO	Designation Management Organization	PA	Protected Areas
FAO	Food and Agriculture Organization	PACT	Project for Agriculture Commercialization and Trade
FDI	Foreign Direct Investment	PPP	Public Private Partnership
FIA	Foreign Investment and Technology	SCD	Systematic Country Diagnostic
FITTA	Foreign Investment and Technology Act	SCT	Smart Choice Technologies
GCI	Global Competitive Industry	SEZ	Special Economic Zone
GDP	Gross Domestic Product	SME	Small and Medium Enterprises
GER	Gross Enrolment Rate	SOES	State-owned Enterprises
GHT	Great Himalayan Trail	SPS	Sanitary and Phytosanitary Measures
GIZ	German Agency for International Cooperation	TSLC	Technical School Leaving Certificates
GSMA	Global System for Mobile Communications	TVET	Technical and Vocational Education and Training
QAA	Quality Assurance and Accreditation	VAT	Value-added tax
ICT	Information and Communication Technology	WBG	World Bank Group
IFAD	International Fund for Agriculture Development	WDI	World Development Indicators
IFC	International Finance Corporation	WEF	World Economic Forum
IMF	International Monetary Fund	WGI	World Governance Indicators
ISP	Internet Service Provider	WHO	World Health Organization
IT	Information Technology	WTTC	World Travel and Tourism Council
ITES-BPO	IT-enabled services and business process outsourcing	UGC	University Grants Commission
ITMP	Integrated Tourism Master Plan	UNWTO	World Tourism Organization
ITU	International Telecommunications Unit	USAID	United States Agency for International Development
INFRASAP	Infrastructure Sector Assessment Program		

All dollar amounts are U.S. dollars unless otherwise indicated.



Executive Summary

The purpose of this Country Private Sector Diagnostic (CPSD) is to assess opportunities and constraints holding back private sector growth. It conducts a diagnostic of the main cross-cutting constraints to private sector competitiveness and growth through data analysis, synthesis of existing research and stakeholder consultations. This exercise also identifies sectors that could play a key role in enabling Nepal's growth, by either enabling other sectors or capitalizing on Nepal's inherent comparative advantage to tap global markets. Sector deep dives help identify private sector constraints specific to these sectors, including sector-specific manifestations of cross-cutting constraints. The CPSD analysis finally identifies key recommendations on policy reforms and investments in public goods (including public-private partnerships) that could enable growth of a competitive private sector.

NEPAL MUST RECHARGE ITS ENGINES OF GROWTH

Nepal has performed a remarkable feat of poverty reduction, but still remains one of Asia's poorest and slowest-growing economies. Despite enduring a period of economic and political crises, the country managed to reduce its extreme poverty rate from 46 percent in 1996 to 15 percent in 2011.¹ But this was mostly brought about by young Nepali men and women choosing to work overseas and sending remittances back to their families in Nepal. Over the past 20 years, Nepal's real GDP growth rate has hovered at 4 percent per year, 2.5 percentage points below the South Asian average.

Institutional challenges and a demanding geography have made it difficult for Nepal to build on its unique advantages. Nepal is richly endowed with natural beauty, fertile land, and an abundance of water, and is located between two economic powerhouses, China and India. But much of the country consists of remote mountainous areas and is prone to natural disasters. In previous decades, deep-seated power imbalances gave rise to political uncertainty and conflict: Nepal has had more than 30 governments between 1990 and 2018. The new constitution and the peaceful transition of government now herald a period of stability, which

will be critical for Nepal to meet the challenge of strengthening its institutions.

With negligible productivity growth, Nepal's output growth has been driven by factor accumulation. In recent decades, growth in total factor productivity (TFP) has accounted for a miniscule fraction of GDP growth. Given diminishing returns to capital, such accumulation-led growth is not sustainable in the long term. Moreover, Nepal has a low rate of investment and its rate of public investment is particularly low.

While remittances have supported the improvement in Nepal's indicators, it creates potential risks from external impacts on the demand for Nepali migrant workers. It is estimated that 28 percent of Nepal's workforce—more than one-quarter—works abroad. Remittance flows were 26 percent of GDP in 2017, the second-highest among all countries with a population of over 1 million.² While providing an important source of income, remittances have also hurt Nepal's competitiveness through appreciation of the real exchange rate.

Nepal's process of structural transformation has been slow and atypical. Though the share of agriculture in output and employment has been declining, the rate of exit is slow. New jobs are being created mainly in low-value services and construction. More worryingly, with its share in GDP falling from 9 percent since 2001 to

just 6 percent today, Nepal's manufacturing base lacks dynamism and is a drag on growth.³

A symptom of low competitiveness, Nepal has not been able to exploit export markets. For medium-sized countries such as Nepal, trade can be an important engine of growth. However, Nepal has been unable to grow or diversify its exports, in terms of either products or destinations. Since the late 1990s, the export-to-GDP ratio has fallen from 25 to 10 percent, largely due to a collapse in Nepal's goods exports to just 3 percent of GDP.⁴ Traditional export mainstays such as textiles are on the decline. Meanwhile, rising services exports have failed to compensate for this decline; moreover, they hinge on demand from tourists. These problems with export growth are mostly due to constraints in the domestic business climate. Nepalese exporters have been unable to benefit from trade agreements and preferential access largely because of supply-side constraints. Most remain small, and struggle with increasing their shipments once they enter a new market, indicating high variable costs due to factors such as costly and unreliable electricity, and limited transportation services.

Nepal will need to increase its rates of investment and productivity growth to meet its growth targets, given the expected decline in remittances and migration flows. If its investment-to-GDP ratio, growth of human capital, and growth of productivity stay at recent historical averages, it will be difficult for Nepal to sustain the GDP per capita growth rate that is necessary to meet its target of reaching middle-income status by 2030.

Nepal needs a comprehensive growth strategy that will both boost investment and accelerate productivity. This should include: (a) putting in place policies that raise the productivity of key enabling sectors (such as transport, logistics, and telecommunications), reduce the cost of doing business, and strengthen integration with the rest of the world; (b) building new sources of growth and revitalizing existing sources of growth in sectors of comparative advantage; and (c) investing in people and putting them to productive use.

Prospects for the implementation of a growth-oriented strategy have recently become more favorable. A confluence of several important political developments could mark the beginning a new era of stability for

Nepal. In 2015, a new constitution was approved and, in 2017, a majority government was elected, and a new system of federalism adopted. A lack of capacity in nascent local-government level and clear national standards could create risks in the transition to this new system; at the same time, the devolution of power to local governments also offers the prospect for better prioritization of key policies.

SMALL FIRMS AND LOW PRODUCTIVITY LEVELS STILL CHARACTERIZE NEPAL'S PRIVATE SECTOR

Nepal's public sector has been withdrawing from most sectors of the economy, leaving more room for the private sector. A policy shift toward privatization in the 1990s has reduced the size of the public enterprise sector to levels below the South Asian average, and concentrated it in just a few sectors, such as utilities. More than 99 percent of formal firms are privately owned.⁵ Even social sectors such as health and education have a significant private sector presence. Despite the political uncertainty, private investment has grown and accounts for an increasingly large share of capital formation.

However, productivity levels remain low. While data constraints make it hard to estimate firm-level productivity, aggregate labor productivity in manufacturing is one of the lowest among comparators. This suggests that most firms are unproductive, and that there is a misallocation of resources across firms. Nepal's export performance also indicates that there are issues with productivity.

With the exception of a few large, influential business groups, most firms are small. A few large, mostly family-owned, businesses continue to be significant players in traditional sectors. These business groups have survived Nepal's political ups and downs by diversifying, and by demonstrating an ability to navigate regulatory hurdles. Apart from these large firms, most other firms are small: only 18 percent of Nepal's formal firms have more than 20 employees.⁶

Nepal's private sector is resilient but will require more dynamism to trigger the response required for

the country's growth ambitions. Firm entry rates are low. Most firms do not grow much as they age, which suggests that they are not making investments that would increase their productivity or product quality. Very few firms engage in trade or technology transfer with foreign countries. Usage of ICT is also relatively low. FDI inflows are negligible, at just 0.4 percent of GDP, or one-third of the South Asian average, and concentrated in just a few sectors, such as hydropower.⁷

NEPAL'S PRIVATE SECTOR FACES A HOST OF BUSINESS CLIMATE CHALLENGES, THE MOST CRITICAL RELATED TO INSTITUTIONS AND INFRASTRUCTURE

Strengthening institutions is critical for achieving Nepal's development objectives. Historically, political instability has made it difficult for Nepal to build strong institutions. Because of this history, Nepal ranks low on cross-country indicators of many dimensions of governance, such as rule-of-law and the control of corruption. With institutions often finding it challenging to insulate policymaking from frequent regime changes, the share of firms citing political uncertainty as one of the major obstacles to operations has been unusually high.⁸ This uncertainty has deterred private investment. Nepal also faces the governance challenge of making the process of policy design and implementation more effective and responsive to the interests of ordinary firms and individuals. This will be the key to increasing the ease of doing business and sustaining productive partnerships between the government of Nepal (GoN) and the private sector. The agenda of strengthening governance is a particularly salient issue in high-potential sectors. For example, the tourism sector needs revised regulations and stronger inter-ministerial coordination to develop strategies that will enable it to move up the value chain.

With key sectors such as tourism and agribusiness being highly reliant on connectivity, strengthening infrastructure is the other critical challenge for private sector development. Nepal ranked 130 out of 138 countries on the 2016 Global Competitiveness Index of infrastructure.⁹ It is ranked 124 out of 160 countries on the 2016 Logistics Performance Index (LPI) and has

relatively low road density. This is noteworthy because critical sectors such as agri-processing have a relatively high share of transport in their input bundle.¹⁰ Limited air and land connectivity also reduces the attractiveness of key tourist destinations. Besides transport, Nepal compares unfavorably with its neighbors on other dimensions of infrastructure, such as digital access, electricity consumption per capita, and transmission losses in the power sector. Not surprisingly, the share of Nepalese firms identifying electricity or transportation as major constraints is one of the highest among Asian comparators.

Although not binding to the same degree as governance and infrastructure, a gap in technical skills and managerial capabilities is constraining growth-oriented firms from scaling up and rising up the value chain. School enrolment rates have grown, but the quality of teaching is still a constraint. Nepal also underperforms on global indicators of higher education and skills, such as the Global Competitiveness Index on higher education and training, and the World Economic Forum "Know-How Index," which measures the breadth and depth of specialized skills. Firms note that a lack of technical and managerial skills has prevented them from moving up the value chain and scaling up. Perceptions of strict visa restrictions for skilled foreign workers appear to add to the problem.

Access to finance and inefficient land markets are also key constraints. Nearly 40 percent of Nepalese firms identify access to finance as a major constraint.¹¹ A key shortcoming is the absence of an effective credit information infrastructure that leads to an over-reliance on immovable assets, especially land and buildings, as collateral. In addition, there is no framework for the use of movable assets as collateral, which especially impacts small and medium-sized firms. Collateral demands on firms also tend to be inordinately high. Inequalities in access to land therefore translate into inequalities in access to finance. Long-term credit is still constrained by limited financial products and the shallowness of the capital market. Nepal's land market is highly inefficient due to institutional gaps, such as poor land records and an ineffective land management policy. This makes it difficult to deploy land efficiently for productive uses.

Excessive barriers to foreign investment and foreign-exchange transactions also constrain the private sector. Linking with international markets can be an important driver of growth for medium-sized countries such as Nepal. However, foreign direct investment (FDI) is deterred by complex procedures and overly restrictive policies. The latter include sector caps, a long “negative list” of sectors barred from FDI, and restrictions on non-equity modes of investment that are often implemented in an inconsistent manner. Foreign trade and FDI are also hampered by restrictions on foreign-exchange transactions, such as difficult procedures for opening U.S. dollar-denominated bank accounts.

Policies on land acquisition and the use of land as collateral, in particular, deter foreign investors and lenders, restricting private sector access to long-term finance. Although foreign investors can acquire land for commercial purposes, the process is difficult and uncertain. The creation of mortgage of land in favor of foreign lenders needs cabinet approval, and the enforcement of security by foreign lenders needs a court order. Foreign lenders also have a lower repayment priority than domestic lenders. Easing these constraints on foreign lenders could significantly improve access to long-term credit.

HOW THE PRIVATE SECTOR CAN BECOME A MORE POWERFUL ENGINE OF GROWTH: HIGH-PRIORITY SECTORS

In leveraging Nepal’s unique endowments, hydropower will be critical to the new growth strategy, provided that the wealth generated from this sector is channeled judiciously. Hydropower could attract massive new investments and an increased inflow of resources into the country, potentially stimulating construction and urbanization.¹² It would also increase the competitiveness of firms in general by easing the supply of power. However, there are some downsides: few jobs would be created and large increases in electricity exports could lead to Dutch disease, further weakening Nepal’s export competitiveness. It would therefore be important to invest the returns from hydropower in removing bottlenecks to private investment and in diversifying the economy by developing those sectors in which Nepal has a comparative advantage.

With the hydropower sector covered as part of the forthcoming World Bank InfraSAP report, this CPSD identifies five sectors where greater facilitation of the private sector could have major impacts on Nepal’s growth trajectory. These five sectors are tourism, agribusiness, education, health, and IT.

Tourism and agri-business are “growth drivers” in that they are sectors with a strong comparative advantage and the potential to compete in large export markets and spur job creation. In tourism, Nepal has unique endowments: the world’s tallest mountains, vast nature preserves ranging from alpine meadows to tropical forests, and some of the world’s key Buddhist and Hindu sites. It can capitalize more fully on these endowments by diversifying and moving up the value chain toward medium and high-end tourism, for example, through developing leisure and outdoor adventure activities in destinations with high potential, such as Annapurna and Lumbini. In agribusiness, Nepal’s rare and varied agro-climatic conditions give it a potential edge in many products, including high-value niche products such as spices, fruit juices, honey, medicinal herbs, tea, coffee, apples, and cut flowers. With more than 70 percent of the population working in agriculture, creating markets in high-potential agriculture value chains, such as tea and spices, could have a substantial impact on living standards in rural areas.

Education and health are important enablers, where private sector involvement can help implement a key pillar of Nepal’s new growth strategy: investing in people and putting more human capital to productive use. In education, the private sector is playing an increasingly important role in technical and vocational education and training (TVET), and in tertiary education. There are significant opportunities for more professional colleges and TVET institutes to meet the need for high-quality and market-relevant skills, thereby easing a constraint on firms’ productivity. In health, the private sector could partner with the GoN to improve health access and the quality of health care, as well as help to expand health insurance coverage. The private sector is already active in these sectors but could play a much larger role, including in parts of the country that are currently underserved. Health and education also offer better job opportunities to women.

The IT services sector, although nascent and small, can help unleash Nepal’s entrepreneurial spirit, and enable productivity growth in other sectors. In the short run, it can increase exports of low- to mid-range business process outsourcing and data analytics. In the longer run, the sector could develop niche expertise and raise the productivity of other sectors, such as tourism and agribusiness (through tailored software such as apps for mountain hiking), retail (e-commerce) and transport (logistical software). Glimpses of this potential can already be seen in fledgling start-ups, such as an Uber-like personal ride-hailing service for Kathmandu’s ubiquitous two-wheelers. The IT sector can also help improve efficiency and transparency in public service delivery and regulatory governance.

The sector deep dives of this CPSD also identified sector-specific constraints, most of which were in fact sector-specific manifestations of key cross-cutting constraints: infrastructure, governance, and skills. In tourism, poor connectivity infrastructure puts many potential destinations out of reach. The challenges facing governance/institutions manifest themselves in the need to update laws and regulations in consultation with all stakeholders—including for protected areas, where a more nuanced approach is needed to balance the public interest in legitimate environmental protection, while enabling more economic opportunities. Furthermore, a lack of coordination between ministries to implement policies hinders the adoption of an effective strategy to upgrade products to attract tourists in the higher-end segments and close the wide skills gap. In agribusiness, poor logistics fragment domestic markets and increase aggregation costs. This weakens value chains and reduces the competitiveness of local produce. This is compounded by inefficiencies in government procurement and distribution of basic inputs, such as fertilizers and improved seed, which exclude the private sector and distort markets. Aggregating land is also difficult, which means that farms often remain small and unproductive, and agribusinesses struggle to scale up.

The cross-cutting constraints regarding infrastructure, governance and skills also adversely impact health, education and IT. In health, current limitations in government capacity to regulate and partner with the private sector are curtailing efforts to increase

access to care and to improve quality through greater private sector involvement. The limited dialogue with the private sector has impeded efforts to modernize and reform service delivery, and devise instruments to effectively contract with private actors. In education, capacity constraints in the relevant government agencies hamper the speedy approval of new colleges, TVET providers and courses. Limited government capacity to regulate quality undermines the incentives of private service providers to improve the quality of the education that they provide. Finally, the development of the IT services sector is constrained by weaknesses in the education system and by poor access to affordable, quality infrastructure, such as IT parks.

HOW THE PRIVATE SECTOR CAN BE ENABLED: HIGH-PRIORITY REFORMS

Cross-cutting constraints need to be urgently addressed to create a better enabling environment for the private sector. At the economy-wide level, the following measures would be advisable:

- » ***Ease barriers to firm entry and operations*** by: (a) simplifying business regulations and streamlining processes; (b) introducing single-window interfaces for regulatory compliance as envisaged under the Enterprises’ Act; and (c) establishing a platform for regular dialogue between the GoN and the private sector to address pain-points and improve coordination.
- » ***Strengthen infrastructure***¹³ by: (a) enacting the PPP Law and developing a PPP pipeline, together with a contingent liability framework; (b) strengthening the Road Board of Nepal and identifying strategic roads to be improved through PPPs; (c) prioritizing airport development through PPPs and reforming civil aviation policies and regulations (see the tourism sector deep dive); (d) developing a reform plan to improve digital infrastructure (see the IT services sector deep dive); and (e) enabling hydropower expansion and strengthening the Nepal Electricity Authority (NEA).
- » ***Enhance access to finance*** by: (a) clarifying regulations and procedures needed to operationalize the Secured Transactions Act; (b) strengthening the creditor information base; and (c) developing a legal

framework for private equity and venture capital. Furthermore, the knowledge base on the financial sector needs to be deepened, with a view to developing more specific recommendations to boost access to finance and develop alternative sources of financing.

- » **Improve allocation of land** by: (a) implementing land zoning; (b) updating the Land Act and making it consistent with Land Acquisition Policy; and (c) developing industrial parks tailored to specific industries.
- » **Remove constraints to FDI** by: (a) reducing the negative list; (b) adopting a new draft Foreign Investment Act aligned with international best practice and obligations; (c) streamlining processes critical to entry and operations, such as investment approvals, repatriation and exit; and (d) streamlining the process of using land as collateral for foreign investors.
- » **Improve firms' capabilities to support scale-up** by introducing a publicly-supported management extension program for firms in key sectors.

The CPSD also recommends sector-specific actions to open up priority sectors. Sector opportunities, key constraints, and priority interventions are listed for each sector in Table 1.

Political will is required to implement these initiatives. The new GoN has signaled a renewed focus on working with the private sector for accelerated growth. This will involve tackling anti-competitive practices in the critical transport and other sectors. Key economic institutions will need to be strengthened, such as those governing land markets. There is a need to push departments to better implement existing policies, clarify gaps, and coordinate more with other agencies. The potential of the new federal system to improve policy design and implementation will need to be fully unleashed by strengthening the capacity of local governments, and further clarifying the roles and responsibilities of different levels of government. These initiatives are feasible. The World Bank Group can support change by sharing experience on international best practice, as well as providing implementation support and financing. ■

TABLE 1 Business opportunities and constraints

TOURISM		
<i>Development impact/potential:</i> Diversifying products to medium/high-end tourism by capitalizing on Nepal's comparative advantages in high potential destinations such as Annapurna and Lumbini, has the potential to create many better jobs and help less-developed parts of Nepal.		
OPPORTUNITIES	KEY CONSTRAINTS	PRIORITY INTERVENTIONS
<ul style="list-style-type: none"> » Mid to high-end tourism, notably nature-based and cultural tourism. Including: <ul style="list-style-type: none"> • Annapurna and Lumbini/Palpa top priority destinations. • Mid-West Nepal and Langtang promising potential. • New mid-high range markets (such as China) and products (such as wellness, soft adventure, village and ecotourism-related). 	<ul style="list-style-type: none"> » Connective infrastructure: <ul style="list-style-type: none"> • One international airport, already exceeding capacity • Poor road networks in areas with tourism potential » The need to revise regulations and make them more predictable, especially civil aviation policies and the Foreign Investment Act: <ul style="list-style-type: none"> • Average five-star hotel project face up to a six-year delay » The need to ease restrictions for investment/construction in Protected Areas. » The need to improve policy coordination: <ul style="list-style-type: none"> • Weak destination development planning 	<ul style="list-style-type: none"> » Upgrade the reliability, safety and efficiency of the airport system by improving operational management of TIA, accelerate ongoing airport construction and assess need for new airports. » Update aviation policies and regulations (for example, adoption of draft Civil Aviation Bill, review of tax on plane leasing). » Develop plans for development of key destinations (Annapurna and Lumbini). » Review policies and regulations governing utilization of protected areas (National Parks and Wildlife Reserve Act of 1973 and Forest Regulations of 1995).

AGRIBUSINESS

Development impact/potential: With more than 70 percent of the population working in agriculture, creating markets in high potential agriculture value chains, such as tea and spices, could have substantial impact on living standards in rural areas. Agribusiness in turn could drive the needed structural transformation of the economy toward higher value-added activities.

OPPORTUNITIES	KEY CONSTRAINTS	PRIORITY INTERVENTIONS
<ul style="list-style-type: none"> » Export-oriented niches: <ul style="list-style-type: none"> • Relatively established: whole leaf, organic tea could rival Darjeeling; spices, like cardamom • Emergent: fresh apples, coffee, honey, and cut flowers » Non-niche products where Nepal could achieve competitiveness in local/regional market in medium to long term: <ul style="list-style-type: none"> • Poultry • Potatoes • Vegetables and ginger 	<ul style="list-style-type: none"> » Low agricultural productivity: <ul style="list-style-type: none"> • Inefficient government seed and fertilizer procurement and distribution systems • Difficulty in aggregating land to commercial scale » Restrictive enabling environment: <ul style="list-style-type: none"> • Strong public sector presence in key markets • Not enough support for agri-business scale-ups and building firm capabilities • Weak quality infrastructure that restricts access to foreign markets • Poor logistics • Insufficient investment in agri-supply chains » Low access to finance: <ul style="list-style-type: none"> • Limited credit products available for smaller agribusinesses, with an absence of leasing or warehouse receipts legislation 	<ul style="list-style-type: none"> » <i>Improve efficiency of input provision by allowing private sector participation in tenders for procurement and distribution of fertilizers and seeds.</i> » <i>Strengthen subsidy allocation efficiency, including through e-vouchers.</i> » <i>Enhance land availability and consolidation by: (a) conducting a land governance assessment, subsequently implementing recommendations starting with areas with the highest agribusiness potential; (b) introduce land zoning as required by the Lands Act (Chapter 9A); and (c) Pilot a land bank to facilitate leasing of unutilized land as proposed in the ADS.</i> » <i>Increase ability to reach foreign markets by (a) identifying priority activities to improve food safety/SPS; and (b) building critical connectivity infrastructure.</i>

EDUCATION

Development impact/potential: Increase in private sector entry and quality in the tertiary education and TVET subsectors could ease a major constraint on firms, namely the limited supply of workers with market-relevant technical and managerial skills.

OPPORTUNITIES	KEY CONSTRAINTS	PRIORITY INTERVENTIONS
<ul style="list-style-type: none"> » Professional colleges with/without foreign affiliation: <ul style="list-style-type: none"> • Engineering and management » Large, professionally managed TVET institutes. » Innovative low-cost solutions, such as e-learning (all mainly oriented to domestic market) 	<ul style="list-style-type: none"> » Private colleges lack autonomy and industry linkages needed to respond to the market: <ul style="list-style-type: none"> • Fee structure, class size and instructor salary • Lack of a publicly supported industry body, such as the Industry Skills Councils, involved in TVET » Quality is under-regulated: <ul style="list-style-type: none"> • Information on graduate outcomes by program/course not disseminated, effectively limiting consumer choice. » Entry and operation are over-regulated: <ul style="list-style-type: none"> • 15-day per year for permission for international affiliation • TVET affiliation can take four years • Slow course approval • Uncertain, arbitrary licensing decisions 	<ul style="list-style-type: none"> » <i>Enable market-oriented decision-making by private colleges by developing a framework for operational autonomy and speeding up new course approval procedures.</i> » <i>Improve quality by building capacity to operationalize the Quality Assurance and Accreditation (QAA) process, and publicly disseminating program outcome information.</i> » <i>Improve ease of entry by simplifying guidelines for affiliation of colleges to universities, licensing of colleges with foreign affiliation, and approval of new TVET courses.</i>

HEALTH

Development impact/potential: Increase in the number and quality of private providers will help address critical human capital constraints by enabling better access in underserved areas

OPPORTUNITIES	KEY CONSTRAINTS	PRIORITY INTERVENTIONS
<ul style="list-style-type: none"> » Partnering with government to improve access outside of Kathmandu Valley: <ul style="list-style-type: none"> • Referrals from public health centers • Rural health camps in partnership with community health facilities • Private provision of services to public hospitals » Health insurance: <ul style="list-style-type: none"> • Participation in the national health insurance program • Underexploited higher-end segment » Rural community pharmacies. 	<ul style="list-style-type: none"> » The need to strengthen institutional capacity to regulate or partner with private sector: <ul style="list-style-type: none"> • Underinvestment in developing physical/clinical standards, accreditation, and dissemination of quality norms or protocols • Limited mechanisms to contract services to the private sector • Ineffective incentives for commercial health-care providers to focus on poor in underserved locations » Lack of dialogue between public and private health providers leading to distrust and an unwillingness to collaborate. 	<ul style="list-style-type: none"> » Strengthen the provision of private sector services to public sector health-care facilities: <ul style="list-style-type: none"> • Build capacity in public sector to contract with the private sector • Support the inclusion of more private facilities in the national health insurance program. • Develop financial instruments that incentivize private expansion into underserved areas » Improve “quality of care:” <ul style="list-style-type: none"> • Benchmark “quality of care” institutions to evaluate gaps and identify areas for reform • Develop and implement a health-care quality plan as recommended by WHO • Develop and implement mechanisms to provide oversight starting with, accreditation and patient feedback

IT SERVICES

Development impact/potential: Relatively unconstrained by Nepal’s weak physical infrastructure (such as roads), logistics, high land prices and small domestic market, the IT services sector can expand good job opportunities for skilled youth, improve the productivity of other sectors and facilitate good governance.

OPPORTUNITIES	KEY CONSTRAINTS	PRIORITY INTERVENTIONS
<ul style="list-style-type: none"> » (Short run) Export-oriented IT services firms, leveraging low-wage advantage: <ul style="list-style-type: none"> • Low-mid range BPO and data analytics » (Medium to long term) e-commerce for domestic market. » (Medium to long term) Niche products <ul style="list-style-type: none"> • “Servicification” of value chain activities, like remote education services • Innovative products, potentially exportable, but leveraging home market advantage: Clean energy software, mountain hiking and tourism apps, geolocation and meteorology apps. 	<ul style="list-style-type: none"> » Limited higher-level technical and managerial skills and experience: <ul style="list-style-type: none"> • Low quality of technical education • High turnover of talent » Regulatory issues: <ul style="list-style-type: none"> • Framework for e-commerce and outsourcing missing • Visa difficulties for skilled foreigners • Weak IP enforcement capacity » Access to finance: <ul style="list-style-type: none"> • Missing market between seed funding and mature stage capital • Challenging FDI regulations » (Digital) infrastructure: <ul style="list-style-type: none"> • ICT infrastructure is costly, low quality and concentrated in the Kathmandu Valley • E-payment infrastructure is nascent • Dysfunctional IT Park 	<ul style="list-style-type: none"> » Improve access to skills through a collaboration between Ministries of Education, IT and Industry to revise graduate courses and introduce IT internship program. » Improve firm capabilities by supporting the development of more business incubators and introducing subsidized management extension programs for IT firms. » Improve access to serviced land and infrastructure by upgrading the existing IT Park with greater private sector involvement, and by developing a reform plan for ICT infrastructure sector.

Introduction

Nepal is at a cross-road. Located in one of the most economically dynamic regions in the world, its development has long been held back by several factors, most notably pervasive political instability. Over the past two years, however, the confluence of a series of favorable political developments has given rise to a wave of optimism about the country's future and prospects for the emergence of an environment more conducive to the development of the private sector.

Against this backdrop, the purpose of this Country Private Sector Diagnostic (CPSD) is to assess opportunities and constraints holding back private sector growth. It conducts a diagnostic of the main cross-cutting constraints to private sector competitiveness and growth through data analysis, synthesis of existing research and stakeholder consultations. This exercise also identifies sectors that could play a key role in enabling Nepal's growth, by either enabling other sectors or capitalizing on Nepal's inherent comparative advantage to tap global markets. Sector deep dives help identify private sector constraints specific to these sectors, including sector-specific manifestations of cross-cutting constraints. The CPSD analysis finally identifies key recommendations on policy reforms and investments in public goods (including public-private partnerships) that could enable growth of a competitive private sector.

NEPAL'S DEVELOPMENT CONTEXT

Difficult geography and political economy have constrained Nepal's development

Despite its unique natural endowments, Nepal remains poor. The country is rich in natural endowments, with per capita water availability and forest cover at more than twice the South Asia average. Yet its per capita GDP of \$853 in 2017 is much lower than those of its neighbors in South Asia.¹⁴

Geography has played a strong role in shaping Nepal's patterns of development. Nepal's land-locked position and mountainous topography increases the cost of doing business and leaves many regions isolated and

difficult to access. It is difficult to build infrastructure in Nepal, especially given that the country is also prone to natural disasters, such as earthquakes and floods.

Until recently, political instability has also been a key factor influencing Nepal's development trajectory. From 1990 to 2018, Nepal had more than 30 governments—an average tenure of less than one year. The short tenure of governments hampered policy consistency and the emergence of a civil service capable of implementing reforms. A comprehensive peace accord signed in 2006 ended a decade-long period of violent Maoist insurgency, although this also required a prolonged political transition that only ended almost one decade later with the adoption of the new constitution in September 2015.

Nepal's output and productivity growth remain slow

Nepal's economic performance has been disappointing, even compared with neighbors facing similar challenges of geography and political economy. With real GDP growth hovering around 4 percent over the past two decades, Nepal remains one of the poorest and slowest-growing economies in Asia (Figure 1a). Indeed, in recent years, other landlocked and topographically challenged countries, such as Afghanistan, Bhutan, and Lao PDR, have outpaced Nepal in GDP growth. Nepal has also done no better than Sri Lanka and Pakistan, countries that have been severely affected by armed conflict and terrorism, respectively. Over the past 20 years, Nepal's per capita GDP growth has been significantly slower than its closest neighbors in South Asia (Figure 1b).

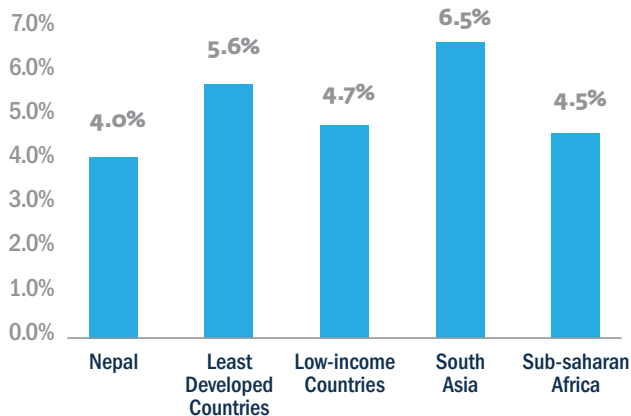


FIGURE 1A Average real GDP growth per annum, 1994–2016

Source: WDI

Output growth has been driven by human and physical capital accumulation, not by productivity improvement. Nepal’s total factor productivity (TFP) declined during the conflict years (1996–2006). TFP growth picked up after 2006, but still accounted for less than 5 percent of GDP growth during 2007–14. This is troubling because, as the cross-country evidence suggests, closing the GDP gap with high-income countries is impossible without sustained TFP growth.¹⁵

Nepal has low levels of investment, which is a major concern for a country whose growth has been accumulation-led. Public investment levels are relatively low: averaging 4.5 percent of GDP during 2007–15, public gross fixed capital formation was below the mean levels for South Asia (7 percent) and low-income countries (10 percent). Private gross fixed capital formation averaged 18 percent of GDP during the same period, below average for South Asia, although slightly above average for low-income countries.¹⁶

Struggling to remain competitive in export markets, Nepal’s economic trajectory has been increasingly dictated by remittances

Nepal’s workforce has become increasingly dependent on emigration for work. It is estimated that 28 percent of Nepal’s workforce works abroad. As a share of GDP, officially recorded remittance flows increased from the equivalent of 2 percent in 2000 to 26 percent in 2017, the second-highest in the world among countries with a population of over 1 million.¹⁷ Such high

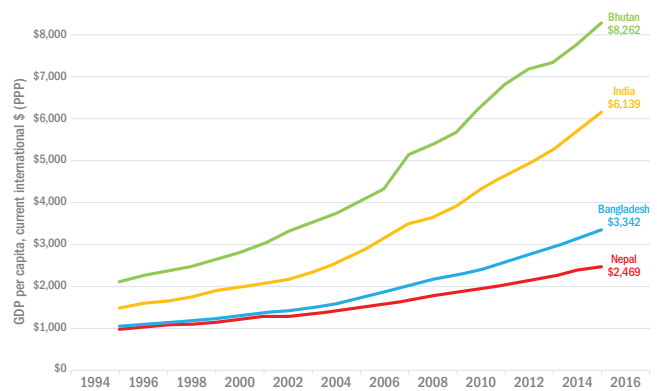


FIGURE 1B Per capita GDP (PPP), 1994–2016

Source: WDI

emigration is largely a response to Nepal’s inability to create good jobs at home. Youth underemployment and unemployment are both high, and most people are stuck in low-productivity sectors in rural areas.¹⁸ Young people entering the labor market have higher educational attainment than older generations and aspire to wage jobs outside agriculture. However, such jobs are scarce and school-to-work transitions are slow: 30 percent of women and 15 percent of men in the 16-to-24 age group are neither working nor in school. The share of rural women aged 16 to 34 who are not in employment, education, or training increased by 20 percentage points between 2003/04 and 2010/11.¹⁹

Remittances have helped to rapidly reduce poverty but also had adverse effects on Nepal’s competitiveness. Over the past three decades, Nepal has experienced a remarkable reduction in poverty, from 46 percent in 1996 to 15 percent in 2011. This has been largely due to a sharp increase in remittances. Remittances have also contributed to macroeconomic and financial stability by providing a steady source of foreign exchange and helping to finance the large trade deficit.²⁰ However, remittances have also hurt Nepal’s competitiveness through appreciation of the real effective exchange rate. Rising imports, in turn, have become an attractive target for taxation, prompting an increased reliance on import taxes. The ensuing relatively high trade barriers are an important additional source of economic distortion, exacerbating the cost disadvantages of the economy.

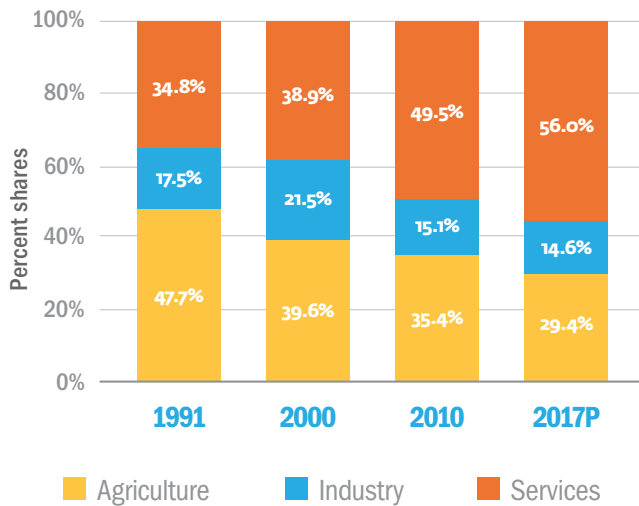


FIGURE 2 Sector-wise contribution to GDP in Nepal

Source: Central Bureau of Statistics. Note: “Industry” includes manufacturing, construction, electricity, gas and water.

Nepal’s structural change has been atypical. Its economy remains largely agrarian: 70 percent of the workforce is engaged in agriculture, which accounts for around 30 percent of value-added (Figure 2). The manufacturing base seems to be vanishing, with the sector accounting for only 6.5 percent of GDP, dropping from 9 percent in 2001.²¹ Unlike the historical experience of today’s high-income countries, Nepal’s structural change has consisted of a shift from agriculture to services, rather than from agriculture to manufacturing. This atypical pattern could be partly due to remittance-fueled investment into construction

and services such as real estate, whose share of GDP has increased. Although the transition from agriculture to services is not necessarily worrisome, in the case of Nepal these sectors do not typically provide high-skilled jobs: even as workers have exited the farm, the skill-content of the average wage-earning job has not increased.²²

Foreign remittances aside, Nepal has a relatively closed economy. Gravity models of trade suggest that Nepal’s export and import shares in GDP are below average, even after the country’s size, remoteness from main markets, and landlocked status are considered.²³ Indeed, the situation has worsened relative to the 1990s. The trade-to-GDP ratio fell from an average of 59 percent in 1995–99, to 46 percent in 2010–14.

Nepal’s goods exports-to-GDP ratio has been flat, and services exports have not risen fast enough to compensate. As a share of GDP, Nepal’s exports fell from nearly 25 percent in the late 1990s to 10 percent in 2017 (Figure 3a). This decline was largely due to failing goods exports: the growth rate of goods exports (in absolute terms) fell from an average of 19 percent per year in the 1990s to just 0.6 percent per year in the decade after.²⁴ As a result, Nepal’s goods exports have fallen as a share of GDP, and are at just 3 percent of GDP. Services exports have expanded rapidly, but this has failed to compensate for the dramatic decline in goods exports as a share of GDP.

At the same time, fueled by remittances, Nepal’s imports have soared. Consequently, the trade deficit

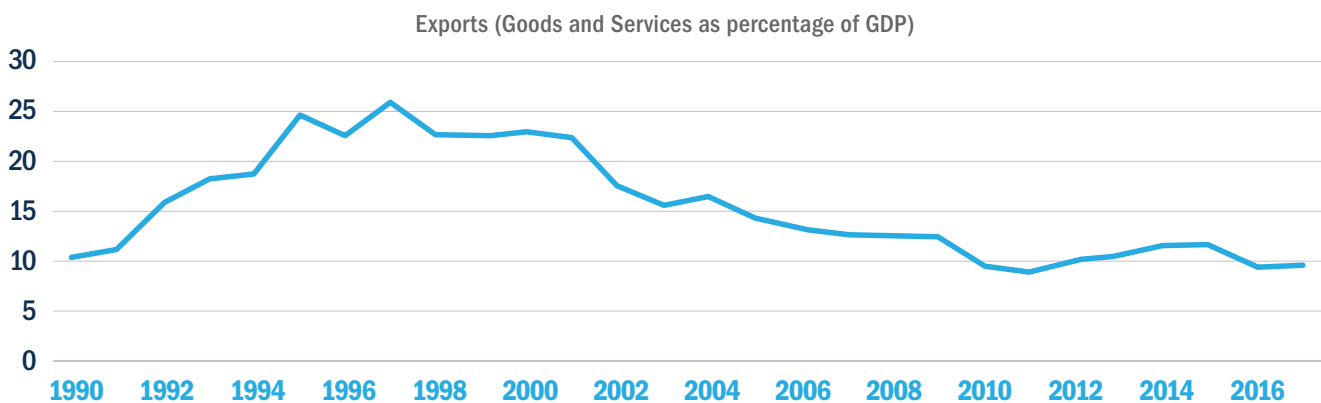


FIGURE 3A Nepal’s trade performance

Source: WDI

reached nearly 33 percent of GDP in 2017. This large deficit has not resulted in a substantial accumulation of net foreign liabilities, as it has been largely financed with workers' remittances from abroad. Even though, with many Nepalis working abroad, the high trade deficit is financeable, the dependence on remittances and the growing concentration of exports may render Nepal vulnerable on the external account.

Nepal's exports remain concentrated in a few destination countries and low-end products.

Although their predominance has declined since 2010, textiles and agri-products still accounted for nearly 65 percent of Nepal's goods exports in 2016 (Figure 3b). Moreover, in a period when total goods exports (in absolute terms) have been largely flat, this compositional shift could be due to the declining competitiveness in traditional export mainstays such as textiles, and without increased competitiveness in new manufacturing sectors. Services exports are concentrated in just two sectors, with travel (tourism) and ICT accounting for more than 80 percent of

services exports. These are largely lower-end products: for instance, the telecom exports of Nepal consist mainly of calls and mobile data services to foreigners visiting Nepal—a byproduct of tourism.²⁵ India accounts for more than two-thirds of Nepal's trade. Nepal's goods exports have in fact become increasingly concentrated in India (Figure 3c).

Weak export performance is largely a symptom of supply-side constraints. In part, Nepal's exporters are disadvantaged by high tariffs on crucial imported inputs. Nepal has consistently applied higher tariffs on the import of intermediate and capital goods than countries that have benefited from integration into global value chains, such as Vietnam and Malaysia.²⁶ But the main sources of disadvantage for Nepalese exporters are internal, and due to a host of business climate issues, such as electricity supply and red tape. For instance, most exporters remain small even after they enter a new export market, and largely do not increase their shipments. This suggests that they face high variable costs of exporting, which could be due



FIGURE 3B Composition of goods exports of Nepal

Source: MIT Observatory of Economic Complexity.

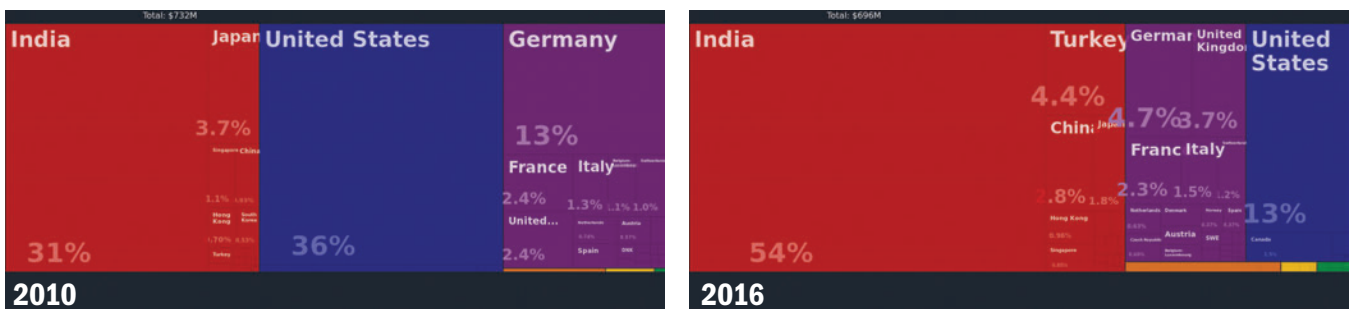


FIGURE 3C Export destinations of Nepal

Source: MIT Observatory of Economic Complexity.

to factors such as high transport and energy costs.²⁷ Nepal's traditional export drivers, mainly textiles, have increasingly struggled to compete with rivals such as Bangladesh and India. Nepalese exporters have been unable to benefit from trade agreements and preferential access largely because of supply-side constraints. For example, evidence suggests that Nepal has only benefited from the South Asian Free Trade Area agreement (SAFTA) as an importer, and only minimally as an exporter. Firms have also struggled to increase the utilization rates of trade preferences (under the Generalized System of Preferences, GSP) provided by high-income countries.²⁸

Nepal needs a new growth strategy that is driven by a competitive private sector

With remittances and migration flows soft, Nepal needs to follow a different growth strategy if it is to attain its objective of becoming a middle-income country. Growth scenarios indicate that if its investment-to-GDP ratio, growth of human capital, and growth of productivity stay at recent historical averages, it will be difficult for Nepal to sustain the GDP per capita growth rate that is necessary to meet its target of reaching middle-income status by 2030.

Nepal needs a new approach that will both boost investment and accelerate productivity, while improving access to external markets. Nepal is not a large economy, and hence greater outward orientation is vital for its firms to access markets and achieve economies of scale. But to be more successful in external markets, Nepal needs to become more competitive. The new growth strategy should: (a) put in place policies that raise the productivity of key enabling sectors (such as transport, energy, and IT connectivity), reduce the cost of doing business, and strengthen Nepal's integration with the rest of the world; (b) build new sources of growth, and revitalize existing sources of growth in sectors of comparative advantage with high growth potential; and (c) invest in people and put more human capital to productive use.

Prospects for reform have recently improved

Several favorable political developments in the past few years have given rise to a wave of optimism about the

prospects for the emergence of an environment that is more conducive to private sector development. In September 2015, a modern constitution was adopted that addressed many outstanding issues related to socioeconomic inclusion and paved the way for a democratic federal system in Nepal.

Federalism offers hope for better governance. With the promulgation of the new constitution in 2015, Nepal embarked on an ambitious reform path to shift from a unitary to a federal system. The new constitution created three types of government at the federal, provincial and local levels, with significant decentralization of decision-making powers and resources to subnational governments. Local elections in Nepal were conducted in 2017, while the provincial and federal elections were completed in January 2018. This new system fundamentally transforms the nature of governance, with a shift away from a Kathmandu-centered polity to a much more decentralized system of administration. The devolution of authority to local governments could potentially enhance prioritization in resource utilization and lead to better results. At the same time, improving the capacity of local governments will be a challenge, as will be the development of clear and binding national standards. Section 3 of this report discusses this issue in more detail.

There is less political uncertainty. Recent elections resulted in the formation of a government with a two-thirds majority, increasing prospects of stable government. The new government has announced a private sector-friendly approach to economic policy and, as evidenced by steps to dismantle anti-competitive practices in the transport sector, has begun to demonstrate its political will to implement reforms.

The government's new growth vision signals a strong commitment to private sector growth. Under Envisioning 2030 the government of Nepal (GoN) seeks to achieve all the Sustainable Development Goals (SDGs) and attain middle-income country (MIC) status by 2030. This will be done through implementing consecutive three-year "Periodic Plans" that are focused on investments in economic, physical and social infrastructure. Targeting a growth rate of 8 percent in 2019 and 9.5 percent by 2021, the government aims to: increase energy output by 1,401

megawatts; build an additional 14,000 kilometers of transmission lines; irrigate an additional 45,000 hectares of land; create 180,000 industrial jobs annually; provide internet access to 70 percent of population; reduce maternal mortality to 125 per 100,000; increase coverage of primary education schooling to 99.5 percent and secondary schooling to 53 percent; and provide 95 percent of population with access to safe drinking water by 2021. To finance this, the government plans to increase its public investment outlay from 34.8 percent of GDP in 2018 to 38.7 percent of GDP in 2021 and increase its aid availability to 9 percent of GDP (from 3.7 percent of GDP, aid use in 2018), while keeping the domestic borrowing level below 5 percent of GDP. Recognizing the role of the private sector in achieving this vision, the government is committed to unlocking the critical bottlenecks constraining private sector participation and foreign direct investment (FDI). ■

Support from the World Bank Group

The World Bank Group's Systematic Country Diagnostic (SCD) identifies realizing opportunities for faster growth and as one of the biggest challenges that need to be addressed. The Country Partnership Framework (FY2019–FY2023) builds on the SCD and highlights three focus areas for Bank Group support:

- Strengthening public institutions for efficient and effective public service delivery, which are important for private sector investment
- More and better jobs, and higher growth through private sector investment
- Greater inclusion and resilience

IFC in Nepal focuses on jobs, financial inclusion, sustainable infrastructure (including power and connectivity), and high-impact sectors (including tourism, agri-business, health care, and manufacturing). As of June 30, 2017, IFC's committed portfolio was about \$43 million and its advisory services portfolio was \$17 million across 10 projects. IFC's portfolio is expected to substantially increase through several new projects, especially in hydropower and tourism.

The State of the Private Sector

Nepal's private sector is resilient, but needs to boost its competitiveness

A retreat from state ownership of enterprises has opened up more space for private firms. Although state-owned enterprises (SOEs) were an important part of the government's economic strategy in the 1970s and 1980s, a major policy shift toward the privatization of SOEs in the early 1990s reduced the number of SOEs from 67 in 1990 to 30 in 2016. The size of the SOE sector is now smaller than that in neighbors such as India and Pakistan (Figure 4).²⁹ With SOEs concentrated in the financial and utilities sectors, the private sector dominates most manufacturing and service sectors (excluding finance and social sectors). According to the World Bank Enterprise Surveys, 99.5 percent of Nepal's formal firms are privately owned.

The private sector plays an important role even in social sectors such as health and education. In Nepal's mixed health-care system, the private sector is especially important in providing service delivery, human resources and education, pharmaceuticals, and health-care financing. It includes both not-for-profit entities and for-profit commercial entities. In the education sector, 15 percent of primary school enrolment in Nepal in 2013 was accounted for by private not-for-profit and for-profit providers, and 26 percent of secondary schools in 2011 were private.³⁰ Private colleges and training institutes account for

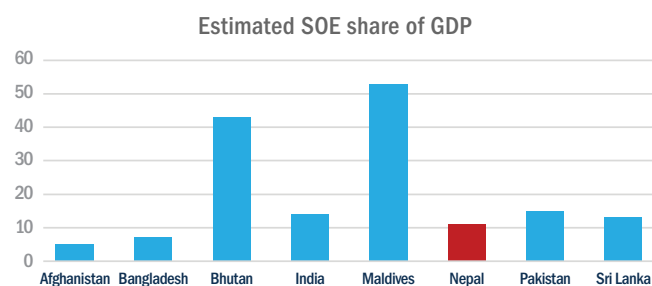


FIGURE 4 Nepal has relatively small SOE presence in the economy

Source: Arrobbio et al., 2017.

the majority of enrolment in higher education, and in technical and vocational training.³¹

Nepal's private investment has shown resilience in the face of prolonged conflict and an uncertain political environment. The ratio of private gross fixed capital formation to GDP has been steadily increasing, from around 10 percent in 1990 to 23.5 percent in 2017.³²

Notwithstanding the resilience of private sector investment, productivity levels are markedly low. Due to data limitations, it is not possible to obtain robust, internationally comparable firm-level productivity estimates for Nepal. However, the aggregate picture is worrying. As shown in Figure 5, Nepal's manufacturing sector has the lowest value-added per worker among a set of comparators from South and East Asia.³³ For example, Nepal's value-added per worker is about one-third that of India. Firm-level evidence from countries with better data availability, such as India, suggests that an aggregate low-level productivity in manufacturing is



FIGURE 5 Nepal's low industrial productivity (value-added per worker)

Note: The figure presents real value added per worker in manufacturing, measured in 2015 US\$ PPP terms. Staff calculations based on World Development Indicators.

the result of two factors. First, it is because the average firm has a low productivity level. Second, there is wide dispersion in productivity levels across firms within an industry, and too many resources are allocated to unproductive firms.³⁴

Nepal’s worsening export performance is also indicative of the low productivity of its private sector. As discussed earlier, Nepal’s total goods exports have been declining as a share of GDP. It has been losing market share in traditional export sectors such as textiles and agri-processing. The increase in the country’s services exports is largely driven by low-end tourism and associated ‘exports’ of telecom services to foreign tourists.

Most firms are small and there is little firm dynamism

Nepal’s private sector is polarized, with a few large business groups and a multitude of small firms. Nepal has a few dominant, large family-run businesses with interests ranging across multiple sectors, from trading to manufacturing and services.³⁵ It is difficult to obtain accurate statistics on the size and composition of these business groups, but the anecdotal evidence suggests that thanks to their size they have endured decades of political turmoil through diversification and an ability to navigate markets and regulations in a way that smaller entrants cannot.³⁶ Most other firms are

small. For example, only 18 percent of Nepal’s formal firms have more than 20 employees. This is low even compared with other South Asian countries such as Bangladesh, India, Pakistan and Sri Lanka.³⁷

Firm entry and lifecycle growth rates are low. The increase in the average age of firms between two waves of the World Bank’s Enterprise Surveys was equal to the time-gap between the two survey waves, suggesting that there was little firm entry.³⁸ Moreover, in common with the rest of South Asia, Nepalese firms grow slowly over time. For example, firms aged 25 years or more in Nepal are only 50 percent larger than firms aged less than five years.³⁹ In contrast, in the United States firms aged 25 years or more are more than seven times larger than those aged less than 5 years.⁴⁰

Very few Nepalese firms engage in trade or technology transfer with other countries. The percentage of Nepalese firms using technology licensed from foreign companies, exporting, and possessing internationally-recognized quality certificates is low by the standards of comparators in South and East Asia (Figure 6).

The ICT adoption rate of Nepalese firms is low, even by the standards of South Asia. Only 80 percent of Nepalese firms are connected to the internet, markedly lower than the South Asian average of 90 percent. Only about 49 percent of Nepalese firms regularly use computers and only 8 percent have purchased software.

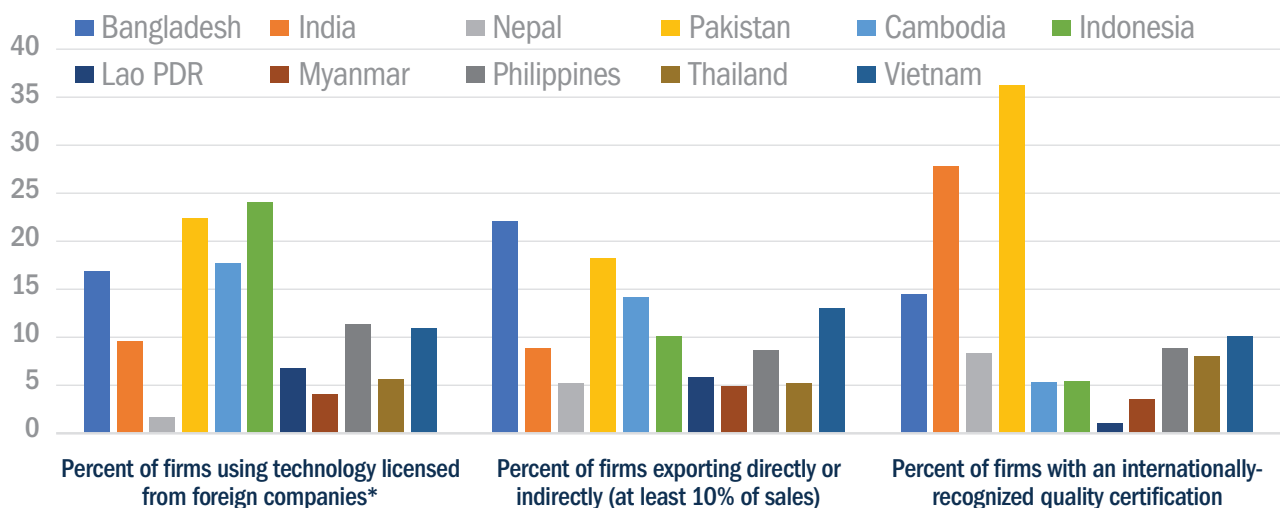


FIGURE 6 Firms engaged in trade and technology transfer—Nepal vs comparators

Source: World Bank Enterprise Survey, 2013.

The corresponding South Asian averages are 68 and 23 percent, respectively.

FDI inflows into Nepal are negligible and are concentrated in just a few sectors from a small number of source countries. Nepal has attracted less FDI than other countries in the region, as well as other comparator economies outside the region. In the past five years (2013–17), annual FDI inflows averaged 0.4 percent of GDP, compared with 1.3 percent in Bangladesh, 1.8 percent in India, 0.8 percent in

Pakistan, and 1.2 percent in Sri Lanka.⁴¹ A look at the sectors that have received FDI shows that most FDI projects that have been announced are in the hydropower (renewable energies), communications, and transportation sectors. According to a recent survey conducted by Nepal Rastra Bank (NRB), Nepal's central bank, the country receives FDI from 39 countries in total. However, in 2016, India and China alone accounted for 28 and 18 percent, respectively, of the total stock of FDI in Nepal.⁴² ■

Cross-cutting Constraints to Nepal's Private Sector Development

Nepal's business climate faces numerous challenges, but the most critical relate to governance and infrastructure. The 2013 World Bank Enterprise Survey suggests that the number of "major" business climate issues is unusually high in Nepal. The survey presents firms with a list of issues, asking them to state the degree to which each issue constrains them. In the case of Nepal, as many as five issues were called a major constraint by more than one-quarter of respondents. The five most often mentioned issues were: electricity, corruption, finance, transportation, and competition from the informal sector (Figure 7). Only one other country in a set of comparators from South and East Asia had as many major issues as Nepal—Pakistan. It is not easy to ascribe Nepal's private sector challenges to a specific cause. However, as discussed below, two issues seem to outrank the others, namely governance and infrastructure.

Strengthening institutions is critical for policy effectiveness

Nepal has scope to improve along many dimensions of governance. For example, in 2016, Nepal was in the bottom 20th percentile on the World Governance Indicator measures of rule-of-law, government effectiveness, and political stability/absence of violence (Figure 8). Furthermore, it ranked in the 23rd percentile on regulatory quality and control of corruption.⁴³ Across the board, Nepal's indicators worsened in 2016 compared with 1996. The challenges relating to governance are also reflected in Nepal's low ease of doing business. In the 2018 Doing Business report, which ranked 190 countries on the ease of doing business, Nepal ranked relatively poorly on "Dealing with Construction Permits" (157), "Enforcing Contracts" (153), "Paying Taxes" (146), "Getting Electricity" (133), and "Starting a Business" (109), with an overall ranking of 105.⁴⁴

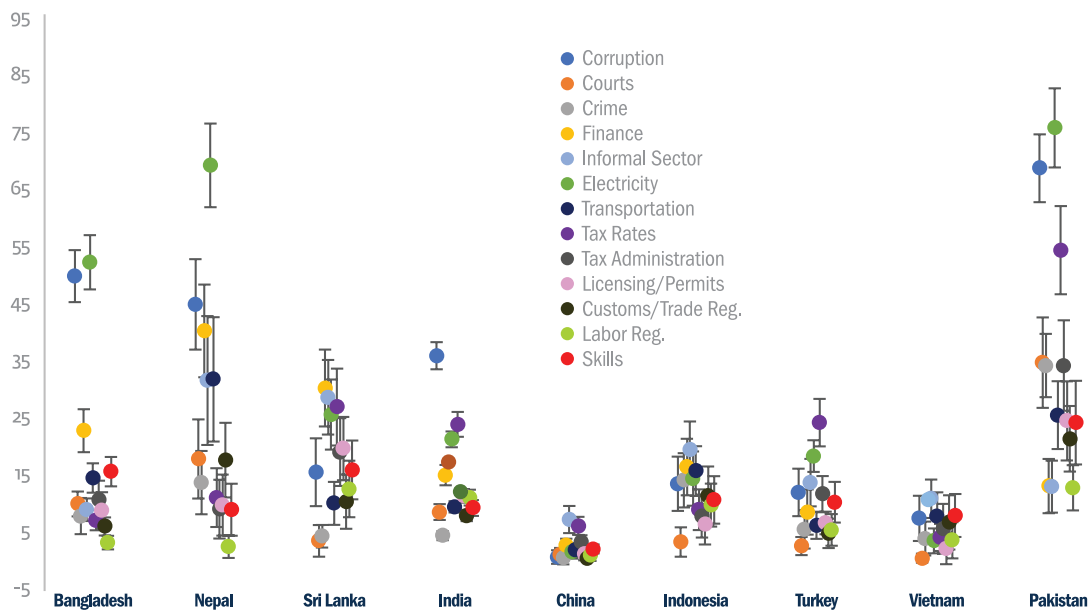


FIGURE 7 Nepal's firms face many major constraints

Source: World Bank Group staff calculations based on World Bank Enterprise Survey 2011–15. For each listed issue, the chart shows percent respondents reporting it as a major constraint, with 95 percent confidence interval.

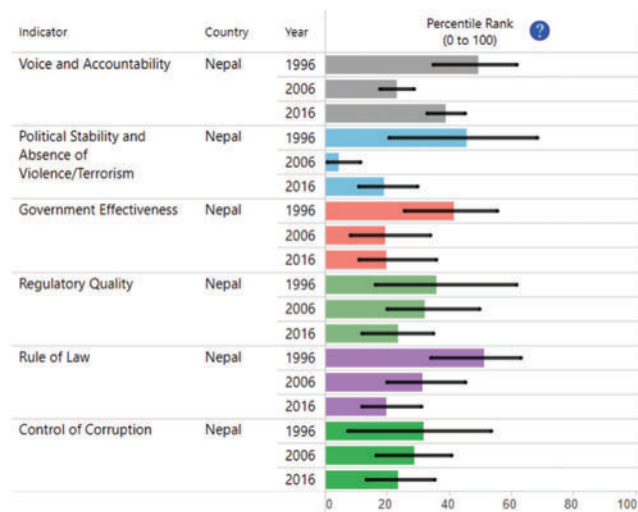


FIGURE 8 World Governance Indicators, Nepal, 1996 to 2016

Source: World Governance Indicators.

The combination of a history of political instability and institutional gaps has created a high level of economic uncertainty for firms, deterring investment. Weakened institutions struggle to insulate economic policy from politics; thus, in the recent past, frequent political regime changes led to frequent policy changes. According to the World Bank’s Enterprise Survey, nearly 49 percent of Nepalese firms pick political uncertainty as the biggest constraint to their business—a share considerably higher than the average for South and East Asia. Most Nepalese firms are small and do not have the resources needed to survive prolonged periods of policy disruption. Their response to the uncertainty up until now has traditionally been to remain small and avoid undertaking large-scale, risky investments.

The challenge today, in the new, more stable political environment, is to make the process of designing and implementing policies more effective and broadly representative. There is much global evidence that weak institutions increase the chances that policies are unduly influenced by a narrow group of larger firms.⁴⁵ Polarized between a few large business houses and numerous small firms, Nepal’s private sector would appear to be prone to this problem. For example, there is evidence that a subset of larger firms obtained tax exemptions and found it easier to evade taxes.⁴⁶ It will be important to create a more level playing field that facilitates greater levels of investment by smaller firms.

Many sector-specific regulations can be reformed to ease the entry and operation of the private sector. For example, in tourism, there is room to revise laws and regulations, improve coordination between ministries to implement policies, and strengthen the ability of government agencies to work with the private sector to open new tourist destinations. In education, there is room to streamline entry regulations and modify those regulations to increase the autonomy of institutions to respond to changing market needs. These sector-specific manifestations are discussed in more detail in the sector deep dives of the CPSD.

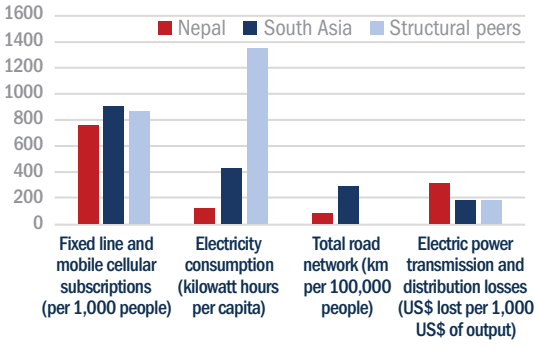
It is also important to reduce the gap in policy implementation. The gap between policy objectives and implementation is related to misaligned incentives, the capacity challenges facing government agencies, and coordination weaknesses across government agencies. Government employees require a stronger incentive structure, and experience high turnover, the limited delegation of responsibility, and a lack of effective performance evaluation. There is ambiguity regarding the roles and responsibilities of different government agencies, resulting in coordination challenges. For example, delayed implementation was a key reason behind the cancellation of Nepal’s only IT Park.

Implementation capacity is reflected in the efficiency challenges of (scarce) public investment. Given its low levels of public investment, Nepal would be expected to have high returns on public investment. However, the returns, as measured by the incremental capital output ratio (ICOR), are estimated to be the lowest in a set of comparator countries from South and East Asia.⁴⁷

Challenges in governance have also impeded PPP projects. Nepal’s previous attempts at PPP projects in sectors such as hydropower have been thwarted by the absence of a strong legal framework for PPPs in key ministries. At a deeper level, however, the country’s recent political uncertainty has made it difficult for Nepal to credibly commit to PPP contracts. Previously frequent political changes led to delays and contractual issues, while inadequate accountability ensured that the political cost of such delays was low. In this respect, Nepal’s recent experience is consistent with the cross-country evidence on the relationship between governance and the likelihood of success in PPP projects.⁴⁸

While federalism will help address these governance constraints, as with any major reform, it needs to be complemented with capacity building measures to fully realize its potential. The new more decentralized system allocates responsibilities over the areas of governance to federal, provincial and local governments, as well as to concurrent lists that are shared across different tiers of the government. While this transition brings opportunities, several outstanding issues relating to the devolution of funds, functions and functionaries will need to be addressed to fully implement the federal mode. The following outstanding issues are of particular relevance to the private sector:

- » More clarity is required on responsibility for regulation and service delivery of concurrent functions. In addition to concurrent functions, some areas that might have been left open during the drafting fall within residuary powers and need to be clarified.
- » The capacity needs of local governments need to be addressed and empowered. The responsibility for delivering basic services such as education, health care and local infrastructure has shifted to subnational governments. This requires more personnel, financing and stronger technical capacity on the ground to develop and implement programs, ensure sound financial management, and effectively manage increased resources.
- » More robust public financial management (PFM) systems need to be developed. There are important gaps in the legal and regulatory framework that subnational governments currently operate under. The management of contracts for PPP require greater clarity on roles and better functional capacity of subnational governments.



Regulatory governance issues that are more specific to the priority sectors are discussed in the sector deep dives later in this report.

Insufficient infrastructure has prevented key sectors from fulfilling their potential

Nepal’s potential growth drivers, such as tourism and agri-processing, are especially reliant on good infrastructure. The top export-potential sectors in Nepal appear to use more transport services than other manufacturing sectors. For example, 39 percent of the services inputs provided to processed food exports are transport, compared with 9 percent for manufacturing as a whole.⁴⁹ Tourism is another critical sector for Nepal and that too is reliant on good infrastructure to reach far-flung tourist destinations.

Hence the current state of infrastructure, and unequal access to it, are major challenges for Nepal’s private sector. Nepal’s ranking is 130 out of 138 countries in infrastructure, according to the Global Competitiveness Index (World Economic Forum, 2016). For instance, Nepal scores below the South Asia average on indicators of digital access, electricity consumption per capita, road network density, and transmission losses in the power sector (Figure 9). Although the electricity supply has become more reliable now, until recently power cuts were endemic, with parts of Nepal experiencing outages lasting up to 17 hours a day in 2016–17.⁵⁰ In the most recent wave of the World Bank Enterprise Surveys (2013/14), two-thirds of Nepalese firms identified electricity as a major constraint, much higher than the regional and global average (Figure 9).⁵¹

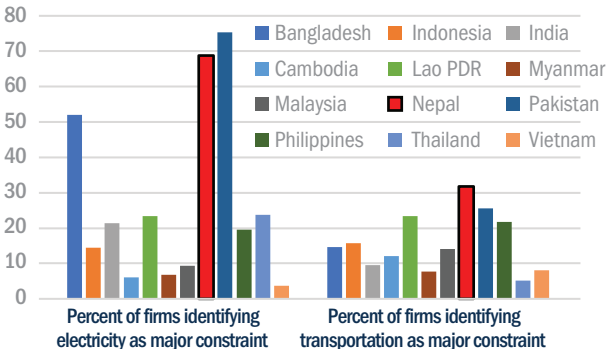


FIGURE 9 Infrastructure access in Nepal and comparators

Source: World Bank Enterprise Surveys, conducted in 2013/14/15/16.

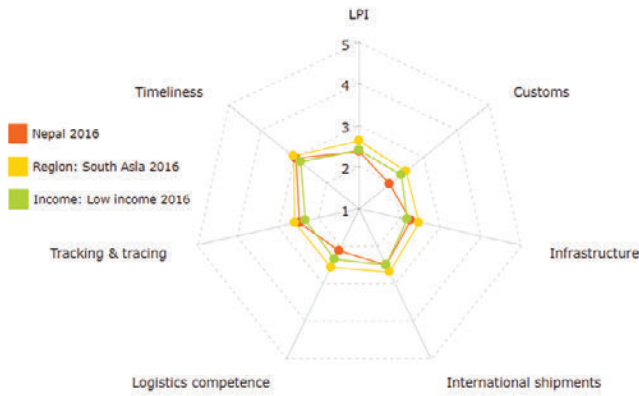


FIGURE 10 Logistics Performance Index, 2016

Source: World Bank LPI. <https://lpi.worldbank.org/>.

Logistical issues add to the problems caused by a lack of physical infrastructure. Nepal’s ranking is 124 out of 160 countries on the World Bank’s Logistics Performance Index (with a score of 2.38), notably lower than the regional average score of 2.62. Relative to comparators, Nepal scores particularly poorly for customs, logistics competence, and infrastructure (Figure 10).

The cost of domestic transportation is high due to poor infrastructure and logistics, and this is a bigger issue for foreign trade than complex border procedures.⁵² Relative to comparators in South Asia, Nepal performs adequately in terms of the time and cost of border

compliance: in 2018, its “Distance to Frontier” ranking on the World Bank Group’s Doing Business measures of Trading across Borders (which reflects border compliance costs) was 77, higher than the South Asian average of 58.⁵³

Poor connective infrastructure and logistics have constrained Nepal from fully realizing the potential of tourism and agribusiness. International benchmarks suggest that the competitiveness of Nepal’s tourism sector is undermined by the quality of air, ground, and tourist service infrastructure. The inadequate road network, for example, makes it difficult to access many areas with nature-based tourism potential. There is an insufficient number of airports serving hill and mountain areas, and domestic airlines have a poor safety record.⁵⁴ International arrivals already exceed the official capacity of Nepal’s only international airport, located in Kathmandu, and air routes to enter Nepal are limited for long-haul markets. Similarly, the cost and time related to transport/logistics is an issue highlighted by many stakeholders in the agribusiness value chain. Nepal’s low road density means that land located close to roads is scarce. Highly dispersed production locations and poor road quality create high access-to-market costs and increased levels of post-harvest losses. Poor transport infrastructure also makes the cost of transacting among regional, central, and border markets very high, fragmenting Nepal’s agricultural markets (Shively and Thapa, 2017). This undermines the competitiveness of agri-products.

	2016					Index Score 2014
	Infrastructure	Affordability	Consumer	Content	Index Score	
Sri Lanka	49.3	71.6	70.1	56.2	61.1	50.4
India	40.0	63.1	45.2	48.7	48.5	39.7
Bangladesh	37.9	51.4	52.5	53.7	48.4	41.6
Nepal	36.0	47.8	50.1	45.2	44.4	34.2
Pakistan	35.3	54.4	26.0	39.4	37.5	32.6
Average	39.7	57.7	48.8	48.6	48.0	39.7

FIGURE 11 Nepal’s Digital Connectivity Challenge

Source: GSMA Mobile Connectivity Index

Digital infrastructure remains nascent.

Telecommunication services have improved in recent years, but there are still major gaps in coverage, quality, and cost. There are also large regional and rural-urban disparities. In 2017, the total penetration rate of fixed lines was only 3.2 percent, centered in Kathmandu and other urban areas.⁵⁵ The broadband (ISP) market has grown but still has extremely low penetration (2 percent in 2017). Internet penetration is low, with only 15 percent of households having internet access,⁵⁶ while 97 percent of all users connect through mobile broadband.⁵⁷ However, the mobile internet market is still at an early stage of development, with outdated technology and penetration rates below most other Asian countries. Nepal scores below the regional average across all parameters for mobile internet adoption as measured by the Mobile Connectivity Index: infrastructure, affordability, consumer readiness and content (Figure 11).

Nepal's infrastructural problems are linked to its governance environment: the limitations in efficiency of public investment and the absence of a sound policy framework for private investors.⁵⁸ The government has enacted several laws to facilitate the construction of new industrial infrastructure (the Special Economic Zone Act, 2016), and simplify regulations, incentivize manufacturing and enhance coordination between government agencies (including the Industrial Enterprise Act, 2016; and the Company Act Amendments, 2017). It has also proposed a new Foreign Investment and Technology Transfer Act (FITTA) that contains several improvements on the current Act, including most importantly a proposal to reduce the negative list (Annex 1). However, implementation of new laws has been suboptimal.⁵⁹ Similarly, six attempts at devising a PPP model to deliver on a major corridor project, the Fast Track Highway, have been elusive since 1996 (World Bank 2017).

Technical and managerial skills, access to finance, and excessive regulation of foreign investors are other major issues

Lack of technical skills and managerial capabilities have hampered growth-oriented firms

Nepal has done well in expanding primary school enrolment, but still suffers from low-quality basic

education and low enrolment rates in higher levels of education. Nepal's primary enrolment rates are above those of comparator countries (Figure 12). However, similar to other countries in South Asia, Nepal still has significant scope to improve the quality of primary education.⁶⁰ For instance, in 2010-11, 56 percent of females and 28 percent of males aged six or above could not read or write a simple sentence.⁶¹ In addition, Nepal's secondary and tertiary enrolment rates remain below those of its comparators.

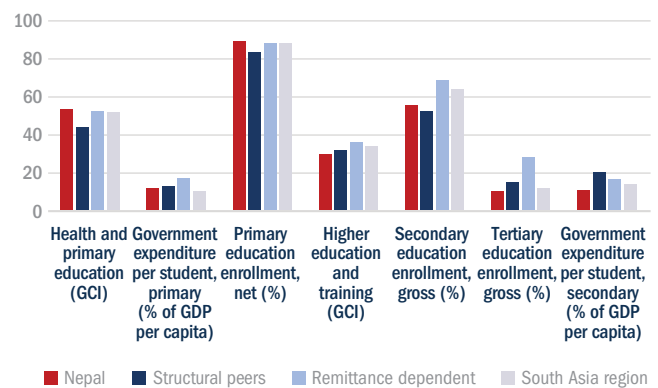


FIGURE 12 Nepal performs well on primary education, but poorly on secondary and higher education

Source: Based on Nepal SCD.

The lack of availability of medium- to high-skilled technical and managerial workers is a problem for firms seeking to grow or move up the value chain. Around 9 percent of Nepalese firms identify an inadequately educated workforce as a major constraint, lower than the South Asia average of 20 percent.⁶² However, in interviews conducted for the CPSD deep dives, many firms noted that the shortage of skilled technical and managerial workers was making it difficult for them to scale up. This suggests that skills are a constraint for upwardly mobile firms. Nepal performs below its peers on the Global Competitiveness Index (GCI) measures of higher education and training, while performing well on primary education and health (Figure 11). Among comparators in South and East Asia, Nepal has a below-average score on the World Economic Forum “Know-How Index,” which measures the breadth and depth of specialized skills use at work (Figure 13). Further evidence for medium and high

skills being in short supply comes from data on wage premiums: the wage rate increases sharply for higher levels, with tertiary education completers earning more than eight times the wage commanded by workers without any education.⁶³

Strict visa regulations for skilled foreign workers further reduce the supply of technical and managerial talent. There is no distinction between temporary and permanent movement of workers, and the visa process is complicated, non-transparent, and expensive.⁶⁴

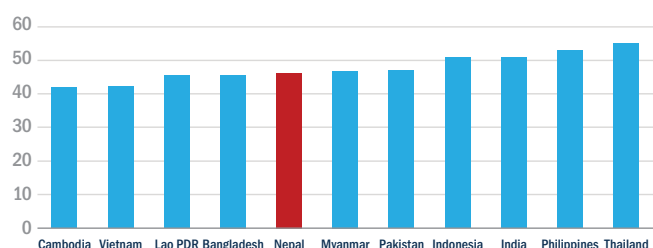


FIGURE 13 World Economic Forum Know-How Index

Source: World Economic Forum Human Capital Index 2017. Note: The Know-How Index is the sub component of the Human Capital Index. Know-how concerns the breadth and depth of specialized skills use at work. It is based on four indicators—(1) High-skilled employment share; (2) Medium-skilled employment share; (3) Economic complexity (a measure of the degree of sophistication of a country’s “productive knowledge” as can be empirically observed in the quality of its export products); (4) Availability of skilled employees (employers’ perceptions of the ease or difficulty of filling vacancies).

TABLE 2 Access to finance indicators

ECONOMY	Percent of firms with a bank loan/line of credit	Proportion of loans requiring collateral (%)	Value of collateral needed for a loan (% of the loan amount)	Percent of firms using banks to finance investments	Percent of firms identifying access to finance as a major constraint
BANGLADESH	34.1	84.4	271.1	19.8	22.8
CAMBODIA	19.9	77.5	165.1	2.5	16.9
INDIA	21.3	84.7	255.1	30.3	15.1
INDONESIA	27.4	80.4	241.1	36.6	16.5
LAO PDR	12.4	96.2	275.9	15.9	5.7
MYANMAR	11.3	98.4	412.9	7.1	9.9
NEPAL	35	89.9	364.2	17	40.1
PAKISTAN	6.7	64	153.4	8.1	13.2
PHILIPPINES	29.9	51	156.7	12.4	10.7
THAILAND	15.5	93.4	320.1	15.3	2.4
VIETNAM	40.8	91	216	29.3	10.8

Source: World Bank Enterprise Survey, 2013

Small and medium-sized firms face uneven access to finance

Although the share of Nepalese firms that have a bank loan is in line with regional comparators, a relatively high number of them identify access to finance as a major constraint. According to the World Bank Enterprise Survey, 35 percent of Nepalese firms have a bank loan or a line of credit, and 17 percent have used bank loans to finance investments (Table 2). Both these numbers compare favorably with other low- to middle-income countries in South and East Asia. However, nearly 40 percent of Nepalese firms identify access to finance as a major constraint, higher than comparators in South and East Asia.

There are several gaps in Nepal’s financial infrastructure, limiting its ability to extend credit to firms. As mentioned earlier, most Nepalese firms are small and medium enterprises (SMES). For many SMEs, their main assets are moveable assets.⁶⁵ However, the legal, regulatory, and institutional framework for moveable asset-based financing needs to be strengthened. The Secured Transactions Act was adopted in 2006 with the aim of strengthening the institutional framework of this sector. But no rules, regulations, or operational procedures have been established to enable its efficient functioning. Furthermore, the Credit Bureau does not have its own

statute and its credit information reporting and sharing is limited, providing only negative information and covering a mere 1.7 percent of the adult population.⁶⁶ Notably, while Nepal scored 10 on the index measuring strength of legal rights,⁶⁷ its score for the depth of the credit information index was zero.

Given the lack of credit information in the market, financial institutions rely on conventional immovable collateral, and collateral demands can be inordinately high.⁶⁸ On average, the value of collateral needed for a loan is 364 percent of the principle (Table 2). This is well above the norm for South and East Asia. In India, for instance, the corresponding number is 255 percent. These high collateral requirements restrict access to finance to those firms with sufficient land and immovable assets. The central bank, Nepal Rastra Bank, has tried to improve financial inclusion by mandating increased lending to productive sectors and deprived sectors, as well as branch expansion, but the results have been mixed.

Long-term credit supply is constrained. While short-term trade finance credit is available through commercial banks, long-term credit is still constrained by limited products offering long-term deposits, low uptake of corporate bonds, non-existent yield curve and the shallowness of the capital market. A regulatory cap on the spread on interest rates that financial institutions, domestic and international, can offer above their base rate reduces the ability of credit providers to accurately price in the risk of lending.

The payments system is still at a nascent stage. Several reforms that were identified in the 2014 Financial Sector Assessment Program have been progressing slowly, and these delays are holding back development of payments gateway and digital financial services. The draft Payments and Settlement Bill is in the process of approval and is expected to provide an enabling framework for implementing digital financial services (DFS) that enhance the safety, reliability and efficiency of the payments system.

Nepal's capital market infrastructure too is relatively weak, hindering the availability of long-term financing. Nepal does not have a specific legal and regulatory framework for Private Equity/Venture Capital (PE/VC), although a few PE funds are in operation. In

the absence of a unified legal framework, the sector operates under a combination of laws and regulations (such as the Company Law, laws on banking, and laws on FDI). Since they are not licensed under the Banks and Financial Institutions Act (BAFIA) legislation, it is unclear if PEVC funds can provide capital in the form of debt (rather than equity).

Strict regulations make it difficult for PE funds to operate in Nepal. The central bank has set strict limits to lending by foreign institutions, which is allowed only in case of unavailability of domestic debt and is subject to an interest rate cap of LIBOR plus 5.5 percent. Strict blacklisting rules are in place for the domestic shareholders and directors of any Nepalese company that defaults on a loan (the rule does not apply to foreign investors). These include the seizing of passports and cessation of any financial activities. For a fund, it implies the cessation of activities if only one investment in the portfolio turns sour. This is a major impediment to PE investments, which are typically funded with a mix of equity and debt. Furthermore, the stock market IPO rules make PE exits difficult. Only new shares can be listed—existing shareholders are not allowed to divest their shares at IPO and are subject to a three-year lock-in period. Shares can only be priced above book value if the company has at least three consecutive years of profits and dividends; even in this case, pricing is not determined by the market but by SEBON valuation rules. There is a limited track-record of IPOs outside the banking sector (75 percent of stocks are financial institutions), trading volumes are low (\$5 million daily average), and foreign investors are not allowed to actively trade.

However, the supply of credit may not be as big a constraint on Nepal's firms as the current condition of governance and infrastructure. In Nepal's current business environment, risk-adjusted returns for lending to SMEs may simply be too low to be profitable. There is not enough evidence to assess how much of the credit problem faced by firms is due to issues specific to financial markets. Moreover, there is limited evidence on exactly which specific issues in financial institutions and policies are the biggest constraints on the supply of credit to SMEs. More work is therefore required to assess the policy reforms needed to unlock access to credit. In this regard, NRB is currently

conducting a study on “SME Financing in Nepal” that is expected to identify obstacles and make relevant policy recommendations. One clear need, however, is to deepen credit information (see recommendations).

The need to rationalize the regulation of FDI, access to foreign lenders and foreign-exchange transactions

Foreign-exchange restrictions affect the entry of foreign investors and constrain links to international markets.

Many of these problems derive from practice more than from the law itself. For example, although firms are formally allowed to open U.S. dollar-denominated accounts, small firms and individuals report that this is difficult in practice. Even with such an account, it is difficult to pay for services in U.S. dollars due to caps on the size of U.S. dollar-denominated contracts. This creates a difficult environment for exporters, who often need to pay for foreign travel or inputs from foreign suppliers. With the growing importance of services sector inputs in manufacturing (the “servicification” of manufacturing), however, this is an issue that goes beyond just services exporters.

There are several regulatory issues that deter foreign investment in Nepal. FDI inflows into Nepal have been hurt by unclear policies, complex procedures, and inadequate investment facilitation. Entry barriers to FDI include sector caps, a long “negative list” of sectors barred from receiving FDI,⁶⁹ and restrictions on non-equity modes of investment. Offshore funds and onshore vehicles with foreign shareholders are both considered foreign investors and require FDI approval for every new investment in a Nepalese company. Rules, regulations and directives by the NRB and other authorities are available only in the Nepalese language. FDI approvals can take several months. Lengthy processes needed to hire foreign workers add to the difficulties of foreign investors.

Several restrictive policies on borrowing from foreign lenders, particularly those related to land markets, hinder access to foreign lenders. Land and buildings are the main forms of collateral for lending in the country. But barriers to granting of mortgage over land and creating security interest for foreign investors is a major constraint to foreign investment and lending.

The creation of mortgages of land in favor of foreign lenders needs cabinet approval, and the enforcement of security by foreign lenders needs a court order. The lengthy process and uncertainty regarding the perfection of security and its enforcement puts lenders at risk in the case of default by borrowers, as the collateral is not effective and the lender does not have recourse over the property in the event of an enforcement action. Hence, foreign lenders often resort to partnering with a local bank or a consortium under a pari-passu security arrangement for debt recovery. Foreign lenders are required to set aside capital at the time of signing loan contracts, with commitment fees accruing only after the NRB’s approval. As a result, the capital allocation remains uncompensated during the time lag between the signing of the contract and disbursement of the loans. Foreign lenders are subordinated to local banks in terms of the priority of repayment. Furthermore, there are interest-rate caps on foreign currency loans. These caps, including those on the cost of hedging against foreign-exchange fluctuations for long tenure, also reduce the attractiveness of the Nepalese market for foreign banks. Finally, the approval process for foreign loans is not clearly delineated in written guidelines and, as implemented, include stringent requirements for central bank approvals, including separate approvals for loan payments (after the loan itself has been approved). The NRB has begun considering the relaxation of some restrictions, as evidenced by the monetary policy for 2075/76, although significant work remains.

The process for offshore capital repatriation is complicated. Nepal has a fixed currency regime (pegged to the Indian rupee) and closely monitors foreign-exchange reserves. Offshore funds require approval of the NRB to repatriate the proceeds of their divestments. Approvals are granted only for amounts calculated under valuation rules set by the regulator, not for the actual proceeds. Strict foreign-exchange controls create an incentive for undervaluing transactions so that less foreign exchange leaves the country. Furthermore, there has been uncertainty with respect to the enforcement of double taxation agreements (DTAs), despite Nepal having many DTAs. This could result in yet another layer of uncertainty for foreign investors when exiting investments.

These constraints limit the availability of foreign lending and compound the existing difficulties in access to finance. Annex 2 lists these constraints and proposed remedies in more detail.

Accessible land is scarce and misallocated

Nepal's land market is highly inefficient due to poorly developed land market institutions and regulations.

This hampers potentially profitable projects from acquiring land in a timely fashion. As Nepal grows, land close to roads is becoming scarcer and more expensive. The challenges of poorly developed institutions and policies add to the problem of acquiring land for productive purposes. The lack of digitized land records undermines clarity and impedes the transfer of property rights. Unclear pricing criteria and an ineffective land acquisition law also make it difficult to acquire farmland for industrial uses. Land acquisition is governed by a Land Acquisition Act (government of Nepal, 1977) that is in need of updating. To ease land acquisition for infrastructure projects, in 2015 the government introduced the Land Acquisition, Resettlement and Rehabilitation Policy for Infrastructure Development Projects (government of Nepal, 2015). However, the Land Acquisition Act and related laws still need to be amended to make them compatible with the new land acquisition policy. Such challenges facing land governance mean that land acquisition (and resettlement of the affected households) often involves costly conflict and is subject to capture by powerful vested interests.

Despite recent reforms, land market policies such as ceilings on ownership make it difficult for firms

to consolidate land to achieve economies of scale.

In October 2017, the Ministry of Land Reform and Management (MoLRM) issued a Land Ceiling Exemption Order to ease the purchase of land for industrial institutions. The order sets new rules on the purchase of land by educational or health-sector-related institutions, hydropower projects, industries, and cooperative farming. The ceilings vary by the type of institution, across domestic and foreign investors, and also depend on whether the land is in mountainous and hilly regions, or in the lowland Tarai region. Projects must clearly justify the necessity of the land in detailed project reports and, in general, firms must submit their five-year business plans to the MoLRM to be permitted to buy additional land. Industry representatives note that the approval process remains cumbersome. Moreover, firms are not allowed to exchange or sell land purchased for industrial purposes, even in case of the shut-down of the industry. Taken together, land regulations seem to pose serious constraints on the achievement of efficient plot sizes, which might particularly hurt agribusiness and SMEs in rural areas.

The difficulty faced by foreigners in owning land and using it as collateral is a major constraint to foreign investment and lending. While it is possible for firms owned by foreign investors to acquire land for business purposes, it is difficult to do so in practice, and there is a lack of clarity in procedures and how they are implemented. Furthermore, as mentioned, the creation of mortgages of land in favor of foreign lenders needs cabinet approval, and the enforcement of security by foreign lenders needs a court order. These policies are a significant deterrent to foreign investors. ■

How the Private Sector Can Revitalize Nepal's Sources of Growth

The private sector can play a key role in Nepal's new growth strategy. The private sector will be critical to building new sources of growth and revitalizing existing sources of growth in sectors with high potential for growth and job creation. Greater private sector participation could also raise the productivity of key enabling sectors (for example, transportation, energy and IT connectivity), reduce the cost of doing business, and strengthen Nepal's human capital.

Hydropower will be critical to the new growth strategy, provided that the wealth generated from this sector is channeled judiciously.⁷⁰ Further developing hydropower would lead to massive new investments and an increased inflow of resources to the country that would stimulate construction and urbanization.⁷¹ It would also increase competitiveness in downstream industries. But there are some downsides: few jobs would be created, and large increases in electricity

exports could lead to Dutch disease, further weakening Nepal's export competitiveness. It will be crucial to use the returns from the hydropower sector to remove bottlenecks to larger investment by the private sector, and to diversify the economy in those sectors in which Nepal has a comparative advantage.

The CPSD conducted a systematic sector scan to identify critical sectors (enablers or growth drivers) other than hydropower (the energy-hydropower sector, as well as transportation, is recognized as a high priority and as such is covered as part of the InfraSAP, and not as part of this CPSD). The scan assessed the "Potential for Development Impact" and "Feasibility" of private investments across all sectors of the Nepalese economy. The potential for development impact of a sector depends on its likely impact on broader developmental objectives, such as jobs, resilience, and environmental sustainability. Feasibility assesses

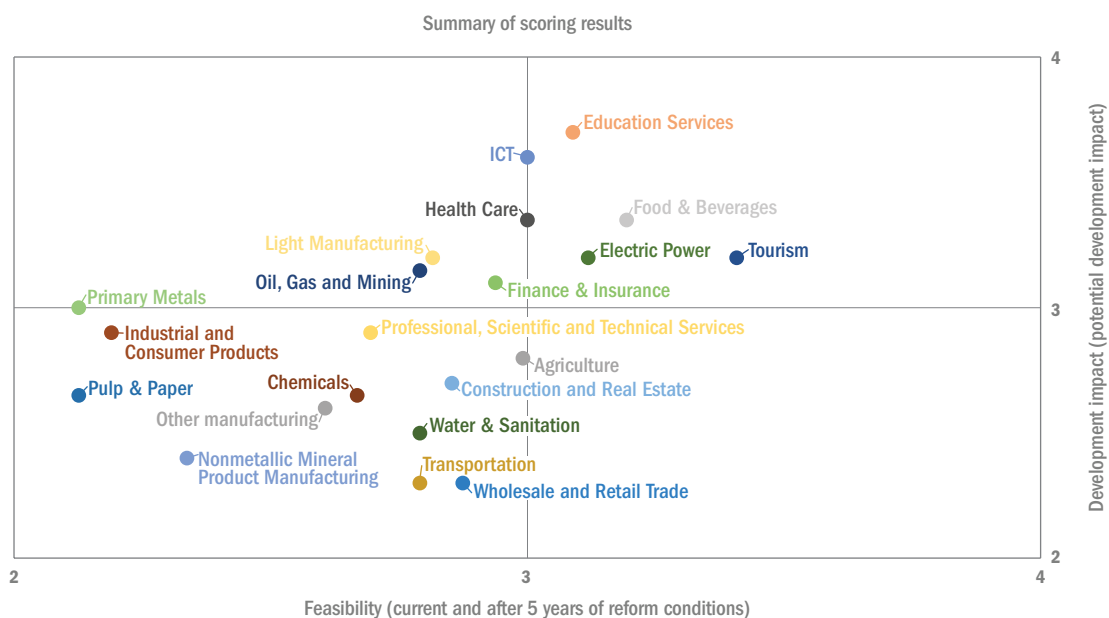


FIGURE 14 Sector development impact and feasibility scores

Source: World Bank Staff Calculations using WDI data

the extent to which constraints to the development of these sectors can be overcome within a reasonable amount of time (for example, three to five years). Given Nepal's natural endowments, capital, and institutions, feasibility could vary across sectors.

Figure 14 summarizes the combined results, while further details of the sector scan are presented in Annex 3.

The scan identified the following high-priority sectors to be considered for deep dives:

Sectors of comparative advantage:

Tourism: High feasibility score due to the unique natural endowments of Nepal. High development impact due to employment potential and scope for increasing backward linkages to the agriculture and horticulture sectors.

Food and beverages (agribusiness): High feasibility score due to unique and diverse agri-climatic conditions. Niche products, such as tea, coffee, cut flowers, vegetables, and fruit all have high potential. Public support and reforms to address value-chain development, land and labor constraints appear doable and politically feasible. High development impact due to extensive backward and forward linkages, including the opportunities to develop high-value niche products and horticulture.

Enablers:

Education: Education has medium-to-high feasibility for increased private sector involvement, particularly in

higher education, and technical and vocational education. The potential for development impact is high: education enables other sectors, and young people can be employed more productively if they have the right skills set.

Health: The health sector has medium-to-high feasibility. While input and regulatory issues are binding to the same degree as in the education sector, there may be less demand for specialized health care owing to the proximity of India as a medical tourism destination. The health sector has high potential development impact owing to the importance of human capital in inducing jobs and growth.

IT Services: The IT services sector has medium-to-high feasibility in Nepal for two reasons. First, low labor costs are an advantage for unsophisticated software development and for business process outsourcing (BPO) activities. Second, ICT exports are less sensitive to transport cost constraints. It has high potential development impact due to its potential to create skilled jobs, build international linkages, and improve the productivity of other sectors.

Considering the scope for value addition, the CPSD has conducted fresh deep dives into education, IT services, and agribusiness, while relying on prior analytical work for health and tourism. The recommendations section of this CPSD also summarizes recommendations from the InfraSAP on the critical infrastructure sectors (transport and energy-hydropower). ■

Opportunities and Constraints in the Key Sectors: CPSD Deep Dives

TOURISM

With a higher employment elasticity than in other countries, and much unexploited potential across the country, Nepal's tourism sector could be an important source of growth and job creation, particularly for women and in rural areas. The key challenge is to diversify the sector's offerings toward medium- and higher-end products, particularly by: (a) managing protected areas more effectively; (b) building key connective infrastructure; and (c) strengthening destination management.

Performance and Opportunities for the Sector to be Transformational

Tourism contributes almost 8 percent to Nepal's GDP and creates more jobs than in other countries.

According to the World Travel and Tourism Council (WTTC), travel and tourism made \$1.6 billion in direct and indirect contributions to Nepal's GDP in 2016.⁷² The WTTC report estimates that the sector supported nearly 1 million (945,000) direct and indirect jobs in 2016, or roughly 6.4 percent of total employment. About 80 percent of these jobs are in the poorest and most remote regions of the country. With every six tourist arrivals to Nepal, one new job is created (almost double the global average of 1:11). Tourism also has high spillover effects to the agriculture, transport, aviation, and hospitality sectors. Tourist hotels and restaurants provide an important market for agricultural products, and there is tourist demand for agri-tourism experiences and destination-branded specialty crops (for example, Nepalese specialty tea) to take home as souvenirs.

Tourism is a high priority sector for the government.

The government of Nepal has formulated its Tourism Vision 2020 and the comprehensive National Tourism Strategic Plan 2015–2024, which aim to establish Nepal as a leading tourist destination in the region and diversify current tourism offerings. Key interventions include: (a) promoting private sector

investment, including FDI and PPPs; and (b) improving infrastructure, particularly in aviation. The Visit Nepal 2020 campaign was launched alongside the recently announced budget for FY 2018/19, with an objective of attracting 2 million tourists in the next two years.

The number of international tourists traveling to Nepal has recently increased after sharp declines due to political instability, the 2008–09 global financial crisis, and the 2015 earthquake.⁷³ With a low of 540,000 visitors in 2015, the numbers rebounded to 750,000 visitors in 2016, and an estimated 940,000 visitors in 2017—a significant and quick recovery for the sector overall.

While the relative importance of Western tourists has declined, they remain the strongest source market.

The tourism sector is also benefiting from growth in neighboring countries, such as India and China, as well as from domestic tourism. Domestic travel and tourism represent a growing and very significant market, but estimates are difficult due to a lack of data. By one estimate, domestic tourism represented around 66 percent of the sector's contribution to GDP in 2016.⁷⁴

However, these positive trends need to be seen against the global performance of the sector, as well as the specific potential of selected destinations (see Annex 4):

» **Business travel:** Growth is expected to accelerate by 5 to 7 percent per year over the next three years.

- » **Wellness travel:** This high-value segment is a global phenomenon projected to grow at double the pace of tourism in general, according to the Global Wellness Institute.⁷⁵ Wellness tourists tend to be well-educated, wealthy, and high-spending; they typically spend 130 percent more than average tourists.
- » **Adventure tourism:** This segment is projected to grow at a compound annual growth rate of over 40 percent in 2017–20.⁷⁶ Adventure travelers tend to be younger, with an average age of 36.
- » **Nature-based tourism:** As incomes rise and urban populations increase, the desire to spend time in natural protected areas grows.

The Nepal Tourism Strategic Plan, prepared in collaboration with the World Bank and IFC, summarizes the potential in terms of both spending and quantity, by market segment, in Figure 15.

Several indicators show that the sector is operating below its full potential, with limited diversification across locations and along the value spectrum

Nepal has not capitalized on the full potential of its tourism resources and is facing the prospect of

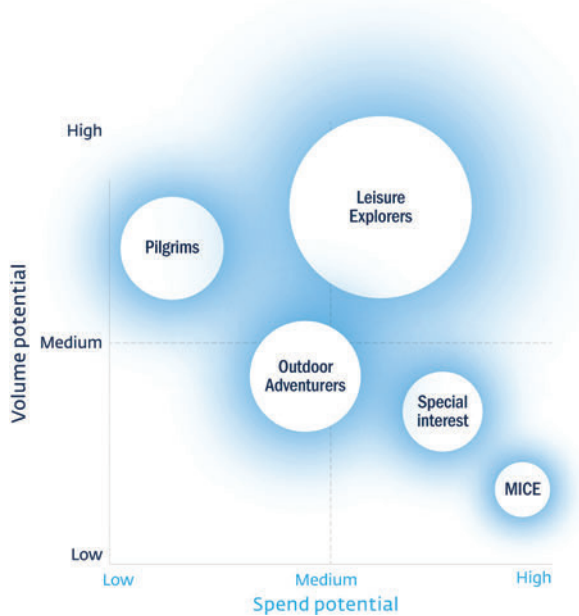


FIGURE 15 Analysis of target market segments by volume and spend potential⁷⁷

Source: Nepal National Tourism Strategic Plan 2015–2024.

remaining a destination for high-volume, low-value tourism segments.⁷⁸ Tourism receipts are still relatively low compared with competing destinations. With an average of \$592 per international visitor in 2016, Nepal’s international receipts are almost half of the global average and one-third of those of Thailand and India.⁷⁹ Nepal’s total tourism receipts are also low compared with most other destinations. Figure 16 illustrates growth in visitor receipts achieved by four post-conflict countries: Peru, Cambodia, Lao PDR and Nepal.⁸⁰ Seen in this context, Nepal’s post-conflict recovery has been modest.

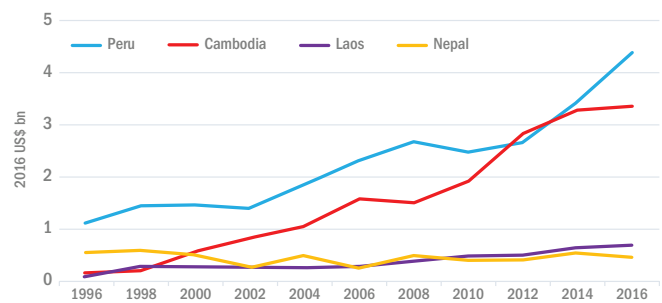


FIGURE 16 Receipts from tourism in four post-conflict countries, 1996 to 2016

Source: World Tourism Council.

Recently, there has been a surge of interest in investing in Nepal’s mid-range and high-end segments. However, this has mostly been confined to the Kathmandu Valley area, despite several destinations in different geographic areas with the potential to attract a significant number of mid-range to high-end tourists.

Nepal’s 12 main destinations have been ranked according to 10 criteria used in the World Bank Group’s new development impact/feasibility approach (Figure 15).⁸¹ This allows Nepal’s destinations to be grouped into three main categories, as follows: (a) destinations with high potential development impact and feasibility (Mid-West, Terai); (b) destinations with low potential development impact, as they are already mature and do not correspond to the overarching diversification objective (Kathmandu Valley, Everest, Chitwan); and (c) destinations with lower priority, because they are remote and would attract a low number of (mid-range to high-end) visitors over the medium term (Far West, East Nepal).

Five selected destinations provide the potential to diversify the tourism offering, while having a notable impact on sustainability and revenues (Annex 5).⁸² An integrated approach in Nepal’s tourism sector could focus on destinations in Provinces 4 and 5, which include Annapurna and Lumbini.⁸³ These provinces offer the possibility of improving and developing a mix of destinations. They fit with the objective of diversification of products, while building on Nepal’s comparative advantage in nature-based, wildlife, and cultural tourism. Langtang in Province 3 has also been identified.

» **Pokhara and Annapurna:**

- **Upgrading and diversifying products for higher yield among mid-range market segments:** The southern section of the Annapurna range offers accommodated lodge-treks combined with good access through Pokhara; the town itself appeals to adventure visitors who are known to select cheaper accommodation to conduct a diverse set of activities, such as zip-lining, paragliding, gyrocopter flights, and so forth.
- **High-end market segment potential:** The Buddhist trekking destination of Mustang north of Annapurna requires special permits, has a

high-end market image, and therefore good potential for higher-end lodge development that could appeal to cultural sub-segments.

- » **Manaslu and Gorkha:** Upgrading and diversifying products for higher yield among mid-range market segments. This true wilderness destination could attract experienced visitors interested in indigenous culture and quality mountain experiences, if quality lodge accommodation along the trails is provided. This destination is starting to become a “trending destination” through the provision of safety access infrastructure, while remaining remote enough for an exclusive market image. It has, however, been severely affected by the 2015 earthquake.
- » **Bardia and Banke:** High-end market segment potential. The park and its landscape linkages offer the potential for an upmarket wildlife product and diversify Nepal as a destination able to attract higher-paying segments by enabling higher-level quality accommodation, ideally managed by an international brand, around diverse wildlife experiences. With good accessibility by air (through Nepalganj) and road, high-end market segments from neighboring India and long-haul markets can be attracted.

International Arrivals per Destination Average of 4 year arrival (2013-2016)

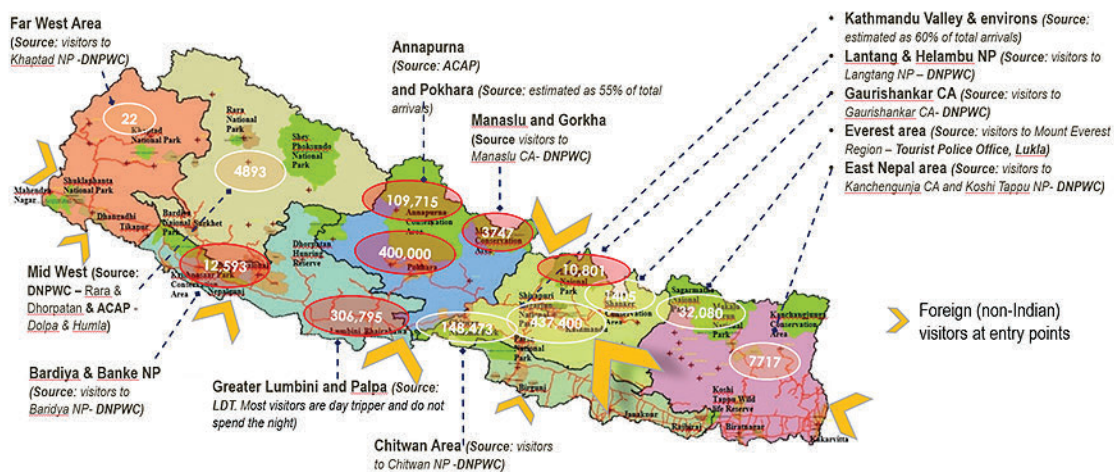


FIGURE 17 International arrivals per destination, 2013–16

Source: Department of National Parks and Wildlife Conservation, Lumbini Development Trust and Anna Purna Conservation Area Project

- » **Lumbini and Palpa:** Upgrading and diversifying products for higher yield among mid-range market segments. Uniquely positioned to take advantage of strong growth in Buddhist tourism, as well as established Hindu itineraries. Religious tourism segments (including Western visitors seeking introductions into Buddhism) and more affluent pilgrims are likely to extend their stay if improved services (interpretation of the archaeological sites, Buddhist teachings, meditation sessions) and accommodation become available.
- » **Langtang:** Upgrading and diversifying products for higher yield among mid-range market segments. The good access from Kathmandu makes this destination area ideal for the vast (and growing) ‘soft-adventure’ market comprising long-haul and Asian source markets through the provision of comfortable accommodation. The area is accessible for over eight months of the year and visitor experiences can range from single-night stay to one-week itineraries creating a large potential market with demand further enhanced based on a good destination image.

Constraints in the Tourism Sector

Given the gap between potential and actual performance, important constraints to the value capture and competitiveness of the tourism sector need to be addressed urgently.

Low investment in transport infrastructure, transport services, and connectivity. The competitiveness of Nepal’s tourism sector is undermined by the relatively poor quality of its air, ground, and tourist service infrastructure. The relatively poor road network, for example, makes it difficult to access many areas with nature-based tourism potential. There are insufficient airports serving hill and mountain areas, and domestic airlines have a poor safety record.⁸⁴ International arrivals already exceed the official capacity of Nepal’s only international airport, located in Kathmandu, and air routes to enter Nepal are limited for long-haul markets.

There is a need to revise regulations and render them more predictable. Nepal ranked 103 out of 136 countries on the World Economic Forum’s 2017 Travel and Tourism Competitiveness Index, far behind regional competitors India (40) and Bhutan (78). This is in part

due to its poor ranking on the “Quality of the Business Environment” pillar, which reflects sector-specific regulatory ease of business.⁸⁵ According to calculations made for a World Bank policy note, construction of a five-star hotel project faces, on average, a 6-year delay if all regulatory requirements are followed. Such requirements include approval of foreign investment, franchising, service outsourcing, management contracts, the repatriation of funds to foreign investors, access to land, and building permits, among others.⁸⁶

Overly strict limitations on tourism activities in protected areas and forests. Regulators are justifiably wary of opening the door to private sector investment in national parks due to concerns about the adverse environmental impact of investors’ activities. However, the process of allocating permits for ecotourism is overly complex and lacks transparency. Regulations need to balance the public interest in legitimate environmental protection with enabling more economic opportunities.

Uncoordinated destination management. The creation of new destinations is constrained by a lack of coordination in addressing deteriorated infrastructure (trekking trails, small bridges, camping sites, picnic spots, recreational parks), inadequate services (water, waste management, electricity), and poor planning and zoning.

Lack of access to finance, including access to foreign lending. While the government has mandated that local banks must lend to the tourism sector, in practice the financial sector is unable to offer attractive financing packages for most tourism projects. The capital market is unable to ease access to finance because it is largely dominated by banks and financial institutions. Only two large hotel chains (Soaltee and Hyatt) are listed on the Nepal stock exchange. As mentioned in the cross-cutting constraints section, several restrictive policies make the Nepalese market unattractive for foreign lenders, who could otherwise become a key source of long-term loans. This could be an especially severe constraint on growth of higher-value tourism as this will require long-term loans.

Lack of skilled labor. A lack of skilled labor is seriously constraining the feasibility of scaling up the tourism offerings in the mid- to high-end segment. Management of upscale facilities requires highly qualified staff, as does the expansion of high-quality services, for example, in mountaineering. ■

AGRIBUSINESS

Nepal has a comparative advantage in agriculture because of its fertile land and abundant water resources, as well as its unique topography. A small but growing private sector has the potential to generate important developmental outcomes. This will, however, require that: (a) productivity is improved by streamlining access to inputs such as fertilizers and seeds; (b) value chains are strengthened through investments, particularly in improving logistics; and (c) private firms are supported to scale up by improving their capabilities, helping them access finance, and making it easier to consolidate land on a commercial scale.

Performance and Opportunities for the Sector to Be Transformational

Nepal has a natural comparative advantage in agriculture. It has three distinct agri-climatic zones, with fertile flat plains, upland hills, and mountainous regions. These allow both tropical and sub-tropical crops to be produced. The production of fruits and vegetables, vegetable seeds, coffee, goats, and honey is accelerating. Tea and coffee exports have also done well, and the poultry and dairy processing industries are growing fast.

The agribusiness sector is currently small and focused on the domestic market. It comprises a mix of a few large business houses with stakes in the larger traditional cereal crops, the food and beverage industry, and a fast-moving consumer goods space. Most other subsectors are characterized by small-scale agribusinesses and traders. In total, there are only about 200 medium-sized and large firms.⁸⁷ Three-quarters of these firms are in livestock and dairy, fruits and vegetables, medicinal and aromatic plant products (MAPS), and coffee and tea. In terms of food processing, 90 percent of firms are below the small-industry level, highlighting the lack of scale in the sector. In recent years, several segments have had negative growth (rice mills in the east and skimmed powder milk plants). A few commodities are being exported, such as lentils, tea, cardamom, fruit, ginger, and MAPs. However, exports are small. Table 3 gives a brief overview of the agribusiness sector with an analysis of current private sector participation along the value chain.

Developing agribusiness is a priority for the government, with the private sector expected to

take the lead. The government's 20-year Agriculture Development Strategy (ADS), adopted in 2015, recognizes the challenges in the sector and provides a comprehensive roadmap for creating "a sustainable, competitive, and inclusive agricultural sector that drives economic growth and contributes to improved livelihoods, and food and nutrition security leading to food sovereignty."⁸⁸ However, both public and private investment in the sector has been limited. For example, FDI in the sector was only \$15 million (out of a total of \$6 billion FDI to Nepal) in 2017.

Opportunities for the Agribusiness Sector⁸⁹

Table 4 summarizes the assessment of competitiveness of agriculture subsectors. Annexes 7 and 8 provide additional data and explain the methodology. Key findings are as follows:

Spices, fruit juices, and tea are the largest export-generating and fastest-growing agribusiness subsectors. Nepal is the global market leader in large cardamom in terms of both production and value, which is reflected in its rapid growth rate. Tea is another growing subsector in which Nepal is establishing itself as a niche player in the whole-leaf and organic tea markets. Production/processing is mostly in the eastern part of the country neighboring India's high-value Darjeeling tea industry, with Nepalese tea featuring many of the same characteristics.

Fresh apples, coffee, honey, and cut flowers have the potential to leverage Nepal's agri-climatic conditions and build on the perceived uniqueness of Nepalese products. They also align well with market trends toward organic

TABLE 3 Current private sector participation in agribusiness

	INPUTS	PRODUCTION	PROCESSING	SERVICES
PRIVATE SECTOR ACTIVITY	<p>LIMITED</p> <ul style="list-style-type: none"> » Fertilizer: Most chemical fertilizers are currently imported by government. Private companies can't compete with subsidized fertilizer » Seeds: Cereal seed development and distribution dominated by public sector SOEs. Private participation mainly in vegetable seeds. 	<p>MODERATE</p> <ul style="list-style-type: none"> » Aggregation: Undertaken by both cooperatives and private entities » Value: Dominated by low value crops with a small but growing volume of higher value commodities for both domestic and export markets. 	<p>LIMITED</p> <ul style="list-style-type: none"> » Limited processing companies across a range of sub-sectors » Most sectors appear to have multiple actors operating within them. 	<p>LIMITED</p> <ul style="list-style-type: none"> » Warehousing: Mainly small private players on cold storage » Logistics: 3-4 main trucking companies
KEY PLAYERS	<ul style="list-style-type: none"> » Fertilizer: Two main companies Agriculture Inputs Company Ltd (AICL) and Salt Trading Corporation Ltd (STCL) are SOEs. » Seeds: National Seed Company Ltd (NSCL) SOE but with a growing private sector presence. » Veterinary: Very limited information. 	<ul style="list-style-type: none"> » Maize: Probiotech/Nimbus (50 Firms operating in Animal feed) » Rice: K.L. Dugar Group, Shivashakti Group, Sharda Group, Golchha Group » Sugar: Shivashakti Group, Golchha Group » Poultry: Valley Poultry, Shreenagar » Dairy: Dairy Development Corp. (SOE) » Tea: Harati Tea Estate, Parajuli Tea Industries, Sachi Pathivara Tea Estate, Modern Tea Ind. » Top Business Houses with Agri: Khetan Group, Sharda Group, Vaidya's Organizations, Jyotie Group » MoAD 		<ul style="list-style-type: none"> » Logistics: 3-4 main trucking companies » Banks: Everest Bank, NIB, Nepal SBI, NMB, Bank of Kathmandu, Himalayan Bank » Insurance: Shakir

TABLE 4 Summary of initial review of agribusiness subsectors⁹⁰

PRODUCT	IMPACT	TARGETED MARKET	COMPETITIVENESS
RICE	HIGH	DOMESTIC	LOW
MAIZE	HIGH	DOMESTIC	LOW
POTATO	HIGH	DOMESTIC	MEDIUM
SUGAR	MEDIUM	DOMESTIC	LOW
FRESH FRUIT & VEGETABLES	HIGH	DOMESTIC; REGIONAL	MEDIUM (NICHE)
POULTRY (BROILERS)	MEDIUM	DOMESTIC	MEDIUM
POULTRY (EGGS)	LOW	DOMESTIC	MEDIUM
FRUIT (JUICE)	MEDIUM	DOMESTIC; REGIONAL	LOW
TEA	MEDIUM	DOMESTIC; GLOBAL	MEDIUM (NICHE)
COFFEE	LOW	DOMESTIC; GLOBAL	MEDIUM (NICHE)
DAIRY	HIGH	DOMESTIC	LOW
SPICES	HIGH	DOMESTIC; REGIONAL; GLOBAL	HIGH
MAPS	HIGH	REGIONAL; GLOBAL	HIGH
HONEY	LOW	DOMESTIC	LOW; MEDIUM (NICHE)
MEAT (W/O POULTRY)	HIGH	DOMESTIC	MEDIUM

Source: Nepal National Tourism Strategic Plan 2015–2024.

foods. Each subsector is currently small and scaling up will require addressing a multitude of factors. These include variable quality, challenges in aggregation of supply from numerous small-scale farmers, access to land, and a lack of technology adoption and compliance with sanitary-phytosanitary measures.

Ginger and vegetables are important products that could attract investment but require government support on cold chains. Ginger is an export earner. However, an inability to comply with phytosanitary standards is currently constraining growth. Vegetables, a smallholder crop, are grown for the domestic market. Together with fruits, they are typically sold through wholesale markets but with limited sorting, grading, and cleaning. However, there is a small but growing modern retail segment that could be a catalyst for longer-term transformation of the fresh fruits and vegetable subsector, provided additional cold-storage facilities can be made available. Strengthening the supply chain from farm to retail is needed, but first-mover costs will be high.

Livestock is a longer-term possibility. The poultry subsector, both for meat and eggs, is a higher-growth subsector that benefits from rising incomes and the lower cost of poultry compared with other meat. Other kinds of meat are also growing, particularly goat. With little in the way of processing, the fresh meat business dominates the industry, keeping it localized, with few larger players outside of poultry.⁹¹ Dairy could also be a subsector where import substitution may be an opportunity. However, the state-owned Dairy Development Corporation controls 40 percent of the subsector and sets farm-gate prices above world market prices. Therefore, profitability of the private processing sector is under pressure.⁹²

The private sector could provide important agriculture support services in the medium to long term. Over the medium term, storage and warehousing is a particularly good opportunity for private sector investment. Currently, there are almost no good quality warehouses for agriculture products in Nepal. Demand is limited by the high cost of post-harvest storage and processing, which can vary from 45 to 100 percent of the farm-gate price. These costs are largely driven by inadequate infrastructure and should come down with

additional investment. The government is also offering numerous incentives for investors.⁹³

Rice, maize, and potatoes are large-scale crops but currently have limited prospects. Rice and maize comprise the two largest cereal crops in Nepal in terms of both production and the participation of smallholders. This creates an opportunity for scale and impact. However, production of each crop is characterized by low yields and high costs of production.⁹⁴ On the processing side, despite the presence of larger business houses with processing facilities, both subsectors are less competitive in efficiency and quality than competitors in India. In fact, it is estimated that up to 80 percent of rice mills in eastern Nepal have shut down due to inefficiency and low competitiveness.

Constraints in the Agribusiness Sector

Along with the cross-cutting constraints around consolidation of land, access to finance, and low managerial capabilities, there are three sector-specific constraints that need to be addressed to create markets.

Low agricultural productivity

Low farm productivity, attributable in large part to the low use of fertilizer and certified high-yielding seed, keeps input costs high. Nepal's usage of fertilizer averages only 50kg per ha, while regional comparators average 150-200 kilograms per hectare. Seed replacement for rice in Nepal is around 5–10 percent, compared with 40 percent in India. The government subsidizes these inputs through its organized aggregation and distribution system. However, the system is underperforming. Supply is unable to meet demand, as distribution is ineffective, and the provision of fertilizer is not based on the needs of the soil or the crop. Government policy is also limiting private sector participation in these markets.

Limited agricultural insurance coverage and markets is also an impediment to improving smallholder productivity. Uninsured risk results in high levels of vulnerability among small- and medium-scale crop and livestock producers and limits innovation. Further development and scaling up of the insurance market will contribute to reducing the production risks faced by crop and livestock owners.

Weak supply chains

The cost and time related to transport and logistics is an important issue. As discussed in the section on cross-cutting constraints, highly dispersed production locations and poor road quality create high access-to-market costs and increased levels of post-harvest losses. Poor transport infrastructure also fragments regional, central, and border markets for agricultural goods (Shively and Thapa, 2017). This undermines the competitiveness of agri-products.

Poor implementation of SPS regulations hurts quality. Much quality testing in Nepal is below international food-safety requirements, and SPS certifications issued in Nepal are not recognized in most countries. This creates a barrier to accessing higher-value export markets, leaving most Nepalese exports to be sold as lower-value products to India. Some progress has been made under the World Bank Group's Project for Agriculture Commercialization and Trade (PACT). However, without additional work to comprehensively address these issues, Nepal will remain relegated to lower-value markets for its products (except for cardamom). This could stifle growth of emerging high-value subsectors.

There are high restrictions on FDI in the agribusiness sector. This is partially attributed to the government's "negative list" of subsectors in which FDI is prohibited, including in poultry, fisheries, and beekeeping. This not only limits access to foreign capital, but also the embedded technology and market connections that FDI can bring.⁹⁵

Government participation in dairy and sugar is dampening private sector interest in investing in these subsectors. Government involvement in setting

prices and payment terms during falling commodity prices undermines profit margins. In the case of dairy, the SOE crowds out private sector players, making economies of scale difficult to achieve.⁹⁶

Land allocation and consolidation

Inefficient land allocation and the difficulty of aggregating land to achieve scale, largely due to the challenges faced by poorly developed land-market institutions, hamper productivity. The lack of land-use planning and management is preventing the efficient use of land. The significant inflow of remittances has driven up land prices in urban/peri-urban areas and along major roads, diverting investment capital from the production system.⁹⁷ As a result, lower-cost land is further away from roads, making logistics and aggregation difficult, and reducing its value as collateral for bank loans. Many farmers also report being hesitant to make large investments in land for fear of future policy changes (for example, zoning related to poultry farming and slaughtering). The lack of institutional arrangements to overcome the limitations of small and fragmented land holdings, produced by complex land ceilings, add to the issue, making it even more difficult for firms to exploit economies of scale expanding to an economically efficient size.⁹⁸ The government recognizes the need to consolidate Nepal's private land. However, the lack of an efficient and meaningful land-use management framework has rendered efforts to regulate land use and consolidate land largely ineffective so far. These include efforts to establish commercial agriculture.⁹⁹ There is little policy or legal support for mechanisms such as including contract farming and land leasing. ■

HEALTH¹⁰⁰

Access to quality health care in Nepal is poor. Expanding the health sector would help address this development need while also creating quality jobs. The private sector has an opportunity to partner with the government to improve access, deliver quality health care, and expand health insurance coverage. While the government realizes the importance of this relationship, the role of the private sector is constrained by limited institutions and a weak regulatory environment. A lack of dialogue with the private sector has also impeded attempts to modernize, reform the sector, and devise instruments to tap private sector potential.

Performance and Opportunities for the Sector to Be Transformational

Nepal has a mixed health-care system that relies on both public and private provision of health-related services and products (Figure 18). Across Nepal, insufficient access to quality, affordable health-care services, along with the increased incidence of new diseases, is causing high levels of premature deaths, although infant mortality and adult mortality rates have declined significantly to below the regional average.¹⁰¹ Degenerative and non-communicable diseases (NCDs) account for 42 percent of all deaths. They make up 23 percent of all disability-adjusted life years, a measure of the number of years of healthy life lost to disease. This is projected to rise.¹⁰² Poor health outcomes are preventing the country from achieving higher levels of productivity and living standards. The primary responsibility for health-care provision remains with the public sector. However, in an environment of limited fiscal resources and poorly developed governance institutions in the public sector, a partnership between the public and private sectors is needed to bridge the existing gap. The private sector could help to increase access by providing services to those with the ability to pay, thereby freeing up public resources to focus on lower-income patients, especially in the underserved rural and mountainous areas. The public sector could also contract out services to the private sector. International experience shows that such contracting arrangements can lower costs substantially, while improving quality and safety.

The overall regulatory and policy landscape in the health sector supports partnership with the private

sector. The National Health Strategy and the State-Non-State Partnership Policy have set the stage for increased collaboration between the public and private sectors. The policy encourages the government to seek the support of large companies and industry associations to improve health communication strategies and source specialized management skills (for example, logistics, inventory, supply chain, and IT applications). It also encourages private sector support in proposing innovative models for health informatics and telemedicine, among other innovations. It is worth noting that the Ministry of Health and Population is already using PPP arrangements.

The private sector already plays a significant role in Nepal's health sector. It is especially important in the areas of service delivery, human resources and education, pharmaceuticals, and health financing. It includes both not-for-profit entities, such as non-government organizations (NGOs) and faith-based service providers; and for-profit commercial entities, such as system-enablers, health-care information/service providers, and producers of health-related products.

Private players face few regulatory barriers to entry. Health-care businesses require few licenses to operate. For example, hospitals need only one more, and pharmaceutical manufacturers only three more, than the number of licenses required for other Nepalese companies. Obtaining the licenses is not costly (for example, \$0.1 for VAT registration, \$2,000 for business incorporation). However, the time needed to obtain these licenses can vary from one day to up to one year.¹⁰³

The for-profit health sector has experienced rapid growth over the past decade. Population growth, rising incomes, and higher incidence of NCDs (Figure 19) are all contributing to a rapid increase in the demand for health care. Furthermore, there is a growing middle class that can afford quality health care, which they associate with private providers. Between 2004 and 2014, the size of Nepal’s health-care market increased at an annual rate of 11.8 percent. In 2011, out-of-pocket expenditures (largely flowing to the private sector) totaled \$570 million, of which 45 percent was spent on drugs and 27 percent on hospital services (curative care). However, private investment is lower than required, and many Nepalis continue to travel to other countries in the region for treatment.

Local companies are investing in improving capacity, technology, and expertise.¹⁰⁴ Furthermore, many hospitals, diagnostic clinics, and pharmaceutical manufacturers are developing PPPs with foreign firms, thereby rising to a level of quality that meets international standards.

Opportunities in the Health Sector

Partnering with the government could open new avenues for private hospitals to improve access. Although the Ministry of Health and Population has

primarily partnered with not-for-profit facilities in the past, there is also an opportunity to cooperate with the many for-profit hospitals. More than 60 percent of patients in the system are referred by public health centers from outside the Kathmandu Valley. Many are seeking specialized care. Private sector providers have expressed an interest in accessing part of this market by charging fees on a sliding scale, organizing medical camps in rural areas, often in partnership with community-run health-care facilities, and by meeting or exceeding the legal requirements to maintain 10 percent of all beds for low-income patients.

While for equity considerations public health insurance should remain the primary option, there is an opportunity for private health insurers. A major milestone in this regard was the passage of the National Health Insurance Act in 2017. First, there are untapped opportunities for the private sector to work with underserved populations through the national health insurance program. At the same time, there is also room to grow the private insurance market. Health insurance is a relatively new product in Nepal and firms have only penetrated 1 percent of the market. There are 17 licensed private health insurers in Nepal. All of them offer similar benefit packages covering major medical expenses (hospitalization), diagnostics,

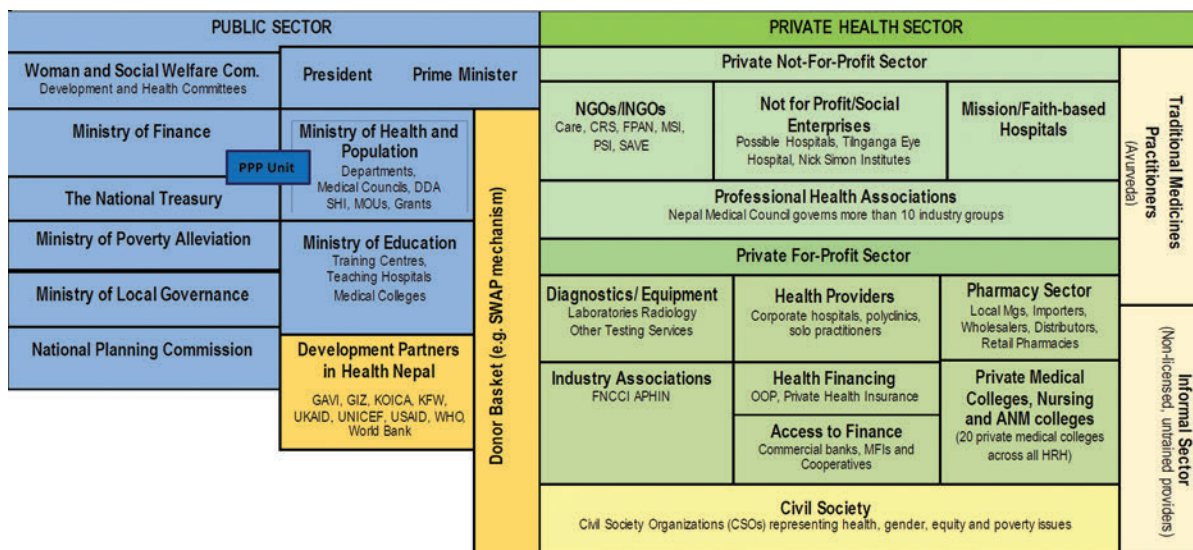


FIGURE 18 Nepal’s health sector landscape

Source: USAID/Nepal Health Private Sector Engagement Assessment (2017).

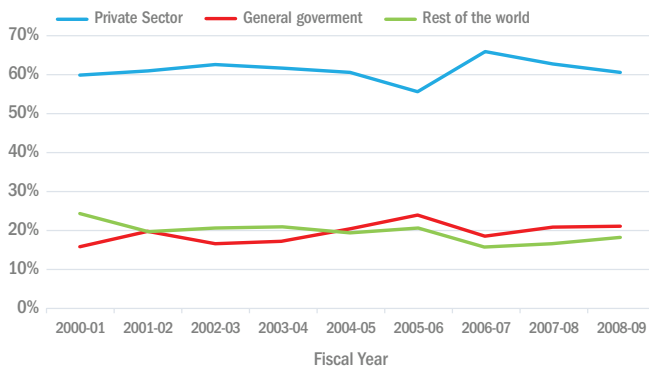


FIGURE 19 Sources of health-care financing in Nepal, 2000–09

Source: USAID/Nepal Health Private Sector Engagement Assessment (2017).

and drugs, but exclude preventative care. There are 20 contracted service providers/hospitals that dominate the private insurance market, and a few that have arrangements with Indian and international hospitals. The industry’s principal clients are global and large Nepalese companies (banks, manufacturers, telecoms) that offer health policies to their employees. However, the high-income and corporate segments have not yet been fully exploited.

Community pharmacies could extend basic health care to rural populations. The Nepalese health system currently struggles to reach rural populations. If supported with quality products and training, privately-run pharmacies could be an effective channel to deliver services and counseling to rural women and provide other benefits to rural and underserved populations.

Constraints in the Health Sector

There is a need to revise, streamline and coordinate the regulation of private health providers. Nepal’s health regulations date back 25 years and no longer reflect international best practice for governing mixed public-private health systems. Moreover, the health system is governed by multiple agencies, making the task of reform more complex than previously. As such, in today’s environment there is a need for much greater coordination and collaboration between agencies.

The Ministry of Health and Population, which oversees private health-care firms, faces the challenges of

training staff and upgrading to modern, standardized systems that reflect best practice for regulating the private sector. The private sector is valued largely for the better quality it provides. However, the institutional foundations needed to ensure private that firms actually deliver high-quality health care are lacking. In more developed systems, this function is provided through a range of interventions, including inspections, accreditation of facilities, ongoing oversight by payers of health care (often health insurance companies), and patient feedback. Little of this currently occurs in Nepal. The lack of effective regulation has led to a proliferation of health enterprises ranging from world-class facilities to others plagued by poor quality and lack of proper quality assurance of drugs procured. These conditions fuel consumer mistrust of private providers and constrain market growth. The low quality of care also reduces the scope for the public sector to contract out to the private sector, since it typically needs to be assured of the quality that private providers deliver before it contracts out to them or incorporates private sector providers into social health insurance schemes.

There are few incentives for commercial health-care providers to expand to new populations in new locations. Private players want to join their non-profit peers in working with the Ministry of Health and Population in the areas of specialty services and diagnostics. However, most partnership arrangements (for example, Memorandums of Understanding, or MOUs) are informal, ad hoc, and based on personal relationships. Much work remains to be done to be able to use contracts as engagement mechanisms. As a result, private health care is mainly confined to high-income groups living in the Kathmandu Valley.

The lack of dialogue between public and private health providers has led to a significant wariness and hesitation to collaborate. This is unfortunate and a missed opportunity in efforts to modernize and reform the regulatory environment. Moreover, the few professional associations that represent commercial interests are seen as highly political entities that advance individual—not sector—interests. ■

EDUCATION

There are considerable opportunities for private sector investment in the tertiary, and the technical and vocational education and training (TVET) subsectors. Policy reforms that facilitate entry and enhance autonomy of private institutes are needed for the private sector to play a greater role. Industry linkages and incentives for improving quality would also be useful. Private sector investment in the education sector could ease a major constraint on firms' growth in Nepal, namely the limited supply of workers with market-relevant technical and managerial skills.

Performance and Opportunities for the Sector to Be Transformational

There is potential unmet demand for high-quality and affordable private education at all levels. The gap between potential demand and supply is most apparent in higher education and TVET. Nepal is undergoing a demographic youth bulge; almost 45 percent of its population is of school or college age. Gross enrolment rates (GER) are a rough indicator of potential unmet demand. While Nepal's primary school GER compares favorably with the South Asia average, its tertiary-level GER is only 12 percent. This is lower than average for South Asia, suggesting the greatest unmet demand is in tertiary education (Figure 20).¹⁰⁵ Similarly, there is potential unmet demand for TVET: although nearly 512,000 youth enter Nepal's labor market every year, less than one-quarter participate in any kind of technical or vocational training.¹⁰⁶

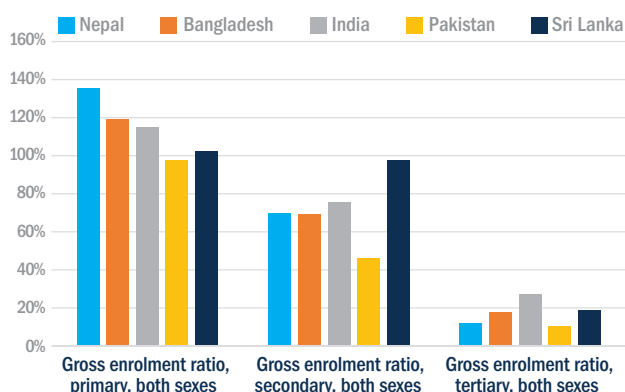


FIGURE 20 Gross enrolment ratios in South Asian countries, 2016

Source: UNESCO. <http://data.uis.unesco.org>.

Private providers of tertiary education and TVET will be pivotal in easing the skills constraint on Nepalese firms by responding flexibly to market demand. Firms need workers with up-to-date technical and vocational skills. This need is particularly urgent in export-oriented sectors, such as agribusiness and tourism, which are crucial to Nepal's growth strategy. With limited financial resources, and little capacity to respond flexibly to market needs, the public sector alone cannot fill this gap. As described below, there is already a sizable private sector presence in tertiary education and TVET. The question is how Nepal can reform policy to enhance the size and quality of this segment of educational service providers.

Higher education is dominated by nine national universities, with a significant share of affiliated private colleges. Private colleges account for the majority share of enrolment in key technical streams, such as

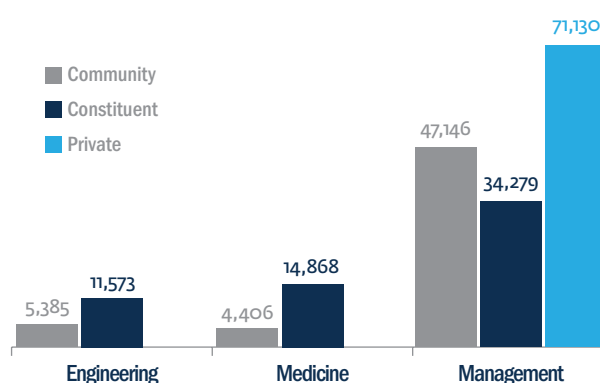


FIGURE 21 Enrolment by college type for select streams (Tribhuvan University)

Source: Primary data from Tribhuvan University.

engineering and medicine (Figure 21). In addition, Nepal has some private colleges that are affiliated with foreign universities.¹⁰⁷

TVET is dominated by small private providers. The Council for Technical and Vocational Education and Training (CTVET) approves and monitors programs that offer Technical School Leaving Certificates (TSLC), diplomas, and short-term vocational training. These courses are offered by community schools, private institutes, and institutes under the direct control of CTVET.

There is scope for the entry of larger, more professionally-run TVET institutes. Although there are more than 500 private TVET providers in Nepal, and more are opening, most of them are small and offer just a few courses. This restricts economies of scale and scope, leaving little room for the adoption of professional management structures. The large number of providers makes it difficult to regulate the quality of TVET. Hence, there is opportunity for larger TVET institutes that leverage modern management and economies of scale/scope to offer high-quality training at competitive prices.

Reforms to facilitate private sector entry and quality in the tertiary and TVET sectors are feasible. The private sector is present at all levels of education: from pre-school to university, and from elite schools to start-ups offering low-cost education, and young colleges affiliated with foreign universities. However, for now, reforms to further open up the sector to private providers are more feasible in tertiary and vocational education. This is because the policy stance toward private sector involvement in primary and secondary schooling is becoming more restrictive and unpredictable. This is ostensibly due to concerns about equitable access. For instance, the Institutional School Standards and Operations Directive of 2013 imposes restrictions on establishing and operating private schools; and the government has not issued new licenses for private schools in recent years.¹⁰⁸ Furthermore, in 2017, a high-level commission on education reforms recommended that all private institutions be replaced with public institutes over a period of 12 years.¹⁰⁹ Such a policy change is not on the horizon for TVET and tertiary education.

Constraints to the Higher Education and TVET Segments

The key constraints to a more enhanced role for the private sector in providing high-quality, market-relevant education are policy-related and include the following:

The key challenge is to ease the regulatory burden on private providers: On paper, policy supports private sector involvement in schooling, higher education, and TVET. But there are serious implementation gaps. In addition, some recent changes in policy—such as the apparent freeze on new licenses for schools—have added to the level of uncertainty for private investors. The lack of a framework for PPPs adds to the sense of uncertainty. Private sector entry is impeded by complicated and unpredictable processes for obtaining official clearance for new institutes and courses. These issues affect both tertiary and TVET segments, slowing down the introduction of high-demand courses in engineering, medicine, and management.

In the tertiary education segment, the regulatory problem is especially severe for foreign-affiliated private colleges. A few examples include the difficult license renewal process they must undergo every year, and the short window for requesting permission to offer new courses each year (just 15 days).

In the TVET segment, a key issue is that the apex institute for TVET (CTVET) takes between four and 10 years to approve new training institutes. The TVET segment also suffers from a lack of coordination across relevant agencies: in addition to CTVET, there are around 17 ministries that provide TVET in their respective sectors. These ministries do not adhere to common norms and standards, and do not coordinate with CTVET.¹¹⁰ While Nepal has developed a National Vocational Qualifications (NVQ) framework,¹¹¹ not all TVET institutes are currently aligned to it.

A low level of autonomy and excessive control by universities prevents tertiary institutes from responding to market demand. Colleges and other tertiary institutes are bound by strict university guidelines on the courses they can offer, the design of course curriculums, class sizes, and fees. This limits the ability of colleges to fully utilize their existing faculty and improve their profitability.¹¹² There are ongoing efforts to introduce more autonomy in colleges, which is a

step in the right direction, but these are proceeding slowly.¹¹³ The University Grants Commission (UGC) has established a new national accreditation system to facilitate autonomy, but the details of this new initiative are still unclear. So far, only seven colleges have been granted enhanced autonomy under the initiative.

Inadequate market data and provider incentives keep the quality of service provision low. Current policy focuses on regulating entry, rather than improving the incentives and effectiveness of providers. In particular, the government does not produce or disseminate output-based assessments of the quality of teaching. These could facilitate market signals and incentivize more effort and investment into improving the quality and market-relevance of teaching.¹¹⁴

Inadequate linkages between educational institutes and relevant industries reduce how responsive they are to market demand. This is particularly concerning in the TVET segment. With very limited industry involvement in designing TVET curriculum, many courses are out of date.¹¹⁵ Furthermore, training institutes do not partner enough with industry to generate internships and placements.¹¹⁶ No publicly supported industry body exists (such as the industry skills councils found in many other countries) to provide information on the demand for skills, assist with developing curriculum, help supply trainers, or provide support for placement services (Annex 10 discusses international experience on closer integration of TVET with industry). ■

IT SERVICES

IT services can offer high-quality jobs for skilled workers, improve the productivity of other sectors, and facilitate better governance. Furthermore, compared with manufacturing, IT services are not as constrained by Nepal's weak transport infrastructure, poor logistics, high land prices, and small domestic market. While the sector has grown rapidly in recent years, partly because of Nepal's low wages, the lack of higher-level IT skills and managerial capabilities in the workforce, regulatory hurdles, weak digital infrastructure, and access to finance are all holding it back.

Performance and Opportunities for the Sector to Be Transformational¹¹⁷

The IT services sector is a nascent but growing one in Nepal. The sector can be divided into three segments: (a) application services (for example, app development, consulting, and systems integration); (b) IT-enabled services and business process outsourcing (ITeS-BPO); and (c) products (for example, e-commerce, internet service providers [ISPs], online payments, and mobile wallets). Firms in the first two segments are more export-oriented, providing foreign markets with services such as call centers, medical transcriptions, back-office operations, insurance claims processing, and digital content development. The sector is still small. In FY 2016/17, the total revenues of registered IT application services firms, ITeS-BPO service providers, and e-commerce firms were estimated to be \$100–\$200 million, \$50–\$100 million, and \$50–\$100 million, respectively.¹¹⁸ But the sector is growing rapidly. According to the Computer Association of Nepal (CAN), employment in IT services is increasing by 15 to 20 percent annually.

IT services firms are small but innovative. While systematic data on IT services firms are unavailable, the anecdotal evidence is that IT services firms in Nepal are generally small, and that some are not even officially registered. Most IT services firms have only 5 to 20 employees, and only about 10 firms have more than 100 employees.¹¹⁹ But despite its modest size, the sector has become a magnet for entrepreneurial talent. Nepalese IT services firms are devising innovative, tailored solutions for local problems. These include low-cost schooling, ride-hailing, and management systems for pharmacies, hospitals, restaurants, and hotels.

In recent years, an emergent digital entrepreneurship ecosystem has nurtured many IT-enabled companies. Local and international incubators and accelerators such as Microsoft Innovation Centre, Rockstart Impact, and Biruwa Advisors, provide mentorship, access to networks, and funding. Some accelerators assist in developing business models and skills and provide co-working spaces.¹²⁰

The low labor cost of junior software developers has been a major factor in the expansion of Nepal's software application sector and its increasing exports.¹²¹ The hourly software development rate in Nepal is around \$10–\$15.75. This is lower than other key Asian outsourcing countries (\$50 in China, \$30 in Vietnam, \$20 in the Philippines, and \$15 in India).^{122,123} With Nepal's low wages, a junior software developer with less than three years' experience costs around \$220 per month compared with an average \$500¹²⁴ in other Asian countries.¹²⁵

Export-oriented IT services firms that exploit Nepal's wage advantage will continue to drive the sector in the short to medium term, although their wage advantage will likely diminish over time. Nepal's IT firms largely operate in segments in which barriers to entry are low. It is highly likely that competition from other low-wage countries (and from new technologies) will increase over time. Indeed, Nepal's IT services sector does not have the scale to follow the same path as India's low-cost outsourcing industry. For example, only 7,500 students graduate each year from computer science and ICT-related courses in Nepal. Of these, only 20 percent remain in Nepal.¹²⁶ By comparison, 2.6 million Indian students graduated from STEM courses in 2016. As such, Nepal will need to pursue a different growth strategy to India's.

In time, IT services could help drive Nepal's growth strategy by developing expertise in niche areas that complement key sectors such as tourism and agribusiness. ICT products and services could help increase the productivity and product diversification of key export-oriented sectors such as tourism. This could include software for real-time booking, property management services, smartphone services, and integration for flights, as well as geolocation and wearable technology apps to enhance mountain hiking.¹²⁷ Other potential niche areas include activities in the value chain of other sectors that require a high degree of local understanding and knowledge (language, geography, culture, networks) to function well. Potential examples include provision of online education services for remote areas in Nepal (as opposed to education software only), and productivity tools for transportation and services.

The emergence of IT-enabled education technology (EdTech) firms points to a potentially important role for IT in easing Nepal's skills constraint. Nepal's nascent education consulting sector includes a group of 15 to 20 IT companies, mostly private, offering courses in management information systems (MIS). There is also a nascent market for EdTech, with private companies offering online courses and practice exams, as well as aggregated information on educational institutions and tutors. Looking ahead, the private sector could offer innovative consulting solutions to improve the quality of education. Some areas in which IT-enabled private educational consulting firms can play a larger role, perhaps in partnership with the public sector, include:

- » PPP models for service delivery, such as e-learning, and
- » Introducing better management technologies in schools, colleges, and TVET institutes

The IT services sector could also increase efficiency and transparency in governance, thereby helping ease a major cross-cutting constraint to the private sector. For example, the government has announced plans for e-governance, smart cities, and a national identification system that will increase the domestic demand for IT application services.

While it will remain small by international standards, the IT services sector could eventually account

for a significant share of good jobs, if the business environment improves. Notwithstanding constraints, there is a high level of start-up dynamism in Nepal. Some IT services firms have managed to stay competitive in export markets for many years.¹²⁸ The IT services sector could also benefit more from proximity to India: firms have learned from India's experience, but also appear to have lost talent to India. Tapping into its diaspora in India and attracting Indian FDI could help Nepal to benefit from its proximity to India.

Constraints to IT Services

Firms are constrained from scaling up or moving up the quality ladder due to a lack of higher-level skills and management expertise. In interviews conducted for the CPSD deep dives, firms noted that the scarcity of experienced technical workers and mid-level managers has made it harder for them to expand. Interviewees also noted that, because of the low quality of technical education, many of them must invest in six to eight months of on-the-job training. Therefore, the quality-adjusted cost of skilled workers is high. The high emigration rate of skilled workers worsens the availability of experienced technical and managerial workers. In the ICT sector, for example, emigration leads to high employee attrition and a shortage of the most able IT graduates. Firms must continuously invest in hiring and skilling fresh college graduates, while few remain long enough to become middle managers.

Ineffective regulations and supporting policies make it difficult to conduct business. Overlapping and unclear mandates across key ministries (the Ministry of Information and Communication, and the Ministry of Education, Science and Technology) have impeded policy coordination.¹²⁹ The IT industry has little interface with the government, partly because the sole industry group (Computer Association of Nepal) has historically focused on IT hardware.¹³⁰ Furthermore:

- » The IT industry lacks regulations for segments such as IT outsourcing and e-commerce.
- » Immigration regulations restrict the supply of skilled foreign workers.¹³¹
- » A tax exemption for IT firms is only available to firms with more than 300 employees, leaving most unable to claim it.

- » Privacy and intellectual property rights remain important concerns for companies and end-users.
- » Apart from the Foreign Investment and Technology Transfer Act of 1992, there is no specific legal framework that addresses IT-related technology transfer issues.
- » The 2015 IT policy, which aims to support the sector through infrastructure development, digitization of government services, and promotion of various IT subsectors, is still in draft form and open to public scrutiny.

A lack of early-stage finance and business incubation support constrains start-ups. A lack of financing for SMEs is a cross-cutting constraint that poses specific challenges to IT start-ups. In interviews conducted for the CPSD, some IT-services firms noted that they are at a point where they typically require \$500,000 to \$1 million to scale up. But accessing long-term bank loans or equity investment of this size is difficult for them. In part, this could be due to a lack of advisory support, which could help IT start-ups become better prepared to seek such funding. Institutions providing this kind of early-stage finance and business incubation (such as the Dolma investment fund) do exist, but firms noted

that they are too few relative to the demand from the IT services sector.

Nepal’s weak IT infrastructure and the lack of quality IT parks have also constrained the IT services sector.

First, IT-services firms are restricted to locations around Kathmandu, the only area with adequate infrastructure. Second, the extremely low penetration rate of broadband, and the mediocre quality and cost of mobile internet, limit domestic demand for IT services. Specialized technology parks can help to provide adequate technological capacities and infrastructure within a limited zone. But the only IT Park in Nepal, which is government-run, has failed to attract firms, largely due to poor infrastructure. Other infrastructural issues include:

- » High fixed cost of logistics infrastructure (relative to Nepal’s market size).
- » Absence of a standardized postal address system.
- » Cash is still the preferred mode of payment among online shoppers in Nepal. Online transactions are more expensive, as they include the cost of buying or renting point-of-service terminals and high transaction fees (between 1.75 and 3 percent).¹³² They also have longer settlement cycles in Nepal (around 30 days) than in other countries. ■

Recommendations

This Nepal CPSD identifies what it will take for the private sector to enhance productivity and create better jobs. The key challenges to be addressed for faster private sector development are: (a) governance and institutions; and (b) infrastructure. In addition, Nepal's inadequate openness to trade limits the degree to which it can benefit from the vibrant markets on its border and from global markets more broadly. Access to credit and skills also remains unequal, limiting productivity growth for some firms. Finally, there is a need to build up firms' capabilities. There is growing global evidence that programs that directly provide consulting advice to firms lead to the adoption of better management practices and have long-term impacts on firms' performance.¹³³

While there are advantages to addressing some issues economy-wide, others may prove more tractable at the sector level. There are benefits to addressing some cross-cutting constraints at the economy-wide level, as these are prerequisites for all economic activity. These include constraints such as basic infrastructure (roads and electricity),¹³⁴ as well as access to land, finance, and basic skills. Similarly, in some cases, firms' capabilities gaps can be addressed through firm-level support programs, which can cover multiple sectors while also being tailored to sector-specific needs where

necessary. In other cases, however, sector-specific programs to unleash private sector potential may be more politically or institutionally feasible.

Thus, this Nepal CPSD presents both cross-cutting and sector-specific recommendations. The first table lists recommendations to address cross-cutting issues, followed by five sector-specific recommendation tables. The two sets are closely connected: where there is potential for overlap, the tables cross-refer to each other to avoid repetition.

Recommendations on cross-cutting issues and infrastructure subsectors

CONSTRAINT	RECOMMENDATION
Regulatory governance	<ul style="list-style-type: none"> » Continue and intensify government efforts to simplify and streamline business laws and regulations. » Strengthen implementation capacity, including by using technology, in key ministries and agencies. (Some details for priority sectors are provided in tables below.) » Introduce a single-window interface for regulatory compliance. » Use institutional frameworks such as the Nepal Business Forum for regular dialogue between government and the private sector, ensuring representation from industry, with emphasis on priority sectors such as agribusiness, tourism, health, education and IT. » Clarify regulatory responsibilities over concurrent functions of the three tiers of government and undertake required regulatory capacity building measures at provincial and local tiers.
Infrastructure	<ul style="list-style-type: none"> » Facilitate PPP in Infrastructure: (from the InfraSAP): <ul style="list-style-type: none"> • Finalize and enact the draft PPP Law after extensive consultations to build consensus among key stakeholders • Develop a PPP pipeline and a clearly defined project screening and prioritization process • Develop standardized documents and tools to support the preparation of high-quality projects • Develop fiscal commitment and contingent liability framework.

CONSTRAINT	RECOMMENDATION
Infrastructure (cont.)	<ul style="list-style-type: none"> » Transport (from the InfraSAP): <ul style="list-style-type: none"> • Roads: <ul style="list-style-type: none"> • Strengthen the Road Board of Nepal (RBN) • Increase incentives for high performance in road maintenance contracts. Further strengthening of the sector can come from identifying a network of strategic roads for increased maintenance and expansion executed through PPPs • Airports: <ul style="list-style-type: none"> • Articulate a clear and comprehensive strategy to expand and improve the country's airport infrastructure, including financing plans • Adopt international management practices with private sector participation » IT Connectivity: Develop a reform plan to improve the efficiency of digital infrastructure and encourage investment into it. This should address business entry and competition, bandwidth availability, passive infrastructure-sharing, and incentives for the private sector to make the investments and share infrastructure. » Energy (from the InfraSAP): <ul style="list-style-type: none"> • Strengthen the capacity of the Nepal Electricity Authority (NEA) and its subsidiaries • Establish a short-term (five-year) plan, encourage private participation, prioritize funding from the Millennium Challenge Corporation (MCC), Asia Development Bank (ADB), and other development partners, and develop its grid code • Standardize and improve the processes for PPPs, licenses and permits, and PDA
Access to skilled labor	<ul style="list-style-type: none"> » Recommendations on strengthening higher education and TVET are presented in the education deep-dive section of this report.
Firms' capabilities	<ul style="list-style-type: none"> » Ministry of Industry to: <ul style="list-style-type: none"> • Build and support network of business advisors, incl. advisors specializing in key sectors like agribusiness and IT services. • Introduce subsidized management extension programs for firms in key sectors, including training on HR interventions to reduce employee attrition.
Access to finance	<ul style="list-style-type: none"> » Conduct a comprehensive diagnosis to develop a financing strategy for SMEs, possibly including alternative finance models such as leasing. <ul style="list-style-type: none"> • Based on diagnostics, modify/draft legislation to support development of key financial products supporting SME growth (warehouse receipts, leasing, secured registries). » Clarify regulations and procedures needed to operationalize the Secured Transactions Act. » Strengthen the creditor information base and explore approaches to covering more SMEs in credit information systems. » Implement a system of lending against warehouse receipts to improve access to finance for the agriculture sector. » Develop a legal framework for private equity and venture capital. » Establish online payment systems in rural areas to ease transactions in tourism, agribusiness and other industries with rural locations.
Constraints to FDI, foreign lenders and foreign exchange transactions	<ul style="list-style-type: none"> » Review negative FDI list with a view to reducing it. » Review and adopt the draft Foreign Investment Act, repealing the Foreign Investment and Technology Act, 1992. <ul style="list-style-type: none"> • Cabinet should undertake a new round of consultations on latest draft of the Foreign Investment Act with domestic and foreign investors as well as international experts¹³⁵ » Streamline approvals of investments and repatriation of benefits (Manual of 2012 and central bank rules). » Reassess the Minimum Capitalization Requirement for Offshore PE Funds and consider reducing it for priority sectors (such as IT).

CONSTRAINT	RECOMMENDATION
Constraints to FDI, foreign lenders and foreign exchange transactions (<i>cont.</i>)	<ul style="list-style-type: none"> » Reassess the interest rate cap on foreign exchange lending and the cap on interest from foreign sources for Fls. » Reassess policies on foreign lenders to ease transactions and grant more equal treatment: <ul style="list-style-type: none"> • Consider granting foreign lenders <i>pari-passu</i> treatment with local lenders in priority of investment • Simplify granting and perfection of security interest process. • Reduce time frame for NRB to grant approval • Permit commitment fees to accrue from the date of submission of the loan documents to NRB but be payable only after NRB approval » Publish relevant regulations and directives in English. » Other related sector-specific recommendations are explained in the deep-dive sections of this report.
Land access and allocation	<ul style="list-style-type: none"> » Conduct a diagnostics of land governance to develop a plan to strengthen land governance and management for easing access to land and improving the efficiency of land allocation. The plan should include measures to: <ul style="list-style-type: none"> • Implement land zoning as required by the Lands Act (Chapter 9A) • Update the Land Acquisition Act (1977) and make it consistent with the Land Acquisition Policy • Ease land-use conversion • Assess the process for granting land for business purposes to foreign investors and implement recommendations to make it more transparent and streamlined • Consider streamlining the procedures for the granting of mortgage over land and creating security interest for foreign investors » Develop industrial parks, including parks tailored to priority industries such as agribusiness to aggregate and title land for commercial use.

SECTOR-SPECIFIC RECOMMENDATIONS FROM THE FIVE SECTOR DEEP DIVES

TOURISM		
OBJECTIVES	RECOMMENDATIONS	PRIORITY LEVEL
<i>Goal 1: Improve the overall tourism business environment</i>		
Modernize key business laws and regulations affecting foreign and domestic private investment	<p>Medium- to long-term</p> <ul style="list-style-type: none"> » Review Tourism Act (1978) against best practices. » Clarify investment approval criteria under Industrial Enterprise Act, 2049 (1992). » Review cap on land ownership preventing large hotels under Land Act 2021 (1964). 	HIGH
Clarify and simplify Protected Areas (PA) and Community Forests (CF) regulations and policies	<p>Short-term</p> <ul style="list-style-type: none"> » Review and clarify policies and regulations governing utilization of protected areas (National Parks and Wildlife Reserve Act of 1973), and community forests (Forest Regulations of 1995): <ul style="list-style-type: none"> • Strengthen the process and content of lease, permits and licenses to upgrade private sector, and local communities' roles in PAs and CFs policies and economic activities • Adopt common guidelines and standards on lodges/teashops in parks, buffer zones and land of conservation areas 	HIGH

TOURISM

OBJECTIVES	RECOMMENDATIONS	PRIORITY LEVEL
<p>Clarify and simplify Protected Areas (PA) and Community Forests (CF) regulations and policies (cont.)</p>	<p>Medium- to long-term</p> <ul style="list-style-type: none"> » Revise royalties and entrance fees to adapt to willingness to pay of types of visitors. » Revise status and mandate of National Trust for Nature Conservation and its regional offices such as ACAP and “contractualize” missions with local governments. » Improve enforcement of environmental safeguards. » Leasing of state-owned land for private investment in destination gateways and destination areas. 	<p>HIGH</p>
<p><i>Goal 2: Improve connectivity</i></p>		
<p>Improve road access to core destinations</p>	<p>Short-term</p> <ul style="list-style-type: none"> » Prepare provincial connectivity master plans for key destinations. <p>Medium- to long-term</p> <ul style="list-style-type: none"> » Build and maintain national/local roads facilitating access to core assets of priority destinations and improve safety and rescue capacity. » Enhance online payment capacity at destination level. » Encourage private sector to develop and operate facilities for transport, such as bus stops and terminals, taxi stands, and rest stops. 	<p>MEDIUM</p>
<p>Upgrade air transport infrastructure and regulations</p>	<p>Short-term</p> <ul style="list-style-type: none"> » Upgrade the reliability, safety, and efficiency of the airport system: <ul style="list-style-type: none"> • Improve operational management of Tribhuvan International airport and accelerate construction of Gautam Buddha International airport and Pokhara airports¹³⁶ • Assess need for Nijgadh Second International Airport • Assess need for reopening or upgrading local domestic airports » Update aviation policies and regulations covering airspace, safety, airlines, airport services, air services tariffs, and taxes (for example, adoption of draft Civil Aviation Bill, review of tax on plane leasing). <p>Medium- to long-term</p> <ul style="list-style-type: none"> » Involve the private sector in management and/or construction of airports through PPPs, as provided under the draft Civil Aviation Bill. 	<p>HIGH</p>
<p><i>Goal 3: Develop priority destinations</i></p>		
<p>Establish strategic coordination and monitoring at national and destination levels</p>	<p>Short-term</p> <ul style="list-style-type: none"> » Establish a national tourism steering committee comprising key ministries, representatives of provinces, and private sector organizations. » Clarify the sharing of powers regarding tourism and related infrastructure amongst the federal, provincial, and municipal governments. » Designate Destination Management Organizations in charge of development of destination plan and day-to-day coordination of public and private stakeholders of selected destinations. <p>Medium- to long-term</p> <ul style="list-style-type: none"> » Formalize in writing the respective commitments of public and private tourism stakeholders for destination development over short to medium term. 	<p>HIGH</p>

TOURISM

OBJECTIVES	RECOMMENDATIONS	PRIORITY LEVEL
<p>Finance and maintain tourism infrastructure identified through an integrated destination approach</p>	<p>Short-term</p> <ul style="list-style-type: none"> » Identify selected destination's growth projections and preferred development scenario based on (a) a market/demand opportunities assessment, and (b) an analysis of infrastructure and visitor facilities gaps. » Prepare a five-year Integrated Tourism Master Plan (ITMP) with active stakeholder engagement. » Implement in parallel a first set of infrastructures needed to fill well identified gaps. <p>Medium- to long-term</p> <ul style="list-style-type: none"> » Ensure that tourism-related infrastructure identified in the ITMP are budgeted and financed by concerned ministries, provinces, and municipalities in selected destinations. This includes trekking and scenic trails, safe drinking water points, rescue shelters, visitor centers, touristic roads, water, solid waste, signage, as well as infrastructure to facilitate access to lakes, villages, and mountain tops. » Involve the private sector in the management and maintenance of tourism infrastructure. 	<p>HIGH</p>
<p>Improve statistical data, market research and destination marketing</p>	<p>Short-term</p> <ul style="list-style-type: none"> » Improve tourism statistics and analytics for effective marketing and promotion strategy (with other statistical bodies and private sector). <p>Medium- to long-term</p> <ul style="list-style-type: none"> » Produce annual tourism reports based on reliable /comprehensive data. 	<p>MEDIUM</p>
<p>Attract investors in destinations with upscale potential</p>	<p>Short-term</p> <ul style="list-style-type: none"> » Approach leading operators for higher-end adventure tourism. <p>Medium- to long-term</p> <ul style="list-style-type: none"> » Advertise internationally selected opportunities for concessions, leases in PA and/or CA with exclusive rights to areas/ activities, with cost-sharing for utilities supply and access infrastructure. 	<p>MEDIUM</p>
<p>Develop local sector capacity around new products and standards</p>	<p>Short-term</p> <ul style="list-style-type: none"> » Design new standards/labels for innovative products, for example, climate-smart solutions, new trekking trails such as the Great Himalayan Trail. » Establish a tourism fund and select local business development services providing small grants, knowledge, and assistance to support innovative/sustainable tourism projects of local communities and private sector. <p>Medium- to long-term</p> <ul style="list-style-type: none"> » Continuously review the performance of small grants and business development services provided in tourism. 	<p>MEDIUM</p>
<p>Enhance training and quality of service</p>	<p>Short-term</p> <ul style="list-style-type: none"> » Develop infrastructure for the Mountaineering Training Academy and improve the training capacity and courses of the Nepal Tourism and Hotel Management Academy. » Develop a training and capacity-building program to be delivered at destination level. <p>Medium- to long-term</p> <ul style="list-style-type: none"> » Implement local training offering under PPP-type arrangements with selected business organizations. 	<p>MEDIUM</p>

AGRIBUSINESS

OBJECTIVES	RECOMMENDATIONS	PRIORITY LEVEL
<i>Goal 1: Strengthening the production base as a foundation for agribusiness competitiveness</i>		
Reform the fertilizer and seed sector policy	Short-term <ul style="list-style-type: none"> » Allow private sector participation in tenders for procurement and distribution of fertilizers and improved seeds. » Implement the e-voucher system proposed in the ADS to reduce inefficiencies. 	HIGH
Land policies that support agriculture sector growth	Short-term <ul style="list-style-type: none"> » Conduct a land governance assessment, and subsequently implement recommendations starting with areas with the highest agribusiness potential. » Pilot a land bank to facilitate leasing of unutilized land as proposed in the ADS. Medium- to long-term <ul style="list-style-type: none"> » Introduce land zoning as required by the Lands Act (Chapter 9A). 	HIGH
<i>Goal 2: Supporting scaling up of agribusiness SMEs</i>		
Enhance capacity and performance of food safety and SPS measures	Short-term <ul style="list-style-type: none"> » Identify priority activities to improve food safety/SPS measures to eliminate bottlenecks for Nepalese products to access higher-value markets. Medium- to long-term <ul style="list-style-type: none"> » Build suitable quality infrastructure to implement standards in collaboration with the private sector. 	HIGH
Support scaling up of agribusiness SMEs	Short-term <ul style="list-style-type: none"> » Scale up and/or replicate existing incubator models (NABIC). 	MEDIUM
Evaluate the government's direct participation in sugar and dairy sectors	Short-term <ul style="list-style-type: none"> » Analyze the potential impact of removing government participation/intervention in the sugar/dairy subsectors with the goal of understanding what those changes could have on crowding in private sector investment. 	MEDIUM
<i>Goal 3: Improve market linkages</i>		
Support value chain linkages	Medium- to long-term <ul style="list-style-type: none"> » Support/facilitate building linkages between key value-chain players (linking producers to agribusinesses) and providing the support needed (training, capacity building, etc.) to strengthen those relationships. 	MEDIUM
Investment in improved logistics/transport for agribusiness	Medium- to long-term <ul style="list-style-type: none"> » Evaluate/benchmark logistics costs of moving agribusiness inputs and outputs, both in the country and to priority destinations. » Determine public/private investment required to support improvements. 	MEDIUM

HEALTH		
OBJECTIVES	RECOMMENDATIONS	PRIORITY LEVEL
<i>Goal 1: Strengthen the provision of private sector services to public sector health-care facilities</i>		
	<p>Short-term</p> <ul style="list-style-type: none"> » Establish a model for contracting services, starting with easier services such as diagnostics or medical waste disposal. » Include more private sector facilities under the envisaged national health insurance scheme. <p>Medium- to long-term</p> <ul style="list-style-type: none"> » Develop financial instruments to incentivize the expansion of private providers into underserved areas. 	HIGH
<i>Goal 2: Strengthen the quality of health care</i>		
	<p>Short-term</p> <ul style="list-style-type: none"> » Benchmark “quality of care” institutions to global standards to evaluate gaps in institutions and identify areas for reform. » Develop and implement a health-care quality plan as recommended by WHO. <p>Medium- to long-term</p> <ul style="list-style-type: none"> » Develop and implement mechanisms to provide oversight over the quality of care starting with patient feedback and accreditation. 	HIGH
<i>Goal 3: Build trust through public-private dialogue</i>		
	<p>Short-term</p> <ul style="list-style-type: none"> » Create platforms, and communication/information exchange mechanisms. <p>Medium- to long-term</p> <ul style="list-style-type: none"> » Support capacity building of health-care private sector representative bodies to engage in constructive dialogue. 	MEDIUM

IT SERVICES

OBJECTIVES	RECOMMENDATIONS	PRIORITY LEVEL
<i>Goal 1: Improve skills and product quality</i>		
Improve the quality and market relevance of skills of IT graduates	Short-term <ul style="list-style-type: none"> » Ministry of IT and Education to initiate IT graduate course revision with industry input. » Introduce internships within three-year graduate courses with course credits. 	HIGH
Develop and implement a niche brand/specialization strategy	Short-term <ul style="list-style-type: none"> » GoN to provide information to help private sector identify potential niches in higher value-added IT outsourcing. Medium- to long-term <ul style="list-style-type: none"> » GoN to provide financial support for technology upgrading and marketing in niche areas. » Align skilling strategy to the needs in niche areas. 	MEDIUM
<i>Goal 2: Improve access to critical infrastructure</i>		
Establish new IT parks/hubs and reform the existing IT Park	Short-term <ul style="list-style-type: none"> » Upgrade the existing IT park, including greater private sector involvement in infrastructure, management and service provision; attracting anchor firms to the IT Park. 	HIGH
<i>Goal 3: Better, less burdensome regulation</i>		
Easing visa procedure for skilled foreign workers	Short-term <ul style="list-style-type: none"> » Clarify the distinction between requirements for work visas of different lengths of stay. » Simplify the visa processes (set fixed timeframes for application process and renewals and reduce the number of check points during visa renewal). 	MEDIUM
Clarify and consolidate mandates across agencies	Short-term <ul style="list-style-type: none"> » Assign clear mandates for regulation and support to IT services firms, including e-commerce. 	MEDIUM
Ease regulations related to entry, external funds and tax incentive for IT industry	Short-term <ul style="list-style-type: none"> » Reassess and lower the 300-employee threshold for eligibility for tax break. 	MEDIUM
Ease monetary transactions for IT firms	Short-term <ul style="list-style-type: none"> » Reassess forex control policy and cap on contracts in U.S. dollar-denominated accounts for IT exporters; implement an international e-payments gateway. » Expedite implementation of e-payment gateway. 	HIGH
<i>Goal 4: Strengthen digital start-up ecosystem</i>		
Improve business incubation support	Short-term <ul style="list-style-type: none"> » Promote grant schemes or angel funds for ICT companies. Medium- to long-term <ul style="list-style-type: none"> » Provide financial assistance to incubators and business support providers. 	MEDIUM

EDUCATION

OBJECTIVES	RECOMMENDATIONS	PRIORITY LEVEL
<i>Goal 1: Grant more autonomy to colleges and other tertiary education institutes</i>		
Speed up upgrading of course curricula to align them better to evolving market needs	Short-term » Ministry of Education and University Grants Commission to work with the universities to speed up new course accreditation and approval procedures, set fixed timeframes for application review and approvals.	HIGH
Introduce a framework granting more autonomy to colleges to raise funding and respond to the market	Short-term » Ministry of Education and University Grants Commission to work with the universities to develop framework for operational autonomy for colleges (in determining fees, raising staff salaries and batch size).	HIGH
Support private colleges in building capacity to exercise autonomy	Short-term » Ministry of Education and University Grants Commission to work with universities to develop a strategy to build managerial and financial management capacity gaps in private institutes. Medium- to long-term » Introduce in-service training and testing to ensure continuous improvement of teacher capacity.	HIGH
<i>Goal 2: Strengthen quality regulation and assessment of colleges and TVET institutes</i>		
Strengthen quality assessment of colleges and TVET institutes	Short-term » Build capacity to operationalize the newly mandatory Quality Assurance and Accreditation (QAA) process for higher education institutes: <ul style="list-style-type: none"> • Leadership capacity in QAA Division • Robust QAA monitoring system • Revise the QAA criteria based on experience to date and stakeholder consultations Medium- to long-term » Ministry of Education to work with CTNET to develop a quality assessment and assurance framework for TVET institutes.	MEDIUM
Strengthen labor market information to help prospective students make better choices	Short-term » Disseminate available administrative information on programs' outcomes regarding completion, employment, and graduate salaries. Medium- to long-term » Ministry of Education to partner with universities and CTNET to strengthen information systems for collecting programs' student outcome data (such as tracer surveys).	MEDIUM
<i>Goal 3: Improve ease and transparency of entry regulation</i>		
Make procedures simpler and more transparent	Short-term » Guidelines for the following procedures/laws to be reviewed, simplified and made more transparent, with explicit processing times: <ul style="list-style-type: none"> • Affiliation of colleges to universities • Licenses for colleges with foreign affiliation • Annual license renewal processes for foreign-affiliated colleges • Approval of new courses in foreign-affiliated colleges (current cap of two courses and 15-day annual window to be revised) • Approval of new TVET courses 	HIGH

EDUCATION		
OBJECTIVES	RECOMMENDATIONS	PRIORITY LEVEL
Make procedures simpler and more transparent (cont.)	<p>Medium- to long-term</p> <ul style="list-style-type: none"> » Introduce systems for performance management and applicant feedback in approving bodies that increase incentives for speed and transparency in approvals. 	HIGH
<i>Goal 4: Strengthen industry linkages in TVET</i>		
Make government role in TVET sector more coordinated	<p>Medium- to long-term</p> <ul style="list-style-type: none"> » Government to consolidate TVET programs run by 17 ministries. 	MEDIUM
Introduce greater industry participation	<p>Short-term</p> <ul style="list-style-type: none"> » Ministry of Education and CTNET to work with industry to develop a framework for sector skills councils (not-for-profit industry bodies to advise GoN on industry demand for skills, help create training curriculum, supply trainers and help with placements). <p>Medium- to long-term</p> <ul style="list-style-type: none"> » Establish sector skills councils. 	MEDIUM



Annexes

ANNEX 1: NEGATIVE LIST OF SECTORS IN WHICH FDI IS PROHIBITED

- 1** Retail business
- 2** Travel agency
- 3** Trekking agency
- 4** Water rafting
- 5** Pony trekking
- 6** Horse riding
- 7** Cigarettes, bidi (tobacco), alcohol (excluding those exporting more than 90 percent)
- 8** Internal courier service
- 9** Atomic energy
- 10** Tourist lodging
- 11** Poultry farming
- 12** Fisheries
- 13** Beekeeping
- 14** Consultancy services such as management, accounting, engineering and legal services.
- 15** Beauty parlor
- 16** Domestic food processing methods in rent.
- 17** Local catering
- 18** Rural tourism

ANNEX 2: TRANSACTION-SPECIFIC CONSTRAINTS TO FOREIGN INVESTMENT IN NEPAL

CONSTRAINT	ISSUES/PROBLEMS	PROPOSED REMEDY
Foreign lenders are subordinated to local banks in priority of repayment	<ul style="list-style-type: none"> » NRB does not approve repayment of foreign lenders if there are outstanding unsatisfied debts to local banks creating a disincentive to foreign lenders 	<ul style="list-style-type: none"> » Grant foreign lenders pari-passu treatment with local lenders in priority of investment.
Interest rate cap on foreign currency loans from IFIs is fixed at 12-month \$ LIBOR + 550 bps. This includes the hedging cost	<ul style="list-style-type: none"> » Interest rate cap reduces attractiveness to foreign lenders. » Hedging is a separate transaction, not part of the loans. » The credit spread of 550 bps applies for all sectors, which may not be sufficient to compensate for riskier sectors and longer tenor loans. 	<ul style="list-style-type: none"> » Reevaluate the rationale behind an interest rate cap. » Hedging cost should be separated from the total interest rate cap. » Given the different risk profile and loan tenor requirements of different industry sectors, interest rate caps by sector could be explored.
Creation of mortgage of land in favor of foreign lenders need cabinet approval and enforcement of security requires a court order	<ul style="list-style-type: none"> » The lengthy process of granting and perfection of security interest 	<ul style="list-style-type: none"> » Simplification of granting and perfection of security interest process. For example, requiring the lenders to dispose the collateral instead of repossessing them
Foreign lenders are required to set aside capital at the time of signing loan contracts. Commitment fees accrue only after NRB's approval.	<ul style="list-style-type: none"> » The capital allocation remains uncompensated during the time lag between the signing of the contract and disbursement of the loans. 	<ul style="list-style-type: none"> » Set a short time frame for NRB to grant approval (10 days). Permit commitment fees to accrue from the date of submission of the loan documents to NRB but be payable only after NRB approval.
Limited risk management products for the clients	<ul style="list-style-type: none"> » There are no provisions for the MFI/ FFI to manage the foreign exchange and interest rate risks 	<ul style="list-style-type: none"> » Permit investors to offer to its clients' risk-management products, such as cross currency swap under which foreign investors would provide a hedge that matches and offsets foreign-exchange liabilities incurred by the client under a non-NPR denominated borrowing. » Another risk management product such as interest rate swap would eliminate the interest rate risk on Borrowers' floating rate liabilities especially in light of a rising interest rate cycle from the U.S. This is also consistent with the recent regulation which allows domestic financial institutions to undertake U.S. dollar loans capped at 3.3 percent. Most of these loans are floating rate by nature and therefore being able to offer interest rate hedging solutions would help these financial institutions to manage their balance sheet more optimally.

CONSTRAINT	ISSUES/PROBLEMS	PROPOSED REMEDY
<p>Limited risk management products for the clients (cont.)</p>		<p>» With foreign institutional investors being able to provide hedging solutions, this would kick-start a derivative market onshore which would further attract US-dollar inflows from outside investors as they would have an instrument to help them hedge their currency and interest rate risks.</p>
<p>Shallow and underdeveloped capital markets</p>	<p>» Highly volatile and speculative capital market hampering the development of debt market</p>	<p>» Enable the issuance of quasi-equity instruments such as convertibles, preference shares to foreign investors. Review stock category, pricing, entry/exit barriers and reduce post IPO lock-in period for financial investors.</p>
<p>Rules/Regulations/Directives by the NRB and other authorities are available in Nepalese language only</p>	<p>» Lack of timely and accurate interpretation of the relevant regulations for foreign investors</p>	<p>» Publish the relevant directives/information in English.</p>

ANNEX 3: THE SECTOR SCAN

The objective of the CPSD Sector Scan is to provide a strategic overview of the main Creating Markets/ Maximizing Finance for Development opportunities in Nepal. This Annex presents the detailed results from this analysis.

The CPSD sector scan consists in assessing the “Potential for Development Impact” and “Feasibility” of private investments across all sectors of the Nepal economy as follows:

- » **Potential for Development Impact:** How private investments in the sector could help Nepal address its main development challenges—GDP growth, jobs, resilience and environmental sustainability
- » **Feasibility:** Given Nepal’s geography, natural endowments and capabilities, the availability of inputs and institutional factors, to what extent can constraints to the development of these sectors be overcome within a reasonable amount of time (for example, five years).

To that end, the Nepal economy was segmented into the following 14 sectors, differentiating between “enabling” and “enabled” sectors:

ENABLING SECTORS	ENABLED SECTORS
Transport (port, road/trucking, rail, air)	Mining (including oil and gas)
Energy (generation, distribution)	Agriculture (crops, horticulture, livestock, fisheries)
Water (irrigation, urban)	Manufacturing (labor intensive, capital/skill intensive)
IT Connectivity (mobile, broadband)	Tourism (ecotourism, cultural, MICE)
Finance (and other professional services)	IT Services (BPO, software, data processing)
Education (primary, secondary, tertiary/TVET)	Construction (industrial, commercial, housing)
Health (primary, secondary, pharma)	Retail (and other personal services)

The development impact and feasibility of each sector was assessed combining quantitative and qualitative analysis. The quantitative analysis used for potential development impact includes multiplier analysis assessing the direct and indirect impact (in terms of growth and jobs) of a sector using a Social Accounting Matrix (SAM). The quantitative analysis used for feasibility includes a benchmarking of the historical performance of more than 7,000 IFC projects across the world examining how these projects have performed in countries with a similar investment climate to Nepal (based on investment climate international benchmarks, for example, the World Bank Group’s Doing Business and the World Economic Forum Competitiveness indicators).

Development Impact Analysis

The Social Accounting Matrix (SAM) multiplier analysis was used to estimate how an increase in sectoral output will affect the country’s GDP and employment. The analysis included both direct and indirect effects, the latter consisting of backward/forward production linkages, as well as consumption linkages.

Figure A-1 shows the results of the SAM multiplier analysis, with the output impact on the Y-axis and the employment impact on the X-axis. Note that these results are based on strong assumptions and should be taken as approximations. Agriculture and food processing sectors have relatively high GDP multipliers, as do services sectors such as communications, business services and insurance. Domestic agricultural products have large indirect effects in Nepal due to their importance in the consumption of the rural population. Such effects are also large for non-tradable services sectors, such as business services, insurance, and communications. Some food-processing sectors also have strong backward linkages with agriculture sectors (with low penetration of imports). Heavy or high-tech industries such as chemical, rubber, plastics, electronic equipment and machinery have low multipliers because of their reliance on imported inputs (weak backward linkages) and high capital intensity.

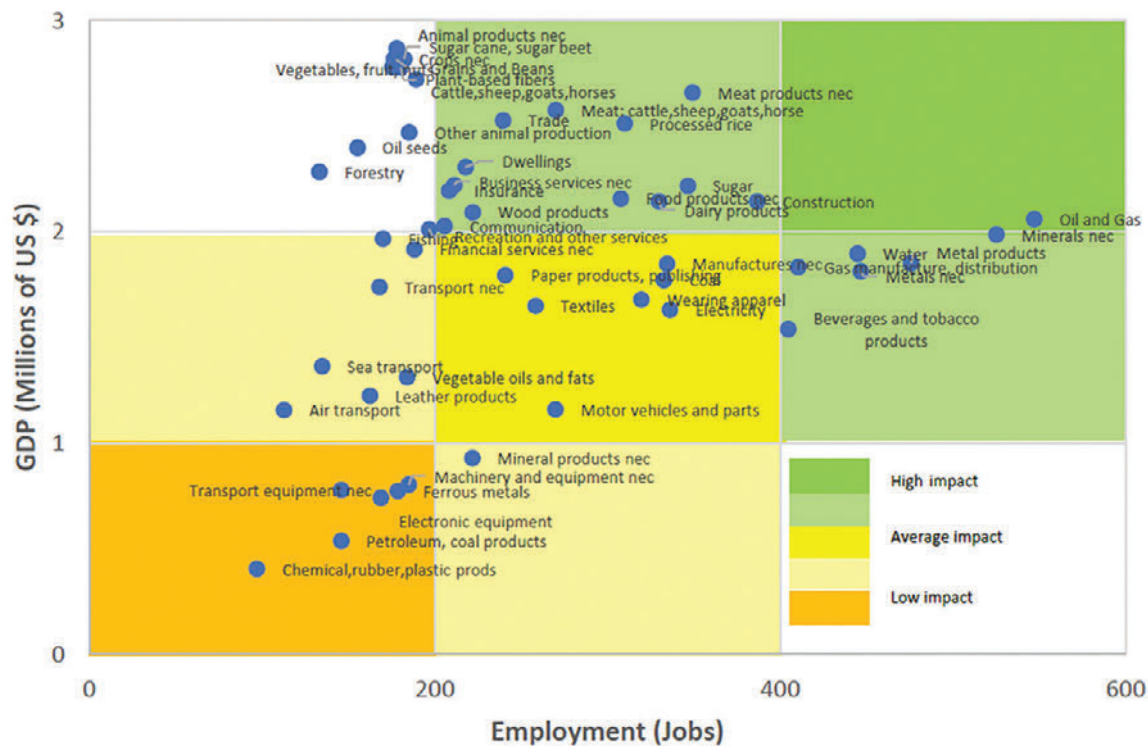


FIGURE A-1 Results of the SAM jobs and GDP multiplier analysis for Nepal

Source: World Bank Staff Calculations using WDI data

The SAM multiplier analysis was complemented by other estimates of how a sector’s expansion will affect competitiveness, resilience and stability, such as an analysis of export performance and complexity data. The SAM analysis was also complemented by the Nepal CPSD team’s subjective assessment of each sector’s potential development impact in terms of employment, GDP, competitiveness, resilience and environmental sustainability. The subjective assessment, based on a literature review and stakeholder meetings, is particularly important in Nepal’s case because SAM estimates are not available for key service sectors such as education, health and tourism.

The final development impact score is a weighted average of scores on the various dimensions. The team assigned relatively high weight to employment and competitiveness impacts since jobs is a priority for Nepal.

Feasibility analysis

The sector feasibility analysis was based on statistical benchmarking and on subjective scoring that relied on a literature review and stakeholder consultations.

The statistical benchmarking exercise uses data on the historical performance of more than 7,000 IFC projects across the world, and on the Trade and Competitiveness 360 database of cross-cutting constraints. According to this analysis, labor, energy and transport are major cross-cutting constraints, largely due to issues with labor relations, electricity supply and connective infrastructure. Firms’ capabilities are also an issue, limiting the feasibility of sophisticated sectors in the medium run. Regulatory barriers, rule-of-law, market contestability and macro stability are generally medium-level constraints, but with serious issues concerning land regulation, market dominance and political stability. A caveat is that these indicators might not have captured all the relevant dimensions of regulatory barriers in Nepal.

The results of the statistical benchmarking (Figure A-2) show the relative severity of these constraints does not vary much by sector. This does not necessarily mean that there are no important sector-specific issues, and the results could also be due to data limitations. Hence, informed subjective assessment based on sector deep dives was critical in the final feasibility assessment.

Benchmarking analysis relative to successful countries by sector for current country performance	DEMAND	PRODUCTION FACTORS			KEY INPUTS			INSTITUTIONS			
	Domestic and/or global market potential	Labor and skills	Geography and natural resource endowment	Existing capabilities	Energy	Transport	Finance (cost and availability)	Regulatory barriers	Rule of law and property rights	Market contestability	Macro and political stability
A - Agriculture and Forestry	1	2	1	6	2	3	0	0	0	1	0
B - Oil, Gas and Mining	1	5	1	4	1	0	0	0	0	0	1
C - Utilities	0	3	1	7	2	0	1	0	1	1	1
D - Construction and Real Estate	0	2	1	6	2	0	0	0	1	1	0
E - Transportation and Warehousing	1	5	1	13	1	2	0	0	0	1	0
F - Food & Beverages	1	1	1	7	2	2	0	0	1	1	0
G - Chemicals	1	2	1	7	3	1	0	1	1	2	2
H - Nonmetallic Mineral Product Manufacturing	2	6	1	9	3	4	0	2	1	3	1
I - Primary Metals	1	7	1	14	2	4	0	2	0	2	0
J - Pulp & Paper	0	1	0	7	2	0	0	0	1	2	0
K - Textiles, Apparel & Leather	1	7	1	15	2	4	0	2	0	2	0
L - Plastics & Rubber	0	1	0	6	1	0	0	0	1	1	0
M - Industrial & Consumer Products	0	2	1	2	0	0	0	0	1	0	0
N - Information	2	6	1	9	2	2	0	1	0	1	0
O - Finance & Insurance	0	1	1	2	1	0	0	0	0	1	0
Q - Wholesale and Retail Trade	2	6	1	14	1	3	0	0	1	1	0
R - Professional, Scientific and Technical Services	1	5	1	11	2	2	0	2	0	1	0
S - Health Care	0	2	1	7	1	0	0	0	0	1	0
T - Education Services	0	2	0	3	2	0	0	0	1	0	1
U - Accommodation & Tourism Services	0	0	0	0	0	0	0	0	0	0	0
V - Electric Power	0	5	0	5	6	5	1	5	7	2	4

FIGURE A-2 Results from the quantitative feasibility analysis

Source: World Bank Staff Calculations using WDI data

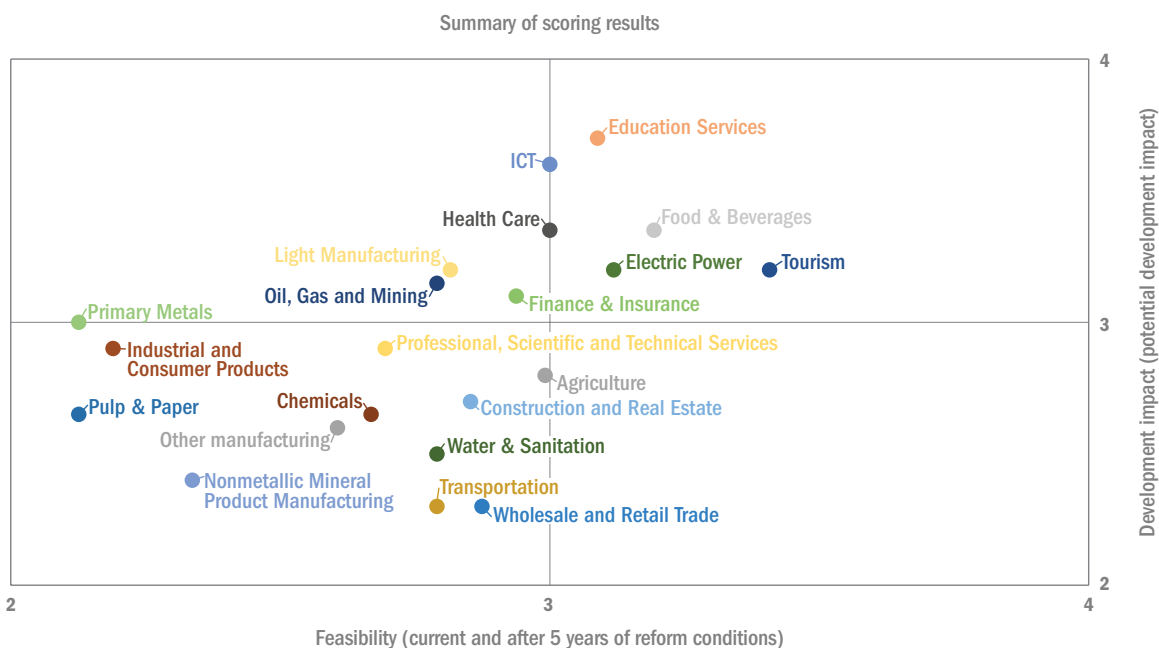


FIGURE A-3 Results from the quantitative feasibility analysis

Source: World Bank Staff Calculations using WDI data

The results from the development impact and feasibility analysis, including the qualitative analysis based on in-depth interviews of experts and firms are summarized in Figure A-3.

The next section of this Annex presents a one-page summary for each of the 14 sectors along which we segmented the Nepal economy.

SUMMARY OF THE SECTOR SCAN

Results for each of the 14 sectors along which the Nepal economy was segmented

1. TRANSPORT (from the InfraSAP)

Sector Background and Current Performance

The share of Nepalese firms identifying transportation as a major constraint for business is one of the highest among Asian comparators. The country faces major connectivity issues with respect to roads and airports. Nepal ranks 124 out of 160 countries on the 2016 Logistics Performance Index (LPI). Nepal's investment gap in transport infrastructure is over \$1 billion per year until 2025, especially in roads, which will require \$6.5 billion between 2016 and 2020.

ROADS

The Strategic Road Network (SRN) is the largest component of the road system; it includes national highways and feeder roads and a few urban roads of national importance. The Local Road Network (LRN) comprises of urban and local roads, including agricultural roads within the districts, urban and rural municipalities. On average 10 percent of the SRN roads carry as much as 90 percent of SRN traffic.

The Ministry of Physical Infrastructure and Transport (MOPIT) is the apex body in charge of managing the full transport sector except airports. However, the Department of Roads (DoR) is responsible for construction, maintenance, and management of the SRN. The Ministry of Finance (MOF) collects fuel levy, vehicle registration charges and allocates funding to the Department of Roads. This ministry is also in charge of donor coordination. The Roads Board Nepal (RBN) handles maintenance funding. It procures toll operators and collect toll revenues. Currently, the source of funding and financing is largely from annual budget allocation (government revenue), and grants and loans from development partners. An alternative funding source has been created in the form of "Road Maintenance Fund" using a small fuel surcharge.

Nepal has a low road density compared with South

Asian peers. The country has 13,000 kilometers of roads, of which 53 percent are black topped and 30 percent earthen; and 40 percent are national highways, while the remaining 60 percent are mostly feeder roads.

Recent survey based on the International Roughness Index (IRI), found 77 percent of the national highways and 82 percent of the feeder roads to be in bad or poor condition. Roads that carry commercial vehicles have capacity constraints including inadequate road width (many of the roads have intermediate lanes), narrow road curvatures and high gradients. In addition, Nepal's urban transport system suffers from inefficiencies and an uncoordinated public transport network.

The cost of transport of goods is high due to long road alignment with higher gradients, long journey time and high fuel consumption. For instance, the cost and time related to transport/logistics is an issue highlighted by many stakeholders in the agribusiness value chain. Highly dispersed production locations, and poor road quality, create high access-to-market costs and increased levels of post-harvest losses. Poor transport infrastructure also makes the cost of transacting among regional, central, and border markets is very high. This causes farm-gate prices to be low and highly volatile. These costs undermine the competitiveness of agricultural products.

AIRPORTS

Nepal's 2015 constitution places national transport policy, civil aviation and international airports under the federal government's responsibility. The Ministry of Culture, Tourism and Civil Aviation (MCTCA) is responsible for planning and monitoring of air transport-related infrastructure and services.

At present, the Civil Aviation Authority of Nepal (CANN) regulates, owns, manages and operates all airports in the country, for infrastructure and services.

Currently, 25 international airlines fly into Nepal and two Nepali airlines fly internationally, while 19 domestic carriers offer flights in the country.

International arrivals already exceed the official capacity of Nepal's only international airport (TIA) in Kathmandu and air routes to enter the country are limited for long-haul markets. Airports require additional investments, including the expansion of Kathmandu Airport and the development of two international airports in Pokhara and Bhairahawa.

Domestic airlines have a poor safety record with international organizations, such as the EU and ICAO, associating high safety risks with TIA and the Nepali airlines. (*Source: <https://www.caanepal.org.np/en/aviation-safety-report/>*.)

As a result of poor air and land connectivity, in hill and mountains areas in particular, many potential destinations are out of reach and the attractiveness of key tourist destinations is reduced. Nepal received 940,000 visitors in 2017, rebounding from a low of 540,000 in 2015 after the earthquake. (*Note: Figures are from the government of Nepal, Nepal Tourism Statistics 2016, Ministry of Culture, Tourism and Civil Aviation. These statistics are mainly based on visas for tourists arriving by air, and therefore do not include Indian visitors arriving by land, who may account for a considerable share of visitors.*)

Development Impact

High. Road connectivity is critical for agribusiness and air connectivity critical for tourism. As Nepal is a landlocked country with weak road infrastructure, business and leisure travelers must get there by air. To travel within the country, the safety record of airports and of domestic airlines are important considerations for tourists.

Feasibility and Main Issues

Medium. Requires careful prioritization (Connectivity Masterplan) and private sector leverage (PPPs). Feasibility is currently hampered by low institutional capacity of government agencies within the strategic road network including a low maintenance budget and poor planning and prioritization of investments. Private sector capacity is also low. Investment delays

and safety concerns negatively impact Nepal's airport infrastructure.

ROADS

Institutional capacity—For the Strategic Road Network, government agencies in procurement management, construction supervision, and contract management suffer from weak institutional capacity. Public budget allocations are not being executed due to weakness in public procurement, slow decision making and contract management and monitoring processes. The DoR particularly lacks sufficient, qualified personnel for construction supervision and contract management and enforcement, which in turn results in delays in project completion.

Financial capacity—The sector has suffered from under-investment due to budgetary constraints and procurement delays, creating a high investment backlog. The MOF does not always transfer all the maintenance funds RBN is entitled to, and the budget provided by RBN for maintenance is low and insufficient. According to RBN, on average only about 36 percent of the total requirement was available for SRN maintenance, leaving a funding gap of about 64 percent. The key road agencies, DoR and RBN, lack the institutional and financial capacity to access commercial sources of financing. At present, funding made available through the government budget (including about 40 percent of development partner financing) is not being fully utilized due to weak institutional capacity.

Local stakeholders' capacity—Capacity for managing projects with private participation in Nepal is low across stakeholder groups, beyond government agencies such as domestic consulting firms, civil contractors, and academic institutions. Local contractors do not have the financial and management capacity to undertake larger projects and investments. Although there are more than 13,000 registered civil works contractors currently in Nepal, there are very few contractors with annual turnover higher than NPR 1 billion (\$10 million). International companies provide the necessary financial and experience related documents to local companies for contract bidding purposes only and leave the implementation responsibility to the local partner. As

a result, delays in project completion and poor-quality construction are common and these are mainly due to inefficient management and low financial capacity.

AIRPORT

Regulation—The development of the sector is constrained by lack of an independent regulator, the need to upgrade regulations and an unpredictable regulatory environment, especially regarding civil aviation policies. The transition process in Nepal’s airport sector is expected to initiate with the enactment of a draft Integrated Civil Aviation Bill. It proposes splitting CAAN into a regulator and a separate service provider entity for airport and air navigation services. The Bill is being placed for Cabinet’s in-principle approval, after which a draft will be prepared by the MCTCA to be tabled in the Parliament. At this stage, absence of clarity on policy and legal issues will impede any commercial investors to finance projects.

Financial capacity—CAAN’s weak financial capacity limits its ability to access commercial borrowing to make new investments in airports. CAAN is being supported by various development partners and foreign governments to provide financing for TIA expansion and the development of two other airports. However, the proposed modernization of TIA has had setbacks due to contractor’s poor performance and construction delays.

Conclusion and Possible Solutions

Most Critical—Covered in the InfraSAP. Transport is a highly desirable sector and can help promote growth if existing constraints are removed. The InfraSAP recommends improving funding practices and raising governance capacity of Nepal’s transport sector generally. It also lays out a roadmap to strengthen the road network, airports, and urban transport.

ROADS

The government should strengthen the RBN and increase incentives for high performance in road maintenance contracts. Further strengthening of the sector can come from identifying a network of strategic roads for increased maintenance and expansion, executed through PPPs or performance-based contracts. It will be crucial to

maintain a credible financing plans for these activities.

To enable tourism, the government should, prepare provincial connectivity master plans for key destinations in the short term. In the medium term:

- Build and maintain national/local roads facilitating access to core assets of priority destinations and improve safety and rescue capacity.
- Enhance online payment capacity at destination level.
- Encourage the private sector to develop and operate facilities for transport such as bus stops and terminals, taxi stands, and rest stops.

AIRPORTS

The government should articulate a clear and comprehensive strategy to expand and improve the country’s airport infrastructure including financing plans. It includes:

- Defining regulatory goals and specific actions related to regulation, safety, structural reforms, and management. In the short term, the government could update aviation policies and regulations covering airspace, safety, airlines, airport services, air services tariffs, and taxes (for example, adoption of draft Civil Aviation Bill, review of tax on plane leasing).
- Preparing a medium-term development plan for all major and regional airports. In the short term, the government should upgrade the reliability, safety, and efficiency of the airport system, including: improving operational management at TIA, accelerating construction of Gautam Buddha and Pokhara International airports and assessing the need for Nijgadh Second International Airport and reopening or upgrading local domestic airports.
- Establishing a credible financing plan: a thorough analysis of revenue potential and financing needs of the sector required to tie up needed financing.

The sector can also be supported by adopting international management practices with private sector participation, such as:

- Introducing international airport management expertise into managing its airports in a safe, efficient and profitable manner.

- Creating a joint task force of CAAN, MCTCA, IBN, and MOF to spearhead key airports management contracts program. There is indeed high potential for full-scale private management of the entire airport operations besides exploring PPP options for

individual areas of operation.

- Strengthening CAAN and its successor entities, by developing medium term corporate plans to enhance technical performance, safety, passenger experience and their specific revenue earning potential.

2. ENERGY (FROM THE INFRASAP)

Sector Background and Current Performance

The Nepal Electricity Authority (NEA) runs and manages public generation plants, the transmission grid and a large part of the distribution network, as well as rural electrification schemes. Previous liberalization efforts attracted private investment in generation, however it remains limited in both the transmission and distribution segments. The sector is currently undergoing restructuring (per Action Plan of 2016, National Electricity Regulatory Commission Act of 2017). NEA is in the process of being unbundled—from a vertically integrated utility into state owned companies for generation, transmission, and distribution.

NEA is the sole owner and operator of the transmission grid and is responsible for construction and maintenance of high voltage lines and substations. NEA also has a monopoly over power distribution across Nepal which includes all planning, construction and operational tasks involving substations below 33 kilowatts and all connections, metering, billing and revenue collection functions. In 2016 NEA had 2.97 million customers who purchased 3746 gigawatts of power, of which 94.2 percent were residential customers. Industrial and commercial customers comprised only 2.1 percent of the customer base but contributed to 40 percent of the electricity while the residential customers made up 48.4 percent of all electricity sales.

Nepal's energy sector operates very much under potential and is less developed than comparator countries. In Nepal, 76 percent of the population has access to electricity (72 percent in rural areas), compared with 94 percent in Pakistan, 89 percent in Sri Lanka and 79 percent in India. Access has improved, although it has not led to a corresponding

increase in consumption. Nepal's per capita electricity consumption at 139 kWh is well below the South Asia average of 550 kilowatt hours, and a twentieth of the global average at 3200 kilowatts. Around 84 percent of consumption is residential (of which 75 percent is biogas and biomass from dung and waste).

Around 69 percent of Nepalese firms identified electricity as a major constraint, much higher than in the region (46 percent) and globally (32 percent). Only one-third of electricity connections are on-grid. Nepal's challenge is to expand generation capacity to meet the increasing electricity demand and to reduce the outage frequency.

GENERATION

Installed generation capacity is mostly from run of the river hydropower; there are over 80 independent power producers (IPPs) that sell output to the NEA. Annual generation from hydropower is about 3,635 GWh, or 73 percent of total supply (27 percent or 1370 gigawatt hours is imported from India), of which 35 percent is from independent power producers or IPP and 65 percent is sourced from NEA-owned power stations.

Nepal attracted private investments in hydropower and installed generation capacity has grown in recent years, yet Nepal is still unable to meet its energy needs and experiences seasonal shortages. The country has only added approximately 30 megawatts annually since 2002. Investment needs remain large (each year around triple the total investments between 2010 and 2015) and untapped potential is especially large in hydropower (c.f. Bhutan).

Parts of Nepal experienced cuts lasting up to 17 hours a day in 2016–2017. Supply of electricity has consistently

fallen short of the peak demand and the country needs to import power from India. Nepal's imports of oil, oil products, coal and electricity from India has grown from 312 kilograms of oil equivalent (ktoe) in 1990, or 5.4 percent of supply, to 2,069 ktoe in 2014, or 17.7 percent of supply. The key constraint on the import of petroleum is the distance of about 900 kilometers from the Nepal border to the nearest seaport, Kolkata, on the east coast of India. Nepal has only one storage project, the rest of the generation stations operate on a run of river basis. Installed capacity is expected to double by 2020 through NEA subsidiaries and new IPPs. However, shortages are expected to continue in the dry season (winter months) until storage projects come online.

Although the GoN has begun to liberalize generation, much of it remains based on run of the river hydro projects leading to shortages during the dry season, due to lack of storage. The transmission grid remains obsolete and much of the additional power being generated cannot be evacuated due to the absence of an adequate transmission grid. In addition, inadequacy in interconnections with India limit the potential for export.

Regarding environmental sustainability, Nepal has significant unused hydropower, solar and wind energy potential. It has economically feasible hydropower potential of 42,000 megawatts. Currently around 23 megawatts of generation comes from micro-hydro schemes, 12 megawatts from solar PV, and less than 20 kilowatts from wind, compared with 2,100 megawatts and 3,000 megawatts of commercially viable solar and wind potential, respectively.

TRANSMISSION

Nepal also compares unfavorably with other countries in the region on transmission and distribution losses in the power sector. Transmission line losses (technical losses due to low voltage lines) reached 5 percent in 2017 and were significantly higher than the acceptable standard of 2 to 3 percent.

Nepal is lacking transmission grid for effective and efficient evacuation. Newly commissioned power cannot be evacuated and there have been significant delays in connecting generation plants to load centers

due to gaps in the transmission grid. This leads to waste/unutilized capacity in generation and is postponing power trade with India, major potential export candidate, with which connectivity is limited to about 150 megawatts.

DISTRIBUTION

Substandard, damaged and unreliable distribution networks cause technical losses and compromise power supply to the end user.

Transmission and distribution losses affect the financial sustainability of the sector along with Electricity Tariff Fixation Commission (ETFC)'s tariffs setting. The NEA sets the prices for purchase of power from IPPs as off-taker and ETFC sets tariffs to be paid by the end user. From 2012 to 2016 NEA suffered severe financial losses from which it has not recovered yet, as ETFC set end-user tariffs that did not reflect costs. The gap between the cost of service and the average price of electricity realized by NEA has narrowed (currently at -0.76 NPR/kWh).

In 2017, average price of electricity was at 9.85 NPR per kilowatt hours. In 1998, ADB advised ETFC to raise consumer tariffs from NPR 4.98 to 7.33 per kilowatt hour. In 2001, ETFC raised tariffs by only 22 percent; increases were stalled for over a decade. Tariffs were raised again in 2012 and were frozen for four years until 2016.

Development Impact

Very High. It has high development impact because it is the sector with the highest growth potential (through exports to India). Competitive hydropower could fuel the competitiveness of energy intensive manufacturing (for example, cement and steel). If properly harnessed, it could replace remittances as Nepal's main engine of growth, generating the resources that could drive a much-faster pace of urbanization and fuel the construction and retail sectors—both sectors that have significant employment potential.

Feasibility and Main Issues

High. It has a high feasibility score given Nepal's natural endowments for hydropower, although development of the sector faces institutional

constraints. As detailed in the InfraSAP, harnessing resources from the hydropower sector will require streamlining of administrative procedures, so that viable opportunities can be approved more speedily, and improvements in Public Financial Management to ensure that revenue and expenditure are being managed transparently. Ongoing restructuring of the National Electricity Authority will likely support the sector. Besides administrative bottlenecks, feasibility of this sector is also hampered by inefficiency and a lack of cross-border energy trade and investment.

Nepal's main issue in the sector is the mismatch between generation, transmission and distribution capacities. The lag between enhanced generation capabilities and the need to upgrade regulations transmission and distribution leads to waste and supply shortages. Administrative bottlenecks limit private investment and create a high-risk perception for the sector.

Lack of expansion/investment plan—Nepal does not yet have a formal comprehensive generation expansion plan while investment needs remain large in order to provide for reliable and balanced generation to manage the fluctuations between dry and wet seasons. Nepal also needs to facilitate cross-border trade to realize its full hydro-electric generation potential and manage peak demand via imports. For transmission, the country needs to (a) increase high voltage transmission lines to connect power generation corridors to demand centers, to modernize distribution assets; (b) modernize aging distribution assets; (c) improve operational and financial performance of the distribution system and its related entities.

Limited development of the financial sector—While the credit market has grown steadily, it is still not conducive to large infrastructure investments with long tenors. In 2016, six hydropower companies covered 9 percent of the total market capitalization. Nepal's bond market is not mature and there is no secondary market. Access to finance has been an issue in the hydropower sector despite government efforts to provide incentives for private investment

Investors' obligation—High concerns related to complex project development and a wide range of investor obligations which include survey, land

acquisition, forest clearing, cost of connective infra (access roads and grid interconnection), and resettlement, create high risk perception for private investment. Unclear and constantly expanding investor obligations to satisfy local communities' expectations and concerns, makes financial planning difficult.

Regulation—Cross cutting legal and regulatory inconsistencies between various strategies, policies, laws and regulations across sectors and thematic areas for example, tax benefits to FDI often not recognized for hydropower investors. Lack of harmony in the provisions for permitting, licensing and negotiating procedures governing investments in generation: various pieces of guidance and requirements do not often harmonize, and developers—both domestic and FDI—often choose not to engage, or pull out after spending resources in scoping needs.

Risk allocation and process—There is lack of optimal allocation of risk between the government and the private party in the IPP process coupled with a lack of certainty regarding the conclusion of the process. The Project Development Agreement (PDA) shifts the risks and responsibilities for exploration, due diligence and stakeholder management to the investor without any guarantee of a PPA at the end of that process. There are protracted negotiations, cumbersome approval processes and a lack of guidance regarding dispute resolution.

Public Finance Management—Tariffs are not cost reflective exposing the government to losses. The ETFC has not increased retail tariffs proportionately to the rising cost of power due to political and civil unrest and to absence of an automatic tariff adjustment mechanism, leading to significant gaps in covering costs.

Conclusion and Possible Solutions

Most Critical—Covered in the InfraSAP. With high development impact and feasibility, the energy sector will likely support overall economic development and growth in other key enabling and enabled sectors. The sector is undergoing restructuring (per Action Plan of 2016, National Electricity Regulatory Commission Act of 2017). The institutional framework is marked by many actors, new and existing, with various functions and

licensing processes for investment. For distribution, NEA's functions are likely to be decentralized with the establishment of seven provincial entities. In addition, the creation of the NERC is expected to pave the way for an independent tariff review mechanism, but it may take time to implement. The rapid evolution of the institutional framework has created some overlap amongst actors and processes. Supporting new entities and providing capacity is key.

The InfraSAP provides a roadmap for developing Nepal's energy sector:

- Given the large untapped potential, hydropower will be critical in increasing Nepal's energy capacity. To support investment needs, Nepal should improve coordination among donor agencies (taskforce), explore new financial products, engage with cross-border investors in the region, and consider a Hydropower Commons to build a supporting environment for hydropower expansion.
- Nepal can supplement hydropower with energy alternatives, such as solar.
- As investments increase, it is necessary to strengthen the capacity of the NEA and its subsidiaries.
- More investment is needed in the transmission and distribution segments. The InfraSAP recommends establishing a shorter-term (five-year) plan, encourage private participation by developing a coherent operational and investment framework, prioritize funding from the MCC, ADB, and other development partners, and develop its grid code.
- Nepal can attract more private investment by strengthening the currently inconsistent confidence of regional investors through reform of IPPs and a uniform policy for foreign investments, and by standardizing and improving the processes for PPPs, licenses and permits, and PDA.

3. WATER (from the InfraSAP)

Sector Background and Current Performance

Lack of irrigation facilities and water supply. Quantity and quality of drinking water in urban areas suffers under rapidly growing population.

Development Impact

High. Effective water service delivery plays an important role on building human capital and reaching middle-income status by 2030.

Feasibility and Main Issues

Medium. Need to reform regulatory framework toward promoting PPPs. Local government faces challenges in revenue collection, which affect its ability to fund urban development including water projects. Municipalities such as Kathmandu, Pokhara, Damak, and Lahan cannot meet service delivery needs due to investment gaps. Local government, the private sector, and banks lack the required capacity. Improved

planning, financial management, procurement, regulatory framework for borrowing, municipal PPPs, and other incentives can help improve feasibility of the water sector in Nepal.

Conclusion and Possible Solutions

Important—Covered in the InfraSAP. As outlined in the InfraSAP, a key priority should be improving capacity of local government by transferring functions and staff, adjusting tax regulations, and clarifying procedures for fiscal transfers. This will cover many aspects and will include raising the credit-worthiness of local government and providing more legal clarity and consistency on their responsibilities. Capacity increases need to include managerial performance, institutional frameworks for planning, procurement, and execution. Financial performance can be improved through a framework for local and municipal government borrowing, monitoring local government debt, and credit ratings.

4. IT CONNECTIVITY

Sector Background and Current Performance

Low penetration, poor quality and high cost.

Telecommunication services have improved in recent years, but there are still major gaps in coverage which is concentrated in the Kathmandu Valley with large regional and rural-urban disparities.

Mobile internet market is still at an early stage of development, with outdated technology. While 3G coverage of the population (90 percent) is above the regional average (78.8 percent), penetration of mobile broadband remains limited in Nepal (15 percent) compared with the region (27.9 percent). Poor quality is limiting the uptake of broadband services, with Nepal scoring 34.3 out of 100 on mobile network performance compared with 37.3 on average in the region. Mobile broadband affordability is also limited compared with regional peers.

Fixed broadband penetration is also limited with 0.8 percent of the population subscribing to the services in Nepal compared with 4.0 percent in East Asia and Pacific.

Nepal's weak IT infrastructure has contributed to the low-quality IT parks and constrained development of the IT services sector.

Development Impact

High. Nepal's weak IT infrastructure and the lack of

quality IT parks have also constrained the IT services sector. First, IT service firms are restricted to locations around Kathmandu, the only area with adequate infrastructure. Second, the extremely low penetration rate of broadband, and the mediocre quality and cost of mobile internet, limit domestic demand for IT services.

Feasibility and Main Issues

Medium. Broadband policy reform needed to increase competition and coverage. Ineffective regulations and supportive policies make it difficult to conduct business. There is no sound policy framework for private investors. Overlapping and unclear mandates across key ministries (ministries of ICT and Science and Technology) have impeded policy coordination. Entry barriers related to competition, bandwidth availability and upfront investments remain.

Conclusion and Possible Solutions

Critical—Discussed as part of the IT Services Deep Dive. A reform plan should be developed to improve the efficiency of digital infrastructure and encourage investment in it. This should address business entry and competition, bandwidth availability, passive infrastructure sharing, and incentives for the private sector to make the investments and share infrastructure.

5. FINANCE

Sector Background and Current Performance

Fragmented banking system dominated by the State. High underlying risks due to pervasive evergreening of loans, vulnerability to external shocks, limited access to finance for SMEs—40 percent of firms access to finance to be a major constraint. Underdeveloped payment infrastructure. Difficult access to foreign exchange. Nearly 40 percent of Nepalese firms identify access to finance as a major constraint.

Nepal's financial sector comprises 241 banks and non-bank financial institutions with 30 commercial banks which represent 82 percent of the credit market. Commercial banks' largest share of lending is for non-infrastructure sectors such as wholesale and retail (23 percent) followed by manufacturing. Commercial bank investment in construction, electricity, gas, water and transportation is roughly 15 percent.

Nepal's capital market is relatively small. In 2016, six hydropower companies covered 9 percent of the total

market capitalization. Nepal's bond market is not mature and there is no secondary market. Access to finance has been an issue in the hydropower sector despite government efforts to provide incentives for private investment

Development Impact

High. Key to promote growth of enterprises—especially SMEs.

Feasibility and Main Issues

Medium. Reforms are known but difficult due to vested interests.

Long-term credit is still constrained by limited financial products and the shallowness of the capital market. A key shortcoming is the absence of an effective credit information infrastructure that leads to an over-reliance on immovable assets, especially land and buildings, as collateral. Inequalities in access to land translate into inequalities in access to finance. In addition, there is no framework for the use of movable assets as collateral, which especially hurts

small and medium-sized firms. Collateral demands on firms also tend to be inordinately high.

Conclusion and Possible Solutions

Need to develop specific action plan to improve access to finance—key measures to be supported by the new Finance and Competitiveness DPO. Key measures would include reducing the role of the state in banks, improving supervision, removing the spread cap on domestic interest rates and on foreign currency loans, improving collateral markets and registries to reduce collateral demands (up to 400 percent of loan value), implementing the 2006 Secured Transactions Act, as well as developing and promoting the Credit Bureau in Partnership with the private sector. Develop robust legal framework to develop the payment system leveraging new technologies—e-payment gateway and digital financial services (see recommendations from the 2014 FSAP). Simplify procedures for accessing forex—for example, increase cap on the size of U.S. dollar-denominated contracts. Develop a legal framework for private equity and venture capital.

6. EDUCATION

Sector Background and Current Performance

The number of private education providers and education technology firms is growing in Nepal, as is share of enrolment in private schools (for example, from 8 percent in 2005 to 16 percent in 2014 at lower secondary level). Over half of colleges (national higher education) are private and these account for the majority of enrolment in technical fields such as engineering. Technical and vocational training centers are predominantly small private providers.

Development Impact

High. The development impact of education is very high, as the youth population could be employed more productively within Nepal if they have the right set of technical and soft skills. Improvements in education can also help meet the demand for highly skilled

workers in the IT services sector.

Feasibility and Main Issues

Medium-High. It has medium-high feasibility due to the potential for increased private sector involvement, particularly in technical and vocational education to meet the growing demand. The large youth population would prefer to study in Nepal (rather than India) if there were easier access to quality, market-relevant education. There is already significant private sector participation in education, but there are issues of quality and scale that could be related to land and regulatory constraints. Easing guidelines from affiliated universities and providing more flexibility can help raise the profitability and competitiveness of private institutes in the tertiary sector. Regulatory reforms to private education are most feasible in the short to medium term for tertiary and technical education.

Conclusion and Possible Solutions

Critical—Selected for Sector Deep Dive.

Strengthening Nepal's education sector is critical to improving employment outcomes and can help support other key industries such as ICT services.

Private participation is feasible at the tertiary and technical levels, especially after the removal of remaining constraints. This includes increasing autonomy under clearer quality control, more strategic and efficient government efforts to improve capacity, and increased linkages to industry.

7. HEALTH

Sector Background and Current Performance

Nepal's health system is composed of a mix of public and private providers. In 2015, Nepal's new constitution created a new structure where health services are provided at three levels: national, under the command of the National MoH; provincial, led by seven Provincial Ministries of Health; and subnational governments. Primary health care, which covers essential and basic health services, is provided mostly by MoH (90 percent). Both public and private providers deliver secondary, or out-patient referral, health care but the public/private mix is unknown. Tertiary health care is highly specialized medical care and mostly provided by the private sector through hospital (in-patient) services.

Growth in private health-care provision was rapid in the past decade (averaging nearly 12 percent annually between 2004 and 2014) and is expected to continue. In 2011, out-of-pocket expenditures (largely flowing to the private sector) totaled \$570 million, of which 45 percent was spent on drugs and 27 percent on hospital services (curative care).

Local companies are already investing in technology, human resources and other capacity improvements. There has been strong growth in the for-profit health sector, with about 3,000 commercial health-care enterprises concentrated in diagnostic and laboratory enters (70 percent), clinics and hospitals (26 percent), and pharmaceutical companies (4 percent). The number of private hospitals has grown from 69 in 1995 to 350 in 2013 while the MoH opened only 19 new hospitals during the same period. Other areas of the sector, such as private medical colleges (PMCs), have experienced similar growth.

The quality of private providers fluctuates, due to a lack of effective regulation. At the same time, the current policy landscape supports partnerships with the private sector in health care. The largest segments are solo practitioners, then pharmacies and hospitals. As a result, commercial clinics and hospitals have become an important source of health care in Nepal, particularly as there are few barriers to entry. Many hospitals, diagnostic clinics, and pharmaceutical manufacturers are developing PPPs with foreign firms, raising to the level of quality that meets international standards. The MoH recognizes the benefits of contracting with private health service providers (for example, better quality, greater capacity, lower costs/higher volumes) and private providers express interest in working with the MoH in the areas of specialty services and diagnostics.

While for equity considerations public health insurance should remain the primary option, there is an opportunity for private health insurers. Health insurance firms have only penetrated 1 percent of the market. There are 17 licensed private health insurers in Nepal. All of them offer similar benefit packages covering major medical expenses (hospitalization), diagnostics, and drugs, but exclude preventative care. There are 20 contracted service providers/hospitals that dominate the private insurance market, and many have arrangements with Indian and international hospitals. Principal clients are global and large Nepalese firms (banks, manufacturers, telecoms) offering coverage to their employees. Yet the high-income and corporate segments have not yet been fully exploited.

Over the past 10 years, Nepal has accelerated progress in several health indicators and has performed well in achieving the Millennium Development Goals for

health. Between 2004 and 2015, life expectancy at birth increased from 66.2 and 63.7 years to 71.1 and 68.2 years for females and males, respectively. The maternal mortality ratio (MMR) decreased from 444 to 258 deaths per 100,000 live births, and the infant mortality ratio (IMR) and under-5 mortality ratio (<5MR) also declined significantly (48.7 to 29.4, and 63.5 to 35.8, respectively). Given the current trends, Nepal should meet the Sustainable Development Goal targets for IMR and <5MR, although it will be very challenging for it to reach the MMR target of 70 deaths per 100,000 births. Other important challenges to Nepal's health advancements persist. For instance, incidence of non-communicable diseases has grown, accounting for 42 percent of all deaths. Health inequity is high: only 62 percent of Nepalese households have access to health facilities within 30 minutes, and there are significant differences between urban (86 percent) and rural (59 percent) access. The Nepal Health Sector Strategy (NHSS) 2015–20 is committed to guarantee access to basic health services as a fundamental right and to achieve universal health coverage (UHC) by providing free services to all.

Health financing as a percentage of GDP and health expenditure per capita are not performing well in recent years. After an increase from 5.8 percent to 6.7 percent of GDP between 2004 and 2011, the total health expenditure (THE) returned to 5.8 percent of GDP in 2014. THE per capita, which rose from \$83 to \$137 between 2004 and 2011, declined in the following years and increased again in 2014, reaching \$137—the same value of four years ago. Nepal's THE per capita is lower than India, Afghanistan and Bhutan but bigger than Pakistan and Bangladesh. Public health spending as a share of government health spending is the second highest among all six countries in the region (11.2 percent).

Many Nepalis continue to travel to other countries in the region for treatment. In addition, although there is a voluntary health insurance scheme, it covers only a small share of the population.

Development Impact

High. The sector has high development impact owing to the importance of human capital (a healthy

workforce) in inducing job creation and growth, although not to the same extent as education. It is also very important to the competitiveness of the Tourism sector as international tourists expect to be able to rely on high quality of local health-care services if needed. Private sector participation is especially important under the uncertainty of public funding to the health-care sector in the transition to federalism in Nepal. Nepal's high levels of premature deaths underscore the importance of increasing access to high quality and affordable health-care services.

Feasibility and Main Issues

Medium-High. It has medium-high feasibility, slightly lower than education. While input and regulatory issues bind both sectors to the same degree, there may be less demand for specialized health care owing to the nearness of India as a medical tourism destination. There are few regulatory barriers to entry, though reform can help better reflect more recent international best practices for health system governance. These reforms should include standardization and quality improvement of training for health-care staff. The government currently competes with the private sector. Public-private partnerships and other government incentives can help encourage entry of private providers, especially in rural locations.

Regulation and accreditation—Private health providers are governed by cumbersome regulations in need of updating that are administered by several agencies, which compromise quality of care oversight. Health regulations are 25 years old and do not reflect international best practices for governing mixed health systems. MoH has not invested in physical/clinical standards, accreditation, dissemination of quality norms, or protocols, nor does it have an adequate legal framework and institutional structure to supervise, monitor, or regulate private health-care providers.

Regulatory Capacity—The Ministry of Health and Population lacks sufficiently trained staff and modern, standardized systems that reflect best practices for regulating the private sector. The private sector is valued largely for the better quality it provides. However, the lack of effective regulation has led to a

proliferation of health enterprises ranging from world-class facilities to others plagued by poor quality and lack of proper quality assurance of drugs procured. The low quality of care also reduces the scope for the public sector to contract to the private sector, since quality assurance is required before contracting or incorporating private providers into social health insurance schemes.

Governance and PPPs—Private players want to join their non-profit peers in working with the health ministry in the areas of specialty services and diagnostics. But most partnership arrangements are informal, ad hoc, and based on personal relationships; much work remains to be done to be able to use contracts as engagement mechanisms. As a result, private health care is mainly confined to high-income groups living in Kathmandu Valley. Despite GoN aims to use private sector engagement to improve public health coverage, quality, and outcomes, the MoH acts as a service provider in competition with the private sector. This complicates the potential for public-private collaboration. The NHSS recommends policies for PPPs, but there is limited capacity and varying degrees of interest in advancing MoH's transition from a direct service provider to a regulator. The lack of dialogue between public and private health providers has led to significant levels of distrust and unwillingness to collaborate. This has impeded attempts to modernize and reform the regulatory environment. Further, professional associations that represent commercial interests are viewed as highly political and focused on individual—not sector—interests.

Health insurance—The mix of the private voluntary health insurance and the new public mandatory health insurance needs to be evaluated to ensure the adequacy of the benefits. In 2017 Parliament approved a new Health Insurance Act, since the current system cannot fully identify and protect the poor, the health insurance policy and national health insurance bill mandating coverage were an effort to reduce impoverishment through catastrophic health expenditure. Poorly regulated or designed health insurance schemes, whether public or private, can exacerbate inequalities, provide coverage only for the young and healthy, and lead to cost escalation.

Conclusion and Possible Solutions

Critical—Selected for Sector Deep Dive. Health care is a critical enabling sector with potential to improve human capital and support growth in other sectors. There is space for increased private sector participation.

Attracting appropriate private sector investment will require an improved regulatory environment, wider social insurance coverage, increased public sector engagement with the private sector, and market creation. This may require some changes in the prevailing mind-set about the role of government versus the private sector in health care.

Possible solutions include:

- Developing partnerships between the government and private hospitals to improve access. Although MoH has primarily partnered with non-profit facilities in the past, there is an opportunity to also cooperate with the many for-profit hospitals. More than 60 percent of patients in the system are referred by public health centers from outside the Kathmandu Valley and many seek specialized care. Private sector providers have expressed an interest in accessing part of this market by charging fees on a sliding scale, organizing medical camps in rural areas, often in partnership with community-run health facilities, and by meeting or exceeding the legal requirement to maintain 10 percent of all beds for low-income patients.
- Supporting community pharmacies with quality products and training for an effective channel to deliver services and counseling to rural women and provide other benefits to rural and underserved populations.
- Building MoH capacity to (a) create a seat at the policy table for the private sector (for example, build associations' capacity to unify the private sector voice); (b) support public-private dialogue to address issues of importance to both private and public sectors (for example, facilitate information flows between private entities and MoH to improve implementation of current subsidies and test new ones such as Special Economic Zones, tax breaks, land concessions, and looking at models such as the Dubai Healthcare City); (c) help MoH assess

policies, regulations, and capacity to regulate quality of services for reforms; and (d) establish a system to collaborate with the private sector (for example, conduct an in-depth analysis of the private sector market, segmentation, or scope of activities, to establish a knowledge base for future interventions).

- Initiating public-private dialogue in the

pharmaceutical sector to advance the manufacture and distribution of affordable drug and health products, including generics. Support would include perform market analysis of private sector expertise and infrastructure requirements to strengthen the public supply chain and develop a strategic plan for improving market efficiencies to expand distribution while ensuring quality.

8. MINING

Sector Background and Current Performance

Limited revenues and exports from mining and unknown potential.

Development Impact

Medium. Limited linkages and capabilities that are not easily transferrable to other sectors. Social and environmental risks. Possibility to generate much needed fiscal resources but these fiscal revenues are quite volatile, given that the sector is subject to international mineral prices with the risk that they lead to the “Dutch disease” when prices are high and

budget crisis when they fall.

Feasibility and Main Issues

Medium. Governance of the sector can be a challenge, especially with limited capacity—decentralization can open up new opportunities. Broad and deep international experience available.

Conclusion and Possible Solutions

The first step should be to conduct a geological survey to better evaluate Nepal’s mining potential, including for local construction materials.

9. AGRICULTURE (Agribusiness—Food and Beverages)

Sector Background and Current Performance

Two thirds of Nepal’s jobs are in the agriculture sector, mostly in subsistence farming of low-value crops for the domestic market. The sector’s production accounts for a quarter of the country’s exports, yet it is still relatively underdeveloped and not currently competitive in regional and global markets. Few large businesses occupy cereals, food and beverages, and fast-moving consumer goods. Other subsectors are characterized by small and below-small businesses.

Nepal’s Fitness ranks in the top 50 percent of countries in all agribusiness sectors (crops, beverage/tobacco, food and animal products). This points to a fairly diversified and complex portfolio but also space to further diversify and upgrade capabilities.

Development Impact

High. This sector has a high development impact score due to extensive backward and forward links, including the opportunity to develop high-value niche products and horticulture. Agribusiness also has the potential to generate better outcomes for the rural poor.

Feasibility and Main Issues

High. It has a high feasibility score due to Nepal’s unique and diverse agro-climatic conditions, with high potential in niche products, tea, coffee, flowers, and vegetable and fruit products. As highlighted by the lack of FDI, there is potential for public support and reforms to address value-chain development, land, labor, and financing constraints. Feasibility of the sector can also be improved through faster and

more cost-effective transport and logistics, scale-up of the agricultural insurance market, and better implementation of internationally-recognized SPS regulations. Other constraints include lowered productivity and quality due to a lack of fertilizer and technology use.

Nepal has many opportunities to upgrade capabilities and increase diversification in agribusiness. Diversification within low-complexity, unprocessed crops is most feasible, but opportunities also exist in food processing and animal products. Agriculture support services such as warehousing and storage are also feasible and growing quickly. The beverage

industry in particular has the potential to feed into the Belt and Road network as infrastructure is enhanced in the region.

Conclusion and Possible Solutions

Critical—Selected for Sector Deep Dive.

Agribusiness can contribute to growth and employment in Nepal, particularly in rural areas. Improving the sector's global competitiveness and scaling up agribusiness SMEs requires the removal of constraints outlined above, most of which are politically feasible. Land policy reform and privatization in the fertilizer industry may be met with some opposition.

10. MANUFACTURING

Sector Background and Current Performance

Nepal's exports are limited and composed largely of textiles (carpets, and synthetic materials) and food products (beverages). The economy's capabilities (as indicated by Economic Fitness) stem primarily from the textile sector, agribusiness, and natural resource extraction and processing.

Development Impact

Medium. Interviews with key stakeholders suggest that cement and steel have high development impact due to forward linkages with the construction and hydropower sectors. Nepal's textile industry may offer opportunities to integrate into the Belt and Road network under infrastructure improvements in the region, given Nepal's complementarity to the demand of neighboring countries.

Feasibility and Main Issues

Medium. Nepal also has the potential for becoming a competitive cement and steel producer due to the prospects of competitive hydropower (both cement and steel require very large amount of power) as well as higher-quality mineral endowments than regional competitors. Opportunities for capability upgrade exist in chemicals, plastics, extractives (incl. wood), and textiles sectors. Diversification to new products in manufacturing is less feasible, though limited opportunities exist.

Conclusion and Possible Solutions

Promote local construction materials (for example, building codes—see one-pagers on Mining and the Construction) and agribusiness (see Agribusiness Sector Deep Dive) and tackle issues in key enabling sectors (transport, energy, finance and education)

11. TOURISM

Sector Background and Current Performance

Tourism directly contributed \$0.8 billion to Nepal's GDP in 2016 (3.6 percent of total GDP) with an additional \$0.8 billion of indirect effects. The number of international visits rebounded since the earthquake

in 2015, and stem from a diversity of source countries including quickly growing India and China. In spite of this positive trend, the sector is operating below potential with limited geographic diversification. Nepal attracts primarily low-budget tourists and receipts per

visitor are lower than in competitor countries, including other post-conflict countries such as Cambodia.

Development Impact

High. It has a high development impact score due to its employment potential and scope for increasing backward linkages to agricultural sectors. Tourism is important for poverty reduction, employment generation, and income redistribution, especially in the country's poorest regions. Five key destinations are likely to positively impact both sustainability and revenues (Pokhara and Annapurna, Manaslu and Gorkha, Bardia and Banke, Lumbini and Palpa, and Lantang).

Feasibility and Main Issues

High. It has the highest feasibility score due to Nepal's unique natural endowments. Targeted government action can increase tourist numbers and spending, and help attract private investments: As other sectors, tourism also suffers from Nepal's infrastructure gaps and particularly the poor safety record. There is also space for more integrated destination management and targeted incentives to attract operators in

segments geared at higher-value tourists (business, wellness, ecotourism, and adventure tourism).

Conclusion and Possible Solutions

Critical—Selected for Sector Deep Dive. Though capabilities are not easily transferable to other sectors, tourism has the potential to positively impact GDP and growth in rural areas if Nepal achieves greater geographic diversification and reaches higher-value segments.

Targeted reform actions can help upscale Nepal's tourist industry. They include (a) addressing regulatory and connectivity constraints, (b) better governance, and (c) diversification of private sector offerings for mid-range and high-end tourists.

Many of the recommended reforms have high feasibility, though resistance is expected toward development of protected areas as well as amended foreign exchange regulations. In developing Nepal's tourism sector, it is important to ensure inclusiveness and share revenues with local communities and governments, as operators are currently based mainly in the capital.

12. IT SERVICES

Sector Background and Current Performance

Nepal's IT services sector is growing, with relatively high export orientation of firms in the IT applications segment (including app development, consulting, and systems integration services). Firms are mostly small-sized, though they are increasingly employing skilled workers (15 to 20 percent growth in employment per year). Contribution to GDP is still small.

Development Impact

High. It has high development impact due to its potential for direct skilled job creation, building international linkages, and improving the productivity and supply chain of other sectors. There is potential to contribute to employment of skilled labor. Domestic demand of IT services is expected to significantly contribute to growth. There is space to increase exports, particularly in IT applications.

Feasibility and Main Issues

Medium-High. It has medium-high feasibility in Nepal due to a labor cost advantage in low-sophistication software development and business process outsourcing (BPO), and because ICT exports are less sensitive to transport cost constraints. However, the limited supply of highly skilled labor restricts the scale of this sector.

The following areas can help improve feasibility:

- **Regulation:** Broadband policy reform is needed to increase competition and coverage, especially in rural areas outside Kathmandu. The IT policy enacted in 2015 needs to be implemented. Low labor costs of junior programmers contribute to feasibility. Regulatory improvement is also needed for IT outsourcing and e-commerce, as is the immigration of skilled foreign workers. Enforcement

of intellectual property rights remains a concern.

- **Infrastructure:** Improvements in technical and physical support infrastructure are needed to attract companies to the government-established IT park. Better rural IT infrastructure, standardization of the postal address system, and cost-effective online transactions systems can help increase feasibility.
- **Education:** Improved training programs are needed to meet increasing demand for highly skilled technical and managerial workers.

- **Other:** access to finance for scale-up of SMEs in ICT industry.

Conclusion and Possible Solutions

Critical—Selected for Sector Deep Dive. ICT services have the potential to contribute to growth and employment in Nepal. A coordinated strategy addressing skills gaps and management capabilities of Nepalese firms, regulatory reform and enforcement, as well as improved access to finance and infrastructure will help support this sector.

13. CONSTRUCTION

Sector Background and Current Performance

Growth has been fueled by remittances. Largely informal at the exception of a few large well-connected conglomerates.

Development Impact

Medium. Major sector for jobs. Real estate developers play a key role in providing serviced facilities for most key sectors, for example, industrial zones for agribusiness, hotels for tourism and intelligent buildings for ICT. Real estate is also linked to demand in upstream industries or services (for example, cement, transport, construction, urban planning, engineering, and architecture) that are job creators and downstream services (for example, telecoms, water distribution, energy, maintenance, security, and waste management) with high value-added. An increase in construction output would have above-average direct and indirect impact on growth and slightly below-average impact on jobs. The sector has the potential to affect the environment (from landscaping to energy efficiency) all along the value chain (from cement production to transport and waste disposal).

Feasibility and Main Issues

Medium. Performance of the sector would be enhanced with improved land and capital markets (resulting in more competition and larger scale construction) as well as improved building codes to promote local materials and green buildings as well as standardization. For affordable housing, there is a remaining trade-off between affordability and infrastructure availability, hence a potential for well-targeted and reasonably priced projects (supported by joint private sector investment and public sector effort in infrastructure development). Infrastructure development (access to utilities, roads, and so on) outside the main cities is still lagging—hence high cost of construction for adding access to basic services. Land tenure and ownership/titles registration issues still affect the sector's development capacity.

Conclusion and Possible Solutions

Conduct a land market governance framework assessment in the new context of decentralization. Leverage housing finance to promote new building codes (see Rwanda CPSD).

14. RETAIL

Sector Background and Current Performance

Growth has been fueled by remittances. Fragmented and largely informal.

Development Impact

Medium. Very important for jobs and backward linkages, for example, agribusiness.

Feasibility and Main Issues

Medium. Like for construction, improved land market would increase competition and large-scale productive players.

Conclusion and Possible Solutions

Conduct a land market governance framework assessment in the new context of decentralization.

ANNEX 4: LARGEST TOURISM SEGMENTS AND PROJECTED GROWTH RATES¹³⁷

Business tourism. In 2016, business tourism worldwide accounted for \$1.8 trillion or 23 percent of tourism's total contribution to Global GDP. The Global Business Travel Association reports that business travel spending grew by 3.1 percent in 2016. Growth is expected to accelerate: 5.2 percent in 2017, 6.1 percent in 2018, and 7 percent in 2019 and 2020. China is the largest business travel market in the world for the second year, surpassing the United States.

Wellness travel. Health and yoga retreats are a growing motivator for travel. The high-value wellness segment is a global phenomenon projected to grow by 9.1 percent a year to 2017, double the pace of tourism in general, according to the Global Wellness Institute.¹³⁸ Wellness tourism is an estimated \$563 billion global market, representing 6.5 percent (691 million) of all domestic and global trips, and accounting for 15.6 percent of all domestic and international tourism expenditures. Wellness tourists are educated, wealthy and high spending; they typically spend 130 percent more than average tourists.

Adventure tourism. Adventure tourism is projected to grow at a compound annual growth rate (CAGR) of over 40 percent in 2017–20, according to research firm Technavio, as more people gravitate to adventure over other tourism activities. A 2013 study by the Adventure Travel Trade Association estimates that the adventure travel market from Europe, North America, and South America is worth \$263 billion. Between 2009 and 2012, the adventure travel market is estimated to have grown an average 65 percent per year. Adventure travelers tend to be younger, with an average age of 36. Per-trip spending (excluding airfare and gear) increased from \$593 in 2009 to \$947 in 2012, an annual increase of nearly 20 percent.

Nature-based tourism. As incomes rise and urban populations increase, the desire to spend time in natural protected areas grows. Nature-based tourism is estimated to account for 20 percent of international travel, or about 240 million trips a year. A study by the World Wildlife Fund (WWF) found that terrestrial protected areas receive 8 billion visits a year, 80 percent of them in Europe and North America, and generate \$600 billion a year in direct visitor expenditure.

Cruise tourism. Worldwide and in Asia, cruise tourism is increasing as larger, more fuel-efficient and less polluting vessels enter the market. Mass market cruising is growing at 8 percent per year and has been discovered by the senior Asian markets. Cruise tourism is worth an estimated \$117 billion a year. About 25.8 million passengers were forecasted to cruise in 2017.

ANNEX 5: TOURISM DESTINATION OPTIONS FOR NEPAL

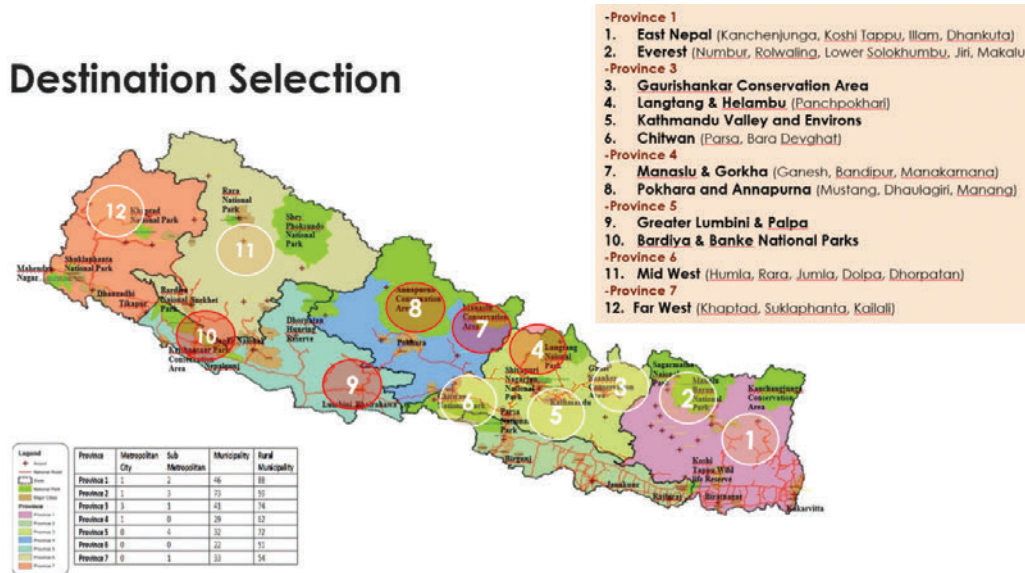


FIGURE A-4

Source: World Bank Staff Calculations using WDI data

Methodology for Prioritization of Tourism Destinations in Nepal

1. Methodology and key definitions

a. Tourism market segments

- LOW-END MARKET SEGMENT:** This segment generally comprises young and ad-hoc domestic travelers, individual long-haul and regional visitors typically staying more than two weeks, and groups visiting for religious or pilgrimage purposes.
- MID-RANGE MARKET SEGMENT:** This segment generally comprises more affluent domestic travelers and families, regional independent leisure travelers, and organized, active travelers from long-haul markets.
- HIGH-END MARKET SEGMENT:** The high-end segment typically comprises individual/small-group travelers who pay special attention to the quality of the experience, as well as specialized hard-adventure (expedition) travelers.

b. Destinations

- Definition:** “A tourism destination is a physical space in which a visitor spends *at least one*

overnight. It includes *tourism products* such as support services and attractions, and tourism resources within *one day’s return travel time*. It has *physical and administrative boundaries* defining its management, and images and perceptions defining its market competitiveness.” (World Trade Organization).

Local tourism destinations incorporate various stakeholders, often including a host community, and can network to form larger destinations. Destinations could be *on any scale*, from a whole country (for example, Maldives), a region (such as the ‘Himalayas’) or island (for example, Bali), to a village, town or city, or a self-contained center (for example, Disneyland).”

Destination offerings may include:

- Attractions
- Public and private amenities
- Accessibility
- Human resources
- Image and character
- Special pricing

In Nepal, destinations include the main and/or secondary gateway allowing access to tourists.

- ii. **Nepal destinations:** According to this definition, 12 main destinations have been identified, disseminated across the 7 newly formed administrative provinces:
 - East Nepal (Kanchenjunga, Koshi Tappu, Illam, Dhankuta)
 - Everest (Numbur, Rolwaling, Lower Solokhumbu, Jiri, Makalu)
 - Gaurishankar Conservation Area
 - Langtang & Helambu (Panchpokhari)
 - Kathmandu Valley and Environs
 - Chitwan (Parsa, Bara Devghat)
 - Manaslu & Gorkha (Ganesh, Bandipur, Manakamana)
 - Annapurna (Pokhara, Mustang, Dhaulagiri and Manang)
 - Greater Lumbini & Palpa
 - Bardiya & Banke National Parks
 - Mid-West (Humla, Rara, Jumla, Dolpa, Dhorpatan)
 - Far West (Kaptad, Suklaphanta, Kailali)

c. Prioritization criteria

- i. Each of these 12 destinations has been ranked according to a set of ten criteria aimed at reflecting the development impact/feasibility approach promoted by the WBG. In the CPSD, these criteria have been adapted to the specific case of the tourism sector and the Nepali context.
- ii. As a result, the 12 destinations can be broadly grouped into three main categories: (a) destinations with high development impact and feasibility; (b) destinations with little development impact, as they are already mature and do not correspond to the overarching diversification objective (for example, Kathmandu Valley, Everest, Chitwan); (c) destinations with weak development impact because they are remote and attract mainly the low-range visitors' segment (for example, Far West, East Nepal).

CRITERIA (DEVELOPMENT IMPACT) (from 1-Low to 5-High)

Employment creation potential	From limited potential over 5 years (for example, less than 500 jobs) (1) to high potential (for example, 5,000+)
Impact on inclusiveness	Potential impact in addressing poverty, marginalized ethnic groups/gender through direct, indirect benefits and trickledown effect
Private sector investment potential	Potential to attract relatively large investors (FDI, large investor and medium size investor), for example, 'Tourist hotel' 3- to 5-star accommodation
Product innovation and value chain addition	Potential to bring added value to the destination/tourist activity, be replicable, and be a substantial value/ "game-changer" to positioning, brand and appeal
Cultural and environment protection	Intervention would contribute to better protect environmental sustainability and/or cultural assets

CRITERIA (FEASIBILITY) (from 1-Low to 5-High)

Potential for more visitors (market appeal)	High value of natural & cultural competitiveness in relation to other natural & cultural destinations
Potential for more spending by visitors	Demand is present for higher spending tourist wishing to visit but can't realize due to constraint factors such as the lack of activities, access and facilities
Access infrastructure	Infrastructure availability, level and planned development in each area (NTSP criteria)
Alignment w/ national and local gov. priorities	Alignment with national territorial development policies and NTSP objectives
Empowerment at destination level	Clarity of local mandates & roles of local stakeholders, communities involved in tourism

2. Main World Bank background assessments used as reference

- a. *Annapurna & Pokhara team assessment 2018*
- b. *Pokhara destination plan 2016*
- c. *Far west destination plan 2015*
- d. *East Nepal destination plan 2015*
- e. *Lumbini & Palpa destination plan 2013*
- f. *Gorkha & Manaslu destination plan 2013*
- g. *Tourism competitiveness diagnostic (WB, T&C 2013)*

ANNEX 6: GOVERNMENT PROGRAMS IN AGRICULTURE

PROGRAM	PROJECT OBJECTIVE
<p>Agriculture Development Strategy (ADS)</p>	<p>Main government strategy to guide policy for the next 20 yrs. Planned \$500 million spending per year to:</p> <ul style="list-style-type: none"> » Accelerate investment in Science and Technology. Invest in the Knowledge Triangle—research, education, and extension (REE). » Ensure broad-based and inclusive agricultural growth. Invest in programs to moderate social and geographic inequalities. » Integrate smallholder farmers with competitive value chains that are able to meet the more demanding requirements of growing urban population in Nepal and abroad » Promote rural infrastructure and rural agroenterprises that energize the economic texture of rural Nepal.
<p>Nepal Trade Integration Strategy (NTIS)</p>	<p>NTIS focuses on developing action plans to address protracted constraints in Cardamom, Ginger Tea and Medicinal and Aromatic Plants (MAP). Focus is on a number of cross-cutting areas which including:</p> <ul style="list-style-type: none"> » Institutional capacity building for trade, including capacity for trade negotiations, » Business environment for investment and trade » Trade and transport facilitation » Standards and technical regulations » Sanitary and phyto-sanitary measures » Intellectual property rights » Issues related to trade in services

ANNEX 7: TOURISM DESTINATION OPTIONS FOR NEPAL

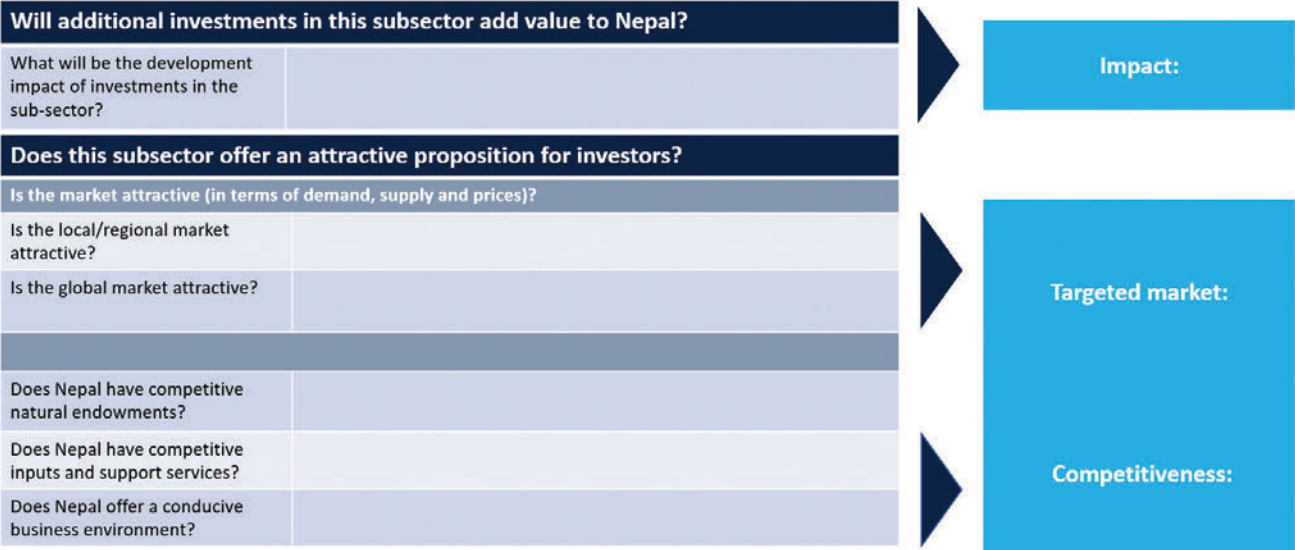


FIGURE A-5 Subsector investment appeal

ANNEX 8: DATA ON HIGHER VALUE / HIGHER GROWTH SUBSECTORS IN NEPAL

SUBSECTOR	# OF FARMERS (estimates)*	CAGR (2010-14)**	YIELD vs. COMPARATOR
FRESH FRUIT & VEGETABLES	369,856	Veg. 4.75%; Fruit 0%	N/A
POULTRY (BROILERS)	50,000	21.8%	FCR: 2.0 vs. 1.5 (breed standard)
POULTRY (EGGS)	Undef.	9.3%	N/A
TEA	20,747	5.5%	1.1 MT/ha vs. 1.7 MT/ha (India)
SPICES	200,000**	Lg. Card. 23%; Ginger -1.6%	Ginger 12 MT/ha vs. 13.5 (Hm.Pr., India)
MEAT (W/O POULTRY)	4,500,000†	4.2%	N/A

*Based on FAO data (1 farmer/1 ha) **estimate from GIZ †Represents 85 percent of households ‡FAO STAT

SUBSECTOR	# OF FARMERS (estimates)*	CAGR (2010-13)**	YIELD vs. COMPARATOR
RICE	1,362,908	0.87%	3.0 MT/ha vs. 4.0 MT/ha (region)
MAIZE	897,583	0.17%	2.5 MT/ha vs. 3.5 MT/ha (India)
POTATO	199,971	(-1.25%)	14 MT/ha vs. 21 MT/ha (India)
SUGAR	53,954	(-1.31%)	53 MT/ha vs. 65MT/ha (region)
DAIRY	450,000**	1.8%†	3-5 liters/day vs. 10 liters/day (India)

*Based on FAO data (1 farmer/1 ha) **estimate from Dairy Association †IFCN Dairy 2011-2014 ‡FAO STAT

ANNEX 9: POLITICAL FEASIBILITY OF RECOMMENDATIONS

Tourism

Political feasibility of measures in the tourism sector varies. Enhanced management of the aviation sector has high feasibility, in view of the clear commitment of the government to this reform. Reform of the regime for protected areas may be difficult and run into resistance from local communities but learning from countries that have successfully accomplished sustainable development of environmentally sensitive areas (such as Costa Rica, South Africa and Rwanda) could help develop a regime that is feasible in Nepal's context. Reform of the foreign investment act, the preparation of a connectivity plan, as well as the building of capacity in key agencies has a high degree of feasibility in view of the stated commitment of the government, while the reform of foreign-exchange (forex) regulations may run into resistance given vested interests and the history of this issue in Nepal.

IT Services

Most of the key recommendations for the IT services are unlikely to face strong political feasibility issues, except for those regarding the ease of transactions (such as forex transactions). The persistent gap between forex transaction regulation on paper and in practice suggests that there is some deep-seated opposition to change, but the exact reasons for that opposition are difficult to identify at this stage. The recommendations about greater collaboration between ministries and industry to improve the skills supply are consistent with recent government initiatives to improve coordination between ministries. The idea of subsidizing interventions to build firms' capabilities may require some convincing as it is a relatively new concept for policymakers, but there is no obvious political economy issue. The process of developing an ICT infrastructure reform could face undue influence from dominant firms, so it will be important maintain independence and transparency in the process.

Health

Some of the priority recommendations for the health sector could face a medium level of political resistance, as they require a change in the prevailing mind-set about the role of the government versus private providers. For the government to support the private sector in serving underserved areas, and develop a PPP framework, a change in the mindset about the role of the private sector in this critical social sector may be required. While strengthening standards and compliance is largely a capacity issue, the general idea of treating the private sector on an equal footing might run into a similar issue.

Education

As with the health sector, the main political constraint to the priority recommendations for the education sector relate to the need to change the mindset about the role of the government versus the private sector in education. Efforts to ease the entry and operations of private colleges could run into this ideological issue. They could also run into some opposition from universities, which stand to lose some degree of power. However, there is reason for optimism: the introduction of greater college autonomy has faced similar issues, but gradual progress has already been achieved.

ANNEX 10: INTERNATIONAL EXAMPLES OF APPROACHES TO STRENGTHEN INDUSTRY LINKAGES IN THE TVET SEGMENT

The CPSD recommends that the government should develop a framework for PPPs in TVET, adapting international models to Nepal's context. This would involve empowering not-for-profit bodies with industry expertise (known internationally as 'Industry Skills Councils' or 'Sector Skills Councils') to become more active in designing course content, internships and placements. The government can learn from international examples of such sector training programs that partner trainees with employers,¹³⁹ such as Malaysia's Industry Skill Council (ISC).¹⁴⁰ In India, for example, the industry association (NASSCOM) works with the IT-ITeS Sector Skill Council (SSC) on initiatives including workforce market intelligence, career awareness, skills definitions, and professional development.

In sectors where large firms or multinationals are present, the government could explore PPP training programs with select large employers. An industry-driven, work-based dual system could also be considered in sectors with sufficient depth to host such a program, for example, tourism. As a case in point, the Republic of Korea's program is led by companies, with their training based on National Competency Standards (NCS) developed in collaboration with the private sector.¹⁴¹ Finally, performance-based funding models, which have already been introduced on a small scale, should be institutionalized if found to have positive results.¹⁴²

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- ⁶ Based on World Bank Enterprise Surveys, 2013.
- ⁷ World Development Indicators.
- ⁸ MCC 2014; ODI 2014; World Bank 2015.
- ⁹ World Economic Forum. 2016.
- ¹⁰ Hollweg 2016.
- ¹¹ World Bank Enterprise Survey 2013.
- ¹² The hydropower sector is discussed in detail in the forthcoming INFRASAP, but a summary of key findings and recommendations is included in this report.
- ¹³ Full diagnosis and recommendations are available in the InfraSAP Report.
- ¹⁴ World Development Indicators (WDI).
- ¹⁵ At least half of cross-country differences in GDP per capita are explained by TFP gaps (Jones, 2016).
- ¹⁶ World Bank 2017.
- ¹⁷ World Bank 2017, based on WDI data.
- ¹⁸ Youth Employment in Nepal, World Bank 2018.
- ¹⁹ Nepal Policy Notes, World Bank 2018.
- ²⁰ Narain & Varela 2017; World Bank 2016.
- ²¹ Source: National Accounts, Central Statistics Bureau of Nepal.
- ²² World Bank 2017.
- ²³ Varela 2017.
- ²⁴ WDI.
- ²⁵ Hollweg 2017.
- ²⁶ For instance, in 2015, Nepal had a simple average tariff of 10.2 percent on intermediate goods, which was 6.3 percent higher than Vietnam's and 6.9 percent higher than Malaysia's simple average tariff on intermediate goods, which stood at 3.9 percent. Likewise, Nepal's average tariff on capital goods was 7.8 percent in 2015, which is more than double that of Vietnam and Malaysia, which had average tariffs on capital goods of 3.1 and 2.3 percent, respectively.
- ²⁷ Narain and Varela 2017.
- ²⁸ Ibid.
- ²⁹ Arrobbio et al 2017.
- ³⁰ World Bank 2016b.
- ³¹ Primary information collected in CPSD Sector Deep Dive.
- ³² In contrast, the similar ratio for government investment remained at about 7.3 percent.
- ³³ According to the World Bank Enterprise Surveys, 99.5 percent of Nepal's formal firms are privately owned. Hence, this aggregate productivity estimate is reflective of the private sector.
- ³⁴ Lopez-Acevedo et al 2017.
- ³⁵ World Bank 2018a.
- ³⁶ Lamsal, Madan and Pande, Sabin Jung. 2018. "Nepal's Top 30 Business Houses: Leading the Way," New Business Age, March 4. <http://www.newbusinessage.com/MagazineArticles/view/2101>.
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- ⁴⁶ DFID 2018.
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- ⁵⁸ At about 5 percent of GDP, infrastructure expenditure is relatively low. Also, the capital budget is underspent, with spending averaging 70 to 80 percent of the amount budgeted in recent years (World Bank 2017). As a result, Nepal has considerable fiscal space.
- ⁵⁹ For example, while Nepal has Special Economic Zones (SEZ), they are not yet fully operational due to inadequate power supply, high taxes per square meter of land, and the requirement that 75 percent of the output by the factories located within SEZ be exported.
- ⁶⁰ Nepal SCD.
- ⁶¹ UNESCO 2015.
- ⁶² World Bank Enterprise Survey 2013.
- ⁶³ Government of Nepal. 2016. *Nepal education strategy draft report 2016*.
- ⁶⁴ UNCTAD 2011.
- ⁶⁵ Enterprise Survey.
- ⁶⁶ World Bank 2018b.
- ⁶⁷ World Bank Doing Business Report 2018.
- ⁶⁸ World Bank Enterprise Surveys 2013.
- ⁶⁹ Annex 1 details sectors currently on the negative list.
- ⁷⁰ The constraints to the power (and transport) sector are being analyzed in the Nepal INFRASAP report.
- ⁷¹ The hydropower sector is discussed in detail in the forthcoming INFRASAP, but a summary of key findings and recommendations is included in this report.
- ⁷² *Total contribution of tourism* includes direct contributions and wider impacts on the economy such as travel and tourism investments spending, government spending that helps travel and tourism sector such as tourism marketing and promotion, and domestic supply chain purchases by sectors directly dealing with tourists. *Direct contribution* includes total spending within a country on travel and tourism by residents and non-residents for business and leisure and spending by government on travel and tourism services directly linked to visitors such as museums". See <https://www.wttc.org/-/media/files/reports/economic-impact-research/countries-2017/nepal2017.pdf>.
- ⁷³ Unless otherwise noted, figures from this section are from the government of Nepal, Nepal Tourism Statistics 2016, Ministry of Culture, Tourism and Civil Aviation. These statistics are mainly based on visa for tourists arriving by air, and therefore do not include Indian visitors arriving by land, who may account for a considerable share of visitors.
- ⁷⁴ WTTC 2017. *Travel & Tourism Economic Impact 2017—Nepal*.
- ⁷⁵ Global Wellness Institute 2017.
- ⁷⁶ Technavio 2016.
- ⁷⁷ MICE is Meetings, incentives, conferences and exhibitions tourism.
- ⁷⁸ Tourism Market Segments in Nepal: (a) Low-end market segment: This segment generally comprises young and ad-hoc domestic travelers, individual long-haul and regional visitors staying typically more than two weeks or group visitors for religious and pilgrimage purposes; (b) Mid-range market segment: This segment will generally comprise more affluent domestic travelers and families, regional independent leisure travelers and organized, active travelers from long-haul markets (c) High-end market segment: The high-end segment typically comprises individual/small group travelers who pay special attention to the quality levels of the experience over price as well as specialized hard adventure travels (expeditions).
- ⁷⁹ UNWTO Tourism Highlights 2017 edition.
- ⁸⁰ Peru—similar topography and attractions to Nepal; Shining Path Maoist insurgency ended in 1992. Cambodia—South-East Asian country at a similar level of development to Nepal; comprehensive peace settlement signed in 1991. Laos—South-East Asian country at a similar level of development to Nepal; civil war ended in 1975 and international isolation ended in the early 1990s with the fall of the Berlin Wall. Source: Visitor Exports, by country, 1996 to 2016 (WTTC).
- ⁸¹ A tourism destination is a physical space with *tourism attractions and resources* in which a visitor spends *at least one night*. It has *physical and administrative boundaries* defining its management, and images and perceptions defining its market competitiveness. According to this definition, 12 main destinations can be identified across the seven newly formed administrative provinces. Smaller destinations have been regrouped into one single destination, considering the potential to link them as an integrated circuit and/or to brand them as a unified destination.
- ⁸² Under the new World Bank Group approach of Maximizing Finance for Development (MFD), the Bank Group systematically identifies opportunities for the private sector where it can have a strong development impact. Development impact and feasibility dimensions can be roughly equated to measurements of the social returns (development impact) versus the risk-adjusted private returns (feasibility) of investment in each sector. A sector needs to score high on both criteria for the private sector to be able to make a meaningful contribution to development objectives—even if social returns are high, the private sector will not step in unless a sufficient share of the returns can be appropriated by the investing firm to generate a profit.
- ⁸³ The numbers assigned to provinces refer to those used by the Nepal government.
- ⁸⁴ Civil Aviation Authority of Nepal. 2018. *Aviation Safety Report*. <http://caanepal.gov.np/wpcontent/uploads/2016/11/Safety-Report-2075-4-6-Final.pdf>.

- ⁸⁵ WEF 2017.
- ⁸⁶ Sotes, Griffin and Ahad 2016.
- ⁸⁷ Defined as agribusinesses with more than \$300,000 in fixed capital investments.
- ⁸⁸ The World Bank has two main projects in the sector: the Project for Agriculture Commercialization and Trade (PACT), focused on agriculture and rural business development that will be closing in June 2018, and the newly approved Livestock Innovation Project that will focus on promoting inclusive value chains for livestock, promoting regulatory reforms and modernizing service delivery in the subsector. IFAD, USAID, FAO, GIZ and other donors are also active in the sector.
- ⁸⁹ Annex 9 describes the method used for subsector level assessment in agribusiness.
- ⁹⁰ Review based on the situation/data available currently. Impact (# of farmers), Target market (current/most likely markets), Competitiveness (based on production/processing data, where available). A more in-depth subsector analysis was not carried out due to time/funding constraints.
- ⁹¹ IFC Industry Specialist John Hatten estimates that GDP/capita of \$1500 is the stage when growth and scale make investment more viable.
- ⁹² A similar issue arises in sugar where government has fixed prices administratively.
- ⁹³ Presently, cold storage investments receive a five-year interest holiday; and a concessional 1 percent tax on equipment (versus 5–10 percent).
- ⁹⁴ 22 percent higher in rice vis-à-vis India. See appendix.
- ⁹⁵ The new foreign investment policy indicates a willingness to shrink the list of prohibited subsectors, but the enacting legislation is still pending before the parliament.
- ⁹⁶ IFC considers 100,000 liters/day to be the threshold for investment in a dairy producer, but only the SOE reaches that threshold.
- ⁹⁷ There are widely reported increases of instances where agricultural land is transformed to residential use. ADS 2013.
- ⁹⁸ The majority of farmers are smallholders, with an average holding of 0.79 hectares in 2001.
- ⁹⁹ Paudel, Panit and Reed 2013.
- ¹⁰⁰ This deep dive summarizes the findings of the USAID/Nepal Health Private Sector Engagement Assessment (2017) and quotes extensively from it.
- ¹⁰¹ WDI.
- ¹⁰² World Health Organization. 2007. *Health System in Nepal: Challenges and Strategic Options*, November.
- ¹⁰³ USAID report.
- ¹⁰⁴ For example, Om, Norvic, B&B, and Grande International hospitals are training their staff (doctors, nurses, technicians) in specialty care and hospital management.
- ¹⁰⁵ UNESCO Institute for Statistics. <http://data.uis.unesco.org>.
- ¹⁰⁶ Nepal Economic Survey, Fiscal Year 2016/17, Ministry of Finance, government of Nepal. [http://www.mof.gov.np/uploads/document/file/Economic percent20Survey percent20English percent20- percent202016-17_20170713052055.pdf](http://www.mof.gov.np/uploads/document/file/Economic%20Survey%20English%20-%202016-17_20170713052055.pdf).
- ¹⁰⁷ Under the Directive for Foreign Educational Institutions Running Higher Level Education, around 70 colleges in Nepal are permitted to offer approved courses in partnership with foreign universities. Source: Ministry of Education, Nepal: http://www.moe.gov.np/assets/uploads/files/foreign_affiliated_college_and_program_2071-2-7.pdf.
- ¹⁰⁸ Based on primary interviews.
- ¹⁰⁹ Himalayan Times. 2017. “Implement programs to end disparity in education: HLEC,” December. <https://thehimalayantimes.com/kathmandu/implement-programmes-end-disparity-education-high-level-educationcommission/>.
- ¹¹⁰ Comprehensive TEVT Annual Report 2072/73, Ministry of Education. <http://www.np.undp.org/content/nepal/en/home/library/poverty/comprehensive-tvet-annual-report-2072-73.html>.
- ¹¹¹ Nepal Vocational Qualification System (NVQS), <http://www.swisscontact.org/nc/en/country/south-asia/projects/projectssouth-asia/project/-/show/nepal-vocational-qualifications-system-nvqs.html>.
- ¹¹² World Bank. 2015. *Nepal Higher Education Reforms Project Project Appraisal Document*.
- ¹¹³ World Bank. 2018. *Higher Education Reforms Project, Mid Term Review Report*. Further, in CPSD primary interviews, some experts suggested that colleges would still have to get approval for the courses they design and offer autonomously.
- ¹¹⁴ World Bank. 2016. *Nepal Education Strategy Note*.
- ¹¹⁵ UNDP. 2012. *Initial Findings from the review of Technical and Vocational Education and Training (TVET) Policy 2012*. <http://www.np.undp.org/content/dam/nepal/docs/projects/initial-findings-from-the-review-of-technical-and-vocational-education-and-training-policy-2012.pdf>.
- ¹¹⁶ CTNET, *Tracer Study of the Graduates of Diploma and TSLC Programs under CTNET*. [http://CTNET.org.np/files/2073percent20Publication percent20Tracer percent20Study percent20Report.pdf](http://CTNET.org.np/files/2073percent20Publication%20Tracer%20Study%20Report.pdf).
- ¹¹⁷ This section is based on a sector deep dive conducted for the Nepal CPSD. It also draws on the preliminary findings of *ICT Strategic Segmentation Analysis: Nepal*, a report prepared by the World Bank Group.
- ¹¹⁸ See background report on Nepal ICT Sector Deep Dive report for details of estimation.
- ¹¹⁹ Estimates from a preliminary draft World Bank report *ICT Strategic Segmentation Analysis: Nepal*.
- ¹²⁰ Such as Ncell App Camp, Nepal Entrepreneurship Hub and Startup Weekend.
- ¹²¹ Overseas Development Institute 2017.
- ¹²² Average software development cost. See <https://qubit-labs.com/average-hourly-rates-offshore-development-servicessoftware-development-costs-guide-2018/>.
- ¹²³ Medium: *Offshore Developer Rates 2017, Global Software Development Prices Overview*. <https://medium.com/@tecsynt/offshore-developer-rates-2017-global-software-development-prices-overview-edc144e340b1>
- ¹²⁴ Payscale Website. https://www.payscale.com/research/IN/Job=Software_Engineer/Salary.
- ¹²⁵ It is not clear how a quality-adjusted wage rate would look like; however, the continuous growth of Nepal’s IT industry suggests that competitiveness is strong.
- ¹²⁶ Chaulagain, A. 2017. *Post-graduate survey*, December. (I. Onugha, Interviewer).
- ¹²⁷ Based on primary interviews conducted for CPSD IT deep dive and on suggestions from a preliminary draft report *ICT Strategic Segmentation*

Analysis: Nepal, under preparation by the World Bank Group.

¹²⁸ Based on primary interviews, some Nepalese IT services firms have been exporting for more than 10 years.

¹²⁹ Ministry of Information and Communication, National ICT Policy 2015. http://www.youthmetro.org/uploads/4/7/6/5/47654969/ict_policy_nepal.pdf; UNCTAD 2011.

¹³⁰ Overseas Development Institute 2017.

¹³¹ UNCTAD 2011.

¹³² UNCTAD 2017.

¹³³ See review in Cirera, Xavier, and William F. Maloney 2017.

¹³⁴ Please see InfraSAP for further details on recommendations on infrastructure.

¹³⁵ World Bank, ADB, DFID. 2016. “Comments on the Draft Foreign Investment Act,” November 6; World Bank. 2016. “Making Nepal’s National Tourism Strategy Work: Legal Recommendation for Unlocking Investment in Tourism Accommodation Infrastructure,” June.

¹³⁶ Tribhuvan International Airport (TIA) is located in Kathmandu; Gautam Buddha International Airport (GBIA) is located in Bhairahawa and serves Lumbini.

¹³⁷ Sources: Global Business Travel Association; Global Wellness Institute; Adventure Travel Trade Association; Technavio; Cruise Lines International Association. Due to lack of projections for the nature segment, an available projection for adventure was used.

¹³⁸ Global Wellness Institute. 2017.

¹³⁹ World Bank. 2018. “Build on foundations by linking skills training to jobs.” In *World Development Report*, Chapter 8: Learning to realize education’s promise. Washington D.C.

¹⁴⁰ “Bridging the Gap: The Private Sector’s Role in Skills Development and Employment.” 2016. Conference paper. Cebu City, October 11–12. <https://www.oecd.org/employment/leed/Summary-Report-2016-SouthEast-Asia-percent20FINAL.pdf>.

¹⁴¹ Ibid.

¹⁴² A recent World Bank-funded project, the Enhanced Vocation Education and Training Project II (EVENT II) offers performance-based quality improvement grants to select public and private TVET providers. See World Bank, 2017. EVENT II PAD.

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2121 Pennsylvania Avenue, N.W.
Washington, D.C. 20433 U.S.A.

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IFC
2121 Pennsylvania Avenue, N.W.
Washington, D.C. 20433 U.S.A.

ifc.org

Contacts

VOLKER TREICHEL | vtreichel@ifc.org

SIDDHARTH SHARMA | ssharma1@ifc.org



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