

**PROMOTING ENTREPRENEURSHIP:
OPTIONS FOR REFORM**

Materials Prepared for an April, 1991 Forum

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INTRODUCTION

With the support of U.S.A.I.D., five Nepalese organizations are sponsoring a forum on Promoting Entrepreneurship: Options for Reform, in April, 1991. At the forum Nepalese entrepreneurs will develop policy recommendations for the government that is to be elected in May. It is hoped that these will be of interest and use to members of the new parliament. This document is intended to provide background information on key issues which have been identified by the sponsoring groups and others. However, the points made do not necessarily reflect the viewpoints of individual sponsoring organizations or individuals.

The issues addressed here are not a complete or exclusive list of problems faced by Nepalese entrepreneurs. They are, however, among the most important issues confronting actual and potential entrepreneurs. The purpose of the April forum is to discuss these and other issues, articulate specific reform proposals, and develop a consensus with respect to priorities for legislative and executive actions. These proposed reforms will benefit not only entrepreneurs, but also the hundreds of workers they will employ as obstacles to growth are reduced or eliminated.

Each of the options under discussion, while distinct, is linked in their overall effect on the private sector. These options are intended to initiate a wide-ranging discussion. If the discussion is open and the agenda which emerges is based on consideration of all viewpoints, the recommendations which will be put forward should enjoy broad support.

Without full participation by Nepalese entrepreneurs in determining how these options could be adopted by the government to resolve specific problems there will be no workable solutions. Participants should critically review these suggestions so that, whichever solutions are advanced, they will specifically address conditions in Nepal. It is for Nepalese to determine which issues and options are most important, how to make them workable, and who should be responsible for their implementation.

It is the intention of the sponsors that this forum be the starting place for concrete reforms; it is the hope that within a short time, one can look back to this period as a turning point in the reform of Nepalese policies toward entrepreneurs.

BUSINESS REGISTRATION OPTIONS

Introduction: In the successful market economies there are fast, efficient procedures for registering an enterprise. However, in Nepal such procedures do not exist. Often it takes anywhere from one to five years to register non-cottage industry enterprises or cottage industries which export, import raw materials, or require foreign exchange/investment. Improving business registration procedures is a good and relatively straightforward means of allowing individuals to take advantage of entrepreneurial opportunities, thereby strengthening the private sector. These improvements are easy to implement and can have an immediate impact on the private sector. This can result in new jobs for Nepalese workers. Each ministry can begin to make these types of changes at any time.

Problem areas identified by both registered and unregistered firms with regard to business registration procedures include:

- A. Unnecessary steps/forms
- B. Complex processes
- C. Failure to assess costs and benefits of existing and newly implemented registration procedures and other regulations

Together these areas constitute institutional constraints to an efficient private sector. The options outlined are based on interviews and discussions with Nepalese in the private, public, and informal sectors and look to improve the efficiency of the business registration process. Each of these issues and possible options will be dealt with separately.

A. Eliminate Steps/Forms

Discussion: Eliminating steps/forms is an obvious starting point for reforming Nepal's business registration process. There is much duplication in the forms that are required to register a business as well as in the content of these forms.

For instance, if the Ministry of Industry requires eight forms and two studies to certify a business, many people feel that other ministries should accept this certificate as verification of the registrants' integrity without requiring that they go through the entire process again.

Every form to fill out and each step which must be complied with imposes a transaction cost on the potential business person. When these transaction costs become too high, entrepreneurs cease to register their businesses and instead operate as unregistered, informal enterprises. And, as a related result, opportunities for employment are also diminished.

Options

- 1. Review each ministry's business registration procedures to determine where elimination or simplification is possible.*
- 2. Eliminate costly feasibility studies and industrial schemes.*
- 3. Decrease business registration fees.*

Option 1:

Review each ministry's business registration procedures to determine where elimination or simplification is possible.

Business registration procedures in each ministry should be thoroughly analyzed to see where shortcuts and simplification can be made. One analysis was done which documented the need for registrants to obtain 54 signatures in order to simply establish a legal enterprise; future surveys should determine which signatures are unnecessary and can be eliminated.

The outcome of this review should be specific recommendations for elimination of specific forms, and parts of forms, and means for sharing information between ministries which will avoid duplication.

Option 2:

Eliminate costly feasibility studies and industrial schemes.

The current requirement that firms prepare feasibility studies/ industrial schemes is restrictive and costly. The government's reason for requiring such a study is to have a baseline from which to monitor an enterprise's activities and assess its risks, especially finances and income. Presumably, the government seeks to reduce business failures in this way. However, the effect is to discourage business registration and cost the government lost revenue for tax-paying, registered enterprises.

Costs of feasibility studies are prohibitive; estimates indicate 5% - 10% of total value of each new enterprise. In developed economies such a procedure is generally unnecessary. Risk is incumbent on the entrepreneur and the government is constrained from determining in advance the viability of a firm. Entrepreneurs would not be willing to risk their own time and money by investing in an economic endeavor if they thought the enterprise would fail. Is the government a better judge of an entrepreneur's abilities than the entrepreneurs themselves?

Rather than require entrepreneurs to prove in advance their citizenship, payment of past taxes, or authorization to conduct business, the government should require only that firms certify compliance before receiving permission to register. If any firm misstates such a condition, enforcement can be focussed on that particular firm, rather than imposing costs on all firms by presuming that all firms are not complying with government regulations.

Proponents of reduced registration requirements believe that it should be the responsibility of governments to register enterprises and not second-guess the business judgments of investors. The impact of these requirement is to discourage business formation. On the other hand, reducing such requirements will encourage business formation and job creation. In countries with growing economies and high levels of job creation, barriers to business formation are low. Rules, such as those found where legacies of past systems still exist, constitute a barrier to the creation of employment opportunities.

Option 3:

Decrease business registration fees.

Fees for registering a business in Nepal are excessive when compared to fees for business registration in most developed economies.

Interviews reveal that the cost of registering a small industry, for example, can be as high as Rs. 150,000 (approx. \$5,000); this is not inclusive of any bribes which are often a necessary part of the transaction. In many developed economies business registration fees rarely exceed \$500.

While lowering fees may cost the government some revenue in the very short term, the income taxes of new enterprises and the people whom they employ will be much more important to the Nepalese government in the long term. It is likely that the cost to the overall economy of lost business formation is much greater than the income from business registration fees.

Some progress toward reducing forms and fees has already been made, but the basic problem is still substantial. Outright elimination of some requirements obviously eliminates related registration fees. In areas where rigid requirements continue, fees are only part of the cost. Moreover, the time involved in obtaining permits can also be considerable. Thus, this option is closely related to those which follow under the heading "Procedure Simplification."

B. Procedure Simplification

Discussion: Business registration is a very cumbersome process. For instance, as many as 54 signatures may be required to process one application; but this does not reflect the full transaction costs involved. Each of these signatures must be obtained at a separate division within each of a number of ministries, the Central Bank, etc. Registrants often have to make numerous trips to various ministerial departments to monitor the progress of the application procedure. Such monitoring frequently takes entrepreneurs away from their jobs so that there is a loss in productivity as well as losses incurred to cover transportation expenses.

Thus, transaction costs for registering a business are prohibitive and, as a result, many entrepreneurs prefer to avoid registration.

Application forms themselves can be very complicated which, in a country where many people are illiterate, further discourages entrepreneurs from registering their businesses. Moreover, interviews reveal that during the registration process, applications are inevitably returned to the applicant because they were supposedly incomplete, filled out incorrectly, processed in the wrong order, or, perhaps, not accompanied by the necessary bribes. Several instances were cited in which a registrant's application was returned, resubmitted, and returned again, several times for a different reason each time. By the time the application was accepted, more than a year had passed.

In addition, application files often move from one department to another at a very slow rate; for instance, it can take two to three months for an application to move from the Industry Department (within the Ministry of Industry) to the Foreign Currency Committee (also in the Ministry of Industry). To further complicate matters, ministry and departmental circulars altering registration procedures are commonplace, thereby creating an uncertain business environment.

These complicated procedures combine to yield the following results:

1. Ministries which lack uniform standards for business registration are staffed by bureaucrats who defer decision making to their superiors; and these superiors then develop a backlog of applications which eventually receive attention only because of the persistence of applicants.
2. Because there are multiple, rather than single, ministries involved in the process there is no single place where applicants can complain if their registration is tied up in a low-level office.
3. Entrepreneurs, and even officials themselves, may be unaware of changes to procedures or requirements. Because rules are not published in advance or codified in any central reference publications, those who want to comply will still find it difficult if not impossible to do so.

One of the most adverse effects that cumbersome business registration procedures have on the overall economy is lost productivity in terms of employment. Many entrepreneurs have had to wait 3 to 5 years to get their businesses legally registered with the government. Many of these businesses could have employed a number of people during that period of time.

Options

1. *Provide a means to assist entrepreneurs to comply with government regulatory requirements.*
2. (A) *Develop uniform, non-discretionary criteria governing the registration process*
(B) *Once uniform criteria are established, decision making can be effectively delegated downward.*
3. *Business registration processes should be completely separate from tax collection processes.*

Option 1:

Provide a means to assist entrepreneurs to comply with government regulatory requirements.

Since many Nepalese entrepreneurs are not fully literate, numerate, or have extensive knowledge of the law, it is important that registration procedures be simple. (However, simplifying procedures may not be incentive enough to encourage many entrepreneurs to register their businesses.) Because of the problem of illiteracy, it may be necessary to facilitate simplified registration processes through other means. One possibility is to establish an "information window" where potential registrants can receive assistance in:

- * filling out application forms,
- * learning about registration procedures,
- * determining which signatures are required,
- * ascertaining in what order applications should be submitted to each of the requisite ministries,

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- * learning about new circulars issued by various government departments and assessing how they will affect the way business is conducted,
 - * codifying and publishing government regulatory changes,
 - * directing inquiries as to existing deadlines within which each ministerial department must complete its processing of an application,
 - * answering any other questions that entrepreneurs might have.

Such an "information window" would be open to the general public and could help lessen the effects of illiteracy on the registration process by ensuring that applicants had filled out their forms according to government specifications. Also, such a window could provide checks and balances to the discretionary power presently held by government decision makers and safeguard the interests of entrepreneurs. To achieve the desired results such a mechanism should be vested with disciplinary authority (such as a tribunal) so that action can be taken against the negligent and unnecessarily slow office.

With appropriate disciplinary mechanisms in place, if a ministry rejects an application that has been filled out correctly or a department takes several months to process an application the applicant would, in effect, have access to legal recourse.

Establishing an "information window" is likely to have immediate results; however, creating a disciplinary mechanism will only work as ministries are forced to comply, and as the "information window" staff gains experience. This compliance by ministries can be accomplished only if there is a commitment at the highest levels of government to the success of the program.

An additional benefit of reduced steps, clearer rules, and more open administration is reduced opportunities for bribery.

While it can be argued that persons wishing to run a business ought to possess the skill and sophistication necessary to fill in government forms, the fact is that the skill necessary to conduct many businesses is not the skill required to fill in forms. Time spent learning forms is time spent not improving a business.

Option 2 (A):

Develop uniform, non-discretionary criteria governing the registration process.

At present there is no uniform set of procedures which govern officials who make decisions during the registration process or delineate the length of time that such processes should take. Governments should be responsible for applying uniform, non-discretionary criteria and providing stable conditions within which entrepreneurs conduct transactions. In Nepal changes in policies and administrative procedures are not subject to public review nor are they assessed as to their potential costs/benefits. As a result, changes in government registration procedures are often unpredictable, have unexpected impacts, do not conform to a set of standard criteria, and are frequently at the discretion of ministry bureaucrats.

All policy and administrative changes should be posted to the public's attention and, where such changes are likely to incur costs, be open to public review. The burden of insuring dissemination of new rules and procedures to trade organizations and lower government offices must be met by those ministries issuing rules. To facilitate a more efficient system, the government should set deadlines for each step in the application process.

The unpredictable, often arbitrary, current system frequently provides incentives for bribery. A related result of the lack of consistent registration criteria is that similar businesses are often treated differently depending on which bureaucrat evaluates a particular application.

Option 2 (B):

Once uniform criteria are established, decision making can be effectively delegated downward.

Authority should be delegated downward. This includes delegating authority within each separate ministry as well as the decentralization of authority to at least the regional, if not the district, level. The most appropriate mechanism is to establish a uniform set of criteria by which decision making is executed.

For instance, in developed economies, when a person goes to the district center for a building permit, it is seldom necessary for the chief of the district office to approve the application. Instead, because subordinates are given a uniform set of criteria upon which to evaluate building permit requests, they can approve the permits without higher authority. The same principle can be established in Nepal's bureaucracies.

One useful mechanism for applying this principle is to provide subordinates with samples of properly filled-out applications that can be used as a basis for their making decisions. These samples could also be posted outside ministry offices or be made available at an "information window." This would improve efficiency and expedite the business registration process.

However, an appeals process should also be introduced along with changes that delegate authority down to lower administrative levels. As many decisions are routinely made by lower government offices, the right to appeal to higher levels will insure consistency between these offices and provide a policy and guidance role for higher level officials.

Option 3:

Business registration processes should be completely separate from tax collection processes.

Unregistered enterprises do not, by definition, pay taxes, but in order to register their enterprises entrepreneurs must show proof of previous income tax payment. How does an owner of an unregistered enterprise, who has never had to pay taxes, demonstrate proof of past payment of income taxes so as to meet registration requirements? This is a vicious circle which keeps many firms who would like to register from being able to. Some entrepreneurs have told of having taxes assessed for as many as seven years prior activity simply to register the business.

To encourage entrepreneurs to register their businesses the government should consider implementing as a pilot program a one-time grace period wherein new enterprises will be allowed to register under a general tax amnesty, including retroactive taxes on enterprises or personal income taxes. By making such an offer the government would not lose any actual revenue since it is not collecting taxes from unregistered firms or personal income taxes from their owners at present. However, in the future, these same enterprises and individuals will be additional sources of revenue, as will their employees. Such an action should take place over a period of, perhaps, one to two years and be highly publicized throughout the kingdom so as to accommodate difficulties in communication and transportation.

Over the longer term, ways to insulate business licensing from tax collection will act to encourage firms to obtain licenses. At the same time, improvement in the fairness of taxes and tax collection procedures (see p.p. 15 - 20 below) will reduce the government's need to rely on registration to expose recalcitrant tax payers.

Failure to Assess Costs/Benefits

Discussion: It is important to be able to determine the effects of laws and policies on economic efficiency. In many countries all new laws and policies are required to carry attachments showing the possible economic costs, as well as benefits, accruing to their enactment.

Conducting analyses of the economic impacts of proposed policies is a skill that is often lacking in many countries. Frequently, laws are passed and policies changed without conducting a prior assessment of their possible effect on the economy or on individual companies or persons. Such analyses could identify potential effects of policies, such as gains or losses to employment of various types of legislation, or the possible costs of complying to a specific rule.

Under its former leadership, Nepal enacted many laws and policies that are inefficient and impose many costs on Nepalese citizens. During this period laws were passed with "general welfare" and "public good" clauses; these laws claimed to support the well-being of the society. However, as in many other countries, no analyses of the possible detrimental effects of these laws and policies were done prior to their enactment. It was only later, after the impacts of these laws and policies became apparent, that steps were taken to mitigate their effects.

Currently, there is a clause in the new constitution which stipulates that any law carried over from the previous government, inconsistent with the constitution, will become void after one year. As each of the existing laws is reviewed it will be important to specify both the expected benefits and the costs. Informed citizens and informed policy makers can make informed choices.

Options

- 1. Conduct analyses of all existing policies and legislation containing public welfare clauses which are related to the economy.*
- 2. Conduct cost/benefit analyses for all new economic legislation and regulation.*

Option 1:

Conduct analyses of all existing policies and legislation containing public welfare clauses which are related to the economy.

Those laws related to business licensing, foreign investment, taxes, exports and imports, which will become void within a year and contain public welfare clauses, should be reassessed in terms of their actual economic costs and benefits.

Aspects of existing laws which should be investigated prior to ratification by the new parliament could include:

1. What is the purpose of the proposed policy?
 - * What economic benefits have occurred from the regulatory or other policy regime established by the law?
 - * To whom have these benefits flowed? In what amount?
2. What costs have been imposed?
 - * How many firms or individuals are affected?
 - * What record keeping, reporting, or compliance costs are imposed?
 - * What skill levels are required to comply?
 - * What impact will compliance have on the operations of affected firms or individuals?
3. Are there overlapping, conflicting or duplicative requirements imposed by national or local authorities?
4. What alternatives were considered? Why was this one selected?

Option 2:

Conduct cost/benefit analyses for all new economic legislation and regulation.

Cost/benefit analyses should be required as accompaniments to all new legislation or regulations. Such analyses stand as a public account of who benefits and who is hurt by specific legislative proposals. In addition, ministries which issue regulations to implement laws should be required to specify, in advance and in public, how the regulation fulfills the legislation's directives and the costs and benefits of the particular rule which is proposed. This will give all interested parties better information on which to base comments to their government and their members of parliament.

In some countries the responsibility and expertise to conduct such analyses is centered in the finance or planning ministries. Other countries provide for collaboration between the responsible ministry and a central office; while still other countries provide for public comment on the analyses prior to their adoption as policy.

TAXATION

Introduction: One important function of any government is to collect revenue. However, the means by which governments collect revenue vary greatly. Typically, in developed economies revenue is collected on the basis of a uniform set of criteria which applies to all similarly situated taxpayers.

In Nepal taxes are not applied uniformly but, often, arbitrarily at the discretion of the tax collector. For instance, many entrepreneurs complain that annual income tax assessments are often adjusted at an arbitrarily-set, rate based on presumed annual income growth of three percent, regardless of whether the enterprise had made profits or losses. Such a practice inhibits entrepreneurs' willingness to disclose information and encourages tax fraud and evasion practices. Furthermore, it is possible that such arbitrary taxation policies have contributed to excessive financial burdens on some businesses, perhaps to the extent that they fail.

It is likely that the indiscriminate nature of tax assessments has forced some registered businesses to engage, partially or completely, in informal/unregistered transactions; that is, transactions considered to be outside legal jurisdiction. Such tax policies may also discourage entrepreneurs from registering their businesses.

We will focus on three issues related to government tax policies, these include: an

1. arbitrary system of tax collection,
2. a high retroactive income tax,
3. alternatives to the proposed wealth tax.

Tax Collection

Discussion: As mentioned in the foregoing introduction, current income tax collection is typically subject to arbitrary annual increases in assessments; i.e., taxes are adjusted by officials presuming an annual rate of new growth at, say, three percent whether or not profits or income have actually been earned. Possible ramifications of such a taxation system are unreasonably high tax burdens placed on firms, while insufficient revenue is collected from very profitable businesses.

Throughout the world, it is not unusual that business is better in some years than in others. In those years when business is not good taxable earnings will be low and in years when business is booming taxable earnings will be high. When taxes are adjusted automatically without regard to actual earnings the burden becomes arbitrary.

Options

- 1. Establish uniform criteria for assessing and collecting taxes while eliminating automatic tax adjustments.*
- 2. Disseminate information to the general public concerning their legal rights as regards tax assessment and tax collection.*

Option 1:

Establish uniform criteria for assessing and collecting taxes while eliminating automatic tax adjustments.

A uniform set of criteria should be enforced which discourages arbitrary tax assessments and automatic tax adjustments. In a country with many illiterate people such as Nepal, it is necessary to avoid complex tax accounting systems, such as those found in some developed economies. Simple tax assessment procedures should be preferred; assessments ought to be limited to basic debit and credit accounting. This will also make collection less complicated by reducing the number of questionable tax statements. Automatic tax adjustments should be eliminated; if an enterprise does not earn profits one year, its taxes should not be adjusted upwards. Likewise, when a firm makes significant profits, taxes should be assessed accordingly.

Option 2:

Disseminate information to the general public and to local tax collectors concerning their legal rights of taxpayers as regards tax assessment and tax collection.

An "information window" could be provided which makes tax information widely available and assists people with their tax questions. While such a service may seem costly in the short-term there are probable long-term gains in tax revenue through declines in fraud, evasion, and avoidance practices.

At the time of business registration, firms should receive clear explanations of various tax requirements. Broadcasting explanations might overcome some problems of literacy.

The single greatest step for increased understanding of Nepal's tax requirements would be to simplify the currently complex and detailed requirements.

Wealth Tax

Discussion: Recently, Nepal's interim government has proposed implementing a wealth tax. Such a tax would be levied on all businesses within a certain range of size and profitability, as well as on certain types of assets including jewelry, automobiles, foreign assets, etc. This proposed wealth tax violates a number of broadly accepted principles of sound taxation. For example, taxes should generally be neutral in their effect on resource allocation and they should be relatively easy to administer. The wealth tax acts in a way counter to both these principles.

Since some forms of wealth can easily be hidden from the authorities (such as jewelry and foreign assets), tax evasion is likely to be a serious problem. A tax which is able to be enforced selectively may have an inhibiting effect on business investment.

In principle, a wealth tax has less damaging effects on the incentive to save and accumulate capital than does a tax on capital income. The capital income tax tends to handicap dynamic entrepreneurs who are building up their wealth, while a wealth tax burdens those who have already accumulated wealth, including the heirs of those who earned the original fortunes. Nevertheless, a comprehensive wealth tax does not seem appropriate for a country without a well-developed fiscal system and without extensive written records of transactions.

Options

- 1. A land tax should be considered in place of a wealth tax as a means of generating additional revenue.*

Option:

A land tax should be considered in place of a wealth tax as a means of generating additional revenue.

An important feature of a tax system is its distributional impact, and this is presumably the major reason for the wealth tax proposal, for the burden of this tax does fall on those with the greatest ability to pay. However, a land tax would have a similar distributional burden. It is likely to be more efficient to strengthen the tax on urban and rural land than to enact the proposed wealth tax.

Much of the rise in land values is not the result of investment by the landowner, and taxation of such increase in land values does not have adverse allocational effects. Moreover, land taxes may be viewed as corresponding in a rough way to the value of services provided by the government to landowners. In strengthening a land tax, it is important to develop fair and open procedures for valuing land.

Land taxes are reported to be among the most unpopular taxes. In a rising land market landowners may feel unfairly treated if their taxes go up while their incomes remain the same.

One way to deal with this is to allow landowners to postpone payment of some of their tax liability until the land is sold. While the landowner's tax liability in a rising land market may be rising faster than his income, his wealth in land is rising at the same time, and the additional tax liability can be paid out from the additional wealth at the time of sale. In effect, the landowner would be borrowing from the government until such time as the land is sold; the postponement provisions should be structured so that the government receives a market rate of interest on its loan.

Analysis of land values and of the turnover in land ownership would be needed prior to setting specific rates of tax and apportioning the incidence of tax between the holding and the transfer of land. Once implemented, a land tax is harder for tax payers to evade (land is visible and ownership is generally clear). Fiscal impacts of adjustments in the levels of taxation can also be more readily assessed.

CONTRACT LAW

Introduction: Capital is a necessary ingredient to all entrepreneurial activities. However, capital is a limited resource in the short-term and, as such, countries must take steps to ensure its supply, distribution, and accumulation. In non-centrally planned economies, markets are the means by which capital resources are allocated. But, markets must function within the broader institutional framework established by governments. These institutions have a strong effect on how capital (and other) resources are allocated. For a thriving market economy there must be institutions that provide secure individual rights. Such rights must insure that individuals, and the firms they create, can best advance their interests by being as productive as possible and engaging in mutually beneficial trade. The incentives to save and to invest resources depend upon individual rights to marketable assets -- on property rights.

a society cannot have much borrowing and lending or obtain many of the other gains from mutually advantageous trade unless individuals and firms have the right to make contracts with one another that will be impartially enforced. If there is no right to create legally secure corporations with limited liability, the private economy cannot properly exploit those productive opportunities that are too large for most individuals to undertake. If there is no legal framework to encourage invention through patents and copyrights or to facilitate risk-sharing through insurance or other mechanisms, a market economy will be defective.

In stable democracies where there is widespread confidence that individual rights can be relied upon over the long run there tends to be greater economic growth. These are the societies where property and contracts are most predictable. It is in these societies that capital is least scarce and where it would accordingly be expected to have the lowest return. Capital nonetheless often flees to these societies from capital-poor countries with undemocratic, unstable, and otherwise inadequate institutions.

Nepal now has a democratic system of government, yet many of the institutions from the previous regime remain in place. One of the primary responsibilities of the newly elected government will be to ensure that the society's laws and policies are in harmony with the new constitution. In order to achieve this many of the institutions which have been carried over from the previous government will need to change. It is important that a democratic government establish institutions which will be representative of all the people and will take the economic actions necessary to insure that resources are allocated as efficiently and evenly as possible. Private-sector led market development is the best means to achieve this.

While there are many policies which contribute to Nepal's private-sector climate, one area where relevant steps are possible is contract law.

Litigation and Enforcement

Discussion: The legal enforceability of contracts helps individuals to advance their private ends by cooperating with one another. Through their cooperation, parties engage in an opportunity to create greater value than is possible when acting alone.

As the contract law in Nepal presently stands, if a dispute is not submitted to the court system within three months of a breach of contract the contract is declared void and liability is dismissed. Such a law is highly inefficient because it encourages those parties which are in breach of contract to use delaying tactics until the three month limit has passed. Thus, the existing contract law discourages the productive combination of resources among parties and is an incentive to limit formal transactions to a small circle of trusted people, i.e., family and friends. In addition to discouraging more productive combinations of resources, an inadequate contract law can also be a disincentive to business registration.

Recent research in the Philippines reveals that entrepreneurs who operate unregistered businesses would be inclined to register if contract enforceability was certain. This problem is common to many developing economies; Nepal is not likely to be an exception.

Options

- 1. Contract law should be amended, extending the existing three month litigation period.*
- 2. A mechanism should be established which guarantees the rapid enforcement of contract disputes.*

Option 1:

Contract law should be amended, extending the existing three month litigation period.

The contract law should be amended to increase the length of time within which litigation may take place. This is especially pertinent given the Nepalese tendency to resolve disputes first through third parties and only later through judicial processes.

Resolution of disputes by third parties can be a long slow process and usually lasts longer than three months. Therefore, in extending the litigation period time should be made available so that, if third-party conflict resolution is unsuccessful, the parties will still have access to means of legal redress. Such an amendment to the contract law should promote greater economic efficiency by allowing entrepreneurs to enter into contracts with the knowledge that disputes about their rights can be resolved by an impartial third party using fair standards of decision making. Also, by strengthening contract enforcement mechanisms unregistered businesses might be induced into the formal economy as there would then be secure means for advancing their individual ends through cooperation.

Option 2:

A mechanism should be established which guarantees the rapid enforcement of contract disputes.

A mechanism (such as a tribunal or bureau) could be established which guarantees the rapid enforcement of contract disputes, particularly for small and medium enterprises. Such a mechanism does not necessarily have to be a dual court system, rather it could be an alternative to which the private-sector had recourse in place of the present overburdened and slow judicial system. There are two possible alternatives for such a system:

1. A small claims court where procedures could be simpler than the existing judicial system.
2. An administrative body with sole responsibility for adjudicating contract litigation.

Further, this mechanism would work best if the entity held disciplinary authority, within statutory limits, to assess damages, require performance, or assess other penalties, for breach of contracts. Models in developed market economies include so-called "small claims" courts or non-governmental arbitration panels.
