



# FROM EVIDENCE TO POLICY:

## SUPPORTING NEPAL'S TRADE INTEGRATION STRATEGY



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# Overview

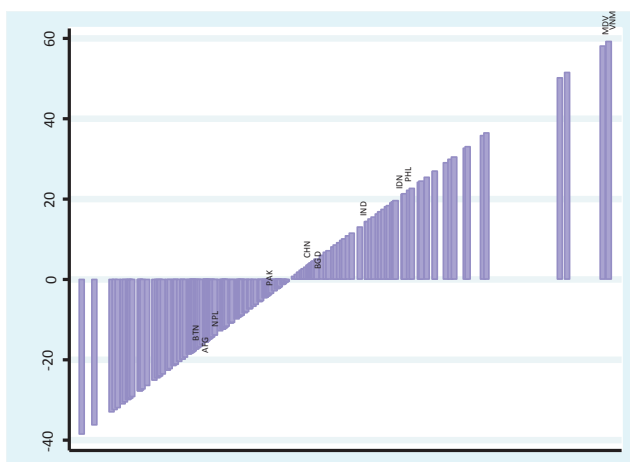
## Introduction

**Trade and integration are critical to achieving the Government of Nepal's ambitious objective of reaching middle-income status by 2030, and reducing absolute poverty to single digits (Government of Nepal, 2015a).**

The envisioned economic transformation requires a shift from a remittance-fueled growth model to one fueled by productivity and investment. Integration into the global marketplace is a powerful vehicle for increased investment and productivity. As a small economy, located within a six-hour flight distance from the fastest-growing markets in the world, Nepal's growth prospects are closely linked to its success in integrating into regional and global marketplaces. The government realizes this and has formulated the National Trade and Integration Strategy (NITS) (Government of Nepal 2015b) that recognizes the importance of integration and proposes lines of action for firms to better profit from it (Box 1). The notes included in this report seek to support the government's strategy by assessing the extent to which Nepal has been able to leverage integration into global markets, and by identifying the opportunities and challenges associated with further integration.

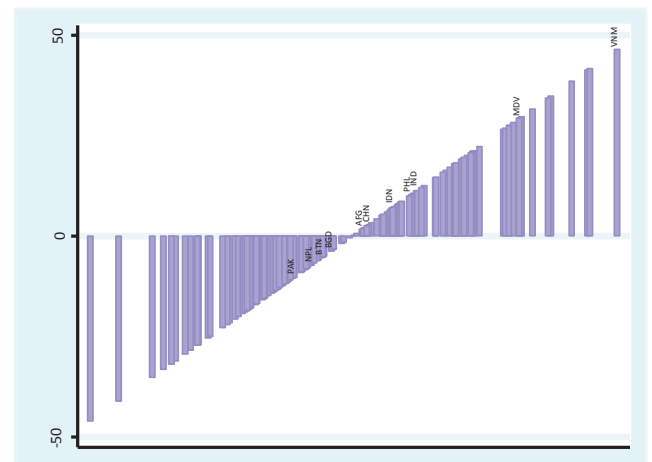
Nepal's integration performance over the last two decades has been lackluster. Many factors affect Nepal's trade prospects. A major one is the political instability that the country has experienced for over 20 years, which has stifled firms' investment and innovation and has diverted the attention of policy makers away from relevant reforms (Box 2). Still other factors are structural; for example, Nepal's geography makes transport costs high and travel times uncertain. Factors related to the country's level of development include infrastructure deficiencies—most notably electricity shortages—that create output uncertainty and increase production costs. Skills shortages make it difficult for upgrading into more skill-intensive activities. In terms of trade integration (both for exports and imports), Nepal shows export and import orientation below average; this assessment also takes into account the country's size, its remoteness from main markets, and its landlocked geography (Figure 1 and Figure 20; see World Bank [2013b] for a full diagnostic of trade competitiveness in Nepal). Policy could have a role to play in improving below-average trade integration.

• **Figure 1: Export Orientation Index - 1990-2014**



**Source:** Calculations based on World Bank World Development Indicators (WDI) data.

• **Figure 2: Import Orientation Index - 1990-2014**



**Source:** Calculations based on WDI data.

# Introduction

**In the last decades, slow growth and job creation have encouraged emigration, further dampening domestic sources of growth.** Tepid growth over the past decade, the slowest in the region, has resulted in few jobs being created, leading to more Nepalese workers seeking opportunities abroad. Their remittances (at 28 percent of GDP in 2013) have helped reduce poverty in the country and finance increasingly large trade deficits. Like other inflows of foreign exchange, remit-

tances have led to an appreciation of the real exchange rate. This has adversely affected export competitiveness and has had no positive effects on productivity (unlike foreign direct investment). This report attempts to determine the extent to which these obstacles can be alleviated by policy decisions, as well as exactly which policy decisions should be prioritized

● **Box 1: A summary of the main objectives outlined in the Nepal Trade and Integration Strategy (2015)**

**The Government of Nepal has recognized the importance of integration into the global marketplace as a means of growth and inclusive development.** Nepal began actively pursuing regional and global economic integration efforts when it open up its economy in the late 1980s. These efforts resulted in Nepal joining the World Trade Organization (WTO) in 2004 and signing 17 trade and 2 transit agreements. Moreover, the Government of Nepal has been seeking to identify constraints to export growth and interventions to alleviate them through different trade integration studies.

**The Nepal Trade Integration Strategy 2015 (NTIS) is the third successive trade integration strategy, with the first one being drafted in 2004 and the second in 2010.** Its preparation includes wide consultations among various stakeholders including line agencies, the private sector, development partners (including the World Bank Group), and others. A national steering committee has been constituted and chaired by the Chief Secretary of the Government of Nepal. The steering committee membership includes the following Ministries: Finance, Industry, Law, Justice, Constitutional Assembly and Parliamentary Affairs, Agricultural Development, Foreign Affairs, and Commerce and Supplies. The committee membership also includes the National Planning Commission, Nepal's Rastra Bank, the Federation of Nepalese Chambers of Commerce and Industries, the Confederation of Nepalese Industries, the Chamber of Commerce, the Planning and International Trade Cooperation Division of the Ministry of Commerce and Supplies, and the Donor Facilitator for Nepal.

**The NTIS covers four cross-cutting areas and three "priority export potential sector."** The cross-cutting areas are: (i) transport and trade facilitation; (ii) standards and technical regulations; (iii) sanitary and phyto-sanitary measures; and (iv) intellectual property rights. The priority export sectors, identified on the basis of export potential and development impact, are grouped into three broad sectors (i) agro-food goods (cardamom, ginger, tea, medicinal and aromatic plants); (ii) craft and manufacturing goods (fabrics, textiles, yarn and rope, leather, footwear, pashminas, and carpets); and (iii) services (semi-skilled and skilled professional services, information technology (IT), business process outsourcing (BPO) and IT engineering, and tourism).

**Focusing on the four cross-cutting areas and priority sectors, and based on identified constraints, the NTIS defines key performance indicators and an action plan to achieve the set objectives.** The key performance indicators focus on increased foreign direct investment (FDI), implementation of actions pending from previous strategies, improvements in logistics performance, and export performance of the priority sectors. The action plan, in turn, introduces short- and medium-term interventions in the cross-cutting areas identified as relevant. Further interventions are aimed at improving export performance of the priority sectors, including capacity building, development of sector-specific export strategies, public sector institutional strengthening, export and investment policy interventions, intellectual property rights enforcement, market access, quality certifications, and branding among others (for the complete NTIS action plan, see Government of Nepal 2015b).

# Introduction

**The policy notes included in this report aim at supporting the NTIS through an evidence-based approach.** To do so, these notes combine the following elements: (i) existing analysis on Nepal's competitiveness from different angles (including existing competitiveness assessments on transport, access to finance, the tourism sector, previous trade competitiveness reports, and so forth); (ii) international experience from comparator countries on good practices for trade policy

reforms; (iii) new analysis for Nepal, applying cutting-edge methods on a wide set of databases; and (iv) field-level interviews with the private sector, and consultations with donors and the Government of Nepal.

## • Box 2: Political Instability in Nepal

**For over 20 years, Nepal has been facing substantial political instability affecting its growth prospects.** In 2006, a decade-long conflict came to an end when key stakeholders reached the Comprehensive Peace Agreement. The country successfully held the Constituent Assembly in 2008, just after the Parliament approved the abolishment of monarchy in December 2007, and the country became a republic in May 2008. Since then, Nepal has been making efforts to establish inclusive and accountable governance structures.

**The transition to peace and democracy has been complex and lengthy.** Stakeholders took eight years of deliberations on a new government structure. The new federal constitution was only completed and adopted on September 20, 2015, soon after the April/May 2015 earthquakes had caused a huge loss of lives and assets. However, the rapid close of the constitutional process itself brought about violent protests and clashes across the country's southern belt bordering with India, which further intensified after September 20. Major disruptions in cross-border trade with India resulted in shortages of essential supplies across the country. These disruptions lasted more than four months and have added to the difficulties that the private sector faces in Nepal to remain competitive in global markets.

**This political instability has affected Nepal's growth prospects through two channels.** First, it has added to uncertainty, which acts as a brake on private sector investment and innovation. Second, it has diverted attention of policy makers away from difficult and important reforms. Political stability is in fact a key element in Nepal's path to become a middle-income country as envisioned in the country's long-term development strategy.

**Source:** Elaboration based on World Bank "Nepal's Development Update" issues for 2010, 2013, 2014 and 2016.



# Introduction

The five policy notes, prepared as a response to a direct request of the Government of Nepal, carefully examine the following topics:

**Policy Note 1** examines the sustainability of Nepal's trade imbalances, their underlying drivers, and the role played by remittances both in financing the trade deficit and in perpetuating it. It sheds light on the relative importance of different drivers of the trade imbalance from a macroeconomic perspective, as well as on their relative contributions during the last decades. Based on reasonable forecasting assumptions for the main identified determinants of the trade balance, the note provides several expected paths for the trade balance in the medium term. It also looks into the links between remittances and the real exchange rate—an indicator of export competitiveness.

**Policy Note 2** looks into the challenges that Nepalese firms face when integrating in value chains, both regionally and globally. It proposes a number of policy recommendations to better support firms in that process so that gains from internationalization materialize. Using firm and customs transaction data and incorporating information collected through field-level interviews, the note identifies key obstacles faced by firms to better use an important platform for integration into global markets—global value chains. It suggests a number of policy recommendations to overcome some of the obstacles. It also provides some international experiences on trade reforms, as well as granular information, for example, on products with high potential for increased trade with the northern states of India.

**Policy Note 3** looks into the services sector and the main factors preventing its growth. The note acknowledges the importance of the services sector in Nepal, particularly its dual role as a direct source of exports and as a provider of key inputs for other sectors of the economy. It identifies sources of potential for services exports, and key obstacles for improved efficiency in the sector. It also presents some good practices from across the world in terms of services trade performance and reforms, and suggests some policy recommendations to alleviate the observed obstacles.

**Policy Note 4** provides an impact assessment of the cash incentive scheme for exporters. It looks both into the design of the mechanism and its impact on the export performance of firms in terms of growth and diversification. It addresses two broad questions: (i) Is the incentive reaching the firms it aims to support? (ii) Is the incentive scheme inducing an increase and diversification in exports that would have not been observed in its absence? To answer these questions, the note combines export transaction data from customs with firm-level data on incentive receipts, as well as information from field-level interviews to the private sector and Government of Nepal.

**Policy Note 5** stresses the importance of supporting the internationalization process of Nepal's firms, as well as setting up the right infrastructure to attract, retain, and connect FDI. This note looks into the functioning of institutions to promote trade and investment in Nepal and proposes both changes in institutional design and in support activities conducted, by looking at international good practices and taking into account the political economy of public sector governance. It offers recommendations on how to improve both design and activities of trade and investment institutions, with the goal of enhancing the country's export competitiveness and ability to attract export-oriented FDI.

## Key Messages

### **Integration offers Nepal an opportunity to move towards a new growth model.**

To benefit, firms in Nepal need to make good use of available platforms for integration. These include (1) regional and global value chains both for goods and services, (2) services trade in activities of marked comparative advantage, and (3) e-commerce for high-quality, low-volume segments. Regional and global value chains (R&GVCs) offer opportunities for firms in Nepal to access markets and benefit from productivity-enhancing technology and skills transfers and know-how. The rise of R&GVCs is one of the most important transformations in global trade and investment, a result of falling transport and trade costs that have permitted the fragmentation of production processes. This has created opportunities for firms to integrate globally by becoming competitive in a specific task, rather than in the full production process. Furthermore, services trade, in particular in activities of marked comparative advantage such as travel and tourism, is a yet untapped opportunity for Nepalese firms. Finally, e-commerce is becoming a powerful platform for firms producing high-quality products in low volumes—a niche that Nepal could occupy.

### **Yet, Nepal's current remittance-driven growth model is introducing an anti-export bias, adding barriers to reaping full gains from integration.**

Remittances are a key source of income of foreign exchange in Nepal. They help alleviate financial constraints of households, lifting many out of poverty. However, from a macroeconomic perspective, remittances are also helping to grow current large trade deficits, and are contributing to an appreciation of the real exchange rate. Results presented in Policy Note 1 suggest that an increase in remittances by 10 percent leads to a 0.5 percent appreciation of the real exchange rate in the long run. Remittances put upward pressure on the prices of nontradable goods, and with a nominal exchange rate regime that is pegged to the Indian rupee, the result is an appreciation of the real exchange rate. As remittances have grown fast

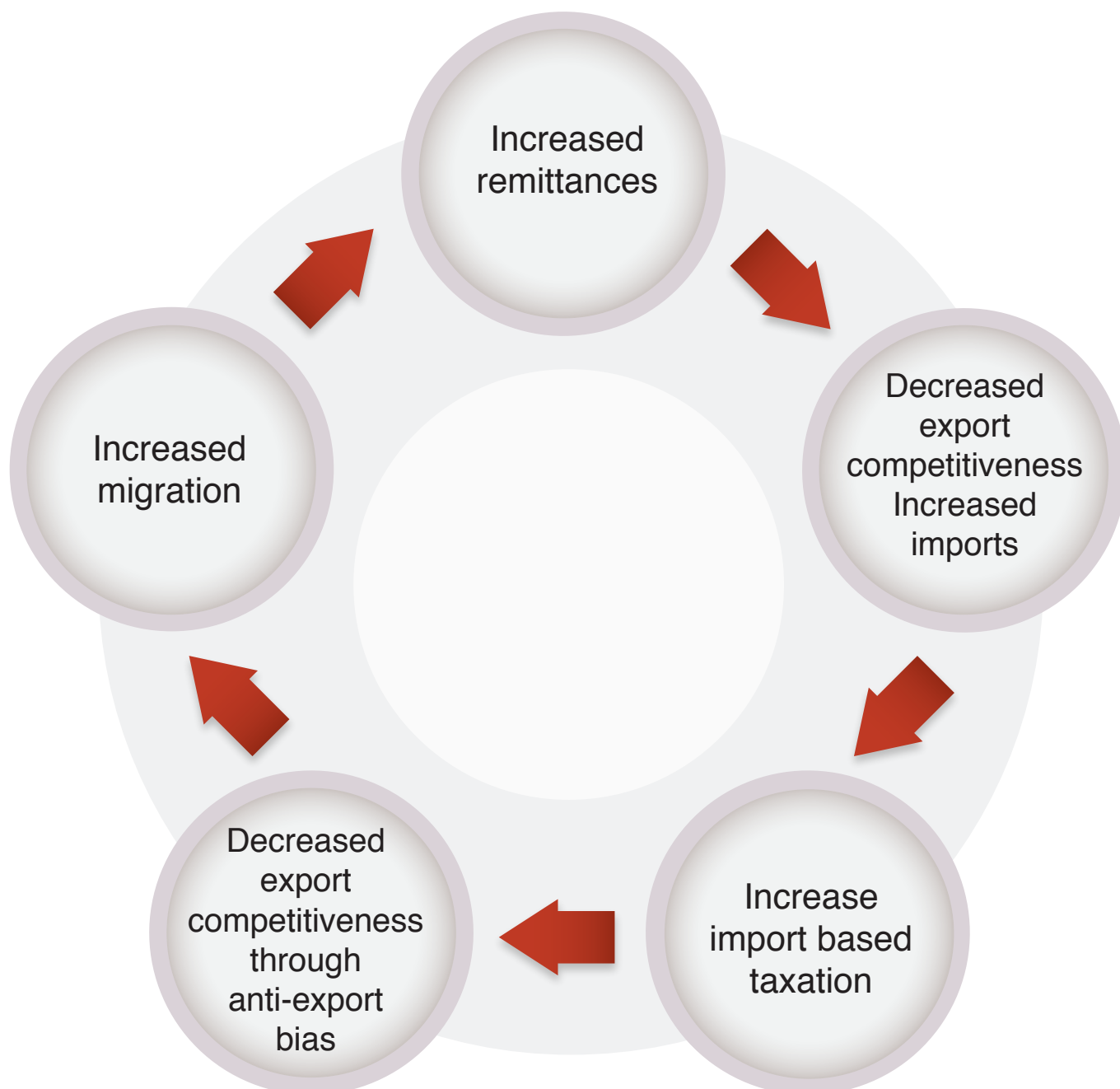
over the last 20 years, real exchange rate appreciation due to this channel is non-negligible. In turn, appreciation of the real exchange rate favors imports, and biases against exports by making domestic goods uncompetitive. The impact is possibly largest on low-value, low-margin manufactured goods, which account for a large share of Nepal's export bundle. Further, from a political economy perspective, rising imports are an attractive taxation base and incentivize increased reliance on import taxes. This adds to an anti-export bias, as exporters rely on imported goods as key inputs for production. Nepal's current model of growth is not delivering required growth and jobs, and is further promoting a bias against domestic production that is likely to perpetuate the current vicious cycle (Figure 3). A move toward a model based on investment and production is necessary to promote faster growth and job creation in Nepal, and integration offers a possible driver in this regard.

<sup>1</sup> See Policy Note 1 for a detailed description of the analysis. With the average quarterly change in remittances over the period 1995Q1 to 2015Q1 being at 5.8 percent, the estimated appreciation of the real exchange rate due to this channel is of 22 percent. The magnitude of the effect is broadly in line with what is observed in the literature.



## Key Messages

- **Figure 3:** *Vicious circle of migration, low competitiveness, and policies biased against exports*



Source: Authors' elaboration

## Key Messages

### **Nepal remains poorly integrated and has more to gain from integration into regional and global value chains.**

Even though its exports have high import content, Nepal is not a good supplier to R&GVCs and is largely missing out on the growing trade in intermediate products (see more in Policy Note 2). A comparison to other countries in the region shows that Nepal has the lowest participation in GVCs through downstream linkages. Less than a fifth of exported domestic value added from Nepal ends up in third countries' exports, which is related to Nepal's relative specialization in finalized goods exports in both agricultural and manufacturing sectors. To increase its chances of discovering its competitive advantage and integrating more into GVCs, Nepal would need to make it easier and cheaper to import goods and services going into exportables, facilitate the entry and operations for foreign investors, and improve the investment climate for firms and reduce the cost this imposes on them.

### **Services export performance has been better than that observed in goods, but there are still untapped opportunities.**

Services exports are an important source of foreign exchange and value added. In gross, services exports reached US\$1.2 billion and represented 54 percent of Nepal's export basket in 2014. In value added, the services sector accounted for 44 percent of all domestic value added exported from Nepal. This figure includes not only direct exports, but also the value added the services sector demands from other sectors for its exports (that is, the backward linkages). Most of these exports are in the travel and telecommunications sectors (80 percent), although there is a nascent, largely informal, but flourishing software and BPO sector. However, in the largest services export sector, travel and tourism, low-value activities predominate. For example, daily tourist expenditures per day in 2012 were US\$38, at the lower end of the distribution, and the tourism offering is relatively concentrated in trekking (see a more detailed analysis in Policy Note 3).

### **E-commerce opportunities are yet untapped.**

There appears to be an opportunity for Nepalese e-commerce to penetrate distant markets. One reason is that many Nepalese firms are concentrating in small-scale production of high-quality products. In addition, Nepal has relatively good air-transport connectivity and a well-established country brand. E-commerce allows firms to connect through an online platform directly with final consumers and reduces transaction costs. More countries are allowing greater amounts of duty-free e-commerce purchases, thus unilaterally providing increased market access to foreign firms, including Nepalese ones. Some progress has been achieved in setting up the necessary soft infrastructure through the approval of the e-signature. However, the lack of an international payments gateway in Nepal prevents firms from using this platform.

## Key Messages

### What is impeding firms from tapping into these opportunities?

**The report identified two types of obstacles: external to the firm and internal to the firm.**

#### Obstacles that are external to the firm

External obstacles are features of the environment in which firms operate that increase their costs, or prevent them from tapping into opportunities. These include, among others, (i) restrictive trade policies that impede firms from accessing foreign markets for their output or to source inputs (both goods and services); (ii) restrictive investment policies and regulatory uncertainty that prevent the attraction and retention of FDI and impede FDI's connection with domestic firms—key for spillovers to materialize; (iii) anticompetitive practices in domestic markets, with implications for provision of quality key backbone services (transport, telecommunications, finance); and (iv) inadequate national infrastructure (both hard and soft), particularly quality infrastructure.

**i. Restrictive trade policies have been increasing production costs of Nepalese firms.** In Nepal, as in other countries, imported inputs (both of goods and services) are key for the vast majority of exporters. More than 90 percent of Nepalese exporters import inputs for production, which is reasonable given the size of the economy. Several industries prioritized by the NTIS rely on significant imports of various raw materials and intermediate inputs for production. For example, footwear exporters import more than 20 raw materials (leather, glue, soles, accessories, and so forth); exporters of pashminas import wool and silk; manufacturers of hand-woven carpets source wool, silk, and dyes from abroad; and higher-end tea exporters source their filter bags internationally. (see both Policy Notes 2 and 3).

**Sourcing inputs at competitive prices, irrespective of their origin, helps firms grow, diversify, and upgrade.** Access to a wide variety of inputs relaxes firms' technological constraints, helping firms diversify into new or better quality products. In Nepal, greater use and variety of imported intermediate inputs is associated with greater exports, diversification of destination markets, and higher export quality (see Policy Note 2). For example, firms that import more than 30 percent of intermediates from outside the region have 16.8 percent larger export values, export to 40 percent more destinations, and secure on average 10 percent higher prices for their products than other firms.

**ii. Attracting and retaining FDI is crucial for export performance and growth and requires less restrictive investment policies.** FDI is vital for accessing new markets, integrating and upgrading in R&GVCs, and ultimately for creating more and better jobs. But inflows into Nepal are very low. At less than 1 percent of GDP, Nepal's FDI inflows are the lowest among comparators. While this is partially explained by firms' perceived risks of operating in the country, the investment regime in Nepal is more restrictive than in other countries at a similar level of development. Restrictive FDI policies compound

the challenges the country faces in attracting foreign investment and may need reconsideration (see Policy Notes 2 and 3).

**iii. Domestic competition at home helps in the provision of more efficient inputs, particularly crucial backbone services.** Good quality, efficient services inputs are important for firms' performance. Insufficient availability of services inputs—including electricity, transport, finance, and water supply—is perceived as an obstacle to the manufacturing and agriculture sectors' performance in Nepal. These backbone services are particularly important for exporters. For example, top export sectors of Nepal use transport services intensively. Almost 40 percent of services inputs provided to processed food exports are from the transport sector. In addition, transport comprises 30 percent of services inputs for leather exporters and 25 percent for beverages and tobacco exporters. In agriculture, 45 percent of services inputs are transport related. Thus, transport sector improvements will have a direct and sizable bearing on the profitability and competitiveness of these export sectors (see a more detailed analysis in Policy Note 3).

**iv. Weak infrastructure makes it more difficult for Nepal to change its export mix.** This includes both hard infrastructure, mainly associated with connectivity, but also soft infrastructure. In particular, quality infrastructure associated with certification and standards is important as Nepal moves towards higher-quality exports. Refusals of Nepalese export products at foreign borders is one example indicating that quality infrastructure remains a challenge in Nepal. In agriculture and within products identified as priorities by the NTIS, average quality is low to medium, compared to that displayed by competitors. For example, in tea and coffee, Nepal's exports are positioned halfway through the quality distribution, with an average unit price of 40 percent of the top exporting country (see Policy Note 2). Part of this is explained by firms' limited capabilities in upgrading quality, but inadequate infrastructure for quality and product certification and compliance with international standards also matters. Quality challenges are also revealed by recurring import rejections of Nepalese products at foreign borders, due to poor handling of products before shipping (including aflatoxin and decomposing foods, and presence of undeclared gluten in allegedly gluten-free flours), or lack of standard compliance (for example, mislabeling/misbranding, or absence of approved drug applications). These recurring import rejections of specific shipments pose reputational risks across the board, and result in lower export prices and higher costs for exporters.

**Inadequate hard infrastructure, mainly related to connectivity, affects producers in general, and tourism in particular.**

Apart from increasing transportation costs and making travel times uncertain, poor connectivity also affects the prospects of upgrading in tourism, as well as the diversification of its offering. The latter requires substantial investment in supporting infrastructure, particularly airports, bus terminals, and rest stops.

## Key Messages

### What is impeding firms from tapping into these opportunities?

#### Obstacles that are internal to the firm

##### **Firms' internal obstacles may prevent them from tapping into the opportunities associated with integration.**

Internal obstacles may be related to low managerial capabilities or difficulties in accessing relevant market information regarding trade opportunities. Many governments worldwide, including Nepal's, support firms in the process of internationalization, typically through information provision ('market intelligence') and sometimes subsidizing capabilities upgrading. What support is the Government of Nepal providing to help firms overcome internal obstacles, and how is that helping firms integrate into R&GVCs?

**i.** *As part of well-needed trade promotion interventions, the Government of Nepal has set up a cash incentive scheme to support exporters. A scheme was introduced in 2010/11 by which firms were eligible to receive 2, 3, or 4 percent of their export value as a cash incentive. To be eligible, firms had to be exporting to countries other than India, and had to be adding domestic value by 30, 50, or 80 percent. The scheme was modified in 2013, reducing the incentive rates to 1 and 2 percent and introducing a fast-track system. This streamlining was introduced as a response to feedback received by the public sector.*

*However, evidence from an impact evaluation analysis reveals that the program is not reaching the firms it is meant to support (see more in Policy Note 4). High fixed costs of filing due to a lengthy and complex mechanism have been impediments for exporters (particularly for new exporters) to claim the incentive. In 2012, only 3.3 percent of eligible firms received the incentive. This increased to above 6 percent in 2013 and 14 percent in 2014, but remained low. Most firms exporting eligible products do not receive any incentive, and those that are receiving it are substantially larger, and tend to receive it systematically. In fact, the conditional probability of receiving the incentive given that the firm had managed to receive it the year before was 50–70 percent. Changes in the scheme introduced in 2013 do not seem to have been fully implemented. This is observed both in the analysis of data and from conducting field interviews with eligible firms. The fast-track system introduced in 2013, by which firms exporting priority products would not need to certify domestic value addition, reflect the systematic feedback of the private sector on the complexity of proving that value added content. In fact, the indicator of the fixed costs of filing for the incentive shows an increase rather than a decrease after the announcement of the fast-track system.*

*The cash incentive scheme appears to have had no clear effect on export growth or diversification. At the aggregate level, there is no conclusive evidence of the incentive program having affected export growth or diversification away from India. Instead, India appears to be growing as a destination market after the implementation of the incentive. Once firm-specific characteristics are controlled for, we find the change in the incentive scheme in 2013 had no effect on firms' export performance. Nor do we see the effective incentive rate affecting export growth or diversification patterns (see Policy Note 4 for more details).*

**ii.** *Traditional trade promotion activities are also sponsored by the Government of Nepal, but these could benefit from improvement in the design, mandates, and coordination among Nepal's trade and investment promotion agencies. Like all governments in the world, Nepal devotes substantial resources to promoting trade, tourism, and FDI. It is important to align these efforts with international good practices, in terms of both the actual interventions to support firms and the design of these institutions and their coordinating mechanisms (see Policy Note 5 for a detailed discussion). There are several agencies whose mandate is to promote trade (primarily in goods or in tourism, with no active promotion of other services exports) or investment (the responsibility of agencies within the Department of Industry and the Investment Board). But these agencies and efforts have limited coordination. In a context in which trade and investment globally are strongly linked, coordination between these agencies should be strong. This may imply operating under a common umbrella, or keeping fluid channels of communication. Also, in Nepal, evidence shows that tourism acts as an export promotion platform for traditional goods. This link needs to be internalized by trade promotion institutions.*

# Policy Recommendations

## How can Nepal benefit more from integration?

Across the different policy notes, evidence points to a number of policy options that will help break the vicious circle described above (Figure 3), increase the competitiveness of the export sector, and create better job opportunities for the Nepalese people. Some policies are horizontal in nature, and some are sector specific. The most important options are summarized below (for the full set refer to the individual Policy Notes).

***Gradually move away from import-based taxation, streamline tariff lines, and reduce tariff rates, especially on intermediates that are key for the production of priority products. In the meantime, streamline the duty-drawback system currently in place for exporters.***

The government may consider reducing or eliminating customs duties or other trade restrictions on inputs (both goods and services) that are key for the prioritized sectors. Given the high share of tax revenue from trade-related taxes, this option requires careful analysis of its fiscal implications and securing alternative sources of public revenues. As a first step, this option implies better understanding of input-output linkages for key products, the elasticity of demand for imports with respect to tariffs, and the exportable potential for products that will benefit from lower input tariffs. In the meantime, the duty-drawback system for exporters needs to be streamlined and made more transparent, and it should be accessible by both direct and indirect exporters (sellers to tourists).

***Improve the national quality infrastructure to boost competitiveness and facilitate entry into R&GVCs.***

Nepal has favorable access to developed markets like the United States, European Union, and Japan for agricultural products (in which sector more than 90 percent of tariff lines do not pay customs duties). However, the inability of exporters to comply with sanitary and phytosanitary standards (SPS) prevent Nepal from taking full advantage of its preferential access. Inadequate national quality infrastructure exacerbates some of the disadvantages that Nepal faces as a landlocked country. Inadequate SPS measures contribute significantly to trade time and costs along the Kathmandu-Kolkata corridor. Anecdotal evidence suggest that import authorities in India

will occasionally send samples to laboratories in Kolkata for testing because SPS certificates granted in Nepal are not recognized internationally. Nepal's current SPS system has major capacity gaps and weaknesses in World Trade Organization (WTO) compliance, namely: (i) the SPS system is not risk-based; (ii) the food control system is mainly focused on quality requirements, not on food safety requirements; (iii) SPS agencies and laboratories suffer from frequent rotation of staff; (iv) insufficient capacity in plant pest surveillance and diagnostics; (v) no capacity to control pesticides; (vi) SPS import inspection is hardly in place and ineffective; and (vii) there is at present no testing capacity and accreditation for food safety parameters in microbiology, pesticide residues, veterinary drug residues, heavy metals, other pollutants, and mycotoxins (World Bank 2015c). Field-interviews and additional analysis show that two interventions could have a great impact in compliance with international standards: standards harmonization and international accreditation (see a more detailed discussion in Policy Note 2).

***Reduce restrictiveness for trade in services and promote competition economy-wide.***

The regulatory environment governing services providers affects both the quality of domestic services provision as well as the ability of countries to export services. This includes the actual laws, as well as how those laws are implemented in practice within a country. Openness in the services sector is part and parcel of a comprehensive growth-enhancing trade policy. Lack of competition impairs the ability of other sectors to use services as inputs, because it creates a reliance on domestic services as inputs for manufacturing production. In India and Indonesia, for example, reforms in the services sectors improved services provision, as well as the performance of manufacturers that used those services (see a more detailed discussion in Policy Note 3). In particular, restrictions around trade in transport services are high. Nepal, a landlocked country, imposes high restrictions in transport services trade. The domestic sector is syndicated and highly anticompetitive, imposing large costs on its users, whose services input spending is largely for transport. Policies to manage and regulate the authority of trucks and to strengthen the government's ability to control these practices should be put in place by the Department of Transportation.

<sup>2</sup> Reis and Varela (2015) show for Nepal, that an increase in tourism inflows from a given country, in a given year by 1 percent, increases exports of traditional goods to that country, one year later, by 0.5 percent.



## Policy Recommendations

***Promote e-commerce platforms with necessary soft infrastructure, including a gateway for foreign payments into Nepal, and strengthen competition in the logistics sector.***

E-commerce is a powerful tool for exporters of high-quality products at low volumes. In this area Nepal has great potential. At the same time, developed countries are increasing the duty-free allowances for products imported through e-commerce. For example, in March 2016, the United States increased that allowance from US\$200 to US\$800. For Nepal to take full advantage of the opportunities of e-commerce, necessary steps regarding the validation of electronic signatures have been taken. However, the necessary licensing of a payments gateway that would allow for foreign payments into Nepal is still pending. It is important that the Central Bank accelerate this process through its recently established Settlements Department (see more details in Policy Note 3). Moreover, a competitive logistics services sector is crucial to fully tap into the potential of e-commerce.

***Revise the export incentive scheme, and implement monitor and evaluation mechanisms for all interventions that imply the use of public funds, as well as impact evaluation analyses.***

It is commendable that the Government of Nepal has requested an impact evaluation of its export incentive scheme. Monitoring policy interventions and rigorously evaluating their impact is of foremost importance to ensure that scarce public funds are allocated to their best use. Evidence provided in this report suggests that the current incentive scheme for exporters has not been reaching the intended firms. Nor has it had any clear impact on export growth or diversification (see more details in Policy Note 4). Resources that are currently committed to this export incentive scheme could be put to better use financing policy interventions that help a wider universe of firms to be more competitive. The items mentioned above, particularly the reduction of tariffs for key intermediates, could be more effective vehicles for the improvement of export performance.

***Attract, retain, and connect FDI to the economy through reforms to the investment policy regime.***

Among the most salient restrictions affecting foreign investment in Nepal are the cumbersome processes for the repatriation of funds and the lengthy processes needed to hire foreign workers. Regarding the former, while the law does

provide foreign investors the right to repatriate funds related to foreign investment, in practice repatriation is difficult and obtaining approvals is a lengthy process (World Bank 2015b). Entry barriers to foreign investment also persist, including foreign ownership limitations, sector caps, a long negative list, and restrictions in nonequity modes of investment. Nepal retains a foreign ownership limit of 51 percent in some selected sectors, such as legal, accounting, and engineering services. The country imposed an even lower foreign participation limit in banking and finance, a sector crucial for the private sector to flourish. Additionally, despite eliminating the minimum investment requirement of US\$200,000, the new Foreign Investment Policy (FIP) significantly expanded the negative list to include poultry, fishery, print, and electronic media. This limits the amount of foreign investment entering Nepal and constrains the ability of important sectors of the economy, including manufacturing, to attract FDI. Restrictions in nonequity modes of investment, such as franchising, in which there is significant technology, training, and skills transfer, face additional delays and costs during entry and operations in Nepal. In particular, slow and arbitrary approval processes, dual registration procedures, delays in trademark registration, and difficulties in remitting royalties and technical fees are among several obstacles faced by these type of investments (World Bank 2015b).

***Over the medium term, unify efforts for investment promotion under one authority, and ideally coordinate these efforts with those related to export promotion of both goods and services.***

In particular, Nepal may benefit from aligning the mandates of its investment promotion agencies to emphasize the attraction of export-oriented FDI (see more in Policy Note 5). After a careful analysis of production structures of neighboring Indian states, investment attraction efforts should also take into account opportunities that integration into regional value chains pose for Nepal (see more in Policy Note 2).



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