To Graduate, or Not to Graduate

Nepal's private sector has expressed concerns over the government's decision to make a transition from the league of least developed countries to that of developing nations fearing the potential loss of special treatments. But is the situation as dire as that ?

--BY Rupak D Sharma

What will happen to international support measures once Nepal graduates from the league of least developed countries (LDCs) to that of developing nations? This is the question hovering over Nepal as the country prepares to exit the group of LDCs.

Nepal became eligible for LDC graduation in 2018 as it had met the criteria developed by the United Nations (UN) for the transition. But the government decided not to take the leap as it was still recovering from the effects of the devastating earthquakes of 2015.

The UN has set three criteria for LDC graduation: income, human assets and economic vulnerability. If an LDC has a per capita gross national income of USD 1,230 or more, it meets one of the criteria for graduation. The other two criteria are: human asset index, which should stand at 66 or more, and economic vulnerability index, should remain at 32 or less. LDCs that meet two of the three criteria during two consecutive triennial reviews of the UN Committee for Development Policy (CDP) -- which assesses the situation of graduating LDCs -- are eligible for graduation. Countries with double the minimum income level can also make the transition to the group of developing nations. This means LDCs with a per capita gross national income of USD 2,460 or more during two triennial reviews of the UNCDP can graduate under the income-only criterion without achieving the targets on human assets and economic vulnerability.

Nepal has met the human assets and economic vulnerability criteria for graduation. As per the review conducted by the UNCDP in 2018, Nepal's human assets index stood at 71.2. Nepal has obtained a score of 28.4 in economic vulnerability index. If Nepal graduates, it will be the first country to leave the group of LDCs without meeting the income criterion. This is where, many say, the pitfall lies.

The Covid-19 pandemic has greatly reduced income of certain groups, pushing an estimated 1.2 million additional Nepalis back into the trap of poverty, according to the National Planning Commission. This loss of income is expected to hit the social sector, where the school dropout rate and malnutrition cases are expected to rise, affecting human assets formation. These aspects have not been taken into account as the country is preparing to make the transition and it may take a few more years to ascertain the impact of Covid-19 on the social sector and the economy. Yet the government is not worried about these issues, as Nepal's scores in human assets and economic vulnerability indices are well above the threshold. This is the reason the government is mulling over moving ahead with the graduation process.

But the private sector lobbying bodies, like the Federation of Nepalese Chambers of Commerce and Industry (FNCCI) and the Confederation of Nepalese Industries (CNI), are not happy with the initiative taken by the government. They have warned that the economy may suffer if the government makes a "premature decision", as graduation would snatch away many special treatments granted to LDCs.

Graduation criteria

	Threshold	Nepal's achievement*
GNI per capita	USD 1230 or more	745
Human assets indiex	66 or more	71.2
Economic vulnerability index	32 or less	28.4

**As of UNCDP report of 2018* *(Source: UN)*

Loss of special benefits

As an LDC, Nepal is currently eligible for many trade preferences and flexibilities under the rules of the World Trade Organisation (WTO). After graduation, those trade-related benefits will either cease to exist or get less generous. For example, Nepal is currently exporting goods to the European Union under the duty-free market access arrangement called 'Everything But Arms' (EBA). Under this arrangement, the EU does not impose any tariff on any goods, excluding arms and ammunitions, imported from LDCs, including Nepal. Once Nepal graduates, it will continue to enjoy the same benefits for a three-year transition period, which can be extended for another three years. But after that period Nepal will no longer remain eligible for those benefits.

Once the concessions evaporate, Nepal can apply for EU's Generalised Scheme of Preferences (GSP) or another arrangement called GSP Plus. But under these two schemes, exports of developing countries can enjoy duty reduction or suspension on only around 66 percent of the tariff lines. Under GSP and GSP Plus, minimum domestic value addition would also jump to 50 percent from 30 percent. This roughly means Nepal must produce at least 50 percent of the inputs, including labour and other raw materials, domestically to utilise special benefits granted by GSP and GSP Plus, as against 30 percent under the EBA arrangement.

Almost all of the countries and regions demand higher domestic value addition on goods of developing nations seeking preferential treatment. Under the South Asian Free Trade Agreement (SAFTA), for instance, LDCs are subject to a local value addition of 30 percent, whereas the threshold for non-LDCs is 40 percent. Goods that fail to meet the criteria on domestic value addition will be denied preferential treatment of duty-free quota-free access. This may amount to a double whammy for countries that have just graduated, as many of their goods will no longer be eligible to make duty-free quota-free entry following the transition. In other words, once countries join the league of developing nations, many of their goods that previously gained duty-free quota-free access because of their LDC status will be subject to higher tariffs, albeit this won't affect Nepal's trade with India, Nepal's largest trading partner, as it is largely guided by the bilateral trade treaty.

Overall, Nepal should expect an average tariff increase of around eight percent on all of the goods that it exports once it graduates, a latest WTO report states. This estimate was made assuming full utilisation of preferential treatment offered to Nepal.

But Nepal has never fully tapped LDC-specific preferences.

Utilisation of LDC-specific preferences

The US, for example, provided duty-free preferential treatment for 66 Nepali products after the devastating earthquakes of 2015. But a study showed that only 2.4 percent of the goods exported to the US in 2017 had actually used that facility. The US also allows duty-free entry to more than 5,100 products manufactured in least developed beneficiary developing countries. Results showed that only 0.5 percent of goods exported by Nepal to the US in 2017 reaped the benefits from the facility.

These examples show that Nepal relies very little on LDC-specific preferences. Estimates of the WTO show that only around 16 percent of Nepal's exports depend on preferences accorded to LDCs. Because of this low exposure, Nepal's exports are expected to shrink by 2.5 percent after graduation. This figure on export reduction is much smaller than that of Bangladesh, which is also all set to make the transition to the league of developing nations. Exports of Bangladesh are expected to plunge around 14 percent after graduation, as over 70 percent of its exports utilise LDC-specific preferences, says the WTO report.

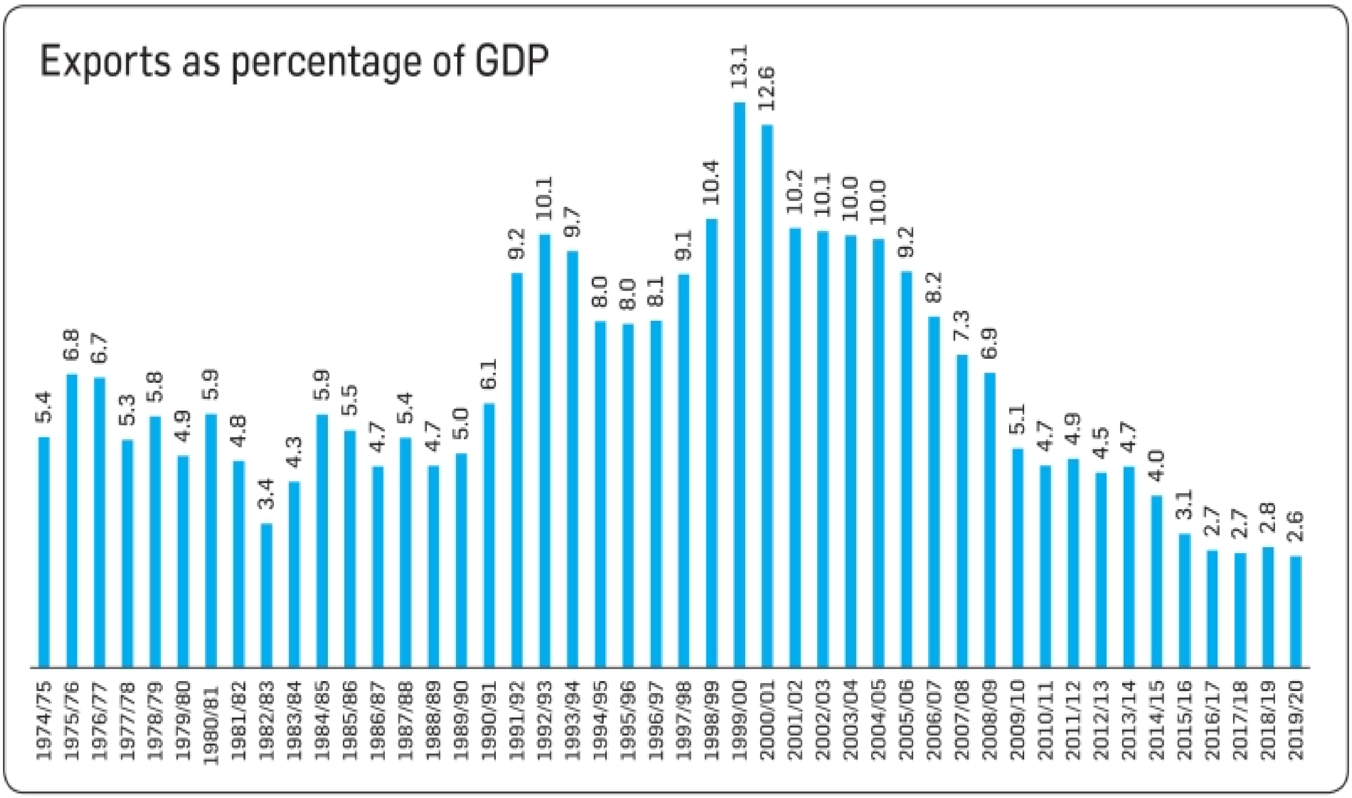
"It would be wise for Nepal to put its graduation plan on hold for now considering the losses that Bangladesh is likely to suffer," said Ranjit Raj Acharya, chairperson of Startup and Innovation Committee of the FNCCI. "The deferral would help Nepal claw back the readymade garment market lost to Bangladesh. This can stimulate Nepal's readymade garment sector, which has not been able to expand at a desired pace."

Readymade garments was once Nepal's biggest export item. It made a contribution of about 49 percent to Nepal's total exports in fiscal year 1999-2000. In those days, over 1,000 garment factories located in the peripheries of Kathmandu Valley and industrial areas of the eastern district of Jhapa provided employment to over 50,000 people.

The sector started suffering after 2001 following the intensification of the Maoist insurgency in the country and 9/11 terrorist attacks in the US, which used to consume over 80 percent of Nepal-made garment products. These factors, coupled with higher production and transaction costs, brought down the share of readymade garments in total exports to 17.8 percent in 2004.

The sector, which had already started reeling from 2001, finally collapsed on 31 December, 2004 following the expiry of the WTO Agreement on Textiles and Clothing. The abolition of the quota regime following the expiry of the WTO pact eroded the price competitiveness of Nepali garments in the US, leading to the closure of most of its factoties in Nepal. A year after the quotas expired, the number of garment factories in the country plunged to around 30 and reduced the number of jobs in the sector to around 4,450. This pulled down the share of readymade garments in total exports to 6.7 percent in 2007. The downfall of the garment sector and inability to diversify exports reduced Nepal's total exports by 1.4 percent in fiscal year 2006-07. In that year, contribution of exports to GDP fell to 8.2 percent from 13.6 percent in 1999-2000.

Nepal then ramped up lobbying for preferential access to the US market, which was essential to revive garments exports from the landlocked country. But at the same time, it did not focus on enhancing the skills of workers, upgrading technology, reforming labour and tax policies, and reducing logistics and other transaction costs. Bangladesh, on the other hand, introduced various reforms and took advantage of its cheap labour to resurrect the industry after the abolition of the quota regime. These measures have helped Bangladesh to become the second largest exporter of garments in the world after China.



(Source: Nepal Rastra Bank)

Enhancing Export Potential

One of the inherent weaknesses of Nepal has been its inability to ramp up exports. A working paper of the UNESCAP said that Nepal has not even tapped into a third of its export potential. In 2017, for instance, Nepal's total exports stood at USD 741 million, which was way below the potential of USD 2.31 billion, according to the paper, which made projections on export potential using the gravity model. The largest difference between actual and potential exports is with India, followed by China. Nepal could potentially earn an additional USD 1 billion from India and an additional half a billion dollars from China, the paper said, adding, Nepal is under-exporting by about USD 50 million to Bangladesh, USD 24 million to Pakistan and USD 18 million to Japan. Nepal's inability to expand sales in the foreign markets squeezed the share of exports in GDP to 2.6 percent in fiscal year 2019-20 from 5.4 percent in 1974-75, the year when Nepal started collecting import-export data.

"Considering the existing situation in which Nepal has not been able to utilise trade preferences to find overseas markets for its goods, graduation is not expected to have a drastic impact on Nepal's exports," said economist Biswo Poudel. "But vulnerability assessment is a must. Based on this study, Nepal should hold discussions at the bilateral level or make use of regional arrangements to make sure its exports do not suffer. What may also come in handy are incentives for sectors that are highly sensitive to erosion in preferential and special treatments. This will help them recoup the losses."

Nepal, so far, has not conducted a comprehensive independent study on the impacts of graduation. Whatever research has been done has been carried out by development partners like the UN. These development partners have developed support mechanisms to help LDCs during the transition phase. Enhanced Integrated Framework, a partnership of 51 countries, 24 donors and eight partner agencies which assists LDCs, for example, has expressed commitment to support LDCs in the area of trade for a period of five years from the date of graduation. The UN Technology Bank has also said LDCs can tap its facility for a period of five years after graduation. Even the WTO, which does not have any provision for LDC graduation, has been holding discussions since 2017 to create support mechanisms for least developed countries that intend to make the transition. This means the graduation issue has entered the WTO agenda.

As the issue of LDC graduation is gaining traction, least developed countries are demanding that concessions accorded to least developed countries by Article 66.1 of WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) be extended to graduated LDCs for a period of 12 years. Article 66.1 of the TRIPS Agreement has exempted LDCs from adhering to any of the pact's provisions, except Articles 3, 4 and 5, which mostly revolve around the notion of the 'most favoured nation', a principle that prevents countries from discriminating between trading partners. If the demand of the LDCs is met, one of the biggest beneficiaries in Nepal would be the pharmaceutical sector, which will be allowed to reproduce, and export patented pharmaceutical products without any hindrance.

These efforts to extract concessions are expected to yield encouraging results as 11 LDCs are now on the path towards graduation and the UN is also concerned about the fate of these countries.

International support measures

Many Asian countries use the Maldives as an example to argue early graduation could lead to problems. The experience of the Maldives, which deferred its graduation for seven years untill 2011 due to the devastating tsunami of December 2004, shows the beating it took, especially in trade, due to the infancy of the graduation programme. At the time when the Maldives graduated, only two countries -- Botswana and Cabo Verde -- had graduated. So, there was a "lack of coordinated commitment from bilateral partners", which failed to make the graduation process smooth.

That is not the case today. The UNCDP has proposed establishing a "graduation support facility to provide technical assistance to graduating LDCs in the preparation and management of graduation". Another UN organisation, UNESCAP is also holding a meeting in Dhaka this year to find out ways to make LDC graduation sustainable. What is also encouraging is that donors, both multilateral and bilateral, have stated in a 2018 UNCDP report that LDC graduation is unlikely to make any significant changes to the allocation of aid, including concessional finance, for Nepal.

Of course, a few UN organisations like the UNDP and UNICEF will cut aid to Nepal after it graduates, as they have an obligation to provide 60 percent of their total support to LDCs. Nepal may also lose another LDC-specific support known as the Least Developed Countries Fund (LDCF) managed by the United Nations Framework Convention on Climate Change (UNFCCC). LDCF offers climate change-related assistance. But even if Nepal loses access to this aid, it will remain eligible to tap into many other climate change funds even after graduation, though it may have to compete with other developing countries as some funds prioritise LDCs, small island developing states, and African countries.

"Nepal must realise that aid and trade preferences are not permanent fixtures. They will cease to exist as the country moves up the development ladder. The long-term solution to Nepal's problems is capacity enhancement in almost every sector. Perhaps, it should also do some soul-searching on how countries like Bangladesh were able to leapfrog while it remained where it was," says Paras Kharel, research director, South Asia Watch on Trade, Economics and Environment (SAWTEE), a prominent think-tank.