# STATUS AND CONTRIBUTION OF FOREIGN DIRECT INVESTMENT IN NEPAL

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## ABBREVIATIONS

**BIMSTEC** Bay of Bangle Initiative for Multi-Sectoral Technical and Economic Cooperation

**CPI** Corruption Index

**DFI** Direct Foreign Investment

**DoI** Department of Industry

**EU** European Union

**FDI** Foreign Direct Investment

**FITTA** Foreign Investment and Technology Transfer Act

**FSI** Failed State Index

**GoN** Government of Nepal

**IMF** International Monetary Fund

**LDCs** Least Deleoped Countries

**LLDCs** Landlocked Developing Countries

**MNES** Multinational Enterprise

**MNCs** Multinational Companies

**OLI** Ownership, Location and Internalization

**OECD** Organization for Economic Cooperation and Development

**SAARC** South Asian Association for Regional Cooperation

**SAPTA** South Asian Preferential Trade Arrangement

**SEZs** Special Economic Zones

**TNCs** Transnational Corporations

**UNCTAD** United Nations Conference on Trade and Development

**UN** United Nations

**U.S./US** United States

# CHAPTER I: INTRODUCTION

## 1.1 Background

In the recent years, Foreign Direct Investment (FDI) policies has become one of the central economic policies for the developing countries, learned from the experiences of newly industrialised countries (NICs) like China, India, Brazil, South Korea, Singapore, Hong Kong and Taiwan which promoted FDI as the catalyst of rapid economic growth in the early stages of their economic development.

The role of FDI in economic growth in the developing countries is that FDI generate more benefits to the recipient countries rather than just full filling the short-term capital deficiency problems. Foreign direct investment has potential to generate employment, raise productivity, transfer skills and technology, enhance export and continue to the long- term economic development of the world's developing countries.

Transfer of technologies and its spillover effect to the local firms make them more competitive and high standards which is necessary to compete with the foreign products. Another, spillover effect of MNEs is that MNEs may provide training and labour management which may make them available to the economy in general. The training to local suppliers by MNEs may increase the high standard production and managerial standards. The relationship between foreign direct investment and economic growth is one of the well studied subject in the field of development economics. The research interest in this field has increased after 1990s wave of globalization and massively increased FDI across the globe and economic growth of FDI receiving countries.

Globalization has been leading reason behind the increase in foreign direct investment in developing countries. Globalization and liberalization has increased the competition among the different firm, companies and MNEs of the world. This has forced firm to change their approaches, direction in search of new market, consumer, sources of raw material, plants, developing new technology and

know-how. All these required large inflow and outflow of capital from one country and to another countries. Hence a FDI flow from developed countries to developing countries has impact economic growth, local market, local competitor, consumer of host countries. Many developing countries in the world whether it may be in Asia, Africa, South East Asia, South America no one has been save from impact of FDI by the large MNEs.

The main importance of FDI on economic growth is that FDI are embedded with the new technologies which become the pivotal driver for economic transformation of developing and under developed economies. The local firms learn new technologies from the MNCs in one hand; they try to improve the managerial and technological aspects of the operations on the other hand. In the recent years, every country has the policy to attract more FDI in their economic policies. FDI, particularly in the form of equity investment, adds to the capital stock of the country and thus enables the recipient country to achieve faster economic growth through momentum in capital formation. Increases in FDI are also seen as leading to increases in exports by creating international markets through new marketing and organizational skills.

The integration of global economies is enhanced by flow of FDI across the globe. MNCs go cross boarder operations with the view of market seeking, raw materials explorations and low operations costs. MNCs are important for developing economies because they invest in the green fields which help to improve the infrastructure of the economy.

Nepal cannot be far from the benefits of Foreign Direct Investment (FDI). So Nepal has given priority for the attraction of FDI and its development by different polices and rules in national and international level to promote foreign investment and technology transfer for making the economy viable, dynamic and competitive through the maximum mobilization of the capital, human and other natural resources.

Nepal’s neighboring countries both China and India have achieved higher economic growth rate along with the massive inflow of FDI. Not only India and China, other neighboring countries recorded higher level of economic grow in the recent years. Nepal had attracted modest FDI in

niche sectors such as tourism, herbal products, mineral deposits (lime stone), and light manufacturing apparel, hydro power and that it had positive impacts on exports, particularly garments. FDI has also enabled the country to export non- traditional manufactured products such as micro-transformers and personal consumer products (UNCTAD, 2003b). Investment was mainly in low-technology, labour-intensive production. The impact of FDI had also been modest, primarily in job creation. According to the various studies an reports done in the field of FDI in the past, FDI inflow was constrained by political instability, outdated foreign investment law, rigid labour regulations and poor physical infrastructure.

Today, Nepal is one of the most liberalized countries in the South Asian region. However, growth performance has not been satisfactory till a year ago but it has been in the increasing trend in the last year after second constitutional election. There are highly liberal FDI and GDP-related policies supplemented by important Acts. In the aftermath of liberalization that began in the early 1990s, FDI increased substantially. However, that could not be sustained for long. After becoming a World Trade Organization (WTO) member in 2004, Nepal has been pursuing further opening up and liberalization policies on the FDI. Nepal is also a member of the South Asian Preferential Trade Arrangement (SAPTA) and the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC). New initiatives on FDI have been taken with the aim of enhancing sustained growth and reducing poverty.

Although the Government of Nepal (GON) is open to foreign direct investment, implementation of its policies is often distorted by bureaucratic delays and inefficiency. Besides this, Nepal is still facing some problems for FDI because of lack of direct access to seaports, difficult land transport and lack of trained personnel, scarce raw materials, inadequate power insufficient water supply, non-transparent capricious tax administration inadequate and obscure commercial legislation, and unclear rules regarding labor relations.

## 1.2 Significance of the Study

Foreign direct investment is very necessary lubricant to generate economic growth in the developing country like Nepal. FDI is frequently viewed as instrumental in promoting industrial growth and foreign trade particularly in developing countries. FDI maintains relatively open economies, stable macro-economic conditions and limited restrictions on foreign exchange transactions. It frequently stimulates competition, productivity and innovation by local suppliers because local suppliers compete for lucrative contracts with multinational enterprise.

Further, it generates income and employment opportunities resulting in higher wages, competitive price, more revenue, skills and technology transfer and increased foreign exchange earnings. Similarly, it enhances entrepreneurial capability when the foreign firms bring with it some firm specific knowledge in the form of technology, managerial expertise, and marketing know-how. It also allows new local entrants to learn about exports markets, provide training for workers and stimulates competition with local firms.

This study of Status and Contribution of Foreign Direct Investment in Nepal would help government, other stakeholders and think-tanks to create the necessary and amicable condition to attract FDI in Nepal.

## 1.3 Statement of Problem

Nepal is potentially attractive location for foreign investors. Sandwiched between two emerging countries of the world with India in the south and China in the North, Nepali manufacturers have free access to the India market, and tariffs on imported raw materials and components are lower here than South Asian countries. The varied climate, natural resources and terrain provide a wealth of niche opportunities, many of which are barely being exploited at all. Nepal has attracted modest FDI in niche sectors such as tourism, light manufacturing (apparel) and mineral deposits (lime stone). The impact of FDI has also been modest primarily in job creation.

With the liberalization and privatization policies undertaken in the 1990s, Nepal should have been able to attract more FDI and private capital flows. But present scenario reveals that the ability of Nepal to attract private capital and FDI has been less than expected. Despite the ample facilities and liberal legal provisions, the flow of FDI to Nepal is not satisfactory. An assessment of the probable reasons for the declining FDI is thus recognized as the problem of the present study.

## 1.4 Objectives of the Study

The basic purpose of the study is to analyze comparison of flow of foreign direct investment in Nepal, South Asia and World. This study explores, whether FDI played role in economic growth or not? The specific objectives of the study are as follows:

- To explore the status and contribution of foreign direct investment in Nepal.
- To study the facilities and policy provided by the Ministry of Industry & supply and Government.
- To suggest recommendations for attracting FDI in Nepal

## 1.5 Approach and Methodology

Based on the statement of problem of this study, it has used the existing literature in order to gain a deeper understanding of this phenomenon as well as analyzed Nepal's data relating to FDI. This study is mainly based on secondary data and information. The description of the situation of FDI in Nepal including historical background is qualitative analysis. While the numerical data of inflows of FDI in the World, South Asia, and Nepal as well the graphic representation of facts and figures are the quantitative analysis.

**Sources of Data**

Secondary data are those, which have already been collected by someone else and those which are contained in the published as well as unpublished reports, books and documents. The

secondary data are gathered from World Bank Reports, UNCTAD reports, data from Department of Industry ,Nepal Rastra Bank, economic reports, various articles and publication dealing in the subject matter of the study, websites etc. The researcher had depended upon the secondary source for the collection of data. The study covers the collection of data only a period of 10 years from the fiscal year 2004 to 2013 and conclusion drawn confines only to the above period.

**Data Analysis**

The goal of analyzing the data is to handle the evidence fairly, to produce convincing logical conclusion and to rule out alternative interpretations. The data was collected from different sources to process, analyze and interpret them to drive meaningful conclusion.

The various data collected from different sources was compiled condensed, analyzed and presented in the form of tables and diagrams, graphs and chart. In order to exclude the irrelevant unnecessary data and process them as per thesis requirements, data was edited and properly tabulated. The data was arranged, grouped and accordingly entered into appropriate tabular form. Moreover, simple one-way table has been used to present the data, which has been flowed by an in-depth interpretation as necessary for the thesis to prepare for the students of Economic department.

## 1.6 Limitation of the Study

Every type of research has limitations and this study is not also immune from this. Due to time and resource constraints, primary survey of FDI could not be conducted. The study has been mainly based on secondary data to assess the policy framework of FDI in Nepal and analyze trend, structure and the contribution of FDI in Nepal.

# CHAPTER II: REVIEW OF LITERATURE

## 2.1 An Overview of Foreign Direct Investment

Multinational corporations (MNCs) commonly capitalize on foreign business opportunities by engaging in direct foreign investment (DFI), which is investment in real assets (such as land, buildings or even existing plants) in foreign firms, acquire foreign firms, and form new foreign subsidiaries. Any of these types of DFI can generate high returns when managed properly. However, DFI requires a substantial investment and can therefore put much capital at risk. Moreover, if the investment doesn't perform as well as expected the MNCs may have difficulty selling the foreign project it created. Given these return and risk characteristic of DFI, MNCs tend to carefully analyze the potential benefit and costs before Implementing any type of DFI.

FDI is conventionally defined as a form of international inter-firm cooperation that involves a significant equity stake in, or effective management control of foreign firm (de Mello, 1997)

FDI is the international movement of capital for specific investment purposes. Such investments are made for the purpose of actively controlling property, assets, or companies located in host countries. Business organizations undertake FDI to expand foreign markets or gain access to supplier of resources or finished products. FDI occurs when overseas companies set up or purchase operations in another country.

FDI can be categorized into three components: equity capital, reinvestment earnings, and intra company loans. Equity capital comprises of the shares of the companies in countries foreign to that of investor. Reinvested earning includes the earning not distributed to shareholders but reinvested into the company. Intra- company loan relate to financial transactions between a parent company and its affiliates. FDI thus may take many forms, including

- Purchase of existing assets in a foreign company

- New investment in property like land and building.
- Participation in a joint venture with a local partner.
- Merger and acquisition of activities.

Balance of payment accounts define foreign direct investment as any flow lending to or purchase of ownership in a foreign enterprise that is largely owned by residents of the investing country. (Kindreberger 1987)

FDI is the act of acquiring assets may be financial, such as bonds, bank deposits, and equity shares or direct investment and involves the ownership of means of production such as factories and land. Direct investment is considered to take place also if the ownership of equity shares provides control over the operation of firm. (Johnson 1970) has suggested the expansion of the concept of foreign investment so that it parallels the modern fisherian approach and distinguishes physical human knowledge capital. Focusing on foreign direct investments undertaken by firms, industrial organization theorist analyzed the location choices of multinational enterprises. This approach was pioneered by John Dunning (1977), who suggested that firms undertake FDI when three factors are present, and the resulting advantages are sufficient to offset the natural disadvantages of having to operate in foreign country. These are known as the "Ownership, Location and Internalization" (OLI) advantages. A firm must have some product or technology that enables it to enjoy some market power in foreign market (ownership advantage), the firm must see some advantage in producing in foreign location rather than at home (location advantage), and there must be some reason for it to want to exploit the ownership advantage internally, rather than use a market based mechanism to gain payments for it (Such as license or sell its product or technology in the market for a fee.

Hymer (1960) introduced microeconomic theory on international production. Hymer noted four discrepancies as noted by Heledd Straker ( Understanding the global firm), (1) the older theory suggested that flow of capital was one directional, from developed to underdeveloped countries, whereas in reality, in the post-war years, FDI was two- way between developed

countries; (2) a country was supposed to either engage in outward FDI or receive inward FDI only. Hymer observed that MNEs, in fact moved in both directions across national boundaries in industrialized countries, meaning countries simultaneously received inward and engaged in outward FDI; (3) the level of outward

Hymer (1960) found that American FDI was mainly concentrated in a few industries and monopolized by several companies. Hymer described two reasons of firms being MNEs, (1960) as quoted by Aliber (1969) (i) There is market imperfections; firms become MNEs due to the possession of a competitive advantage and their ability to maximize their productivity by using this competitive advantage in another country. (ii) The competitive structures of some industries would encourage firms to internationalize more than those in other industries. These advantages must not be available to host country firms on the same prices and terms as to the source-country firms. Multinational companies (MNC's) were the product of imperfect markets and monopoly advantages where the companies had the advantage with regards to choosing where to invest. FDI was found to vary between industries, meaning that if capital availability was the driver of FDI, then there should be no variation, as all industries would be equally able and motivated to invest abroad; (4) as foreign subsidiaries were financed locally, it did not fit that capital moved from one country to another. A number of conclusions can be drawn from Hymer's analysis that helps frame up this study:

- First, FDI tends to flow into differentiated markets where a MNC believes they will have an advantage competitively.
- Second, companies that are able to make investments overseas all have certain advantages, such as economies of scale, differentiated products, special skills, and low-cost production. These companies will make investments in regions that do not have these advantages.
- Third, there are many ways in which MNCs can invest overseas in such as exporting, and licensing, in addition to direct investment. MNCs without local partners always prefer to choose foreign direct investment.

- Last but not the least Hymer found that about half of the overseas operating capital of American firms came from host countries; thus FDI tends to flow into the countries or regions that have developed financial systems and capital markets.

Caves (1971) classified multi plants in to three groups:

(1) Horizontal multi plant enterprises: multi plants which produces the same types of goods from its plants and serve across the geographic markets and they can control with lower costs and higher productivity to exist in the market.

(2) Vertically integrated MNEs: Such MNEs produce goods as the input for other plants to reduce the costs and reduce the uncertainties of products.

(3) Portfolio diversification and the diversified MNE. He also argues MNEs pursues profits by moving equity from countries its return is to low Countries where it is high. The firm's make profit because of the activity.

Buckley and Casson (1976) in their internalization theory suggested that multinationals came into existence because of market imperfections created the opportunity to internalize transactions within a firm. Rather than conduct business externally between two firms- in separate countries, it made sense to instead maximize profits by doing business internally across national boundaries. Two things are important here (i) firms would choose the least cost location and (i) firms would internalize until the cost outweighed the benefits.

- In reality, all MNEs do not choose the least cost location to internalize the profit from abroad. Cultural, regulatory and environmental factors are also considered by the entrepreneurs to set up MNEs instead of cost factors (Jigme, 2006).

Vernon's (1966, 1976) Product Life Cycle theory is another development in theory of Internalization in FDI literature. According to Vernon, the form of entry into foreign market depends on stages of product life. Products pass through introductory phase, growth, maturity

and decline phase. Many firms launch in new products where the products are developed and FDI will local market oriented. In later stage, when products become standardized and mass production prevails. Cost considerations in the context of increased competition will pressure on MNEs to relocate its production to less advanced countries with comparative advantage of cheap labour. Hence, FDI in the later phase of PLC will be export oriented, influenced by cheaper labor force. In the decline stage of PLC, the product innovating country becomes the net importer of the products.

- PLC theory is applicable for some products but it is not applicable for the vertically integrated MNEs. Some critics say that sometimes entrepreneurs purchase foreign assets prior to actually launching the products (Jigme, S. 2006).

Kojima (1978) focused that FDI move abroad due to the location advantage because. Hence, FDI should move from industries in countries which have less comparative advantages to the host countries where better comparative advantages are prevailing and not realized yet.

Prof. J. H. Dunning (1981, 1985, and 1988) synthesized the prior theories FDI and developed the theory of eclectic paradigm. The operations of MNEs are determined by three factors: Ownership-specific advantages (O), the firm of one nationality possess advantages relative to those of another country in host country market. Internalization- specific advantages (I), the extent to which enterprises find it profitable to use these advantages themselves rather than externalize them through licensing or similar contracts with independent firms. Location-specific advantages (L), the extent to which firms find profitable to combine the use of internalized ownership-specific advantages with resources in a foreign country rather than in the home country. FDI will take place when three advantages come together. OLI guides MNEs regarding investment, ‘why’, ‘where’ and ‘how’.

Dunning’s model for key factor determinants internalization process is shown as follows.

- Factors

- Internalization
- FDI

Lall (1996) describes the advantage of ownership advantages “market failures lead to the growth of large firms and oligopoly market structure in national economies (so creating ‘ownership advantages). Those firm may choose to exploit these advantages by direct investment rather than licensing to them to unrelated firms (because of the transnational advantages of internalizing the relevant markets), and the process of internalization may itself generate fresh ownership advantages”.

The basic reasons for attracting FDI by developing countries are:

- Capital Transfer: Developing countries lack capital resources. FDI is an Importance means of capital flows.
- Productivity Improvement: FDI facilitates technology transfer. Technological up gradation results in productivity improvement.
- Management Development: Local management people get trained in foreign firm. They acquire new concepts, tools and techniques of management.
- Employment: Foreign Company generates employment. Due to cheap labor in developing countries, outsourcing is on the increase by global companies. Worker acquires new skills.
- Better Product: Foreign Company produces qualitative and branded products. They have high image. They assure quality and supply of product.

## 2.2 FDI and Entry Model

Dunning (1996) firms initially engage in across national boundaries for one or two reasons. One to acquire inputs at lower cost than from domestic sources and second to protect existing market or to new seek markets for domestically produced goods. The mode of entry in to foreign production will differ according to the reason for that entry. Some MNEs go across the national boundaries seeking raw materials, some market seekers and some low cost seeking

countries. Green field investment, Merger and Acquisition, and Joint venture mode of entry involves equity investments. In Greenfield investment, foreign firms invest infrastructure development for the resource utilization and production. The investment in Greenfield sectors develops infrastructure in addition to create job opportunities.

In Merger and Acquisition, foreign firms enter the host countries by acquiring the equities or buying the assets, investing technology, brands and information etc. Merger and acquisition enhances the efficiency of the local firms from the foreign management skills, technology and marketing strategies. Basically, merger and acquisition doesn't create new industry. Both Greenfield investment and merger and acquisition create a single firm ownership of business. But joint venture business establishes the ownership among two or more firms.

According to World Investment Report (UNCTAD, 2008) growth in FDI flows in 2007 was driven by cross-boarder M & A activity; a number of mega deals including over US $ 1 billion pushed the total value of cross-boarder M&A to record of US $ 1,637 billion in 2007.

Impact of FDI on economic growth: Some Empirical Evidences

- The massive literature on role of FDI on economic growth has shown various types of affects (positive, negative or insignificant) of FDI in various countries.
- Berry and Kearney(2006) the most common character through which spillover are understood to operate include technology transfer, demonstration effects (through management skills and training to export) and greater competition(leading to productive efficiency). A significant presence of MNEs can bring about fundamental changes in industrial structure, particularly for smaller and medium sized countries. If foreign MNEs operate in sectors that are imperfectly correlated with those dominated by indigenous firms, FDI can help create a better diversified economy.
- Chung et al (2003) Technology transfer occurs when there is contact between foreign and local firms. Japanese auto transplants increased production process in North

American significantly influenced the industry's productivity growth during this period (1982-1991).

- Caves (1974) argued that FDI also improves the allocative and technical efficiency through competitive pressure. Foreign entrants break down entry barriers, compete for factor inputs and customers and reduce the market power of entrenched firms.
- Zhang et al (2004) studied on impact of MNEs behavior through FDI on international trade and vice versa. They used Granger causality co integration approach to observe the direction of FDI and trade linkage of Chinese economy in 1980- 2003 period. They found that more imports lead higher level of FDI, more FDI leads to more exports and more exports FDI. This virtuous process reflects China's open door policy.
- Chakraborty and Basu (2002) study showed two-way link between foreign direct investment and growth for India using structural co integration model with victor error correction mechanism. They found strong evidence of GDP Granger causing FDI flows for India, there was not significant role in the short run adjustment process of GDP. Short-run increase in FDI flows for India is labor displacing in nature. The technology transfer brought in by FDI causes an excess supply of labour creating downward pressure on unit labor cost.
- Borenzstein et al (1995) introduced a new model showing the impact of FDI in economic growth using an endogenous model growth model. They analyzed FDI flows from industrialized countries to 69 developing countries during 1970-1989. They argued that due to the direct FDI there is increase in capital accumulation and in host countries and transfer of technology lead increases productivity which causes the economic growth of the host countries. Their result showed that FDI is an important vehicle of technology transfer, contributing more economic growth than domestic investment where they make a case of minimum threshold stock of human capital necessary to absorb foreign technologies and linkage between FDI and human capital and domestic investment are crucial to achieve the economic growth. Other subsequent studies by Subramanyam et al., (1996) within the growth theory frame work analyzed the role of FDI in growth process in the context of 46 developing countries with different trade policy regimes.

From their cross-sectional panel data analysis, they found that countries that pursue all outwardly oriented trade policies are strongly benefited from FDI than those countries adopting an inward oriented policy.

- De Mello (1996) based on neoclassical approach argue that FDI affects only level of income and leaves long run growth unchanged. They argue that technological progression and other external factors main source of economic growth. Their argument is that long-run growth arises because of technological progress and population growths both were exogenous. Hence, according to neoclassical models of economic growth, FDI will only be growth advancing if it affects technology positively and permanently.
- Endogenous growth theorists believe that economic growth is generated from within a system as a direct result of internal process. Aghoin and Howitt(1998) the enhancement of nation's human capital by investing more on human capital formation would lead to faster economic growth. The recent endogenous models show that FDI can affect growth endogenously growth models if it generates increasing returns in production via externalities and spillover effects Deme and Graddy (2006). In these models, FDI is considered to be an important source of human capital and technological diffusion.
- According to Romer's (1990) endogenous growth model; growth is driven by technological change from intentional investment made by profit maximizing firms. He argues that stock of human capital determines the rate of growth. In his view, there is increasing returns scale (IRS) in aggregate level where as constant returns to scale (CRS) in the firm level and firms don't take account of spillover effect of externalities but economy as a whole experiences the increasing returns to scale which causes the endogenous growth. Endogenous growth theoreticians FDI and trade stimulate the technological diffusion and contribute economic growth.
- Barell and Pain (1996) studied the econometric model of foreign direct investment and examined the extent to which the model explain the level of outward direct investment by U.S companies over last two decades. Their analysis show that market size and factor cost, both labor and capital are important factors in the investment decision because MNEs are trying to maximize the value of the firm by allocating the resources in right

place. Feder et al. (1983) analyzed export-led economic growth hypothesis. They argued that exports increase factor productivity because of the better utilization of resources and economies of scale. Some economists argue that open trade policies foster FDI because of the conducive economic climate for the MNEs. In this regard, Rodrizguez and Rodrik (1999) presented a skeptical view by linking between open- trade policies and economic growth. They argue that previous studies didn't consider the institutional differences among countries in an upwardly biased estimate of trade and other policy restrictions. Their analysis showed that the relationship between average tariff rates and economic growth is only slightly negative and nowhere near statistical significance.

- The issue whether FDI and trade trigger economic growth or economic development attracts FDI and trade is unsolved (Makki and Samwaru, 2004) since past studies were one sided i.e. analyzed the impact of FDI and trade on economic growth (Borenszteinet al, 1995 and Balasubramanyam et al, 1996) or analyzed the effect of economic growth on FDI (Barrel et al, 1996).
- Kim and Seo (2003) analysed the dynamic relationship between FDI and economic growth and domestic investment in Korea for the period of 195-1999 using vector auto regression model. They found that there some positive effects of FDI on economic growth but insignificant. However, their findings show that domestic investment s negatively affected by FDI shock, and FDI does not crowd out domestic investment in Korea.

## 2.3 The Ownership, Location, and Internalization (OLI) Paradigm for FDI

The Ownership, Location, and Internalization (OLI) paradigm is generally viewed as the preeminent theoretical framework for foreign investment decisions (Dunning 1993) The OLI framework postulates that the decision to produce internationally is based on three conditions. First, a firm should possess ownership-specific advantages over firms in other countries. Possible examples include unique property rights or a broad variety of other intangible aspects, such as a product innovation or an advantage in marketing. Additionally, some location

advantage must be gained by going abroad, such as a savings in transport costs, natural resources specific to the host country, proximity to a large market, or a need to get around trade barriers. Finally, a firm must desire to maintain possession of this advantage, rather than simply selling or licensing it to foreign companies. In other words, the firm must want to internalize its advantages across different markets.

The political environment of a host state can affect the ownership, locational, and internalization aspects of the OLI paradigm. Through the proper regulatory environment, a state can enhance ownership advantages by helping a firm preserve its intangible aspects or monopolistic advantage over local producers. State credibility decreases political risk and cost of internalizing production as multinationals gain confidence that the state will not adopt policies after initial investment that negatively affect their operations (Jensen 2003). Yet the role of the host state is strongest as a location factor. Obviously, some locational criteria, such as natural resources and port access, are essentially fixed. There are various other ways, however, that states can make their location more desirable. They may offer preferential taxation policies and other financial incentives (Oman 2000). Moreover, as discussed below, the political environment of a host country and the education and skill levels of the workforce may also factor as locational criteria.

Dunning (1981) suggests that transnational corporations (TNCs) will invest in a foreign location only if the latter offers certain location-specific advantages in terms of resources and facilities that make it possible for the TNCs to explore their firm- specific ownership advantages. Various authors, such as Root and Ahmed (1979), Schneider and Frey (1985), Dunning (1993; 1994) and Burrell and Pain (1997), suggest that location decisions are influenced by a number of factors. Tuselmann, (1999) divides these factors into two groups:

- Supply factors (such as labor costs, skills level of the labor force, and corporate taxation)
- Demand factors (such as market size and growth, and geographical location).

**Diamond Model**

As Dunning's Eclectic Paradigm explains about how Ownership and Location advantages are coined for the internalization by means of FDI, the MNCs decision for investing in a host country depends on how competitive and conducive environment is prevailed in a particular country. This concept was developed by Michael Porter in his Diamond Model. He has incorporated four components like Factors conditions, Demand conditions, Strategy, structure and rivalry and Related and supporting industries to explain the competitiveness of a host country for attracting FDI.

**Double Diamond Model**

The Conventional Theory of FDI or Porter's Diamond Model was a masterpiece in explaining the upward flow of FDI but the explanatory power of the Diamond Model came into question as the current trend of FDI from less developed countries to more developed countries could not be explained by this model. Therefore, Moon Hwy Chang and Jeffrey Alan Roehl extended the Diamond Model into Double Diamond Model explaining that the motivation factor for foreign investment by the MNCs is not only the potential advantages but also disadvantages. They explain if an MNC realizes some deficiencies in terms of competitiveness compared to its competitors, then it goes to invest abroad so that it could get access with high skills, technology and be able to fix its disadvantages. Therefore, Double Diamond Model explains more clearly about the current trends of FDI flows.

## 2.4 Importance of transparency in FDI

Transparent economic policies are vital for foreign investors, and the reasons are several. The first reason is that non-transparency imposes additional costs on businesses. These additional costs arise as firms have to tackle the lack of information that should have been provided by the appropriate government department in the implementation of its policies and in the activities of government institutions. For example, firms bidding for a state asset expect to receive full information from the government about the company to be privatized. Any set of

information that falls short of the expectation of the bidders will have to be supplemented – at extra costs, and the latter are typically incurred by the bidders.

Additional costs are also incurred because of corruption - another element of non-transparency identified above. In many countries, bribery is illegal. Bribery raises, therefore, the risks and the costs of non-compliance, and the companies will only take the risk if the rewards are sufficiently high. Corruption can indeed be very costly to firms. By way of example, bribes are estimated to have accounted for 7 percent of revenue of firms in Albania and Latvia in mid-1990's and in Georgia the corresponding figures was even higher – 15 percent (Kaufmann, Pradhan and Ryterman 1999) This process would lead to an investment selection that often has little to do with choices based on bona fide project appraisal but rather to projects selected on the basis of contacts, pressures, rent-seeking alliances etc. Moreover, the majority of law-abiding companies will typically avoid doing business in countries in which bribery is an inseparable part of business. In brief, the existence of strong legal provisions against bribery and their effective enforcement will go a long way towards inducing FDI flows.

The second reason why transparent economic policies are important for FDI is because they facilitate cross- border mergers and acquisitions. When firms decide to acquire companies abroad, they will often have to have their acquisitions approved by the Monopoly Commission or its equivalent in the host (i.e. foreign investment receiving) country. However, the practices of these competition commissions often vary from country to country and from region to region. For example, Neven, Papandroupulos and Seabright (1998) argue in their study of the European competition policy that the Competition Commission of the European

Union enjoys high level of discretion with very little transparency. It is perhaps, therefore, not surprising that we have so far witnessed little of cross-border mergers and acquisitions within the European Union.

The third reason is closely related to the previous discussion of competition policies. Foreign investors require transparent protection of property rights. As we have argued above, investors

generally require that their property be protected and that the protection be transparent. What holds for investors in general holds, of course, it holds for foreign investors in particular. This conclusion is intuitive but it also has a strong backing from business attitude surveys and from empirical literature such as the study of Rapp et al. (1990) who find that effective protection of intellectual property rights is strongly correlated with inflows of foreign investment.

The fourth argument for transparent economic policies is that they positively influence business attitudes. Virtually all surveys of business attitudes convincingly show that companies base their decisions to invest abroad on their perceptions of what economists like to call “fundamentals" (Hoekman and Saggi 1999). The latter include macroeconomic conditions such as low and predictable inflation, prospects of fast economic growth, healthy balance-of-payments position. They will typically also include factors such plentiful and relatively skilled labor force, access to natural resources, efficient infrastructure etc. Furthermore, and most importantly in the context of our paper, investors typically seek clear, open and predictable economic policies that minimize the risks of unpleasant and costly surprises. Open trade and investment regimes are particularly powerful instruments to attract investments in general and foreign investments in particular (Selowsky and Martin 1997). Clearly, transparency of economic policies and government institutions figures prominently on the minds of businessmen and in the meetings of corporate boards of multinational companies.

The absence of comprehensive and symmetrical legal provisions concerning business practices has a number of effects for companies. One of the most serious effects is arguably their impact on the competitive position of firms which may differ among countries as a result of these differences. For example, U.S. Federal law prohibits U.S. firms from using bribery to gain access to foreign markets. By contrast some European countries allow firms to treat bribes paid as deductions in calculating their tax liabilities. This asymmetry of rules poses a disadvantage for U.S. firms. Therefore, the elimination of corruption is an important issue for U.S. firms as a means to level the playing field.

Finally, there is another, and perhaps the most important reason why economic policies must be transparent if countries can establish favorable conditions for capital inflows. The reason is countries' policy performance and transparencies are monitored by outside agencies which have a crucial impact on decisions of foreign investors. These agencies include the IMF and various private credit rating agencies. Their influence is different – the IMF provides a “credit of approval" of sound economic policies while credit rating agencies evaluate the credit risk of the country concerned. Their similarity rests on the fact adverse judgment on government policies in a given country will typically lead adverse perceptions by foreign investors of that country. As frivolous as it might sound it is a well known fact from the business community that foreign investors would base their investment decisions on credit assessments and country rankings established by some credit rating agencies. The fact that we shall also heavily rely on country rankings in our empirical part further below is not, therefore, an entirely academic exercise but one that is strongly derived from the reality.

## 2.5 FDI and Corruptions

Foreign Direct Investment (FDI) plays a significant role in modern economies. World FDI flows have increased from $25 billion in 1973 (Drabek, 1998) to $1.4 trillion in 2007 (Kekic, 2007). For lesser developed countries, FDI flows often outstrip foreign aid and make-up a sizable part of local and national economies (Drabek, 1998). In a highly globalized world, successful competition for FDI is a vital part of policymaking and a requisite part of developing states.

Various barriers limit FDI flows: lack of private property rights, poor infrastructure, excessive regulation, high tax rates, and - not surprisingly - corruption. Many authors focus on the question of whether corruption has a positive or negative effect on FDI, growth, and productivity. Responding to conventional wisdom and Samuel Huntington’s comment that "in terms of economic growth, the only thing worse than a society with a rigid, over-centralized, dishonest bureaucracy is one with a rigid, over-centralized, honest bureaucracy" (Huntington 1968), Kaufmann and Wei find that corruption does not "grease the wheels" of business. High levels of corruption are associated with greater capital costs and lower profits; bribe-paying

may not be an effective strategy for business (Kaufmann and Wei, 1999). Corruption is also associated with lower levels of development (Ades and Tella, 1997), and there is considerable evidence that it limits private investment (Mauro, 1998). Much of the literature on corruption focuses on the negative impact of corruption and bribery on FDI, growth, education spending, and related topics.

One reason that corruption can preclude a partner state from receiving a high level of FDI is that with corruption comes uncertainty (Wei, 1997). All else being equal, states would prefer to pay a higher tax rate in a partner country than contend with a high level of corruption because, with corruption, the total costs cannot be known (Wei, 1997). Smarzynska and Wei demonstrate that moving from Mexico's level of corruption to Singapore's affects FDI more than a 20% tax rate increase (Smarzynska and Wei, 2000).

Imagine building a large factory overseas, paying a few bribes to acquire land and infrastructure, and initiating production. A year later, the electricity goes out, and a government employee explains to the factory owner that he has two options: be without power for three months or pay an additional "fee." This "fee" could cost him anywhere from $1 to $100,000 (or more), but he had no reasonable way to prepare for it - all he knew was that corruption would be a business cost. His business is completely at the mercy of corrupt practitioners; new "fees" can crop up at any time. It is easy to see why the presence of corruption has a negative impact on FDI flows and private investment (Wei 1997, Kaufmann and Wei 1999, Mauro 1998). By contrast, transparency has a strong positive effect on FDI flows (Drabek and Payne 2001).

Corruption may also decrease FDI flows because it can lead to inefficiency (bottlenecks, high costs) and violations of business norms and best practices, making international investors more concerned with corruption than local investors (Habib and Zurawicki, 2002). Habib and Zurawicki argue that the level of corruption in investor states will impact where their corporations choose to invest; businesses will try to do business in environments where they

are comfortable. Corporations from corrupt states may feel more comfortable investing in corrupt states. To test their hypothesis, they interact the CPI score in host countries with the CPI score in investor states in a regression explaining FDI outflows using data from 1996-1998.

The data supports their hypothesis, but the data is limited because the CPI expanded greatly in the years following the conclusion of their project; between 1996 and 1998, CPI was only available for a small number of states. Also, the effect may have less to do with norms and more to do with comparative advantage: states from corrupt states may have fewer restrictions on their ability to pay bribes in host states, enabling them to out-compete states with strong anti-bribery laws for contracts abroad. This is better evaluated by using the Bribe Payers Index and OECD Convention Ratification to see which states frequently pay bribes overseas.

Two papers by Peter Egger and Hannes Winner look specifically at the question of how corruption and risk affect FDI flows (Egger and Winner 2003, 2006). In their 2006 paper "How Corruption Influences Foreign Direct Investment: a Panel Data Study," Egger and Winner examine how other factors impact corruption’s effect on bilateral FDI flows. Their observations are FDI country pairs from 1983-1999, and to assess level of corruption (or perceived level of corruption), Egger and Winner use the Transparency International Perceptions of Corruption Index (CPI). Their empirical model follows other corruption studies, regressing bilateral FDI flows on CPI and other variables. By building in variables to account for country size, location, factor endowments, and transport costs, they conclude that - while corruption has a negative impact on FDI flows - the interaction of corruption with other factors (factor endowments, location, etc.) can amplify or minimize this impact. Egger and Winner also conclude that corruption is more relevant for FDI flows between two OECD states and less so for OECD states investing in non- OECD states.

Taken as a whole, decreasing corruption leads to higher rates of FDI. But corporations from some states are less willing to pay bribes - Switzerland and Sweden, for instance - while others are more likely to pay bribes (Bribe Payers Index 2006). It therefore follows that the significance

of corruption is different depending on a recipient state's target investors and current investment partners. Corporations from states with a higher tolerance for bribery have a comparative advantage at investing in states with high levels of corruption because they are more willing to suffer the costs of doing business. Bribe-taking states should see a higher rate of investment from states that have a greater tolerance for bribe-paying. On the other hand, when an investor state makes it more difficult for its corporations to pay bribes overseas (through greater transparency, regulation, reporting, etc.), it will decrease its corporations' ability to out compete corporations from states with lax bribe-paying laws for desirable contracts in corrupt states.

## 2.6 Key determinants of FDI

Theoretically, FDI can benefit both the home country and host country in many ways. But, MNCs decision to go to invest in a country will be determined by a number of factors. They will be motivated when the business environment in the host country is conducive and their investment is secured. From the home country perspectives, the main objective of the MNCs to go abroad is to gain profit. FDI originates from the decision of a transnational corporation (TNC) to locate or relocate part of its activities in a selected host country. This decision is underpinned by the desire to exploit its specific advantages in the form of technology, managerial expertise, marketing know-how, etc. Although, countries do offer financial incentives and various concessions to attract such investment, they are thought to be relevant to TNCs' decision making only if the general business environment is conducive for making profit (Wells and Allen, 2001; Caves, 1996). Assuming that a favourable investment environment exists, it is important to figure out the motives of the TNCs to operate in the host countries. So, the decision of the MNCs to invest in a host country depends on these motives as well as their firm-level advantages and country-level advantages too. The following table presents the key determinants of FDI.

| Key determinants and factors for FDI inflows | | |
|---|---|---|
| Economic Conditions | **Markets** | Size, income level, urbanization, stability and growth prospects, access to regional markets, distribution and demand patterns |
| | **Resources** | Natural resources, location |
| | **Competitiveness** | Labour availability, cost, skill, trainability, managerial, technical skills, access to inputs, physical infrastructure, supplier base, technological support |
| Host Country Policies | **Macro policies** | Management of crucial macro variables, ease of remittance, access to foreign exchange |
| | **Private sector** | Promotion of private ownership, clear and stable policies,, easy entry and exit policies, efficient financial markets |
| | **Trade and industry** | Trade strategy, regional integration and access to markets, ownership control, competitive policies, support for SMEs |
| | **FDI policies** | Ease of entry, ownership, incentives, access to inputs, transparent and stable policies |
| MNEs Strategies | **Risk perception** | Perception of country risk based on political factors, macro management, labor markets, policy stability |
| | **Location sourcing,**<br>**integration transfer** | Company strategies on location, sourcing of products/ inputs, integration of affiliates, strategic alliances, training, technology |

Source: Lall (1997)

Before making decision to invest in a particular country, the MNCs analyse the possible risks and benefits factor of their investment and if they find the investment environment is favourable, they decide to enter in the host country as a form of FDI. But, the MNCs have to choose the mode of entry

## 2.7 Factor affecting Foreign Direct Investment

Capital flow resulting from FDI change whenever conditions in a country change the desire of firms to conduct business operations there. Some of the more common factors that could affect a country FDI are identified here.

**High Transportation Cost**

High transport costs arising from its unique geography are obviously a significant constraint faced by Nepal and put it at a disadvantage compared to many other low- wage countries in attracting export-oriented FDI. Apart from the long distance to Indian ports (the port of Calcutta is about 1,000 kilometers away by the shortest route), inefficiencies of the Indian railways and ports add to the cost of transport for potential exporters from Nepal. It is also alleged that shipments from Nepal are given low priorities at the highly congested Indian ports.4 However, focusing on high transport costs per se can lead to misleading inferences for Nepal's potential in labor-intensive export industries for two reasons. First, the relative cost advantage of Nepal arising from low wages (less than $20 per month for the average factory worker) may, in certain cases, outweigh the relative disadvantage arising from high costs of transport. Second, landlocked economies, such as Nepal, can choose to specialize in "low weight per unit value" products, provided, of course, the overall economic environment is conducive for the production for such products (Srinivasan, 1986). Moreover, it is important to note that adverse cost implications arising from landlessness can be minimized through suitable government policy in the areas of land and air transport, and customs administration (Bagchi, 1998).

**Changes in Restrictions**

During the 1990s, many countries lowered their restrictions on FDI, thereby opening the way to more FDI in those countries. Many US based MNCs including Bausch and Lomb, Colgate-Palmolive, and General Electric, have been penetrating less developed countries such as

Argentina, Chile, Mexico, India, China, and Hungary. New opportunities in these countries have risen from the removal of government barrier.

**Privatization**

Several national governments have recently engaged in privatization, or the selling of the same of their operations to corporations and other investors. Privatization is popular in Brazil and Mexico, in Eastern European countries such as Poland and Hungary, and in such Caribbean territories as the Virgin Island. It allows for greater international business as foreign firms can acquire operations sold by national governments.

Privatization was used in Chile to prevent a few investors from controlling all the shares and in France to prevent a possible reversion to a more nationalized economy. In the United Kingdom, privatization was promoted to spread stock ownership across investors, which allowed more people to have a direct stake in the success of British industry.

The primary reason that the market value of a firm may increase in response to privatization is the anticipated improvement in managerial efficiency. Manager in a privatization is the anticipated improvement in managerial efficiency. Manager in a privately owned firm can focus on the goal of maximizing shareholder wealth, whereas in a stated –owned firm business, the state must consider the economic and social ramifications of any business decision. Also, managers of a privately owned enterprise are more motivated to ensure profitability because their careers may depend on it. For these reasons, privatized firms will search for local and global opportunities that could enhance their value. The trend toward privatization will undoubtedly create a more competitive global market place.

**Potential Economic Growth**

Countries that have greater potential for economic growth are more likely to attract FDI. When assessing the feasibility of FDI firms estimate the after tax cash flows that they expect to earn.

**Tax Rates**

Countries that impose relatively low tax rate on the corporate earning are more likely to attract FDI. When assessing the feasibility of FDI, firms estimate the after tax cash flows that they expect to earn. Interest in the effects of taxes on FDI has been considerable from both international and public economists. An obvious hypothesis is that higher taxes discourage FDI with the more important question one of magnitude. De Mooij and Ederveen (2003) provides an even more detailed discussion of the literature than that provided here and finds a median tax-elasticity of FDI of -3.3 across 25 studies. However, some of the more well-placed articles in the literature have highlighted why such a number may be quite misleading. As these papers point out, the effects of taxes on FDI can vary substantially by type of taxes, measurement of FDI activity, and tax treatment in the host and parent countries. Another important issue is that a MNE potentially faces taxes in the host and the home countries. Countries have different ways of addressing this double taxation issue, which further complicates expected effects of taxes on FDI.

Most of the literature on taxation effects of FDI point to Hartman's papers (1984;1985) as the starting point of the literature, as these were the first to point out a way in which certain types of FDI may surprisingly not be very sensitive to taxes. The key insight by Hartman is that earnings by an affiliate in foreign country will ultimately be subject to parent and host country taxes regardless of whether it is repatriated or reinvested in the foreign affiliate to generate further earnings. There is no way to ultimately avoid foreign taxes on these earnings. On the other hand, new investment decisions consider transfers of new capital from the parent to the affiliate that do not originate from the host country and, thus, have not yet incurred any foreign taxes. This has a number of important implications. First, it means that firms will want to finance new FDI through retained earnings as much as possible, before turning to new infusions from the parent. Second, this means that FDI through retained earnings should only respond to host country tax rates, not parent country tax rates or the parent country's method of dealing with double taxation issues. FDI through new transfers of capital, on the other hand, will potentially respond to both parent and host country taxes and rates of return available in both the parent and host markets.

Hartman (1984) tests this by examining behavior of foreign affiliates in the United States. Important for the empirical analysis, Hartman is only able to gather data on host country (US) tax rates and returns, but not parent (foreign) country tax rates and returns. Thus, he separately regresses retained earnings FDI and new transfer FDI on the host country (US) tax rate, not controlling for these unobservable parent country tax rates. He finds that retained earnings FDI responds significantly to the host country tax rate as hypothesized. Transfer FDI, however, does not respond significantly to host country tax rates which can then be explained by not controlling for parent country tax rates (and differences in returns across the countries). This estimation strategy by Hartman is clearly not ideal for identifying the hypotheses.

Ideally one would want information on the parent country tax rates and explicitly control for these in the estimation, rather that assuming that their omission will bias a current observable variable's coefficient to insignificance. Slemrod (1990) goes a step in this direction by using disaggregated country-level panel data and controlling for the system used by the parent country to deal with double taxation (those that allow MNEs to use foreign repatriated income as a credit on their parent tax liability and those that allow for exemptions), which he argues should matter for the tax response.6 His results are decidedly mixed often revealing an insignificant tax response for retained earnings FDI or even a negative response. This study has clearly cast doubt on the Hartman model, yet there have been no significant attempts since to re-estimate with better data or approaches.

Slemrod's (1990) idea that policies to deal with double taxation may affect tax responsiveness did take hold in the literature. The common distinction is between territorial countries that do not tax any income outside of the parent country, exempting foreign-earned income from tax liability, and a worldwide tax method which considers all earned income by its parent firms potentially taxable, but may treat foreign income in a number of ways to avoid double taxation of the MNE. Two standard treatments to deal with this double taxation issue are for the home country to offer a credit or a deduction of foreign tax payment made by the MNE.

The potential for these tax treatments to affect the analysis of FDI and taxation first played a large role in the literature as researchers began to examine the impact of a significant US tax

reform in 1986 on inward US FDI. Scholes and Wolfson (1990) hypothesizes that US FDI from MNEs under worldwide systems would likely increase when US tax rates increased!

This seemingly counterintuitive notion comes from the realization that with a credit system, for example, the MNE would not see any increase in its tax liability under a worldwide taxation system. On the other hand, the US domestic investors (and MNEs under a territorial tax system) would bear the full brunt of the added US tax liabilities. With firms all bidding for the same assets in the US, the worldwide-tax MNEs would be advantaged and invest more.

While Scholes and Wolfson (1990) performs only very simple statistical tests to show that US FDI goes up after 1986 without controlling for other factors, Swenson (1994) does a more careful examination of the Scholes and Wolfson hypothesis by examining the differential impact that the U.S. 1986 tax reform had on FDI across industries that had varying changes in tax rates after the reform. Specifically, Swenson examines industry panel data from 1979 through 1991, exploiting the industry variation in tax changes from the 1986 tax reform, and finds that FDI did indeed increase with greater average tax rates, particularly for worldwide taxation countries.

One worrisome issue with Swenson's study is that confirmation of the Scholes and Wolfson hypothesis is shown when using data on average tax rates, but rejected when using effective tax rates. Auerbach and Hassett (1993) provides further evidence against the Scholes and Wolfson hypothesis by developing a model of FDI that predicts the *types* of US investments that should be encouraged by the tax reform for territorial-tax MNEs versus worldwide-tax MNEs. In particular, their model shows that territorial-tax MNEs should have incentives to focus more on merger and acquisition (M&A) FDI, whereas worldwide-tax MNEs should have been discouraged from such FDI relative to investment in new equipment. The data, however, suggest that the substantial increase in FDI after the 1986 US tax reform was through M&A FDI by MNEs from worldwide-tax countries (mainly Japan and the United Kingdom).

Thus, in many ways, the effects of the 1986 tax reform on FDI are very much an open question to this day. However, while the particular question is now somewhat dated, the notion that FDI from worldwide taxation countries that offer their parent firms credits should be relatively insensitive to tax rates is of continuing interest. This is best represented by Hines (1996) which creatively brought the issue of the territorial- versus worldwide-tax treatment issue to the pre-

existing literature by examining whether state-level taxes affect location of US inward FDI. Previous studies examining the effect of state taxes on state location of FDI found insignificant results (see, e.g., Coughlin, Terza and Arromdee, 1991).7 Like federal taxes, MNEs facing state-level taxes may differ in their responses based on whether they face a territorial-tax or worldwide-tax system in their parent country. Hines' (1996) empirical strategy is to investigate the distribution of FDI across U.S. states and examine the tax sensitivity of FDI into a state of "non-credit-system" foreign investors relative to that of "credit-system" foreign investors. He finds that higher tax rates of 1% are associated with a 9% larger FDI decrease by the non-credit-system investors relative to the credit-system investors.

In summary, the literature has pointed out quite nicely that there is more than meets the eye initially when considering the effects of taxes on FDI.8 MNEs face tax rates at a variety of levels in both the host and parent country and policies to deal with double taxation can substantially alter the effects of these taxes on a MNEs incentive to invest. As has been alluded to above, empirical approaches and data samples have differed a fair amount, so that there are still significant questions about how much taxes (and tax reforms such as that in the US in 1986) affect FDI. The evidence seems more convincing that a credit system to deal with foreign taxes by an MNE makes taxes in the host country relatively inconsequential.

There are other weaknesses with the literature that clearly need to be addressed. First, all the studies mentioned above examine (at best) industry-level data for models that are typically of firm-level activity. This can create an issue with interpreting the empirical evidence back to the theory. The most obvious example of this is the use of average tax rates as the variable of interest which has obvious errors-in-variables issues. Whether average or effective tax rates are preferred as a measurement of tax liability is rarely discussed, but can show quite different effects on FDI as exemplified by the Swenson (1994) study.

The literature has also only recently begun to examine other related taxes beyond corporate income taxes. For example, a recent working paper by Desai, Foley and Hines (2004) finds evidence that indirect business taxes have an effect on FDI that is in the same range as corporate income taxes. In a similar vein, the effect of bilateral international tax treaties on FDI activity has been an unexplored issue empirically until just recently. There are thousands of

such tax treaties which negotiate reductions in countries' withholding rates among other things.

Hallward-Dreimeier (2003) and Blonigen and Davies (2004) find little evidence that these treaties affect FDI activity in any significant fashion.

**Exchange Rates**

Firms typically prefer to direct FDI to countries where the local currency is expected to strengthen against their own. Under this condition, they can invest funds to establish their operations in a country's currency are relatively cheap (weak). Then, earnings from the new operations can periodically be converted back to the firm's currency at a more favorable exchange rate.

For a typical developing economy, labor-intensive, consumer goods manufacturing is generally considered to be the natural starting point in the process of export-led industrialization. While the availability of cheap and trainable labor is a prerequisite for attracting export-oriented FDI, the availability of a wider array of complementary inputs, including operator, technical and managerial skills, suppliers of intermediate goods, and high-quality infrastructure, are also essential. Also, given the large initial fixed costs involved, Transnational Corporations (TNCs) would be reluctant to establish assembly plants in a country without having confidence in the policy continuity and political stability of that country. For these reasons, so far, only a limited number of developing countries, mostly the high performing East Asian countries and more recently some transition economies in Eastern Europe, have been able to attract FDI in assembly operations. The so-called "life- cycle" investors who expand their production networks globally, largely on scale economy and efficiency considerations, rarely find low-income countries attractive locations for investment. (Athukorala, P. C. and Sharma, K., 2006)

The effect of exchange rates on FDI has been examined both with respect to changes in the bilateral level of the exchange rate between countries and in the volatility of exchange rates.

Until Froot and Stein (1991), the common wisdom was that (expected) changes in the *level of the exchange rate* would not alter the decision by a firm to invest in a foreign country. In rough terms, while an appreciation of a firm's home country's currency would lower the cost of assets abroad, the (expected) nominal return goes down as well in the home currency, leaving the rate of return identical. Froot and Stein (1991) presents an imperfect capital markets story for why a currency appreciation may actually increase foreign investment by a firm. Imperfect capital markets mean that the internal cost of capital is lower than borrowing from external sources. Thus, an appreciation of the currency leads to increased firm wealth and provides the firm with greater low-cost funds to invest relative to the counterpart firms in the foreign country that experience the devaluation of their currency. Froot and Stein (1991) provides empirical evidence of increased inward FDI with currency depreciation through simple regressions using a small number of annual US aggregate FDI observations, which Stevens (1998) finds is quite fragile to specification. Klein and Rosengren (1994), however, confirms that exchange rate depreciation increases US FDI using various samples of US FDI disaggregated by country source and type of FDI.

Blonigen (1997) provides another way in which changes in the exchange rate level may affect inward FDI for a host country. If FDI by a firm is motivated by acquisition of assets that are transferable within a firm across many markets without a currency transaction (e.g., firm specific assets, such as technology, managerial skills, etc.), then an exchange rate appreciation of the foreign currency will lower the price of the asset in that foreign currency, but will not necessarily lower the nominal returns. In other words, a depreciation of a country's currency may very well allow a "fire sale" of such transferable assets to foreign firms operating in global markets versus domestic firms that may not have such access. Blonigen uses industry-level data on Japanese mergers and acquisition FDI into the US to test this hypothesis and finds strong support of increased inward US acquisition FDI by Japanese firms in response to real dollar depreciations relative to the yen. As predicted, Blonigen finds that these exchange rate effects on acquisition FDI are primarily for high-technology industries where firm-specific assets are likely of substantial importance.

Other studies have generally found consistent evidence that short-run movements in exchange rates lead to increased inward FDI, including Grubert and Mutti (1991), Swenson (1994), and Kogut and Chang (1996), with limited evidence that the effect is larger for merger and acquisition FDI (see, e.g., Klein and Rosengren, 1994). Thus, the evidence has largely been consistent with the Froot and Stein (1991) and Blonigen (1997) hypotheses. One serious issue in the literature is that these exchange rate effects have been tested almost exclusively with US data, though some studies have focused on US outbound FDI, while others have used US inbound FDI.

These previous studies have also made the implicit assumption that exchange rate effects on FDI are symmetric and proportional to the size of the exchange rate movement. The financial crises of the late 1990s have just begun to spur a small nascent literature on the effects of large sudden exchange rate swings on a variety of economic variables, including FDI by MNEs.

Lipsey (2001) studies U.S. FDI into three regions as they experienced currency crises (Latin America in 1982, Mexico in 1994, and East Asia in 1997) and finds that FDI flows are much more stable during these crises than other flows of capital. Desai, Foley and Forbes (2004) compares the performance of U.S. foreign affiliates with local firms when faced with a currency crisis and find that U.S. foreign affiliates increase their investment, sales and assets significantly more than local firms during and subsequent to the crisis. They attribute the differences to MNEs abilities to finance investment internally to a larger extent than local firms. While these papers are quite informative, there are clearly more questions to be answered in this literature.

A final related strand of the literature studies how uncertainty and expectations about future exchange rate movements may affect FDI decisions. An early paper by Cushman (1985) lays out a very nice firm-level model of international investment that depends on the interaction of exchange rate expectations, trade linkages, and financing options the firm may have.

Specifically, the paper examines four possible regimes for an MNE: 1) Foreign production and sales, either financed by foreign or domestic sources, 2) Direct investment financed domestically, but foreign production and sales with a imported input from the home country, 3) Direct investment financed domestically, but domestic production and sales with an imported input from the foreign country, and 4) Domestic financing of investment for production at

home with export sales to foreign market or domestically-financed foreign investment for production and sales in foreign market.

The paper's treatment of both the MNE's financing options and its trade linkages is the strength of the paper. However, this is a weakness as well, since the effect of the exchange rate and its expected movements varies considerably across models and is often ambiguous in sign for a given model. In addition, his firm-level modeling shows that if firms are heterogeneous in their financing options and trade linkages, then examination of aggregate data (industry- or country-level) may very well show ambiguous results that hide these very real firm-level effects .

Cushman, however, tests his firm-level model with data on U.S. bilateral country-level FDI, though data availability in the 1980s makes this understandable.4 Cushman's empirical analysis finds evidence that an expected real appreciation of the home currency increases FDI, whereas the current level of the exchange rate has no consistently significant impact. These results with respect to the expected exchange rate effect are consistent with certain versions of models 3 and 4 noted above. The firm-level modeling of the Cushman paper is impressive, but there is a clear need for more updated work using firm-level data to accurately test its hypotheses.

Campa (1993) lays out a much simpler and (perhaps more) elegant approach than Cushman (1985) to examine how exchange rate uncertainty affects FDI based on options theory in Dixit (1989). Greater exchange rate uncertainty increases the option for firms to wait until investing in a market, depressing current FDI. Campa finds evidence for this using data on FDI into the US in the wholesale industry. Again, a broader firm-level database would be likely preferred to test these hypotheses and Tomlin (2000) also points out that the Campa (1993) estimates are sensitive to empirical specification. A related paper by Goldberg and Kolstad (1995) alternatively hypothesizes that exchange rate uncertainty will increase FDI by risk averse MNEs if such uncertainty is correlated with export demand shocks in the markets they intend to serve. They confirm this hypothesis with empirical analysis relying on quarterly bilateral data on US FDI with Canada, Japan, and the United Kingdom.

In summary, the literature has derived important and interesting firm-level models of how exchange rate uncertainty can affect FDI flows, depending on firm characteristics. Ironically, the modeling is much stronger than the empirical work, and there has been very little firm-level empirical analysis of these hypotheses. In addition, two of the main papers in the area – Campa (1993) and Goldberg and Kolstad (1995) – have apparently contradictory hypotheses which both confirm using US data on FDI. Thus, the topic of exchange rate effects on FDI is an area rich for future work. One related issue that likely deserves more attention is how one measures expected exchange rate levels, uncertainty, or even volatility. Each of these papers has their own way of measuring these variables, but further investigation into appropriate measures and sensitivity of results to alternative measures deserves some attention as well.

**Institutions**

The quality of institutions is likely an important determinant of FDI activity, particularly for less-developed countries for a variety of reasons. First, poor legal protection of assets increases the chance of expropriation of a firm's assets making investment less likely. Poor quality of institutions necessary for well-functioning markets (and/or corruption) increases the cost of doing business and, thus, should also diminish FDI activity. And finally, to the extent that poor institutions lead to poor infrastructure (i.e., public goods), expected profitability falls as does FDI into a market.

While these basic hypotheses are non-controversial, estimating the magnitude of the effect of institutions on FDI is difficult because there are not any accurate measurements of institutions. Most measures are some composite index of a country's political, legal and economic institutions, developed from survey responses from officials or businessmen familiar with the country. Comparability across countries is questionable when survey respondents vary across the countries. In addition, institutions are quite persistent, so there is likely to be little informative variation over time within a country.

For these reasons, while cross-country FDI studies often include measures of institutions and/or corruption, they do not often have it as a focus of the analysis. Wei's papers (2000a; 2000b) are exceptions that show that a variety of corruption indices are strongly and negatively correlated with FDI, though other studies can be found that did not find such evidence (e.g., Wheeler and Mody, 1992). Hines (1995) provides an interesting "natural experiment" approach by examining how the 1977 U.S. Foreign Corrupt Practices Act which stipulated penalties forU.S. multinational firms found to be bribing foreign officials. His estimates find a negative impact on U.S. FDI in the period following this Act. Analysis of such natural experiments hold out the hope of even more convincing evidence in the future, though finding such natural experiments is often difficult.

### Trade protection

The hypothesized link between FDI and trade protection is seen as fairly clear by most trade economists – higher trade protection should make firms more likely to substitute affiliate production for exports to avoid the costs of trade production. This is commonly termed tariff jumping FDI. Perhaps because the theory is fairly simple and general, there have been few studies to specifically test this hypothesis. Another possible reason is data-driven. It is difficult to quantify non-tariff forms of protection in a consistent fashion across industries. Many firm level studies have controlled for various trade protection programs using industry-level measures, but often with mixed results, including Grubert and Mutti (1991), Kogut and Chang (1996), and Blonigen (1997). An alternative to industry measures is provided by antidumping measures which apply *firm-specific* antidumping duties that are often quite large. Using these more precise measures of changes to a trade protection faced by a firm, Belderbos (1997) and Blonigen (2002) both find more robust evidence of tariff-jumping FDI, though Blonigen's results strongly suggest that such responses are only seen from multinational firms based in developed countries. This may be another reason why support for tariff-jumping of other measures of

trade protection have been mixed – FDI requires substantial costs that many small exporting firms may not be able to finance or find profitable. Indeed, trade protection may explicitly target such import sources where FDI is less likely.11 This would suggest one way in which FDI and trade protection may be endogenous, an issue that has been hardly explored empirically. An exception is Blonigen and Figlio (1998) that finds evidence that an increase in FDI into a U.S. Senator's state or U.S. house representative's district increases their likelihood to vote for further trade protection.

**Trade Effects**

The previous partial-equilibrium studies discussed to this point have largely ignored trade effects of FDI which are intimately connected with underlying motivations of FDI behavior. Perhaps the most commonly cited motivation for FDI is as a substitute for exports to a host country. As laid out by the model of Buckley and Casson (1981), one can think of exports as involving lower fixed costs, but higher variable costs of transportation and trade barriers. Servicing the same market with affiliate sales from FDI allows one to substantially lower these variable costs, but likely involves higher fixed costs than exports. This suggests a natural progression from exports to FDI once the foreign market's demand for the MNE's products reach a large enough scale (size).

Early papers by Lipsey and Weiss (1981;1984) find a positive coefficient when regressing US outbound FDI measures to host countries on exports to the host countries, which is inconsistent with the notion of FDI replacing exports. However, these papers ignore the endogeneity that comes from the characteristics of the host market that would generally tend to increase or decrease MNEs' desire to FDI and export to the market in the same direction.

Grubert and Mutti (1991) instrument for export sales and estimate a negative coefficient using similar data to Lipsey and Weiss (1981), though it is statistically insignificant.

Blonigen (2001) considers the issue that trade flows may be either finished products that are substitutes for the product that would be produced by an MNE's affiliate in the same country or intermediate inputs that would be used by the MNE's affiliate to produce a finished product.

The former situation would suggest a negative correlation between "trade" and "FDI", whereas the latter would see a positive association between the two. Blonigen uses product-level trade and FDI data for Japanese 10-digit Harmonize Tariff System (HTS) products in the United States to show that new FDI in the US by Japanese firms increases Japanese exports of related intermediate inputs for these products, whereas new FDI leads to declines in Japanese exports of the same finished products. Head and Ries (2001) and Swenson (2004) show similar evidence when using data on Japanese firm-level data or US industry level data, respectively.

## 2.8 Important factors influencing foreign investment decisions

- Rapid expected growth of the economy and increase of demand for the foreign firm's product
- High expected rate of return in supplying primarily in the host market
- Increasing import restrictions, which began to endanger exports to host country
- Host country's government incentives and other guarantees
- Foreign investment by other foreign firms in host country.
- Other considerations
- Incentives and guarantees provided by the parent firm's government
- Lower unit production costs for export base.

# CHAPTER III: AN OVERVIEW OF NEPALESE ECONOMY

## 3.1 Current Challenges

- Nepal is among the poorest countries in the world and currently ranks 157th out of 187 countries on the Human Development Index. However, the proportion of poor people was halved in only seven years.
- Poor reliability and access to power are the most serious infrastructure bottlenecks to growth. Increasing access to electricity in a timely and cost-effective manner is one of the most significant development challenges facing Nepal today. Ironically, Nepal has one of the largest untapped hydropower resources in the world – an estimated 83,000 MW of hydropower potential.
- Poor physical connectivity has been another major challenge to Nepal's development efforts. Its road density is one of the lowest in South Asia.
- Investments in Nepal are constrained by a challenging regulatory and legal framework for foreign investment, poor governance and accounting practices, weakness in the domestic banking sector together with lack of a swap market for the Nepali rupee, poor implementation of property rights, and heightened political uncertainty. In addition, the country's logistical limitations, absence of supporting infrastructure, and the relatively smaller size of projects constrain investments, especially in the manufacturing sector.
- Given that productive agriculture is a crucial element of inclusive growth, enhancing the efficiency of irrigation systems will continue to be critical to increase agricultural productivity, incomes, and rural livelihoods.
- Preoccupation with the prolonged political transition has overshadowed economic issues. As a result, inadequate attention has been given to reforms that could improve the investment climate, stimulate growth, and create more private-sector jobs.

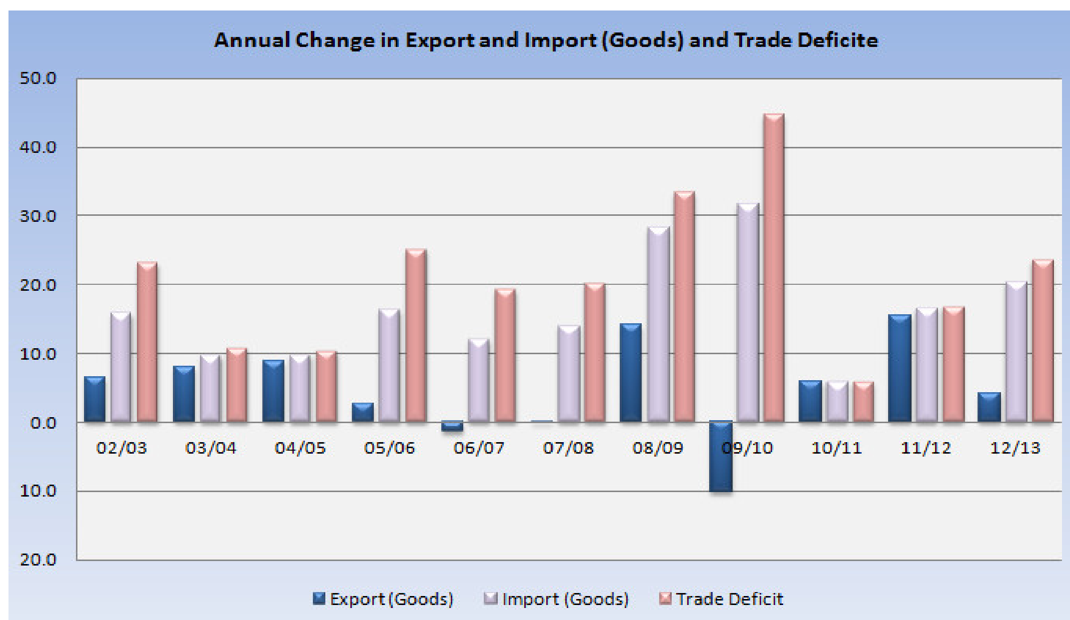
The table below shows the GDP of Nepal in compare to the neighbouring countries in the year 2013:

Amount in Mn $

| ***Country*** | Afghanistan | Bangladesh | Bhutan | Indian | Maldives | Pakistan | Sri Lanka | Nepal |
|---|---|---|---|---|---|---|---|---|
| ***GDP*** | 20,310 | 150,000 | 1,781 | 1,877,000 | 2,300 | 232,000 | 67,180 | 19,800 |
| ***Growth of GDI*** | 3.7 | 6 | 2 | 4.7 | 4.7 | 4.9 | 7.3 | 4.6 |
| ***FDI*** | 1,638 | 8,596 | 163 | 226,748 | 1,980 | 27,589 | 7,846 | 514 |

Source: http://data.worldbank.org/

## 3.2 Export - Import Scenario




*Source : Economic Survey 2012-13, Ministry of Finance*

## Exports of some major Commodities

**Amount in ten million NPR**

| Particulars | Fiscal Year | | | | | | First Eight Months | |
|---|---|---|---|---|---|---|---|---|
| | **2007/08** | **2008/09** | **2009/10** | **2010/11** | **2011/12** | **2012/13** | **2012/13** | **2013/14** |
| Pulses | 145.84 | 624.71 | 395.20 | 335.80 | 249.70 | 267.10 | 236.00 | 132.60 |
| Cardamon (Large) | 6.50 | 6.39 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Medicinal Herbs | 9.79 | 41.20 | 23.94 | 12.60 | 19.80 | 0.90 | 0.80 | 65.70 |
| Catechu | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Wollen Goods | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Nepalese Paper & Paper Products | 34.71 | 36.12 | 55.33 | 39.90 | 58.70 | 24.40 | 14.50 | 17.30 |
| Hides & Skins | 24.87 | 5.82 | 30.70 | 43.40 | 72.40 | 100.60 | 64.50 | 78.80 |
| Carpets (Hand Knotted Wollen) | 504.82 | 573.55 | 407.87 | 486.00 | 693.80 | 607.50 | 387.60 | 481.60 |
| Readymade Garments | 475.58 | 490.47 | 389.07 | 306.30 | 400.60 | 308.30 | 193.40 | 271.30 |
| Handicrafts | 19.40 | 107.78 | 108.28 | 45.80 | 51.00 | 21.40 | 15.60 | 27.60 |
| Ornaments | 26.94 | 26.24 | 12.66 | 9.10 | 11.00 | 7.60 | 5.20 | 7.10 |
| Pasmina | 64.34 | 152.69 | 126.76 | 227.30 | 323.00 | 165.50 | 108.90 | 142.70 |
| **Total** | **1312.79** | **2064.97** | **1549.81** | **1506.10** | **1880.00** | **1503.40** | **1028.50** | **1224.70** |
| **Others** | **758.29** | **604.19** | **533.22** | **591.70** | **584.50** | **1088.30** | **746.80** | **812.50** |
| **Grand Total** | **2071.08** | **2669.16** | **2083.03** | **2097.80** | **2464.50** | **2591.80** | **1775.40** | **2037.20** |

## Import s of major commodities

**Amount in ten million NPR**

| Particulars | Fiscal Year | | | | | | First Eight Months | |
|---|---|---|---|---|---|---|---|---|
| | **2007/08** | **2008/09** | **2009/10** | **2010/11** | **2011/12** | **2012/13** | **2012/13** | **2013/14** |
| Gold | 375.05 | 1657.46 | 4163.58 | 1135.76 | 2577.00 | 2611.40 | 1715.00 | 1708.70 |
| Silver | 44.67 | 117.54 | 325.09 | 372.56 | 437.10 | 878.30 | 494.20 | 689.40 |
| Petroleum products | 52.30 | 95.57 | 169.36 | 165.99 | 168.20 | 226.20 | 136.70 | 77.60 |
| Other Machinery & Parts | 390.20 | 597.23 | 765.61 | 640.92 | 719.80 | 813.10 | 560.60 | 690.30 |
| Electrical goods | 394.52 | 824.16 | 683.77 | 650.55 | 731.20 | 579.50 | 412.60 | 488.30 |
| Threads | 139.58 | 217.30 | 273.52 | 194.29 | 188.70 | 162.10 | 111.20 | 158.90 |
| Raw Wool | 139.48 | 35.59 | 87.33 | 91.27 | 65.70 | 105.10 | 61.90 | 81.20 |
| Transportation equipments | 439.18 | 550.21 | 423.59 | 421.52 | 285.90 | 359.10 | 230.00 | 378.30 |
| Medicine | 126.30 | 311.73 | 335.80 | 213.54 | 197.60 | 263.40 | 152.60 | 180.40 |
| Chemical Fertilizer | 1.96 | 7.98 | 70.35 | 236.81 | 229.10 | 483.90 | 278.50 | 447.10 |
| Paper | 103.97 | 101.97 | 142.65 | 178.89 | 175.80 | 172.90 | 99.60 | 158.20 |
| Computer parts | 226.97 | 376.97 | 534.11 | 617.83 | 615.00 | 454.30 | 306.70 | 289.90 |
| Aeroplane spare parts | 104.99 | 202.04 | 221.82 | 247.24 | 140.60 | 206.30 | 136.40 | 132.60 |
| Telecommunication accessories | 497.94 | 406.44 | 852.19 | 949.32 | 845.90 | 1348.90 | 741.90 | 942.90 |
| Cloths (cotton & others) | 196.66 | 292.73 | 191.05 | 260.91 | 127.50 | 259.50 | 163.30 | 310.90 |
| Polithene granules | 371.89 | 361.65 | 578.76 | 470.12 | 578.70 | 452.50 | 308.00 | 477.30 |
| Crude Palm Oil | 574.68 | 294.93 | 202.64 | 609.66 | 31.30 | 339.10 | 211.60 | 266.70 |
| Crude Soyabean Oil | 160.00 | 365.86 | 433.75 | 650.76 | 996.20 | 1062.80 | 736.30 | 1079.50 |
| Copper Wire Rod,Scrape & Sheets | 194.11 | 181.36 | 177.62 | 131.28 | 187.50 | 122.90 | 84.90 | 220.60 |
| Raw Silk | 0.55 | 4.10 | 3.18 | 0.00 | 0.00 | 14.80 | 7.60 | 15.80 |
| Others | 3421.12 | 5200.38 | 5086.32 | 5185.81 | 6928.90 | 8055.00 | 5531.00 | 6549.70 |
| **Total** | **7956.12** | **12203.20** | **15722.09** | **13425.03** | **16227.80** | **18970.90** | **12291.90** | **15344.10** |

The major trading partners for the export were India (67.7%), USA (7.7%) and Germany (4.5%) whereas the major trading partners for import were India(63.4%), china (11.7%) and UAE (5.6%) in the year 2012. (Source: https://data.un.org/CountryProfile.aspx?crName=Nepal)

India is Nepal's major trading partner. According to Indo-Nepal trade treaty 2002, India has fixed quota for duty free accession to India. The limitation of quota system on major exports reduces the competitive strength of Nepalese exports.

# CHAPTER IV: POLICY & INSTITUTIONAL FRAMEWORK

## 4.1 Policy initiatives

Although the pace of reform has definitely been slow because of the nagging post-conflict transitional phase, reforms have paid off. For example, paying taxes and obtaining business permits in Nepal are becoming less complex. Moreover, three recent developments in the policy arena are likely to provide the much needed shot in the arm for attracting investment—both local and foreign— particularly in the hydroelectricity sector.

First, the GoN announced 2012/2013 as Nepal Investment Year (NIY), with a target of attracting US$1 billion worth of FDI in a year. This figure was definitely quite ambitious because, even going by the approved investment data, Nepal would had to attract seven times more FDI than it did in 2010/11. However, this has sent a strong signal to the market that the government is serious about promoting FDI in the country.

Second, in order to provide fast-track approval for mega projects—both local and foreign—and facilitate their foray into the Nepalese business scene, the government has established the Investment Board, chaired by the Prime Minister. The Board plans to offer one-window solution to investors by getting all his/her issues, such as registration, licensing, immigration issues and bill clearance to even acquiring a mobile sim card, resolved from the same place.

Third, in order to provide financing to medium to bigger size hydroelectricity projects (in excess of 25 MW) and construction of transmission and distribution lines, with participation of the Central Bank and other public sectors institutions, the GoN established the Hydropower Investment and Development Company in 2011. Although the company has started its operation with effect from 30 July 2012, in the initial stage, it is planning to lend to hydropower projects as a part of consortium financing together with other banks and financial institutions in the country.

Apart from these initiatives taken at the national level, the GoN has recently signed the Bilateral Investment Protection and Promotion Agreement (BIPPA) and Double Tax Avoidance Agreement (DTAA) with India, which has the largest stake in Nepal in terms of FDI. Although these agreements alone may not help in attracting FDI and they are no substitute for better investment climate, they are still important in the sense that they do send some positive message to foreign investors that their investment would be protected in the host country and they have a legal recourse should there be a problem. Moreover, Nepal is actively engaged in the negotiations of the investment protection and promotion agreement within SAFTA. Once signed, this can help Nepal send positive signal to investors from other countries in the region, besides India, about its commitment to protect and promote investments from the region.

## 4.2 Nepali laws and policies governing foreign direct investments ( FDI)

- Interim Constitution of Nepal,2006 (Art.19,34(4)and art.35(12)
- Various separate sectorial parliamentary Statutes, Rules, Guidelines, Directives etc.
- Sectorial Policies : FIOW policy,1992,Industrial Policy,2011 and many other policies,
- Judicial precedents,
- International treaties : BITs/BIPPAs,

## 4.3 Major relevant laws concerning FDI

- Foreign Investments and Technology Transfer Act,1992,(FITTA)
- Industrial Enterprises Act,1992,
- Electricity Act,1992,
- Nepal Petroleum Act,1983
- Private Investments in Infrastructures Act,2006,

- Mines and Mineral Resources Act,1985
- Bank and Financial Institutions Act,2006,
- Companies Act,2006,
- Investment Board Act,2011,
- Foreign Exchange (Regulation ) Act,1963,
- Contract Act,2000, • Arbitration Act,1999,
- Income Tax Act,2002,
- Labor Act,1991,
- Privatization Act,1992 and many other sectorial Acts

## 4.4 Major sectoral Policies Governing FDI

- Foreign Investment and One Window Policy,1992,
- Industrial Policy,2011,
- National Agriculture Policy,2004
- Hydro-power development Policy,2001,
- Telecommunication Policy,2004,
- Tourism Policy,2008,
- Aviation Policy,2006,
- Commerce Policy,2008,and many other sectorial policies,
- A new Foreign Investment Policy,2014 ( draft) is under consideration by GON that revisits and substantially amends the existing policy.

## 4.5 Foreign Investment under the law of Nepal

1 Foreign Investment : Investment made by a foreign investor in any industry in form of: a. investment in equity,

b. reinvestment of earning deprived from existing investment,

c. investment made in form of loan or loan facilities

d. transfer of technology,

e. lease finance,

f. opening a branch to carry out business.

2. Transfer of technology: transfer of technology under an agreement between foreign investor and an industry on the following matters:

a. use of any intellectual property rights of foreign origin,

b. acquiring any foreign technical consultancy and management,

c. acquiring foreign market service.

3. Foreign investor: individual, firm, company, foreign government or international agency.

4. Portfolio investment is not a part of FDI so far.

## 4.6 Entry and Exit of FDI

- Theoritically, GON follows open/free admission/entry of foreign investments,
- Foreign investment is opened almost in all sectors of economy ( both in manufacturing and service sectors),
- A negative list (certain exceptions) is included in FITTA where FDI is restricted,

- No limitation in equity ownership ( up to 100%) ,
- No minimum threshold for foreign investment,
- Foreign Investor may dispose off his/her investment at any time/free exit,
- An investor has to follow approval requirements under the law,
- Foreign Investor has to establish an enterprise to start business in Nepal.

## 4.7 Negative list under FITTA (schedule to FITTA)

- A negative list means an area where FDI is restricted.
- Small scale industries like cottage industry and micro- industry.
- Sensitive industries –atomic energy , radioactive materials.
- Arms, ammunitions , explosives.
- Security printing, mint.
- Real estate business.
- Some other small scale business.
- Proposed Foreign Investment Policy intensively revisits the existing negative list.

## 4.8 Procedures for approvals of Foreign Investments

- An investor has to apply GON,DOI/BOI depending the volume (amount) of investment for their approvals,
- An investor has to disclose details of the project,
- DOI has to approve FDI up to Rs.50 million (sec.3(3) to FITTA)
- DOI has to refer the case to Industrial Promotion Board if the amount exceeds to it, (sec.3(3) to FITTA)

- The authority that approves the investment has to approve within 30 days, (sec.3(3) to FITTA)
- Investment value of which exceeds 1 billion, BOI has to approve FDI, (BOI Act,sec.10(5)
- A permit/license is to be issued by the concerned authority,
- The potential investor has to incorporate a business enterprise to start business.

## 4.9 Projects fallen under the ambit of BOI (section 9, Investment Board Act)

- A project cost of which is more than NPR ten billion.
- Certain infrastructure projects like tunnel roads, highways, high bridge, rope-ways, railways as GON prescribes,
- Regional or international airports,
- Chemical fertilizer and petroleum refinery plant,
- Hydro-power generation more than 500 MW capacity,
- SEZ, Export Promotion Zone or Special Industrial District, IT parks,
- Any other infrastructure, manufacturing or service industry cost estimate is more than ten billion NRs,
- Special treatment to the projects established under BOI Act,
- Additional facilities, incentives and exemptions shall be extended to the investment under BOI Act than those provided under Industrial Enterprises Act,1992 and FITTA (sec.12,17 BOI Act),
- BOI Rules,2012 in rule28 provide the criteria and facilities to be given to such projects.

## 4.10 Rights , Guarantees and security of FDI

- Fair and equitable treatment: No discriminatory treatment in all time,
- Most-favored nation treatment: transfer of funds, incorporation of a company ,FDI approval etc.
- National treatment: management, operation, protection, incentives etc.,
- Guarantee against expropriation: no nationalization,(Industrial Enterprises Act,sec.21)
- Nepal is a party to MIGA that protects political risks of FDI,
- An industry established under FDI in Nepal is entitled to the incentives awarded to other industries,(FITTA,sec.2(a),
- Guarantee for repatriation of FDI, (sec.5(2) FITTA)
- Nepal is a party to BITs/BIPPAs concluded with some countries that protects FDI of the country concerned.

## 4.11 Incentives provided to an Industry established under FDI

- Investment incentives: 'measurable economic advantages that GON provides to the industry,
- Incentives may be regulatory, fiscal(tax holidays/concession) or non-fiscal( grants, loan, rebate),
- Incentives provided by the Industrial Enterprises Act,1992 and Industrial Policy,2011 are extended to the industry under FDI as well,
- Reinvestment and extension of industry under FDI is possible,
- Guarantee of incentives for the period prescribed at the time of registration/permission ,(Industrial Enterprises Act,sec.20)

- Nepal has concluded bilateral treaties on Avoidance of double taxation with some countries,

## 4.12 Land Acquisition Facilities

- An investor is free to manage land by himself/herself,
- If the investor fails to manage/acquire land by his/her efforts, may request GON,
- GON shall have to acquire required land cost of which shall be borne by the investor,(land AcquisitionAct,1977),
- Land shall be registered with the company and title of the land shall be vested upon it,
- Government/public land required for the industry shall be given on long-term lease basis,
- If the land ceiling exceeds, GON may consider it.

## 4.13 Visa Arrangements for FDI Investors

- Non-tourist visa: to study or to carry out any research work for FDI, (sec.6(1),FITTA)
- Business visa: to a foreign investor or his /her dependents or representatives ,( sec.6(2) FITTA)
- Business visa: to a licensee foreigner who invests for export trade, (Immigration Rules, rule 9(1)
- Business visa: to a licensee foreigner who invests for trading and industrial enterprise. Immigration Rules ,rule 9(1)
- A foreign investor who makes FDI exceeding one hundred thousands US Dollars at a time and his/her dependents shall be given residential visa,(sec.6(2) FITTA).

## 4.14 Foreign Exchange and Repatriation Facilities

- An investor is entitled to open and operate bank accounts in Nepal in foreign currency,
- An investor is entitled to transfer funds in foreign currency through banking channel,
- An investor making investments in foreign currency is entitled to repatriate the following amounts:

a. amount received from sale of shares of foreign investment,

b. amount received as profit or dividends in lieu of FDI,

c. amount received as payment of principal and interest on any foreign loan,

d. amount received as royalty, fee etc. under the technology Transfer Agreement( FERA,sec.10 c(5)

## 4.15 Resolution of investment Disputes

- Investment disputes are contractual matters under Nepal law,
- Disputes between a foreign investor and Nepali investor or concerned industry shall be settled by mutual consultation in the presence of DOI,(sec.7,FITTA)
- If disputes could not be settled in that manner it shall be settled by arbitration under UNCITRAL Arbitration Rules,(sec.7(2) FITTA)
- Disputes in regard to foreign investment exceeding NRs.5oo million, may be settled by any manner as the parties design,( Parties are free to decide the manner for dispute resolution),( sec.7(4),FITTA)
- Nepal is a party to New york Convention on Recognition and Enforcement of Foreign Arbitral Award(1958),
- Arbitration Act,1999 is based on Model UNCITRAL Commercial Arbitration Act (1985) • Nepal is also a party to the ICSID Convention (1969)

## 4.16 Legal and Institutional Framework

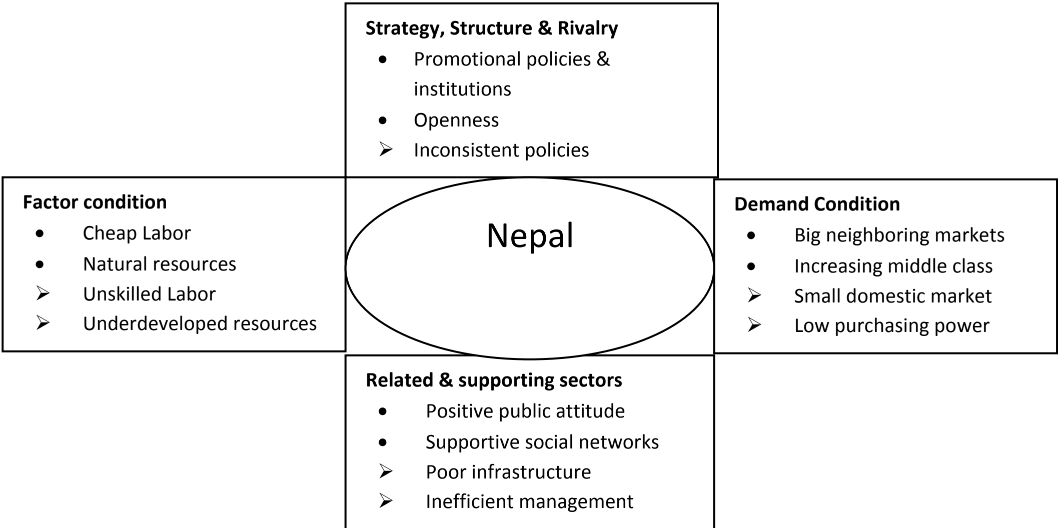
Nepal cannot be far from the benefits of Foreign Direct Investment (FDI). So Nepal has been given priority for the attraction of FDI and its development by different polices and rules in national and international level to promote foreign investment and technology transfer for making the economy viable, dynamic and competitive through the maximum mobilization of the capital, human and other natural resources.

### Major institutions for promoting FDI in Nepal

| **Institutions** | **Objectives** | **Main Functions** |
|---|---|---|
| Ministry of Industry, Commerce and Supply | Industrial Promotion | Formulation of policy frameworks |
| Department of Industry | Industrial Administration | − Registration of Industries<br>− Providing incentives and facilities to the industries under industrial Enterprise Act and Foreign Investment & Technology Transfer Act |
| Company Registrar's Office | Company Administration | Incorporation of Companies |
| Nepal Industrial Development Corporation | Provides financial supports | Provides term loans and credits for industrial development |
| National Productivity and Economic Development Centre. | Feasibility Study | Prepares feasibility reports and provides policy feedbacks to the policy makers. |
| Industrial District Management Office | Infrastructural support | Provide infrastructures like utility services and other facilities. |
| Investment Promotion Board | Investment promotion and looking for potential investors. | − Helps in creating investment friendly business environment − Provide policy recommendations<br>− Find potential investors and recommends to the government |

| Federation of Nepalese Chambers of Commerce and Industry | Industrial and business promotion | − Provide policy feedback to the government<br>− Facilitate private sector investment |
|---|---|---|

## 4.17 Analysing the business condition in Nepal applying Diamond Model




## 4.18 Prospects of Attracting FDI

Today, Nepal is one of the most liberalized countries in the South Asian region. However, growth performance has been very poor in recent years. In this context, a closer examination of the linkages between foreign direct investment and growth is critically important from a policy point of view. There are highly liberal FDI and GDP-related policies supplemented by important Acts. In the aftermath of liberalization that began in the early 1990s, FDI increased substantially. However, that could not be sustained for long. After becoming the member of World Trade Organization (WTO) in 2004, Nepal has been pursuing further opening up and liberalization policies on the FDI. Nepal is also a member of the South Asian Preferential Trade

Arrangement (SAPTA) and the Bay of Bengal Initiative for Multi-Scrotal Technical and Economic Cooperation-Free Trade Area (BIMST-EC FTA). New initiatives on FDI have been taken with the aim of enhancing sustained growth and reducing poverty.

Another major inducement for Indian investors has been the opportunities for profit-making created by Nepal's low tariffs. Because of the successive tariff cuts from the late 1980s, tariffs on many imported intermediate products in Nepal are much lower than in India. This difference, combined with a virtual open border between the two countries, has made simple processing industries for a number of products (including vegetable ghee, copper wires and some cosmetics) geared to the Indian market highly profitable.

As India and China have been enormously raising their global business as well as both inflow and outflow of FDI, it can be a good strategy for the other neighbouring countries like Nepal to get benefitted from these economies. Like many other emerging market economies, South Asian countries have also taken a number of steps to liberalize FDI regimes by augmenting the automatic approval route, lowering sectoral caps, simplifying exchange controls and intensifying investment promotion. They have been initiating more promising FDI policies in terms of pre- entry and post-entry treatment of foreign investors. Indeed, the South Asian Countries are aiming to expand the cooperation among them for attracting more FDI and to get mutually benefitted.

For this purpose, most countries have adopted an "FDI targeting approach". In that context they are aiming at FDI in certain priority sectors. As shown in the table below, it clearly shows that most countries are marking investment in light and labour intensive industries where regional firms have developed competitive advantages. That's why; Nepal has to explore the ways how it can get benefitted complementarily from the countries of proximity.

| **Countries** | **Priority Sectors** |
|---|---|
| Pakistan | Priority industries: tourism, housing, engineering, chemicals and construction. "Value added export industries": manufacturing categories such as garments, bed |

| | |
|---|---|
| | linens, surgical instruments, and sporting goods. High-Tech and Information Technology industries: chip manufacturing, software development and precision equipment manufacturing. |
| Bangladesh | Textiles, Electronics, IT, natural gas based industries, frozen foods, leather, Ceramics, Light engineering and agro based |
| Nepal | Tourism, Medicinal and aromatic plants, agro based (mushroom., spices, vegetables, fruits), Dairy, Tea, Sericulture, Hydro power, leather, Poultry and textiles |
| Sri Lanka | Electronics, light engineering, Textiles, Rubber, mineral and processing, Tourism, IT, Gems and Jewellery, Health care and Pharmaceuticals, ceramics, services |
| Bhutan | Hydro power, agro processing, tourism, medicinal plants, |
| Maldives | Marine based industries, Tourism, Infrastructure and air and sea transport |

*Source: Compiled from the FDI promotion agency of each country*

## 4.19 Key policies of the Government of Nepal (GoN) for promoting FDI

- Foreign investment will be encouraged in sectors such as hydropower, tourism, agriculture and non-timber based high value products, development of education and health-related facilities, financial services, information technology and biotechnology related industries.
- FDI will be encouraged in export oriented industries, natural resources excavation, construction of tool roads and construction of goods management and terminal.
- Individual interested in investing in the development of infrastructure for dissemination of employment technology, compatible with the existing economic structure, will be encouraged.
- An appropriate policy will be adopted to attract capital, skills, efficiency, and technology of non-resident Nepalese.
- Nepalese diplomatic missions abroad will be mobilized to promote foreign investment.

- A high level investment promotion board will be established to facilitate foreign investment. This board will function as a 'one-window' shop for meeting the requirements of projects
- Opportunities will be provided to international oil companies for the exploration of petroleum at feasible locations.
- Effort to facilitate the entry of foreign investment and technology in the areas of comparative advantage and priority sectors will be made by creating an investment-friendly environment (DoI,2009)

## 4.20 Key policies of the Government of Nepal (GoN) on the industrial sector

- Necessary amendments will be made in the policies related to industry, foreign investment and trade
- Procedure will be simplified to attract foreign investment and to establish new business.
- The government will be extend support for the promotion, identification and development of products having comparative advantage in areas such as hydroelectricity, herbal production and processing, organic farming, information technology and medicines.
- An industrial security force will be constituted incorporating the private sector for better industrial security. Multinational companies will be invited for the exploration and extraction as well as production of petroleum products.
- A law relating to special economic zones (SEZs) will be enacted.
- SEZs will also be developed in Jhapa ,Dhanusa, Birgung, panchkhal, Jumla and Dhangadi to accelerate the establishment of infrastructural industries to enhance Nepal's export capacity as well as increasing industrial processing of local resources.
- The government will reform Nepal Industrial Development Corporation (NIDC) as it is in a state of inaction due to inadequate capital and weak management.
- The government will take initiative to establish infrastructure banks with the involvement of the private sector.
- Load-shedding will be ended in industrial corridors.

- The government will make available public and barren land on long – term lease to the private sector to establish dairy industries, amusement parks, tourist rest houses and resorts, hotels, universities and technical institutes with their investments.

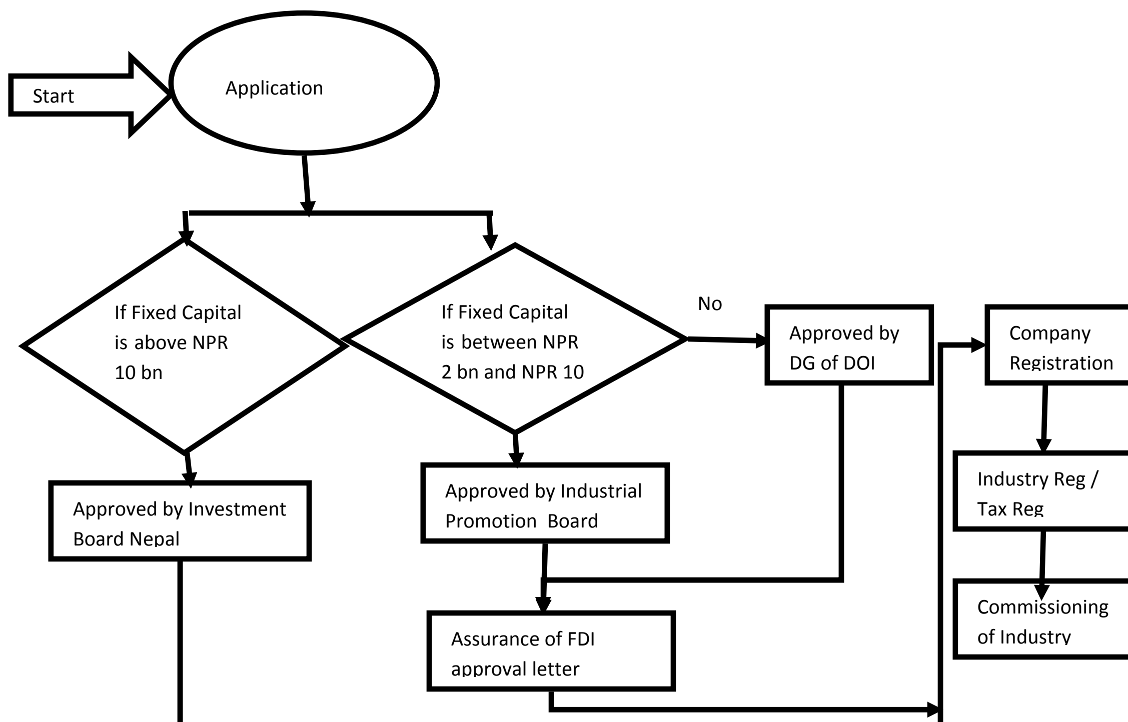
## 4.21 International Relations

Nepal foreign policy is guided by the principles enshrined in the Charter of the United Nations (UN) and the Non- Aligned Movement. As such, Nepal enjoys cordial relations with all countries of the world. This is manifested by her diplomatic relations with 128 countries, maintained though twenty-six residential embassies, three consulates and numerous honorary consul generals or consulates abroad. Similarly, twenty- two embassies, consulates, cooperation offices, country representatives of various international organizations, including the UN, World Bank, International Monetary Fund (IMF) and Asian Development Bank (ADB) , based in Kathmandu, have made significant contributions to help Nepal achieve its foreign policy and economic development goals.

Economic diplomacy has been adopted as another significant dimension of Nepal's foreign policy priorities in recent years. Its main objectives are to promote Nepal's export trade, attract greater number of tourist to Nepal and enhance the flow of foreign direct investment (FDI) in to the country.

Nepal attaches considerable importance to the promotion of close economic cooperation in South Asia. Towards this end, it is actively working with other members of the South Asian Association for Regional Cooperation (SAARC) for the realization of South Asian Free Trade Area (SAFTA), and is also engaged in sub-regional cooperation in the form of the South Asian Growth Quadrangle (SAGQ), comprising, among others, Bangladesh, Bhutan and India. Nepal has also been a member of the Bay of Bangle Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC). Nepal acceded to the World Trade Organization (WTO) in 2004. Nepal has been member of the UN and its specialized agencies since 1966 and World Bank and IMF.

## 4.22 FDI Approval Procedure




After obtaining approval for foreign investment, the industry is required to apply for registration of industry at the DOI within 35 days. If the registration cannot be done within the stipulated time, the investor will have to apply for an extension of the validity period.

- Once the applicant submits the application with required documentation at the registration unit, it goes to the Director General who then forwards it to the FDI Director.
- The documents are assessed by the officers and staff at the FDI section.
- The application is presented in the FDI approval committee.
- Copies of the project reports must be sent to the License Director and Technical Director prior to the meeting.
- The members of the committee study the documents, discuss it objectively, and express their concerns, if any.

- Even if there are concerns expressed or other documents to be received, the applications are generally recommended for final approval with the condition that the concerns are addressed and the documents received.
- Once these conditions are fulfilled, the application is sent to the Director General for final approval. It takes 5-10 days for FDI approval, from the application date. If the capital investment is more than NRs. 10 billion, the Investment Board can directly deal with the investor, and the procedure will be followed accordingly.

## 4.23 Foreign Investment Procedures in Nepal

Foreign investment in Nepal is regulated and administered by the Foreign Investment and Technology Transfer Act and Industrial Enterprises Act. The Department of Industries (DOI) is the sole agency for administration and implementation of the Foreign Investment and Technology Transfer Act in Nepal.

**FI can be made in any industry in the following forms:**

- Investment in shares (equity);
- Reinvestment of the earnings derived from equity;
- Investment made in the form of loans or loan facilities; and
- Investment in kinds, e.g. machineries and equipment.

However, as per the decision of the Government made on September 5, 2012, the minimum amount of FDI has increased to NPR 5 million for each investor from USD 20,000 ( Approximately NPR 1.6 million).

Areas allowed for Foreign Investment

Foreign investors are permitted to own up to 100% equity share in any industries except the following:

- Cottage industries (except industries using electricity more than 5 kW)
- Personal service businesses (e.g. hair cutting, beauty slaon, tailoring, driving training, etc.)
- Arms and ammunition industries
- Gunpowder and explosives

- Industries related to radio-active materials
- Real estate business (excluding construction industries)
- Film industries (national languages and other recognized languages of Nepal)
- Security printing
- Bank notes and coins
- Retail business (excluding international chain retail businesses with business in at least two countries)
- Tobacco (excluding more than 90% exportable)
- Internal courier service
- Atomic energy
- Poultry
- Fisheries
- Bee keeping
- Consultancy services (e.g. management, accounting, engineering, legal services); (Maximum of 51% FI is allowed)
- Processing of food grains on rent
- Local catering Services
- Rural tourism

**Entry Conditions on Investment**

FITTA 1992 allows foreigners to invest only in private limited companies and in public limited companies registered with the Company Register Office (CRO). They are not allowed to invest in proprietorship or partnership firms.

**"Private Limited Company"** means a company which by its articles:

Limits the number of its shareholders from 1 to 50, excluding persons who are in the employment of the company, and Prohibits any invitation to the public to subscribe in its shares.

**"Public Limited Company"** means a company that:

Has a minimum number of 7 shareholders (there is no maximum limit), and Offers shares and debentures to the public through a prospectus which complies with the requirements of the Companies Act 2006 and Securities Act 2007.

# CHAPTER V: DOING BUSINESS IN NEPAL

A healthy business and investment climate is essential for the success of private sector led economic growth. There have been improvements in Nepal's business environment with the end of the ten year insurgency, and particularly the successful completion of elections in 2013 and the subsequent formation of a constituent assembly. A review of the country's performance in global indices, as can be seen in Table 1, indicates a gradual improvement in its business environment.

## 5.1 Basic reasons to invest in Nepal

- Nepal Government is liberal on foreign investment and allows 100% foreign ownership in most of the sectors of economy
- The investment rules and procedures of Nepal are attractive
- The tax rates are relatively low (lowest in South Asia)
- The export and import rules and procedures are open and liberal
- Low labor costs and an increasingly literate population gives global companies based in Nepal a competitive edge in the global market
- About 63 minerals have been identified in Nepal so far (2010-2011) and the Himalayas are expected to have large reserves of limestone, talc and other industrial/construction minerals
- Easy Repatriation Procedure -Profits, dividends, payments received as principal or interest, and other forms of earnings can be easily repatriated by the foreign investors.
- Products manufactured in Nepal can enter custom-free to the vibrant Indian market.
- Investment Board Act 2011 providing 'one window service' to foreign investors.
- Industrial Enterprise Act 1992 prevents industries from being nationalized.
- Strategically located between two emerging giants (India & China), the products would have access to vibrant export markets.
- Since large-scale foreign investment have only started entering Nepal, less competition and minimal threat from other producers.

**Global Index Rankings of Nepal**

| Index | 2011 Ranking | 2012 Ranking | 2013 Ranking | 2014 Ranking |
|---|---|---|---|---|
| Doing Business Index | 116/183 | 107/183 | 103/185 | 105 / 189 |
| Global Enabling Trade Report | 118/125 (2010) | 124 / 132 | - | 116 / 138 |
| Corruption Perceptions Index | 154/182 | 139/174 | 116 / 177 | - |
| Global Competitiveness Report | 125/142 | 125/144 | 117 / 148 | 117 / 148 |
| Logistic Performance Index | 147/155 (2010) | 151/155 | - | 105/ 160 |
| Global Peace Index | 95/153 | 80/158 | 82/162 | 76 / 162 |

*Source : Business Conditions and Sector Potentials in Nepal 2014*

## Economic Indicators

| Economic Indicator | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| Per capita GNI, Atlas method ($) | 400 | 440 | 490 | 540 | |
| GDP growth (% change per year) | 5.8 | 3.9 | 4.3 | 3.8 | 4.6 |
| CPI (% change per year) | 7.7 | 12.6 | 9.6 | 9.6 | 8.3 |
| Fiscal balance (% of GDP) | -2.1 | -3.3 | -1.9 | -2.4 | -2.2 |
| Export growth (% change per year) | 9.3 | -4.7 | -6.3 | 11.7 | 5.7 |
| Import growth (% change per year) | 24.1 | 8.3 | 35.5 | 8.9 | 4.7 |
| Current account balance (% of GDP) | 2.9 | 4.2 | -2.3 | -0.9 | 4.9 |
| External debt (% of GNI) | 27.6 | 27.0 | 23.5 | 22.0 | |

*Source: "Doing Business 2015", World Bank*

**Starting a Business**

Nepal is ranked 104 overall for Starting a Business. Nepal's ranking in starting a business has slipped by 8 positions to 104 from 97 last year. The cost of starting a business is higher here compared to the per capita income putting the country in the seventh position in South Asia. When entrepreneurs draw up a business plan and try to get under way, the first hurdles they face are the procedures required to incorporate and register the new firm before they can legally operate. Economies differ greatly in how they regulate the entry of new businesses. In some the process is straightforward and affordable. In others the procedures are so burdensome that entrepreneurs may have to bribe officials to speed the process or may decide to run their business informally.

**Dealing with Construction permit**

Nepal is ranked 91 overall for Dealing with Construction Permits. Nepal stands at the first position in terms of procedures to deal with construction permits in South Asia. The cost of dealing with construction permits is among the lowest in South Asia after the Maldives and Bhutan.

Once entrepreneurs have registered a business, what regulations do they face in operating it? To measure such regulation, Doing Business focuses on the construction sector. Construction companies are under constant pressure; from government to comply with inspections and with licensing and safety regulations and from customers to be quick and cost-effective. These conflicting pressures point to the tradeoff in building regulation; the tradeoff between protecting people (construction workers, tenants, passersby) and keeping the cost of building affordable. Striking the right balance is a challenge when it comes to construction regulations. Good regulations ensure safety standards that protect the public while making the permitting process efficient, transparent and affordable for both building authorities and the private professionals who use it. If procedures are overly complicated or costly, builders build without a permit, leading to hazardous construction.

**Registering Property**

Nepal is ranked 27 overall for Registering Property. Even amongst the South Asian countries, Nepal is ahead in registering property where it is ranked first. The procedure to resister property is the easiest in Nepal, and it takes the least time. The cost of registering property is also the lowest. Formal property titles help promote the transfer of land, encourage investment and give entrepreneurs access to formal credit markets. But a large share of property in developing economies is not formally registered. Informal titles cannot be used as security in obtaining loans, which limits financing opportunities for businesses. Many governments have recognized this and started extensive property titling programs. But bringing assets into the formal sector is only part of the story. The more difficult and costly it is to formally transfer property, the greater the chances that formalized titles will quickly become informal again. Eliminating unnecessary obstacles to registering and transferring property is therefore important for economic development.

**Getting Credit**

Nepal is ranked 116 overall for Getting Credit. Nepal's getting credit indicator is among the poorest in South Asia. Firms consistently rate access to credit as among the greatest barriers to their operation and growth. Doing Business constructs two sets of indicators of how well credit markets function: one on credit registries and the other on legal rights of borrowers and lenders. Credit registries, institutions that collect and distribute credit information on borrowers, can greatly expand access to credit. By sharing credit information, they help lenders assess risk and allocate credit more efficiently. And they free entrepreneurs from having to rely on personal connections alone when trying to obtain credit. Three indicators are constructed to measure the sharing of credit information:

**Protecting Investor**

Nepal is ranked 71 overall for Protecting Investors Companies grow by raising capital, either through a bank loan or by attracting equity investors. Nepal's performance is moderate in

terms of protecting investors. Selling shares allows companies to expand without the need to provide collateral and repay bank loans. But investors worry about their money, and look for laws that protect them. A study finds that the presence of legal and regulatory protections for investors explains up to 73% of the decision to invest. In contrast, company characteristics explain only between 4% and 22%. Good protections for minority shareholders are associated with larger and more active stock markets. Thus both governments and businesses have an interest in reforms strengthening investor protections. To document some of the protections investors have, Doing Business measures how economies regulate a standard case of self-dealing, use of corporate assets for personal gain.

**Paying Taxes**

Nepal is ranked 126 overall for Paying Taxes. Taxes are essential. Without them there would be no money to provide public amenities, infrastructure and services which are crucial for a properly functioning economy. But particularly for small and medium size companies, they may opt out and choose to operate in the informal sector. One way to enhance tax compliance is to ease and simplify the process of paying taxes for such businesses.

**Trading Across Border**

Nepal is ranked 171 overall for trading across borders. The benefits of trade are well documented; as are the obstacles to trade. Tariffs, quotas and distance from large markets greatly increase the cost of goods or prevent trading altogether. But with bigger ships and faster planes, the world is shrinking. Global and regional trade agreements have reduced trade barriers. Yet Africa's share of global trade is smaller today than it was 25 years ago. So is the Middle East's, excluding oil exports. Many entrepreneurs face numerous hurdles to exporting or importing goods, including delays at the border. They often give up. Others never try. In fact, the potential gains from trade facilitation may be greater than those arising from only tariff reductions. Nepal is among the poorest nations in terms of export ease as the country has been

ranked six in terms of documents needed for export, and it is seventh in terms of the time to export and cost of export.

**Enforcing Contract**

Nepal is ranked 134 overall for Enforcing Contracts. Nepal's position in terms of enforcing contracts is relatively better compared to few South Asian countries. Where contract enforcement is efficient, businesses are more likely to engage with new borrowers or customers. Doing Business tracks the efficiency of the judicial system in resolving a commercial dispute, following the step-by-step evolution of a commercial sale dispute before local courts. The data is collected through study of the codes of civil procedure and other court regulations as well as through surveys completed by local litigation lawyers (and, in a quarter of the countries, by judges as well).

**Closing Business**

Nepal is ranked 107 overall for closing a Business. Closing a business is, however, very difficult in Nepal with the cost of insolvency being the highest and the time to go through insolvency is also among the highest. The Doing Business indicators identify weaknesses in the bankruptcy law as well as the main procedural and administrative bottlenecks in the bankruptcy process. In many developing countries bankruptcy is so inefficient that the parties hardly ever use it. In countries such as these, reform would best focus on improving contract enforcement outside bankruptcy.

The data on closing a business are developed using a standard set of case assumptions to track a company going through the step-by-step procedures of the bankruptcy process. It is assumed that the company is a domestically owned, limited liability corporation operating a hotel in the country's most populous city. The company has 201 employees, 1 main secured creditor and 50 unsecured creditors

Assumptions are also made about the debt structure and future cash flows. The case is designed so that the company has a higher value as a going concern—that is, the efficient outcome is either reorganization or sale as a going concern, not piecemeal liquidation. The data are derived from questionnaires answered by attorneys at private law firms.

To sum up from this chapter, the data on regional and Nepal's foreign direct investment trends starkly reveal that Nepal, so far, doesn't figure on the global map. Nepal has not even met the necessary preconditions for FDI and has a long way to go to make the environment investor friendly. It is therefore imperative that Nepal creates the necessary preconditions for an FDI framework. The most important and necessary precondition is to create "stability in the business environment", an investment climate. With stability in the environment other condition must follow. They are: political stability, policy stability price level stability, foreign exchange stability and a dispute settlement regime that is stable and transparent.

Above all, it is still important for the low income developing countries like Nepal to focus more on policy factors. These will include factors. These will include factors that could integrate them into the global trading system, fiscal and non-fiscal incentives, and improvement of infrastructure, human resources development, the creation and nurturing of local entrepreneurship. All of these will have to be creating consistent with the entrenchment of suitable political and legal framework and such other conditions for productive investment and private sector participation in order to set the stage for the process of growth and development.

Only when these necessary and sufficient preconditions are in place, Nepal would be in a position to attract private capital flow and foreign direct investment

## 5.2 Overview on potential Sectors to invest in Nepal

Nepal has great potential for investment, and the country is pursuing a liberal Foreign Direct Investment (FDI) policy to create an investment-friendly environment to attract FDI. The major areas of investment include hydropower, manufacturing, services, tourism, construction, agriculture, and mineral and mining.

### Hydropower

Nepal has the capacity to generate 83,000 MW of hydroelectricity, of which about 43,000 MW is techno-economically feasible. At the end of 2014, only about 800 MW was generated from hydropower projects. Of that total, 174.53 MW (24.9%) was generated through private investment. Nepalese industries and consumers suffer from huge power cuts each year. The annual domestic energy demand is estimated at 4,833.35 GW, of which 3,850.87 GW is generated from various sources and the remaining 982.48 GW is cut as load shedding. Nepal is unable to meet the demand, and approximately 694.05 GW is imported from India annually.

The Government of Nepal (GON) has already declared a national power crisis. So far, the Nepal Electricity Authority (NEA) has signed Power Purchasing Agreements (PPAs) worth 714.77 MW during 2011, which is almost double the total capacity of power purchase agreements signed in the past. The total capacity of PPAs signed has reached 1118.35 MW (Source: Nepal Electricity Authority)

### Tourism

Nepal's abundance of natural resources, diverse culture and ethnicity, numerous archaeological and heritage sites, and diverse topography, including eight of the world’s ten highest peaks (including Mt. Everest), are some of the attractions for potential investment.

World heritage sites such as Lumbini (the birth place of Buddha), Chitwan National Park, Sagarmatha National Park, Pashupatinath, Janakpur  Swayambhunath, Bouddhanath, Changu

Narayan, Kathmandu Durbar Square, Bhaktapur Durbar Square, and Patan Durbar Square are attractions to tourists worldwide.

Nepal offers a variety of interests to tourists, ranging from cultural tourism, nature/eco-tourism, adventure tourism, health and education tourism and religious tourism. The Himalayas, foot trails, rafting, paragliding, fauna, religious sites, eco-tourism and biodiversity are potential areas for investment.

## Industrial Manufacturing

The GON has promulgated a new Industrial Policy 2010 to develop the industrial sector and to provide protection and facilities to investors. Similarly, the draft of a Foreign Investment Policy has been prepared. Industrialization is considered one of the most vital indicators of economic growth and prosperity of the nation. Therefore, the GON is committed to supporing industrialization by establishing industries based on agriculture and local resources in rural sector, and establishing and developing industrial zones in urban areas.

Steel–rolling mills, cement, cigarettes, jute, sugar, tea, beer, carpets, garments, textiles, oilseed mills, and food mills are some of the most viable areas for investment in manufacturing and production industries in Nepal.

## Agriculture

Agriculture is the mainstay of the Nepalese economy, contributing approximately one-third of total GDP. A total of 74% of the total population still depends on agriculture for their subsistence. However, the growth rate of agriculture has not been encouraging, due to low investment both by the GON and the farmers themselves.

Nepal has great potential in tea, ginger, cardamom, and sugarcane production, which have high demand in the international market. Rice, wheat, and maize are the main food crops, and mustard, soybean and sunflower are the major oilseeds. Potato, lentil, tobacco and jute are the major cash crops, which have high demand in local market.

The Terai, Hills, and Mountains are suitable for various types of agriculture. There is considerable scope for commercial farming, tea, cardamom, coffee, honey, and ginger.

### Mine and Minerals

The GON has formulated acts and regulation to promote mineral exploration and development in the country. Two separate acts and corresponding regulations exist to deal with different minerals. These are categorized into:

1. All mineral resources (except petroleum)
2. Petroleum

There are several areas in which to invest in commercially viable mining and mineral industries. Limestone, dolomite, quartz, talc, coal, peat, precious and semiprecious stones, and brine water (salt) are some of the economic minerals used by cement, soap, marble, paper, dead burnt magnesite, and agriculture lime industries. The promotion of gum industries is highly recommended. Ruby, sapphire, tourmaline, aquamarine, garnet, kyanite, and quartz crystals also have high potential in Nepal. International companies can invest in cement, coal, petroleum exploration and production, and precious and semiprecious stone.

### Service

Possible sectors for investment in service industries include medical colleges, schools, hospitals, and IT businesses.

### Information and Communication

IT includes telecommunications, electronic media, print media, postal services, and the development and production of motion pictures in Nepal. The tele-density per hundred persons is 27, which includes the involvement of the private sector. At present, 70% of the population has access to television; however, a much larger percentage has access to mobile phone services. Difficulties have arisen in the expansion and development of these services to rural areas due to geographical complexities and the lack of infrastructure development.

The GON aims to promote national unification by providing access to all in the IT sector. The government plans to establish a optical fiber network in all 75 districts of Nepal by 2015. Therefore, there is the increased opportunity for private sector investment in this sector.

## Infrastructure Development

Highways, airways, and rural roads connect all districts of Nepal. Hydroelectricity projects of varying scopes are in process and construction, and various international organizations are engaged. Plans to build a fast-track road linking the capital city to international airports and other locations are being formulated.

# CHAPTER VI: STATUS OF FOREIGN DIRECT INVESTMENT IN NEPAL

Nepal is trying to attract FDI with the different rules and policies. Besides this, FDI has been involved in every five years Government plan and also some institutional arrangements for FDI promotion have been implanted for its development. In the recent decade, Nepal is well coming FDI and has been benefited. Nepal, strategically located between the two world's economic giants – China in the North and India in the East is a fertile land for investment given its rich natural resources, young and vibrant population and unique geo-topography. This strategic location not only offers unparalleled and preferential access to the China and India markets for bilateral trade and investments, but also provides the potential of Nepal acting as a transit hub which could facilitate increased trade in the future.

The government is deepening and broadening management while opened up to trade and FDI during the liberalization movement in the 1990's. Nepal became the member of WTO in 2004, reinforcing its commitment to integration with South Asian and other regional and global economies. It has further established its interest in economic integration through its memberships in regional economic blocs such as SAARC (South Asian Association for Regional Cooperation), BIMSTEC (Bay of Bengal Initiative for Multi-Sectorial Technical and Economic Cooperation) and SAFTA (South Asian Free Trade Area). Involvement in various multi and regional forums has provided Nepal with free and preferential access to international market.

Today, almost all developing countries are trying to attract foreign direct investment with objectives of getting access to foreign capital, technology and market. Similarly, Nepal is no different than other countries.

The volume of FDI inflows to Nepal has historically been very low. During 1980-1989, FDI flows to Nepal were minimal or even negative, with an annual average of Rs.45 million. There was a distinct acceleration during the 1990s, although total flows remained small: averaging Rs.18 billion per annum during 1990-2000. One factor explaining the increased FDI in the 1990s is Nepal's more liberal trade policy. For example, the unweighted average rate of import tariff

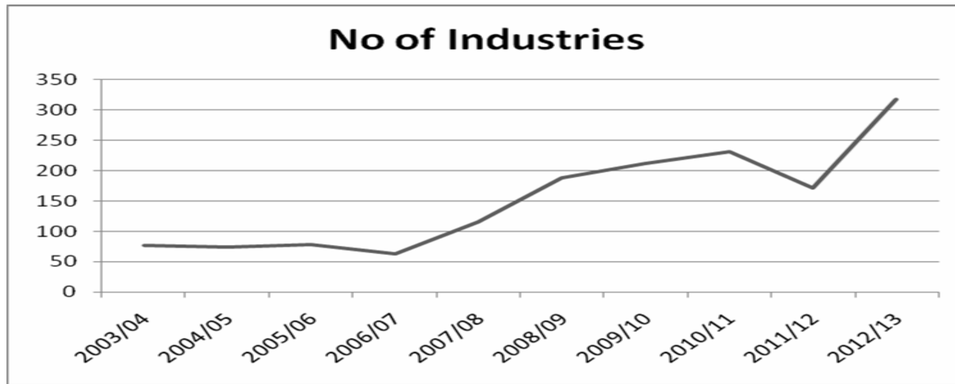
was drastically reduced from 111 per cent in 1989 to 16 per cent by 1992; and the number of tariff slabs fell from more than 100 in the 1980s to only 5 in 1996 (RIS, 2002). In addition, the establishment of bonded warehouses and the introduction of a duty drawback scheme reduced the previous trade policy's anti-export bias. Complementing this overall trade reform programme was a bilateral trade treaty with India concluded in 1996, which allowed India to import goods from Nepal free of import duty and quantitative restrictions if the goods were manufactured in Nepal (except those on the negative list). This has been cited as an explanation of the considerable expansion of Indian investment in Nepal after 1996 (RIS, 2002). Another factor was the liberalization of the exchange rate regime. The currency was made partially convertible in the current account in March 1992 and fully convertible in February 1993. Since 1994 all individuals and firms have been allowed to open accounts in major convertible currencies with domestic banks after showing evidence of the source of foreign exchange.

The importance of FDI and technology transfer in the country's development process was more emphasized after 1990. In 1991, the tax holiday period was extended to ten years for investments in national priority activities, which were defined to include industries producing goods that meet basic needs (such as food, clothing and housing and so forth), export promotion activities (where exports are 50% or more of total sales) and hotels and tourist projects. The Foreign Investment and Technology Transfer Act of 1992 opened up foreign investment in all industries except in defence, cigarettes, bidis and alcohol and, 100% foreign ownership was permitted. The development of hydropower was also opened up to foreign investment. The Act guaranteed 100% repatriation of equity, dividends and the payment of principal and interest on foreign loans in convertible currencies. Under the Foreign

## 6.1 Distribution by sector, origin and geographical location

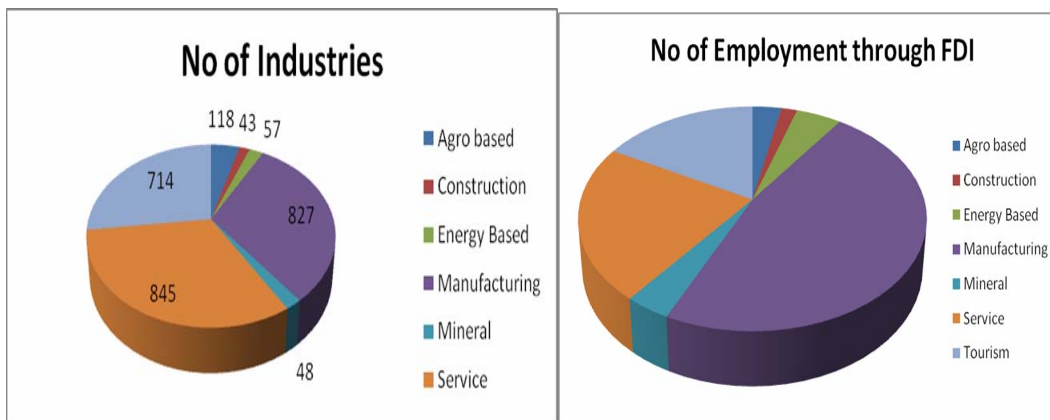
Available data for FDI reflect that total 2652 projects have been registered in Nepal comprising seven categories of industries, worth a total of investment equal to Rs.216 billion. The total fixed cost is estimated to be Rs. 181 billion while the total foreign direct investment (FDI) is estimated to be Rs. 52 billion as of July 2012/13. The registered projects provided employment

to 181,051. The below graph presents no of industries approved for foreign investment from the year 2058 to fiscal year 2069/2070. These data are taken from the "Industrial Statistics" which is published by the Department of Industries (DoI) each year.




*Source : Industrial Statistics published by Department of Industries, Nepal*

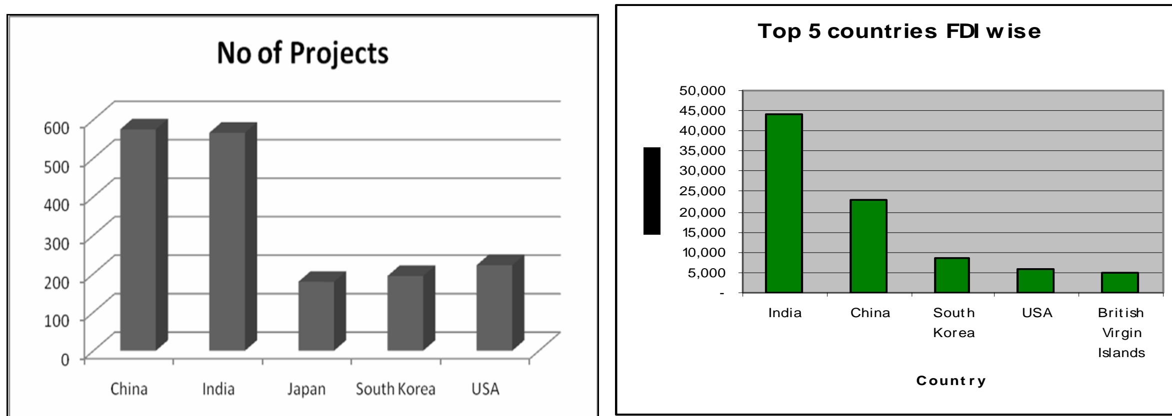
FDI is highly concentrated in the service sector, which accounted for 32 percent of approved FDI projects, 19 percent of foreign investment and over 22 percent of total employment. It is followed by manufacturing sector with over 31 percent of approved projects, 38 percent of foreign investment and 47 percent of total employment. Tourism stands in third position with 27 percent of approved projects, 12 percent of foreign investment and 17 percent of total employment. The energy based sector, though comes at fourth position by share in approved projects, it is second highest to attract the FDI with 26 percent of total foreign investment. The below figure shows the number of industries registered and no of employment created in Nepal under FDI till the year 2012/13.



*Source : Industrial Statistics published by Department of Industries, Nepal*

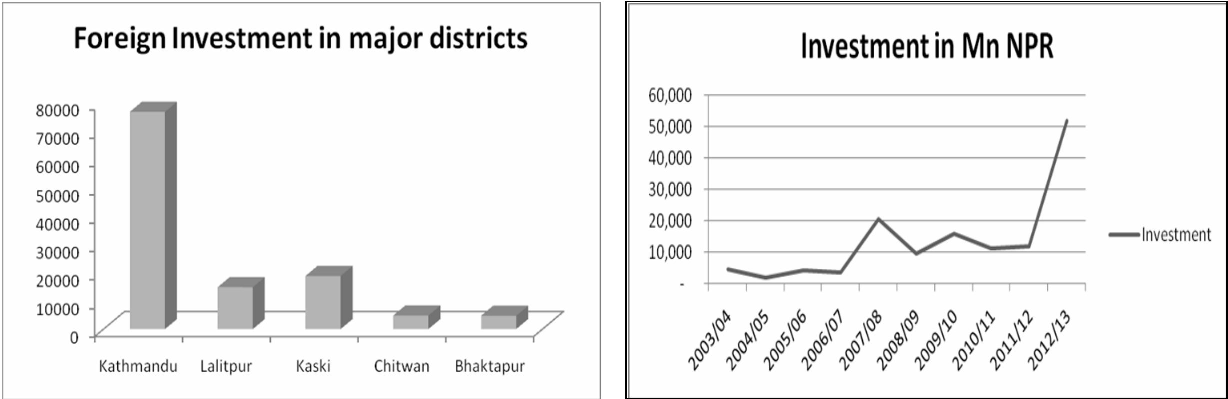
In average no of industries and number of employment are increasing year by year. Though the employment is increasing each year but this increment is mostly at the lower level .The reasons behind it may be lack of skilled manpower and brain drain etc. Most of the companies which are invested by the foreign investors, are hiring foreign workers. In such scenario Nepal has to focus in technical and practical education, develop the policies to retain skilled and educated manpower to reduce the rate of brain drain as well as to focus in establishing the stable business environment.

In country-wise FDI distribution, five countries accounts for about 59 percent of cumulative FDI. India alone accounts for 35 percent, followed by China with 10 percent, USA with 7 percent, South Korea with 5 percent and Japan with 2 percent. In total, investors from 76 different countries have invested in Nepal, but the scale and number of projects in most cases is small. Most of the FDI projects are of small size with 72%, medium-sized 17% and large-sized industries 11%. Many foreign investors in Nepal are individuals rather than corporate entities. Most of the FDI projects are of small size 80%, medium-sized 11% and large-sized industries 9%.



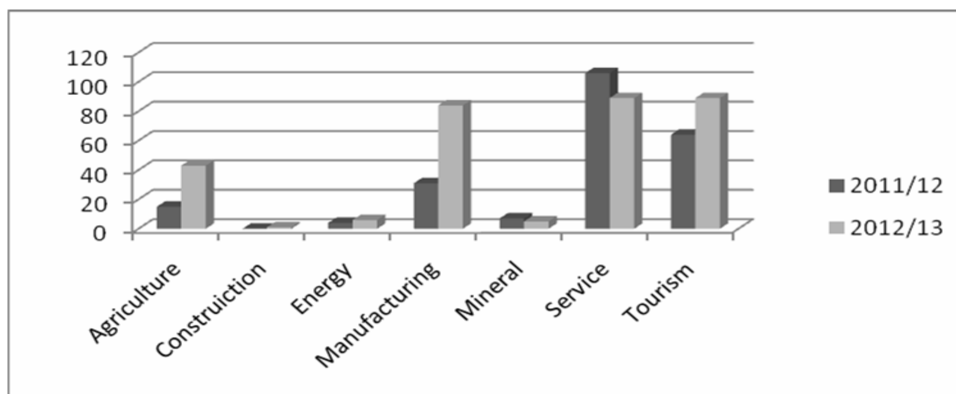

Further, the geographical distribution of FDI within Nepal is strongly concentrated in the Kathmandu Valley, which includes the capital city, Kathmandu, and offers the best infrastructure (transportation, power and telecommunications) and proximity to administrative decision centers. Fifty-seven per cent

of total FDI-related projects are located in this region, accounting for 36 per cent of total project cost and 45 per cent of employment. Little FDI is found in Nepal's hilly and mountainous region, which hosts only 12 per cent of projects in operation and 14 per cent of employment, although it is inhabited by more than half of Nepal's population. The inflow of FDI in Nepal from 2003/04 to 2012/13 is presented in the figure below.




With the gradual improvement in peace and security situation and investment-friendly environment, the inflow of foreign direct investment has increased. The Government of Nepal, Department of Industry granted approval to 317 joint venture projects with a foreign direct investment commitment of Rs. 52 billion in 2012/13 with an employment of 16,569. Out of 317 registered projects, 89 are service-related, 89 tourism, 84 manufacturing, 43 agriculture, 6 energy, 5 mines and 1 is construction-related projects. In the last year couple of years there have been remarkable increment in the energy, mining and tourism projects. There were 227 industries registered under FDI in the year 2011/12 which shows that there is increment of 40% in the approval of registration of industries in compare to the previous year.

The below figure shows the comparison of industries registered in 2011/12 and 2012/13.




This increment shall be more in the running year as there is huge inflow of FDI in energy, mining and tourism in the last one year. On the basis of number of projects, China stood first (97) followed by India (41) and USA (24) in the year 2012/13 with employment commitment of 16,569 people.

Figure depict the trend of number of industries approved for foreign investment, we can find that there is not the constant trend some time it goes up and some time it goes down but in average the number of industries is increasing year by year. Nepal can attract more industries in coming days if it focuses to improve the determining factors like private property rights, infrastructure, regulation, tax rates, corruption transparency etc.

## 6.2 Trend of Global FDI

Both developed and developing countries have been attracting FDI by offering several incentive packages and concessions to foreign investors. The developing countries particular have been making extra efforts to create an environment, which is conducive for attracting such investment. In order to attract FDI on large scale, governments have taken several steps to remove the barriers and irritants, which hinder the flow of investment.

In 2013, FDI flows returned to an upward trend. Global FDI inflows rose by 9 per cent to $1.45 trillion in 2013. FDI inflows increased in all major economic groupings − developed, developing, and transition economies. Global FDI stock rose by 9 per cent, reaching $25.5 trillion.

UNCTAD projects that global FDI flows could rise to $1.6 trillion in 2014, $1.75 trillion in 2015 and $1.85 trillion in 2016. The rise will be mainly driven by investments in developed economies as their economic recovery starts to take hold and spread wider. The fragility in some emerging markets and risks related to policy uncertainty and regional conflict could still derail the expected upturn in FDI flows.

As a result of higher expected FDI growth in developed countries, the regional distribution of FDI may tilt back towards the “traditional pattern” of a higher share of developed countries in global inflows .

FDI flows to developing economies reached a new high at $778 billion (table 1), accounting for 54 percent of global inflows, although the growth rate slowed to 7 per cent, compared with an average growth rate over the past 10 years of 17 per cent. Developing Asia continues to be the region with the highest FDI inflows, significantly above the EU, traditionally the region with the highest share of global FDI. FDI inflows were up also in the other major developing regions, Africa (up 4 per cent) and Latin America and the Caribbean (up 6 per cent, excluding offshore financial centres).

**Amount in Bn $**

| Region | FDI inflows | | | FDI Outflows | | |
|---|---|---|---|---|---|---|
| | 2011 | 2012 | 2013 | 2011 | 2012 | 2013 |
| **World** | 1700 | 1330 | 1452 | 1712 | 1347 | 1411 |
| Developed Economies | 880 | 517 | 566 | 1216 | 853 | 857 |
| European Union | 490 | 216 | 246 | 585 | 238 | 250 |
| North America | 263 | 204 | 250 | 439 | 422 | 381 |
| Developing Economies | 725 | 729 | 778 | 423 | 440 | 454 |
| Africa | 48 | 55 | 57 | 7 | 12 | 12 |
| Asia | 431 | 415 | 426 | 304 | 302 | 326 |
| East and South-East Asia | 333 | 334 | 347 | 270 | 274 | 293 |
| South Asia | 44 | 32 | 36 | 13 | 9 | 2 |
| West Asia | 53 | 48 | 44 | 22 | 19 | 31 |
| Latin America and the Caribbean | 244 | 256 | 292 | 111 | 124 | 115 |
| Oceania | 2 | 3 | 3 | 1 | 2 | 1 |
| Transitional Economies | 95 | 84 | 108 | 73 | 54 | 99 |
| Structurally weak, vulnerable and small economies | 58 | 58 | 57 | 12 | 10 | 9 |
| LDCs | 22 | 24 | 28 | 4 | 4 | 5 |
| LLDCs | 36 | 34 | 30 | 6 | 3 | 4 |

Although FDI to developed economies resumed its recovery after the sharp fall in 2012, it remained at a historically low share of total global FDI flows (39 per cent), and still 57 per cent below its peak in 2007. Thus, developing countries maintained their lead over developed countries by a margin of more than $200 billion for the second year running. Developing countries and transition economies now also constitute half of the top 20 economies ranked by FDI inflows. Mexico moved into tenth place. China recorded its largest ever inflows and maintained its position as the second largest recipient in the world.

FDI by transnational corporations (TNCs) from developing countries reached $454 billion – another record high. Together with transition economies, they accounted for 39 per cent of global FDI outflows, compared with only 12 per cent at the beginning of the 2000s. Six developing and transition economies ranked among the 20 largest investors in the world in 2013. Increasingly, developing-country TNCs are acquiring foreign affiliates of developed-country TNCs in the developing world.

Although historically FDI in many poor developing countries has relied heavily on extractive industries, the dynamics of greenfield investment over the last 10 years reveals a more nuanced picture. The share of the extractive industry in the cumulative value of announced cross-border greenfield projects is substantial in Africa (26 per cent) and in LDCs (36 per cent). However, looking at project numbers the share drops to 8 per cent of projects in Africa, and 9 per cent in LDCs, due to the capital intensive nature of the industry.

Moreover, the share of the extractive industry is rapidly decreasing. Data on announced Greenfield investments in 2013 show that manufacturing and services make up about 90 per cent of the total value of projects both in Africa and in LDCs.
FDI inflows to Africa rose by 4 per cent to $57 billion, driven by international and regional market-seeking and infrastructure investments. Expectations for sustained growth of an emerging middle class attracted FDI in consumer-oriented industries, including food, IT, tourism, finance and retail.

The overall increase was driven by the Eastern and Southern African subregions, as others saw falling investments. In Southern Africa flows almost doubled to $13 billion, mainly due to record-high flows to South Africa and Mozambique. In both countries, infrastructure was the main attraction, with investments in the gas sector in Mozambique also playing a role. In East Africa, FDI increased by 15 per cent to $6.2 billion as a result of rising flows to Ethiopia and Kenya. Kenya is becoming a favoured business hub, not only for oil and gas exploration but also for manufacturing and transport; Ethiopian industrial strategy may attract Asian capital to develop its manufacturing base. FDI flows to North Africa decreased by 7 per cent to $15 billion. Central and West Africa saw inflows decline to $8 billion and $14 billion, respectively, in part due to political and security uncertainties.

Intra-African investments are increasing, led by South African, Kenyan, and Nigerian TNCs. Between 2009 and 2013, the share of announced cross-border greenfield investment projects originating from within Africa increased to 18 per cent, from less than 10 per cent in the

preceding period. For many smaller, often landlocked or non-oil-exporting countries in Africa, intraregional FDI is a significant source of foreign capital.

Increasing intra-African FDI is in line with leaders' efforts towards deeper regional integration. However, for most sub regional groupings, intra-group FDI represent only a small share of intra-African flows. Only in two regional economic cooperation (REC) initiatives does intra-group FDI make up a significant part of intra-African investments – in EAC (about half) and SADC (more than 90 per cent) – largely due to investments in neighbouring countries of the dominant outward investing economies in these RECs, South Africa and Kenya. RECs have thus so far been less effective for the promotion of intraregional investment than a wider African economic cooperation initiative could be.

Intra-African projects are concentrated in manufacturing and services. Only 3 per cent of the value of announced intraregional greenfield projects is in the extractive industries, compared with 24 per cent for extra-regional greenfield projects (during 2009-2013). Intraregional investment could contribute to the buildup of regional value chains. However, so far, African global value chain (GVC) participation is still mostly limited to downstream incorporation of raw materials in the exports of developed countries.

With total FDI inflows of $426 billion in 2013, developing Asia accounted for nearly 30 per cent of the global total and remained the world's number one recipient region. FDI inflows to East Asia rose by 2 per cent to $221 billion. The stable performance of the subregion was driven by rising FDI inflows to China as well as to the Republic of Korea and Taiwan Province of China. With inflows at $124 billion in 2013, China again ranked second in the world. In the meantime, FDI outflows from China swelled by 15 per cent, to $101 billion, driven by a number of megadeals in developed countries. The country's outflows are expected to surpass its inflows within two to three years. Hong Kong (China) saw its inflows rising slightly to $77 billion. The economy has been highly successful in attracting regional headquarters of TNCs, the number of which reached nearly 1,400 in 2013.

Inflows to South-East Asia increased by 7 per cent to $125 billion, with Singapore – another regional headquarters economy – attracting half. The 10 Member States of ASEAN and its 6 FTA partners (Australia, China, India, Japan, the Republic of Korea and New Zealand) have launched negotiations for the RCEP. In 2013, combined FDI inflows to the 16 negotiating members of RCEP amounted to $343 billion, 24 percent of world inflows. Over the last 15 years, proactive regional investment cooperation efforts in East and South-East Asia have contributed to a rise in total and intraregional FDI in the region. FDI flows from RCEP now makes up more than 40 per cent of inflows to ASEAN, compared to 17 per cent before 2000. Intraregional FDI in infrastructure and manufacturing in particular is bringing development opportunities for low-income countries, such as the Lao People's Democratic Republic and Myanmar.

Inflows to South Asia rose by 10 per cent to $36 billion in 2013. The largest recipient of FDI in the sub region, India, experienced a 17 per cent increase in FDI inflows to $28 billion. Defying the overall trend, investment in the retail sector did not increase, despite the opening up of multi-brand retail in 2012. Corridors linking South Asia and East and South-East Asia are being established – the Bangladesh-China-India-Myanmar Economic Corridor and the China-Pakistan Economic Corridor. This will help enhance connectivity between Asian subregions and provide opportunities for regional economic cooperation. The initiatives are likely to accelerate infrastructure investment and improve the overall business climate in South Asia.

FDI flows to West Asia decreased in 2013 by 9 per cent to $44 billion, failing to recover for the fifth consecutive year. Persistent regional tensions and political uncertainties are holding back investors, although there are differences between countries. In Saudi Arabia and Qatar FDI flows continue to follow a downward trend; in other countries FDI is slowly recovering, although flows remain well below earlier levels, except in Kuwait and Iraq where they reached record levels in 2012 and 2013, respectively.

FDI outflows from West Asia jumped by 64 per cent in 2013, driven by rising flows from the GCC countries. A quadrupling of outflows from Qatar and a near tripling of flows from Kuwait

explained most of the increase. Outward FDI could increase further given the high levels of GCC foreign exchange reserves.

FDI flows to Latin America and the Caribbean reached $292 billion in 2013. Excluding offshore financial centres, they increased by 5 per cent to $182 billion. Whereas in previous years FDI was driven largely by South America, in 2013 flows to this subregion declined by 6 per cent to $133 billion, after three consecutive years of strong growth. Among the main recipient countries, Brazil saw a slight decline by 2 per cent, despite an 86 per cent increase in flows to the primary sector. FDI in Chile and Argentina declined by 29 per cent and 25 per cent to $20 billion and $9 billion, respectively, due to lower inflows in the mining sector.

Flows to Peru also decreased, by 17 per cent to $10 billion. In contrast, FDI flows to Colombia increased by 8 per cent to $17 billion, largely due to cross-border M&As in the electricity and banking industries. Flows to Central America and the Caribbean (excluding offshore financial centres) increased by 64 percent to $49 billion, largely due to the $18 billion acquisition of the remaining shares in Grupo Modelo by Belgian brewer AB InBev − which more than doubled inflows to Mexico to $38 billion. Other increases were registered in Panama (61 per cent), Costa Rica (14 per cent), Guatemala and Nicaragua (5 per cent each). FDI outflows from Latin America and the Caribbean (excluding offshore financial centres) declined by 31 per cent to $33 billion, because of stalled acquisitions abroad and a surge in loan repayments to parent companies by foreign affiliates of Brazilian and Chilean TNCs.

Looking ahead, new opportunities for foreign investors in the oil and gas industry, including shale gas in Argentina and sectoral reform in Mexico, could signal positive FDI prospects. In manufacturing, automotive TNCs are also pushing investment plans in Brazil and Mexico. The growth potential of the automotive industry appears promising in both countries, with clear differences between the two in government policies and TNC responses. This is reflected in their respective levels and forms of GVC participation. In Mexico, automotive exports are higher, with greater downstream participation, and higher imported value added. Brazil's

producers, many of which are TNCs, serve primarily the local market. Although its exports are lower, they contain a higher share of value added produced domestically, including through local content and linkages.

FDI to transition economies at record levels, but prospects uncertain FDI inflows to transition economies increased by 28 per cent to reach $108 billion in 2013. In South-East Europe, flows increased from $2.6 billion in 2012 to $3.7 billion in 2013, driven by the privatization of remaining State-owned enterprises in the services sector. In the Commonwealth of Independent States (CIS), the 28 per cent rise in flows was due to the significant growth of FDI to the Russian Federation.

Although developed countries were the main investors, developing-economy FDI has been on the rise. Prospects for FDI to transition economies are likely to be affected by uncertainties related to regional instability. In 2013, outward FDI from the region jumped by 84 per cent, reaching a record $99 billion. As in past years, Russian TNCs accounted for the bulk of FDI projects. The value of cross-border M&A purchases by TNCs from the region rose more than six-fold, and announced greenfield investments rose by 87 per cent to $19 billion.

Over the past decade, transition economies have been the fastest-growing host and home region for FDI. EU countries have been the most important partners in this rapid FDI growth, both as investors and recipients. The EU has the largest share of inward FDI stock in the region, with more than two thirds of the total. In the CIS, most of their investment went to natural resources, consumer sectors, and other selected industries as they were liberalized or privatized. In South-East Europe, EU investments have also been driven by privatizations and by a combination of low production costs and the prospect of association with, or membership of the EU. In the same way, the bulk of outward FDI stock from transition economies, mainly from the Russian Federation, is in EU countries. Investors look for strategic assets in EU markets, including downstream activities in the energy industry and value added production activities in manufacturing.

Inflows to developed countries resume growth after a sharp fall in 2012, inflows to developed economies recovered in 2013 to $566 billion, a 9 per cent increase. Inflows to the European Union were $246 billion (up 14 per cent), less than 30 per cent of their 2007 peak. Among the major economies, inflows to Germany – which had recorded an exceptionally low volume in 2012 – rebounded sharply, but France and the United Kingdom saw a steep decline. In many cases, large swings in intra-company loans were a significant contributing factor. Inflows to Italy and Spain rebounded sharply with the latter becoming the largest European recipient in 2013. Inflows to North America recovered to $250 billion, with the United States –the world's largest recipient – recording a 17 per cent increase to $188 billion.

Outflows from developed countries were $857 billion in 2013 – virtually unchanged from a year earlier. A recovery in Europe and the continued expansion of investment from Japan were weighed down by a contraction of outflows from North America. Outflows from Europe increased by 10 per cent to $329 billion. Switzerland became Europe's largest direct investor. Against the European trend, France, Germany and the United Kingdom registered a large decline in outward FDI. Outflows from North America shed another 10 per cent to $381 billion, partly because United States TNCs transferred funds from Europe, raised in local bond markets, back to the United States. Outflows from Japan grew for the third successive year, rising to $136 billion.

Both inflows and outflows remained at barely half the peak level seen in 2007. In terms of global share, developed countries accounted for 39 per cent of total inflows and 61 per cent of total outflows – both historically low levels. Although the share of transatlantic FDI flows has declined in recent years, the EU and the United States are important investment partners – much more so than implied by the size of their economies or by volumes of bilateral trade. For the United States, 62 per cent of inward FDI stock is held by EU countries and 50 per cent of outward stock is located in the EU. For the EU, the United States accounts for one third of FDI flows into the region from non-EU countries.

FDI inflows to LDCs up, but LLDCs and SIDS down FDI inflows to least developed countries (LDCs) rose to $28 billion, an increase of 14 per cent. While inflows to some larger host LDCs fell or stagnated, rising inflows were recorded elsewhere. A nearly $3 billion reduction in divestment in Angola contributed most, followed by gains in Bangladesh, Ethiopia, Mozambique, Myanmar, the Sudan and Yemen. The share of inflows to LDCs in global inflows remains small at 2 per cent.

The number of announced greenfield investment projects in LDCs reached a record high, and in value terms they reached the highest level in three years. The services sector, driven by large-scale energy projects, contributed 70 per cent of the value of announced greenfield projects. External sources of finance constitute a major part of the funding behind a growing number of infrastructure projects in LDCs. However, a substantial portion of announced investments has so far not generated FDI inflows, which can be due to structured finance solutions that do not translate into FDI, long gestation periods spreading outlays over many years, or actual project delays or cancellations.

FDI flows to the landlocked developing countries (LLDCs) in 2013 fell by 11 per cent to $29.7 billion. The Asian group of LLDCs experienced the largest fall in FDI flows of nearly 50 per cent, mainly due to a decline in investment in Mongolia. Despite a mixed picture for African LLDCs, 8 of the 15 LLDC economies increased their FDI inflows, with Zambia attracting most at $1.8 billion. FDI remains a relatively more important factor in capital formation and growth for LLDCs than developing countries as a whole. In developing economies the size of FDI flows relative to gross fixed capital formation has averaged 11 per cent over the past decade but in the LLDCs it has averaged almost twice this, at 21 per cent.

FDI inflows to the small island developing States (SIDS) declined by 16 per cent to $5.7 billion in 2013, putting an end to two years of recovery. Mineral extraction and downstream-related activities, business and finance, and tourism are the main target industries for FDI in SIDS.

## 6.3 FDI In the South Asian Region

The FDI inflow in South Asian countries is given in the following table. The table below shows the FDI inflow in South Asia from 2001 to 2010:

(Million USD)

| YEAR | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|
| Afghanistan | 1,010 | 1,105 | 1,180 | 1,392 | 1,475 | 1,569 | 1,638 |
| Bangladesh | 4,399 | 4,816 | 5,279 | 6,072 | 6,166 | 7,750 | 8,596 |
| Bhutan | 22 | 26 | 53 | 67 | 88 | 142 | 163 |
| India | 105,790 | 125,212 | 171,218 | 205,580 | 206,354 | 224,988 | 226,748 |
| Maldives | 558 | 740 | 898 | 1,114 | 1,371 | 1,655 | 1,980 |
| Nepal | 126 | 127 | 166 | 253 | 348 | 440 | 514 |
| Pakistan | 25,621 | 16,473 | 17,673 | 19,828 | 20,916 | 23,125 | 27,589 |
| Sri Lanka | 3,530 | 4,283 | 4,687 | 5,008 | 5,990 | 6,931 | 7,846 |

*Source:* http://www.unctad.org/sections/dite_dir/docs/WIR11_web%20tab%201.pdf

# CHAPTER VII: CONTRIBUTION OF FDI IN THE ECONOMY OF NEPAL

Foreign direct investment (FDI) is always contributing in the positive growth toward the economy of one country due to the investment by another country or country's personnel's. The effectiveness and efficiency of Global economy depends upon the investor's perception, if investment seen with the purpose of long terms investment in the social-economical development then it is said that the investment contributes positively towards global economy. The FDI may also be affected due to the governmental trade barriers and policies for the foreign investments and leads to less or more effective toward contribution in economy as well as GDP and GNP of the country. In Nepal more than 25% of the registered projects under FDI fall in sectors such as, service, manufacturing, tourism and energy. The various indicators to assess the input of FDI are as follows.

## 7.1 Productivity

Multinational companies are bringing with them some firm-specific knowledge (in the form of technology, managerial expertise, marketing know-how etc.) that cannot be effectively leased or purchased on the market by host country firms. For instance, affiliates of MNCs–as part of the parent company's global network–have excellent marketing networks, possess experience and expertise in the many complex facets of product development and international marketing, and are well placed to take advantage of inter-country differences in the cost of production. On these grounds, FDI is widely considered as an effective means of acquiring technology and marketing know-how.

## 7.2 Investment Inflow

The investors are bringing capital in Nepal. The total 2652 projects have been registered in Nepal comprising seven categories of industries, worth a total of investment equal to Rs.216 billion. The total fixed cost is estimated to be Rs. 181 billion while the total foreign direct investment (FDI) is estimated to be Rs. 52 billion as of July 2012/13. The FDI is also helping to reduce the balance of payments of the country. The goods produced by the industries under FDI are exported to foreign countries bring foreign currencies to Nepal.

## 7.3 Technology Transfer

The foreign investors are also bringing the new technologies to Nepal which is helping the local producers to learn know-how and apply it in the domestic companies and ultimately help in increasing the productivity of the companies as well as workforce.

## 7.4 Capital Development

The local capital is not enough for the required investment in the big projects like mega hydropower projects, mining projects and big hotels where there is huge investment in billions of dollars. For example NPR 140 billions of commitment is under mining projects whereas more than NPR 400 billion is under hydropower projects. These amounts of capital are not possible from the local capital.

## 7.5 Employment Generation

The registered projects under FDI are providing employment to local workforce. They have created employment to 181,051 till 2012/13 whereas the number of employment created by FDI in the 2012/13 was 16,569.

## 7.6 Reduction in the import items:

From the data available the FDI is second highest in the manufacturing sector which means the import items are displaced by the product manufactured in the country.

## 7.7 Tax Revenue

Profits generated by FDI are contributing to corporate tax revenues in the country.

## 7.8 Human Resource Development

The local staffs are gaining employee training in the course of operating the new generation and experiencing the multinational concept of operating the company.

However in this study because of data availability only few indicators are used. These are investment flow, capital development and employment.

# CHAPTER VIII: CHALLENGES IN THE GROWTH OF FDI IN NEPAL

While there are some typical challenges that each post-conflict LDC like Nepal faces in terms of attracting as well as retaining investment, Nepal faces certain constraints that are neither common nor explained by any theory. Given the fact that there is need to utilize FDI to achieve the development objectives such as poverty alleviation and inclusive economic growth pursued by the Government, these challenges become even starker. It is general assumption that the development objectives can be achieved, among others, through: i) Meeting the financing needs for large infrastructure projects; ii) meeting the technology transfer requirement of the country; iii) provision of employment opportunities to poor, marginalized and vulnerable people such as women, dalits and other ethnic communities that are excluded from the development mainstream and making; and iv) retaining maximum possible value addition in the national economy.

For the purpose of this thesis, the challenges can be broadly divided into four categories:

i) Political and governance related;

ii) Legal, institutional and policy-related;

iii) Infrastructure-related;

iv) Resource-related.

## 8.1 Political and governance-related

Ninety percent of the respondents of an enterprise survey conducted in Nepal in 2009 viewed that political instability is a major to severe obstacle constraining investment climate, and 70 percent of them thought that this was a major obstacle. At the same time corruption, which is a proxy for governance, was considered a major to severe obstacle by 21 percent of the

respondents, and none of them felt that this was a major obstacle. In the study, it was found that the situation has improved slightly in the past two years or so, not least because they too singled out political instability and governance as the major constraints to investment climate. Lengthening of the political transition has deterred Nepalese as well as foreign investors from making investments in Nepal due to the insecurity resulting from uncertainty. This sentiment has become widespread, particularly after the failure of the government to write a new constitution, which was expected to chart out a new political course for the country to move towards a credible development trajectory. While political environment as a problem has also been highlighted by Nepal Economic Outlook, failure to promulgate the new constitution means that even local investors are shelving their investment plans and holding back on their commitments for the time being. In such a situation, it would be imprudent to assume that foreign investors will substantially increase their investments. The attendant fallout has been a constant deterioration in the quality of governance indicators, which creates uncertainty as well as impacts on the competitiveness of enterprises, and perpetuates the culture of impunity. One of the extreme examples of this latter tendency is the state seizure by interest groups, which can go to any extent to declare strikes and resort to bandh combining violence with extremism, to make their demand met. The organizers of these strikes and bandh are either oblivious of the costs of their actions to the economy in general, and production loss as well as the signal they send to investors in particular, or they are emboldened by the impunity surrounding political order. What is surprising is that these kinds of activities are considered perfectly legitimate not only by strike enforcers, but also by public at large. As if this was not enough, donation and extortion rises with the formation of each new political party, with the private sector getting jittery each time a party splits. With the judiciary, considered a sacred institution in the past, too having come under the shadow of suspicion, there is a limited possibility for the governance situation to get any better any time soon.

## 8.2 Legal, institutional and policy-related

Overlapping and often contradictory laws and institutional arrangements, differing priorities of various agencies of the government, coupled with serious gaps between policies and their actual implementation on the ground, are collectively responsible for the deterioration in the quality of investment climate in Nepal. Implementation Evaluation of Foreign Direct Investment Policy in Nepal, commissioned by the Economic Policy Network a joint initiative of the Ministry of Finance and the ADB reveals that the fiscal incentives, including income tax relief provided by the Foreign Investment and Technology Transfer Act, 1992 and Industrial Enterprises Act, 1992, are nullified by the provisions of the amended Revenue Act and the New Income Tax Act.57 Similarly, even if concerned foreign investors fulfill all the requirements and the DOI recommends for the provision of visa for those investors and their dependent family members, the Department of Immigration under the Ministry of Home does not provide such visas in a hassle-free manner. These problems arise mainly due to differing priorities of the different government agencies, with officials from other ministries not prepared to —own the idea that increased foreign investment is indeed good for the economy. Moreover, there is a feeling that it is the sole responsibility of the Ministry of Industry or the DOI to attract and retain foreign investors. For example, the Ministry of Finance is singularly concerned about revenue generation with its Department of Internal Revenue and Department of Customs both remaining uncooperative while providing fiscal incentives to foreign investors. Regarding institutional arrangement, although the one window policy has been around for more than a decade, and the DOI was responsible to provide one stop facility to all the foreign investors, this has never been the practice, because all that DOI can do is to provide recommendations. Foreign investors are obliged to visit the Department of Immigration for the purpose of visa, the Ministry of Environment for conducting Environmental Impact Assessment (EIA) or Initial Environmental Examination (IEE) and the Department of Revenue/Customs for obtaining fiscal incentives/exemptions promised by various legislation. With the establishment of the Investment Board, there have been discussions going on as to whether it offers one window

facility to foreign investors or it simply is —one more window. The problems on the policy side are twofold. First, there is no policy stability in the country, which is partly because of the prolonged political conflict. Second, even those sound policies that have been formulated are hardly implemented. The gap between policy and implementation is due to a combination of factors as highlighted in a study focusing on South Asian LDCs, including Nepal. First, policy itself could be faulty, if the implementation is found lacking even after repeated attempts. Second, public officials choose not to implement some policies, either because the policies are top-down or externally driven and the public officials do not own them or because they do not have the capacity to implement the policies.

## 8.3 Infrastructure-related

The IFC enterprise survey finds that two major infrastructure-related constraints are electricity and transport, with 57 percent of the enterprises surveyed suggesting electricity as the —major to very severe obstacle and 16 percent finding this as the —most important obstacle. The corresponding figures for transport were much lower, at 25 and 2 percent, respectively. However, other studies find both of these as the major constraints, which is vindicated by the interviews conducted with stakeholders and experts for the purpose of this study. Both the factors dampen investors' confidence and deter them from making or retaining, let along increasing, investment in Nepal because they severely erode the competitiveness of enterprises due to the higher transaction costs they inflict. Since the problem of electricity shortage is not likely to be resolved anytime soon, the alternative is to invest in captive generators, which are very expensive to run due to rising fuel prices. As far as transport infrastructure is concerned, the underdeveloped nature of Nepal's transport sector, coupled with the dilapidated nature of its road infrastructure, is highlighted by a number of global reports, including the Enabling Trade Report, Global Competitiveness Report and Logistics Performance Indicators . For example, according to the Global Enabling Trade Report 2012, although Nepal's overall ranking appears reasonably good (better than Bangladesh), it is due largely to better performance on two indicators. First, airport density is bound to be higher in a country with mountainous terrain like Nepal, where

road network is rudimentary and not yet fully connected to all the district headquarters. Second, although the percentage of paved road is reported to be 55.5 percent in Nepal this is due to the fact that the total road length itself is limited in the case of Nepal. Moreover, the reported figure does not take into account the condition of the road, which means even dilapidated roads are categorized as paved road, irrespective of their condition.

**Availability and quality of transport infrastructure in South Asia**

| Country/Indicators (N = 132) | Bangladesh | India | Nepal | Pakistan | Sri Lanka |
|---|---|---|---|---|---|
| Transport infrastructure (overall) | 126 | 76 | 96 | 75 | 58 |
| Airport density, number per million population | 132 | 128 | 42 | 116 | 131 |
| Trans-shipment connectivity index, 0– 100 (best) | 96 | 18 | | 27 | 23 |
| Paved roads, % of total | 120 | 69 | 63 | 59 | 43 |
| Quality of air transport infrastructure, 1–7 (best) | 109 | 62 | 113 | 78 | 56 |
| Quality of railroad infrastructure, 1–7 (best) | 74 | 24 | 128 | 60 | 38 |
| Quality of roads, 1–7 (best) | 102 | 78 | 119 | 72 | 45 |
| Quality of port infrastructure, 1–7 (best) | 105 | 76 | 125 | 66 | 42 |

*Source: Foreign Direct Investment in Nepal, Swatee*

Given the fact that 79.15 percent of total export and 81.51 percent of import take place via land route, the salience of the quality of road transportation cannot be overemphasized. Therefore, the most important index for us is the —quality of roads , in which Nepal finds itself at the bottom of the list with ranking of 119 out of 132 countries included in the report. This is vindicated by a study which asserts that most of the road traffic from Kathmandu (the capital

city) and major business centres to all major border points to India has to travel through 36 km Mungling Narayanghat road, which is the major bottleneck due to poor road conditions and frequent landslides during rainy seasons. Moreover, a number of bridges along the Hetauda to Pathalaiya sector, which are used by east-bound cargos, are only single lane and could become a major constraint as traffic increases. Congestion at the Birgunj border point is a frequent phenomenon as the custom yard for road-based cargo is inadequate.

## 8.4 Resource-related

Although there are several problems that the investors face under this category, three key resources, human, financial and technological resources has been focused in the study.

**Human resources**

There are several levels at which the issue of human resource constraints should be looked at. First, Nepal does not have enough educated human resources endowed with skills required for being productively employed in manufacturing and services sectors. Although there has been some improvement in the general level of literacy as well as education in the country due to higher levels of investment made in the education sector, Nepal has a long way to go before achieving the quantitative as well as qualitative targets on education. Even those who are educated have already migrated abroad in search of greener pasture. This is vindicated by the fact that Nepal has the highest incidence of brain drain in South Asia, followed by Bangladesh, as revealed by the Global Competitiveness Report. Second, but related issue is that although most industries are operating below capacity due to electricity and other problems, the situation has arisen whereby the industrialists are mulling over scaling down their production due to acute shortage of human resources. Due to the shortage of workers, wages have shot up such that Nepal has become the country with the highest wage overhead in South Asia. Finally, those workers that have been left behind are heavily unionized and are apt at demanding higher wages and facilities without making commensurate increase in their own productivity. They are politically motivated, and operate more as sister wings of their political parties than as a productive force concerned about enhancing the productivity of the enterprise, letting business

survive in the fiercely competitive market and wait to share the reward later, let alone struggling for the emancipation of workers.

**Financial resources**

As for access to finance, IFC (2009) finds that only 74 percent of the firms have a bank account and 39 percent have a line of credit or a loan from a financial institution. It also states that most firms rely on internal funds to finance the bulk of their investments and their working capital needs. Three years on, some improvement in the situation is shown by the Doing Business Report. However, it is still a bit nuanced and has to be understood differently depending on the size and origin of the company. While there is little problem in terms of access to finance (in particular obtaining credit from banks) for relatively large companies and companies of foreign origin, according to a survey of small and medium enterprises conducted in 2011, it is highly restricted in the case of micro, small and medium enterprises.83 According to the survey, the major reasons for the reluctance of these enterprises to obtain loan from banks are in the following order: high interest rate; collateral-related problems; and lengthy and burdensome process. Access to finance should still be considered a minor hindrance for foreign investors in establishing their presence in Nepal due to two major reasons. First, foreign investors—particularly multinational corporations—are generally considered cash rich and having deep pockets. The whole idea of investing in another country is to utilize the excess funds they have to access foreign markets or exploit other comparative advantages of the host country. Second, as noted above, banks and financial institutions in Nepal are generally more inclined to offer loans to foreign investors at cheaper rates as compared to local entrepreneurs. This is admittedly due to risk perception, as Nepalese bankers believe that foreign investors are less likely to default due to their generally well-established reputation and credibility in the national as well as international markets. However, there could be occasions when foreign investors would like to make use of the local financial market for financing their projects as well as meet their working capital requirements. In such a situation, the Nepalese market is not considered attractive for those investors because the capital market in the country is relatively under-developed, and when it comes to obtaining large amount of loan, even banks and financial

institutions are constrained due to the single borrower limit imposed by the Central Bank of the country. Since the single borrow limit is 25 percent for funded facilities (such as loans and advances) and 50 percent for non-funded facilities (such as letter of credit and bank guarantee) and the several class A commercial banks still have their core capital below NRs. 3 billion, the maximum amount of funded-facility they can provide to an enterprise or a group is less than NRs. 700 million. This amount is not at all enough for large infrastructure projects such as hydropower (for which cost of generating one kilowatt of power on average is NRs. 150 million and other projects such as road, rail or airport construction.

**Technological resources**

As for the issue of technology, based on various indicators prepared by international organizations, such as the Global Competitiveness Report at the macro level, or the IFC Enterprise Survey at the micro-level, Nepal ranks the lowest in the region. For the macro level analysis, we take two indicators included in the Global Competitiveness Report. The first one is technological readiness, which measures the agility with which an economy adopts existing technologies to enhance the productivity of its industries (WEF 2012b:) . The second indicator relates to innovation, which is particularly important for [developing] economies as they approach the frontiers of knowledge and the possibility of generating more value by only integrating and adapting exogenous technologies tends to disappear (ibid: 7). Table below provides a comparative picture of these indicators for South Asian countries.

**Technology-related indicators for South Asian countries, 2012-2013**

| Country (N = 144) | Technological readiness | Innovation |
|---|---|---|
| | Rank | Rank |
| Bangladesh | 125 | 123 |
| India | 96 | 41 |

| | | |
|---|---|---|
| Nepal | 129 | 133 |
| Pakistan | 118 | 77 |
| Sri Lanka | 89 | 58 |

*Source: Foreign Direct Investment in Nepal, Swatee*

The table shows that two developing countries of the region, namely India and Sri Lanka, are well placed in the technological frontiers because they have better indicators than many other developing countries outside the region (not shown here). Although Pakistan's ranking for the technological readiness indicator may not be considered good enough for a developing economy, its ranking on the innovation front is satisfactory. However, two LDCs in the region Bangladesh and Nepal lag far behind other countries, but Nepal is the worst performer in the region along both the indicators presented in the table. In terms of innovation, Nepal ranks 11th from the bottom, although it is marginally better placed in terms of technological readiness on which it ranks 15th from the bottom.

# CHAPTER IX: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

## 9.1 Summary

Nepal has a long way to go to make the environment investor friendly. A developed stock exchange, full convertibility of foreign exchange or free mobility of capital and easy repatriation of profits and deregulations are some of the preconditions for FDI. These preconditions are yet to be fully achieved in Nepal.

At the same time, political instability and social and political disturbances have affected the joint venture projects already operating in Nepal. Some of such undertakings have been withdrawing their capital. For instance, the French shareholders have withdrawn their capital from the Nepal Indosuez Bank. Similarly, the Kodak Company and Colgate- Palmolive have closed down their factories at Hetauda in the past. Surya Nepal has closed its textile industry due to union and other political instability couple of years ago. Indian businessmen involve in developing hydropower plants have been various obstacles from the local parties. These recent developments appearing in the Nepalese business scenario have been a big set back to the ongoing efforts of the government to attract foreign investment.

The major findings of this study are as follows:

1. The country at present lacks any long terms vision with internal security emerging as major issues.
2. The local investors have to be encouraged and foreign participation needs to be increased with the provision of adequate incentives for income tax holidays, repatriation of investment, and if possible, constitutional guarantee for private property rights.
3. Foreign aid has to be replaced by foreign investment, especially in export promoting high technology industries.
4. Security and Maoist insurgency was not only the reason for the declining trend for foreign investment in Nepal.

5. Failure of the government mechanisms for improving degree of effectiveness in FDI utilization.
6. Natural and domestic resources should be utilized at maximum.
7. Following the global trend and trying to implement them in context of Nepal is not going to work, as Nepal presents a different economic scenario and investment environment.
8. Foreign investment in Nepal has developed a wrong perspective among the people that is dependency and long term it is very dangerous for the growth and sustainability of the country.
9. There should be division of areas so that there arise no bottleneck for being landlocked country.
10. Furthermore, the results indicate that most of the causal links are found in developing countries which experience a higher level of corruption in the form of excessive patronage, nepotism, job reservations, "favor-for-favors", secret party funding, and suspiciously close ties between politics and business.

## 9.2 Conclusions

The review of global, regional and Nepal's FDI and trade reveals clear patterns and trends. The global environment of FDI and trade suggests a conducive environment if competitive one. The tremendous growth in the global FDI and trade as revealed by the data is testimony to this. On the one hand the trend and patterns for Nepal is slow.

It is disheartening to note that despite a recent growth in FDI achieved by Nepal, the country still receives the lowest amount of FDI in the region. Nepal's FDI potential is heavily under-exploited, despite the fact that the country offers a huge potential not only for market seeking investors but also resource seeking ones. A country of nearly 28 million people, where the richest 20 percent of the population has a combined income of US$ 7.26 billion, cannot be considered a small market by any standards. Besides, due to favourable market access opportunities it has received, particularly in the European and Indian markets, market-seeking investors should find it worthwhile to invest in Nepal. Resource-seeking investors can invest in Nepal to tap the immense hydropower potentials. Besides, those foreign investors, who are now mature enough and can take long-term risk, could make investment in other infrastructure projects such as road, rail and airport construction. On the flip side, however, Nepal does not seem to offer a hospitable investment climate for foreign investors. Although there are several reasons that could deter investors from making long term investment in Nepal, three problems stand out. First, the political instability and resultant policy and legal uncertainty means foreign investors would think twice before investing in Nepal. Second, poor infrastructure, in particular electricity and road network, which raises the cost of doing business in Nepal, works as a strong disincentive not only for foreign investors, but also for local investors, to invest in Nepal. Third, militancy of trade unions, which have become emboldened particularly in the aftermath of the declaration of Nepal as a republic, has created havoc for the overall business climate of the country. Their never-ending demand for increased benefits/facilities, which, according to them, should not necessarily be linked to their productivity, coupled with their cavalier attitude towards work and poor work ethics, means that foreign investors would most likely invest in

other countries or locations (such as those Indian states which are Nepal's immediate neighbours) where they can lead a comfortable life as well as earn a reasonable amount of profit.

The government has constituted the board of investment under the chairmanship of the Prime Minister. The purpose of this body is to create a amicable environment in the country including policy and legal reforms for domestic as well as foreign investment. The safety of investment would also be the prime concern of this body. The government has also announced that a Monitoring Unit would be created in the office of the Prime Minister to supervise and monitor the investment climate in the country.

Inflows of FDI into Nepal accelerated after the economic liberalization of the 1990s but remain low in relation to the size of population and economic activity, and also in comparison with other least developed landlocked states in the Asian region. The overall inflows are so low that, all in all, FDI has not been a significant development catalyst. It is not necessarily due to a lack of potential. Nor it is because FDI has been excluded from most sectors of the economy. The answer is that Nepal has failed to offer investors satisfactory standards of policy, administration of taxes and regulations and stable political environment which are of vital interest to business. Indeed, apart from the important liberalization of power generation, there has been little focus on removing these barriers, even those in selected industries of high FDI potential. Therefore, better performance in attracting FDI requires fundamental changes.

One of the reasons for a number of Indian companies to have established their presence in Nepal after the onset of economic liberalization in Nepal, and in particular after the signing of a relatively more favourable Indo-Nepal Trade Treaty in 1996, was precisely to tap the vast Indian market. Although Indian authorities are notorious in imposing (often arbitrary and non-transparent) non-tariff barriers on Nepalese exports to their market, the incidence of such barriers tends to be lower when the exporting company is an Indian company. However, what is sorely lacking in the context of Nepal is an opportunity to exploit the trade-investment

linkage targeting the Chinese market. The situation is not likely to change significantly in the near future because of accessibility problem beyond the Tibet Autonomous Region (TAR) and a lack of meaningful market access opportunity provided by China.

Moreover, given the fact that the rapidly growing neighbouring countries—India and China—in general, and bordering Indian states in particular, are power hungry, there is a strong likelihood of FDI coming from these two countries as well as from Indian states like Bihar. Entries of Indian companies such as GMR and Reliance Industries (a private sector venture) and Satluj Jal Vidyut Nigam (a public sector undertaking), Chinese companies such as Three Gorges Corporation, Hongshi Hodlings Group of China and Dangote Group of Nigeria in Nepal are considered as precursor to the trend that is likely to set in.

Overall the foreign direct investment has increased drastically in the last one year and this seems to continue as long as the political situation does not get worse and hamper the investment climate.

## 9.3 Recommendations

With the limitation of time and resources, this thesis could not explore the in depth study of FDI in Nepal. Nepal is very viable place for FDI in terms of natural resources and environment. If we want we can attract more FDI in Nepal, first we must take initiation to establish the stable political environment, we should focus on good governance as we know that good governance can establish so many stable variable which helps to inward FDI. Similarly Nepal is also lacking a smooth financial system. A good financial system can also help to attract FDI. In Nepal the cost of financing is higher than other similar countries. It should be taken under consideration. Another important factor is that our bureaucratic system.

We should bear in mind that not all types of foreign investment contribute to income and employment generation. The government should selective about FDI; the government should not discriminate against domestic investors. The industries using FDI should also be evaluated in terms of their potential to create employment, promote exports, transfer technology and encourage human development friendly activities. The industries having market prospects in India and other SAARC countries have to be promoted. The extended South Asian Market after the implementation of SAFTA need to be kept in consideration in providing public support to new industries.

Given the imperatives to attract a growing amount of foreign investment surmounting the challenges discussed, the following recommendations, which are divided based on their time horizons, are worth taking note of:

**General recommendations in the short term**

- In order to attract investment as well as to compete with various neighbouring states in India offering favourable incentives to attract investments, Nepal needs to immediately enact the legislation on special economic zone (SEZ) and expedite the process of completing SEZs, which are under construction. The SEZs should, at a bare minimum,

provide required infrastructure facilities and strictly implement flexible labour laws that allow for adherence to strict disciplines, including linking of wages with productivity, imposing no-work no-pay system, and imposing ban on strikes.

- Power problems should be resolved through reduction in leakage, operating thermal plants to the fullest extent possible and importing electricity from India. A market-based mechanism should be fixed for the adjustment of fuel prices.
- Board of Investment should be empowered further for providing fast track approval to big projects. Contradictory provisions in various legislation should be streamlined and ambiguities corrected so as to provide predictability to investors. A system should be devised such that facilities provided by laws are automatically granted to investors.
- Enforcing of strikes and bandhs through violent means should be banned.
- Current level of investment made on education should be maintained and skill development trainings should be provided by mobilizing government resources as well as those of the private sector and donors.
- Resources and expertise should be provided to DOI for monitoring the developmental impact of FDI, including preparation of database on the proposed, approved and realized flow of FDI, employment generated, tax paid and corporate social responsibility projects implemented by them.

**General recommendations in the medium to long term**

- Policy making process should be made inclusive, capacity of government officials should be enhanced and strict reward and punishment system should be devised within the bureaucracy.
- A sustained improvement in business climate should be achieved, among others, through consistency in the application of policy and law, adequate provisioning of infrastructure facilities and a proactive agenda for the development of skill and technology.

- Foreign and local investment—both public and private or combinations thereof—should be mobilized for the construction of hydroelectricity projects (mainly focusing on reservoir type) and for the construction of roads and trade corridors.

**Sector wise recommendations in the short-term**

- Tourism, especially in niche markets;
- Manufacturing for regional and global markets with privileged access;
- Production of herbal products for medicines and cosmetics.

**Sector wise recommendations in the medium-term (3+ years)**

- Power generation for the Indian market;
- Other agro-based industries;
- Privatization-related opportunities in the utilities and in some manufacturing.

**Sector wise recommendations in the long-term (10-20 years)**

- ICT-based services;
- Business, professional and financial services for the region;
- Light manufacturing for the domestic market, linked to exporters.

The above mentioned necessary recommendations might help in attracting more private capital fund and foreign direct investment.

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# ANNEXES

## Foreign Equity Investment in a New Industry

| Documents required: | | |
|---|---|---|
| **SN** | **Document** | **No. of Copies** |
| 1 | Project Report | 3 |
| 2 | Joint Venture Agreement (JVA), in case of more than one investor | 3 |
| 3 | Citizenship certificate of local party or Certificate of Incorporation, including Memorandum of Association and Articles of Association if the local party is a company | 1 |
| 4 | Copy of passport of foreign party or Certificate of Incorporation, including Memorandum of Association and Articles of Association if the party is a company | 1 |
| 5 | Bio-data / Company profile of the foreign party | 1 |
| 6 | Financial Credibility Certificate (FCC) of the Foreign Investor provided by a home country bank or domiciled country bank | 1 |
| 7 | Authority letter from the concerned companies or individuals to carry out any necessary work on their behalf, if applicable | |

## Deposits and Fees

The fees need to be deposited at the time of Foreign Investment Approval, and are refundable after the operation of industry.

**(Amount in Nepalese Rupees)**

| Range of Fixed Asset | Deposit |
|---|---|
| Fixed assets less than or equal to 2,500,000 | 4,000 |
| 2,500,000 less than (Fixed assets) less than or equal to 5,000,000 | 7,000 |
| 5,000,000 less than (Fixed assets) less than or equal to 10,000,000 | 10,000 |
| 10,000,000 less than Fixed assets | 20,000 |

The amount shall be deposited at the **Nepal Rastra Bank** Account number SA.A. 131232

The non-refundable fees for the Company Registration:

| Range of Authorized Capital | Fee |
|---|---|
| 500,000 less than (Authorized Capital) less than or equal to 2,500,000 | 9,500 |
| 2,500,000 less than (Authorized Capital) less than or equal to 10,000,000 | 16,000 |
| 10,000,000 less than (Authorized Capital) less than or equal to 20,000,000 | 19,000 |

Similarly, an additional fee will be calculated at the rate of NPR 30 per NPR 100,000 of authorized capital.

## Technology Transfer

Technology transfer is possible even in areas where foreign investment is not allowed.

Forms of Technology Transfer to be made under an agreement between an industry and a foreign investor include:

1. Use of any technological right, specialization, formula, process, patent or technical know-how of foreign origin;
2. Use of any trademark of foreign ownership; and
3. Acquisition of any foreign technical consultancy, management and marketing service.

| **Documents required:** | | |
|---|---|---|
| **SN** | **Document** | **No. of Copies** |
| 1 | Technology Transfer Agreement (TTA) | 3 |
| 2 | Citizenship certificate of local party or Certificate of Incorporation, including Memorandum of Association and Articles of Association, if local party is a company | 1 |
| 3 | Copy of passport of foreign party/or Certificate of Incorporation, including Memorandum of Association and Articles of Association, if the party is a company | 1 |
| 4 | Bio-data / Company profile of the foreign party | 1 |
| 5 | Industry Registration Certificate | 1 |
| 6 | Copy of the minutes of the Board of the recipient company | 1 |
| 7 | Authority letter from the concerned companies or individuals to carry out any necessary work on their behalf, if applicable | |

## Foreign Investment in an Existing Industry by Share Transfer

| Documents required: | | |
|---|---|---|
| **SN** | **Document** | **No. of Copies** |
| 1 | Request from the share transferor | |
| 2 | Request from the share transferee | |
| 3 | Share Transfer Agreement | 3 |
| 4 | Copy of minutes of the Board meeting of Nepalese company regarding inclusion of foreign investor into the company | 1 |
| 5 | Copy of minutes of Board meeting, Certificate of Incorporation and company profile of the foreign party if the party is a company | 1 |
| 6 | Copy of passport and Bio-data of foreign party, if party is an individual | 1 |
| 7 | Financial Credibility Certificate of the Foreign Investor provided by a bank | 1 |
| 8 | Current Share Holders' List as certified by the Company Registrar's Office | 1 |
| 9 | Auditor's Report | 1 |
| 10 | Tax clearance certificate | 1 |
| 11 | Authority letter(s) from the companies concerned to sign on behalf of the companies | |

## Loan Investment in an Existing Nepalese Industry

| **Documents required:** | | |
|---|---|---|
| **SN** | **Document** | **No. of Copies** |
| 1 | Loan Agreement | 3 |
| 2 | Certificate of Incorporation, including Memorandum of Association and Articles of Association of the lending agency | 1 |
| 3 | Certificate of Incorporation, including Memorandum of Association and Articles of Association of the lending agency | 1 |
| 4 | Industry Registration Certificate | 1 |
| 5 | Copy of the minute of the Board of the recipient company regarding the loan to be acquired | 1 |
| 6 | Authority letter from the concerned companies or individuals to carry out any necessary work on their behalf, if applicable | |

## Summary of procedures for starting a business in Nepal—and the time and cost

| SN | Procedure | Time to complete | Cost to complete |
|---|---|---|---|
| 1 | **Verify the uniqueness of the proposed company name**<br><br>Verification of the uniqueness of a company name can now be done online. To reserve the available company name, the company must submit an application to the Office of the Company Registrar. The company name reservation can also be completed online for no charge. | 1 day | No Charge |
| 2 | **A professional verifies and certifies the memorandum and articles of association** | 5 days | NPR 10,000 depending on |

| | | | |
|---|---|---|---|
| | Although professional verification or certification prior to submission to the official agency is no longer required, entrepreneurs continue to use the services of professionals in practice for verifying and drafting the memorandum and articles of association. This is mainly done to avoid mistakes since there are no standard memorandum and articles of association's forms that entrepreneurs can use. | | the professional's charges |
| 3 | **Buy a stamp to be attached to registration form** | 1 day | NPR 5 |
| 4 | Register at the Office of the Company Registrar, Department of Industry<br>To register a company, the promoter must submit an application as prescribed by the Ministry of Industry, Commerce, and Supplies. Online filing of the required documents has been introduced. The registration fee is based on the company's authorized capital:<br>Up to NPR 100,000 (authorized capital): NPR 1,000.00<br>NPR 100,001 to NPR 500,000: NPR 4,500.00<br>NPR 500,001 to NPR 2,500,000: NPR 9,500.00<br>NPR 2,500,001 to NPR 10,000,000: NPR 16,000.00<br>NPR 10,000,001 to NPR 20,000,000: NPR 19,000.00<br>NPR 20,000,001 to NPR 30,000,000: NPR 22,000.00<br>NPR 30,000,001 to NPR 40,000,000: NPR 25,000.00<br>NPR 40,000,001 to NPR 50,000,000: NPR 28,000.00<br>NPR 50,000,001 to NPR 60,000,000: NPR 31,000.00<br>NPR 60,000,001 to NPR 70,000,000: NPR 34,000.00<br>NPR 70,000,001 to NPR 80,000,000: NPR 37,000.00<br>NPR 80,000,001 to NPR 90,000,000: NPR 40,000.00<br>NPR 90,000,001 to NPR 100,000,000: NPR 43,000.00<br>More than NPR 100,000,000: NPR 43,000 plus NPR 30 for each additional NPR 100,000. | 7 days | NPR 9,500 |
| 5 | **Make a company rubber stamp** | 1 day | NPR 275 |
| 6 | **Register for VAT and income Tax with the Inland Revenue Office, the Ministry of Finance** | 1 day | No Charge |

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|  | The company must disclose the office address and withhold 10% tax of the rent for at least 3 months and deposit it to the tax office. If the company's objectives include goods or services subject to VAT, both registrations (VAT and income tax) should be obtained simultaneously. |  |  |
| 7 | **Enroll the employees in the Provident Fund**<br><br>From the basic salary of each employee, 10 % is deducted each month, and a matching contribution is made by employer. The contribution is made to the provident fund and released on employee retirement. The employer also has to pay gratuity on retirement of an employee at the rate prescribed by labor regulation. Both of these rules are applicable only if the company appoints 10 or more employees. | 1 day | No Charge |

*Source: Doing Business – 2014, Economy Profile, Nepal*

## Summary of procedures for dealing with construction permits in Nepal —and the time and cost

| **SN** | **Procedure** | **Time to complete** | **Cost to complete** |
|---|---|---|---|
| 1 | **Purchase building permit application from Kathmandu Metropolitan City (KMC)** | 1 day | NPR 1,000 |
| 2 | **Request and obtain temporary building permit**<br>The 35 days are divided as follows:<br>Day 1: BuildCo submits the drawings to the municipality along with a copy of the title certificate.<br>Day 2: The municipality forwards the file to the municipality ward office where the land is located.<br>Day 4: The ward office checks the field and sends a notice to the site's neighbors.<br>Day 8: Start of the maturation of notice period.<br>Day 23: Start of the local inquiry done by the ward office.<br>Day 27: The ward office sends the file back to the municipality. | 35 days | NPR 282,000 |

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| | Day 29: The municipality starts the process of issuing a temporary approval of the drawings. At least one of the neighbors must give their consent in order for the project to be approved. Otherwise, the builder can submit a "commitment letter" certifying that he is responsible for any potential dispute in the future. This can delay the approval process to around 2 months.<br><br>An applicant must submit the following documents along with the building permit application:<br>Identity document of the owner (or Company Registration Certificate)<br>Certification by a registered architect or engineer<br>Cadastral extract<br>Proof of land ownership/lease<br>Building Plans<br>Lot plan<br>Proof of tax payment<br>Structural plans (not required for buildings with ground coverage area of less than 1,000 sq.ft and less than 3 stories)<br>The originals of all documents must be demonstrated when submitting the copies to the Urban Development Department of Kathmandu Metropolitan City.<br>The building permit fee is calculated as follows:<br>Built-up area up to 3,000 sq.ft: 10.00 rupees per sq.ft<br>Built-up area between 3,001 and 5,000 sq.ft: 15.00 rupees per sq.ft<br>Built-up area 5,001 sq.ft and above: 20.00 rupees per sq.ft<br>For apartment housing and group housing, the application fee is a flat 25.00 rupees per sq.ft.<br>In addition to the building permit fee, the Urban Development Department also charges a Designer Fee of 2,000.00 rupees. The project designer must be licensed by the Department. The license is called Certificate of Designer and is renewed every year at the Municipality.<br>The annual fee is 3,000.00 rupees. The Municipality charges an additional 2,000.00 rupees for each building design. | | |
| 3 | ***Receive inspection from respective ward**<br>The ward office visits the site and distributes a notice to | 1 day | No Charge |

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| | neighbors. | | |
| 4 | **Request permanent building permit**<br>The company applies for the permanent building permit once the construction has reached plinth level. | 1 day | No Charge |
| 5 | *** Receive plinth inspection from the Municipality**<br>Before issuance of the construction permit, an on-site inspection is conducted by an official from the municipality or the Town Development Committee to ensure that the construction (up to plinth level) conforms to the approved drawings. The company's engineer or architect has to be present during the inspection. | 1 day | No Charge |
| 6 | **Obtain permanent building permit**<br>After inspecting the construction site, the municipality engineer writes a "site report" and issues a permit for construction above the plinth level. | 30 days | No Charge |
| 7 | **Request completion certificate** | 1 day | No Charge |
| 8 | *** Receive final inspection from the Municipality**<br>Before issuance of the completion certificate, the municipality conducts an on-site inspection to check if the construction conforms to the approved drawings.<br>An inspector visits the site in 2-3 days after the request for completion certificate and writes a report to the more senior engineer. | 1 day | No Charge |
| 9 | **Obtain completion certificate**<br>There will be 4 signatures on the completion certificate: (1) junior engineer, (2) senior engineer, (3) chief engineer of Kathmandu Metropolitan City and (4) departmental engineer. It takes approximately 7 days to get the certificate after the inspection. These signatures are required for any kind of permit. | 30 days | No Charge |
| 10 | **Request and obtain water and sewage connection**<br>BuildCo submits an application for water and sewerage service to the drinking water and sewerage offices. The drinking and sewerage offices then send their recommendation to the road department to grant permission to dig the road for the connection. The Department of Roads then grants its permission to dig the road. The tap and sewer connection is then carried out. | 15 days | NRP 8,000 |

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| 11 | *** Receive inspection from water and sewage offices** | 1 day | No Charge |
| 12 | *** Obtain Telecommunications Connection**<br>The client must fill out the application form and submit it to NTC together with company registration certificate, PAN, etc. NTC will check the junction box and give client the quote (deposit, connection fee, etc.). | 7 days | NRP 2,200 |
| 13 | *** Receive Telecommunications Inspection** | 1 day | No Charge |

## Summary of procedures for getting electricity in Nepal—and the time and cost

| SN | Procedure | Time to complete | Cost to complete |
|---|---|---|---|
| 1 | **Submit application to Nepal Electricity Authority (NEA) and await site inspection**<br>The photocopy of documents needed to be submitted along with application form mentioning the load in kW / MW and type of voltage (low voltage/medium voltage/high voltage) are: citizenship of owner, land deed, certificate issued from the commerce department to operate the warehouse, tax registration certificate, construction approval certificate from the municipality, contract agreement between land owner and warehouse runner, if the land is leased.<br>No need of notarization, NEA personnel will attest after verification with the original copies. Approval of load estimate - In this case an approval from Regional director or Manager may be required – decided on case by case basis and in about 50% of cases, this might be so. | 7 calendar days | NPR 50.00 |
| 2 | **Nepal Electricity Authority conducts site inspection, verifies load estimate and provides estimated cost**<br>It is expected that someone from owner’s side is present during external site inspection to answer any questions that NEA personnel might have.<br>NEA personnel will make a visit to site to ascertain the appropriateness of the place where the energy meter is to be installed, and also they check the transformer installed at consumer's site (As per NEA rule, the consumer has to install his own transformer for the load above 50kVA.). | 7 calendar days | No Charge |

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| | Approval of load estimate is needed to decide how much of a supply is needed for the building. - In this case an approval from Regional director or Manager may be required – decided on case by case basis, and in about 50% of cases, this might be so. | | |
| 3 | **Get transformer tested at NEA lab and complete connection works**<br>Cost includes purchase of Poles, Insulators, Transformer (150KVA), cutout, lightning arrestor, earthing materials, hardwares, drop cable, MCCB, meter box and other fitting materials. Cost also includes purchase of Distribution transformer.<br>Distribution Transformer can only by purchased after approval of load estimate. Availability of DTs in ready stock is not always the case, and there is always some waiting time. The transformer has to be tested for quality as it has been purchased privately. The installation of the transformer is done by a private contractor. | 35 calendar days | NPR 754,005.00 |
| 4 | **Submit test report and request and receive site inspection**<br>Customer has to make payment, submit NEA test report. | 7 calendar days | NPR 35,500.00 |
| 5 | **NEA performs external connection, and electricity starts flowing** | 14 calendar days | No Charge |

## Summary of procedures for registering property in Nepal—and the time and cost

| SN | Procedure | Time to complete | Cost to complete |
|---|---|---|---|
| 1 | **Obtain tax clearance certificate and certificate of access and building from the Municipality (relevant ward committee)**<br>The seller must go to the local government to certify the type of road that adjoins the property. Kathmandu municipality is divided into 25 wards. The seller has to go to the ward committee to take the certificate in one day and it costs Rs 3000. At the same time, he can obtain a tax | 2 days | The cost of obtaining certificate is different in different municipality. In Kathmandu Municipal corporation it cost NPR.105 to 1005 for obtaining certificate of access and building.<br>NPR 5,000 for main road.<br>NPR 3,000 for side road.<br>NPR 2,000 for gravel road. |

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| | clearance letter. A tax clearance certificate must be obtained from the Municipality regarding the payment of the property tax. If the property is not yet registered in the Municipality for tax purposes then it might take a few days to collect the necessary papers of building permit, land deed, land revenue papers, field visit of municipal engineers to verify and assess the property, etc. In any case it should not take more than seven days. | | NPR 1,000 for track road.<br>Obtaining the Tax clearance certificate involves<br>Payment of land revenue and<br>Payment of land and building property tax.<br>This tax is applicable only for plots containing buildings of any kind and if it is situated in municipal area. |
| 2 | **Hire lekhandas or a junior lawyer**<br>Legally, the parties can prepare the transfer deed by themselves, but normally it is done by the lekhandas, or scribes. | 1 day | NPR 7000 |
| 3 | **Registration of the deed and issuance of a new title certificate**<br>The transfer deed is submitted for registration to the Land Revenue Office. The authenticity of the seller is checked by the Land Revenue Office against the Citizenship Certificate. The existence of liens or encumbrances on the property is also checked on the same day by the Land Revenue Office.<br>The registration fee (4.5% of property price in case of municipal areas, according to Finance Act of 2065 Nepalese calendar (2008), implemented in June 2008) is paid at the Land Revenue Office at the moment of applying for registration. Parties must sign and thumb print on the transfer deed. After the verifications of all documents by the officer, the transfer deed will be registered and the title certificate will usually be issued on the same day.<br>The documentation shall include:<br>Land Ownership Certificate (already in possession of the seller) | 2 days | 4.5% of property<br>price (registration fee)<br>======================= |

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| | Citizenship Certificate of seller and buyer or/ Incorporation Certificate of Company<br>Tax clearance certificate from the Municipality/ Village Development Committee (obtained in Procedure 1) | | |

*Source: Doing Business – 2014, Economy Profile, Nepal*

## Industries Permissible for Foreign Investment

| Industry Category | Maximum FDI Permissible | Name of the competent authority (Regulator) | Relevant Acts & Policies | Remarks |
|---|---|---|---|---|
| Manufacturing | 100% | Department of Industry | Industrial Enterprises Act, 1992 | No additional procedures required except for certain industries which required special permission |
| Financial Services/Banks and Finance Companies and Branch Office of a Foreign Bank | (20 to 85)% | Nepal Rastra Bank | Nepal Rastra Bank Act<br>Foreign Investment and Technology Transfer Act (FITTA)<br>FOREIGN EXCHANGE Regulation Act (FERA) | Approval of Nepal Rastra Bank required thereafter, registration of the company is to be done and application filed for license to operate a bank, or financial institution |
| Airline Industry | (49 to 95)% | Civil Aviation Authority of Nepal | The Aviation Policy 2063 (2006)<br>Civil Aviation Act, 2053, Civil Aviation Rules, 2052 (1996) | FDI is permissible in domestic airlines, international airlines, flying schools and repair and maintenance work |

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|---|---|---|---|---|
| Telecommunications | 80% | Nepal Telecommunication Authority, Ministry of Information and Communication | Telecommunication Act | Approval of Nepal Telecommunication Authority is required to operate services and obtain license prior to operation |
| Roads, Ropeways, Cable car | 100% | Transport Management Office | - | - |
| Media & Advertising – TV, Radio and Newsprint | 100% | Ministry of Information and Communication | The Nepal Broadcasting Regulation, 2052 (1995)<br>National Broadcasting Act 2049 (1993) | The MOCI and NTA provides license for establishing media and broadcasting business in Nepal |
| Pharmaceutical & Chemical Industries | 100% | Department of Health Services | Industrial Enterprises Act Drug Act | Approval from the Department of Drug Administration for setting up the industry, manufacturing and selling the drug is required |
| Textile and Garment | 100% | Department of Industry | Industrial Enterprises Act | No specific requirements |
| Agriculture and Dairy | 100% | Ministry of Agriculture and Co-operatives | - | No specific requirements |
| Consultancy and Management Services | 51% | No Specific | Foreign Investment and Technology Transfer Act (FITTA) | Accountancy, Engineering, Legal & Management Services not allowed |
| Mining | 100% | Department of | Department of mines | License from the |

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| | | Mines | and Geology (Department) Act<br>Mines and Minerals Act, 2050 (1993)<br>Mines and Minerals Regulations, 2056 (1999) | Department of Mines has to be obtained for mining activities in Nepal |
| Hydro-Power Generation | 100% | Department of Electricity Development | Electricity Act<br>Electricity Rules | Approval from the DOED is required prior to operation of the industry |
| Power Trade | - | Department of Electricity Development | Electricity Act<br>Electricity Rules | Export of power to India is permitted for companies generating electricity |
| Transmission Lines | 100% | Department of Electricity Development | Electricity Act<br>Electricity Rules | - |
| Hotels, Resorts & Restaurant | 100% | Ministry of Tourism | Tourism Policy, Tourism Act | Approval from the Department of Tourism required for operating restaurant, hotels, resorts |
| IT & IT enabled (BPO, KPO) | 100% | Department of Science and Technology | IT Act | No specific requirements |
| Vocational, Educational Training and Coaching | 100% | No specific | Foreign Investment and Technology Transfer Act | Only Skill Training and Language allowed |
| Hospitals & other Medical Services | 100% | Ministry of Health & Population | Nepal Health Professional Act,<br>Nepal Medical Council | Approval from the Ministry of Health is required for establishing hospitals and |

| | | | | providing medical services |
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| Recreational Health Centers | 100% | Ministry of Health & Population | - | - |
| Solid Waste Disposal & Management | 100% | Ministry of Environment, Science and Technology | Environment Protection Act | - |
| Film Industry | 100% | Cinema Board of Nepal | Motion picture (Production, Exhibition and Distribution) Act 2026 (1969) and Rules | Film produced in the language if the nation not allowed (FITTA, 1992) |
| Cargo Industry | 100% | No specific | - | Domestic Cargo not permitted under FDI |
| Medical Education | 100% | Ministry of Education | MoHP's Directive on Establishment, Operation, Standards and Infrastructure of Private and Non-governmental Health Institution, 2061 | Affiliation to a University has to be entered into and approval from the Ministry of Education required |
| Engineering Education | 100% | Ministry of Education | Technical Education Policy of Ministry of Education | Approval is granted under the Technical Education Policy of Ministry of Education |
| Management Education | 100% | | | |
| Insurance & Re-insurance | JV Company Branch Office | Insurance Board | Insurance Act and related directives | Approval from the Insurance Board has to be obtained prior to commencement of business in Nepal |
| Construction | 100% | No Specific | Local Self Governance Act | Approval from the Department of |

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| | | | | Road, Transport and Physical Planning required |
| Thermal & Alternative/ Renewable energy | 100% | Ministry of Energy | Electricity Act | Allowed only in Energy Generation |

*Source : Nepal-India Chamber of Commerce and Industry – Doing Business in Nepal (A Guide for Indian Investors)*

## Treatment and Protection of Foreign Investors

Nepal has entered into Bilateral Investment Promotion and Protection Agreement (BIPPA) with six countries, these are;

| **Country** | **Agreement** | **Date of Agreement** |
|---|---|---|
| **India** | Agreement between the Government of Nepal and the Government of India for the Promotion and Protection of Investment | October 21, 2011 |
| **Finland** | Agreement between the Government of Nepal and the Government of Republic of Finland on the Promotion and Protection of Investment | February 3, 2009 |
| **Mauritius** | Agreement between the Government of the Republic of Mauritius and His Majesty's Government of Nepal for the Promotion and Reciprocal Protection of Investments | August 3, 1999 |
| **United Kingdom of Great Britain and Northern Ireland** | Agreement between His Majesty's Government of Nepal and the Government of the for the Promotion and Reciprocal Protection of Investments United Kingdom of Great Britain and Northern Ireland for the Promotion and Protection of Investments | March 2, 1993 |
| **Germany** | Treaty between the Federal Republic of Germany and the Kingdom of Nepal concerning the Encouragement | October 20, 1986 |

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| | and Reciprocal Protection of Investments | |
| **France** | Agreement between His Majesty's Government of Nepal and the Government of the Republic of France on the Reciprocal Promotion and Protection Investments | May 2, 1983 |

- Nepal and USA entered on Trade and Investment Framework Agreement (TIFA) on April, 2011.

## Dispute Settlement

- For industries with fixed assets investment of up to NRs. 500 million, if the dispute cannot be settled by mutual consultations in the presence of the DOI, it shall be settled by arbitration in accordance with the prevailing arbitration rules of the United Nations Commission on International Trade Law (UNCITRAL)
- The arbitration should be held in Kathmandu
- The laws of Nepal shall be applicable in arbitration
- For industries with fixed assets investment of above NRs. 500 millions, disputes may be settled as mentioned in the Joint Venture Agreement/Share Purchase Agreement.

**Repatriation**

Foreign investor making investment in foreign currency shall be entitled to repatriate the following amounts:

1. The amount received by the sale of the share of foreign investment as a whole or any part thereof;
2. The amount received as profit or dividend from foreign investment;
3. The amount received as the payment of principal or interest on any foreign loan;
4. The amount received under the agreement for the technology transfer in such currency as set forth in the concerned agreement as approved by the DOI; and/authorized

Source:

http://www.investnepal.gov.np/portal/index.php?p1=content&p2=9&mid=17#.VPGb3NKUdqc

**Size of the Market**

The principal attraction for foreign investors to Nepal is the size of the market. In 2012-13, Nepal had the gross national disposable income (GNDI) of NRs. 2,195,827 millions. At NRs. 95 to a dollar, this amounts to approximately $23113.968 million USD. Nepal's GDP is NRs. 1,701,194 millions, per capita GNDI in 2012-13 was $926 USD, and per capita GDP was $717 USD (CBS National Account, 2013-14).

**Return on Investment (ROI)**

Compared to other countries in South Asia, Nepal offers the lowest tax burden in the region. Some of the reasons for comparatively high ROI in Nepal include:

- Huge investment potential in tourism, hydropower, agriculture, and mine and mineral sectors;
- Abundance of natural resources;
- Maximum income tax rate of 25% and value added tax (VAT) of 13%;
- Income tax exemption on profits from exports and interest income on foreign loans;
- Tax rate of 15% on royalties and technical and management fees; and
- Customs, excise duties, and VAT levied on raw materials and auxiliary raw materials of export-oriented industries is reimbursed to the exporter on the basis of the amount of exports within 60 days of application.

**Industrial Infrastructure Development**

The Industrial Infrastructure Development Program was brought into effect in 2008-09 in order to develop Nepal's physical infrastructure, establish and operate feasible industries, and promote an investment-friendly environment for industrialists and entrepreneurs. Under this program, road construction and electricity transmission line expansion works are undergoing in

Udaypur, Makwanpur, Dhading, Lalitpur, Dang, Rolpa and Palpa districts. Cement industries are also planned for these districts.

**Labor Practices**

Labor practices of Nepal are guided by the Labor Act of 1992. The creation of a new labor law is in process, and is being drafted with input from regular bipartite discussions and consultations with trade unions and employers, and with tripartite consensus of the GON, employers, and trade unions.

## Industrial Policy, 2010

The Industrial Policy, 2010 was created to bring about positive changes in the overall economic and social sectors of the country through speedy industrial development. This policy will boost industrial development activities, create employment opportunities , increase income levels, and ultimately ensure that the industrial sector contributes to the national economy as a leading sector.

**Key Objectives**

- Increase industrial product exports and ensure a rise in national income and employment opportunities through an increase in qualitative and competitive industrial products and productivity;
- Increase the contribution of the industrial sector to national and regional development by mobilizing local sources, raw materials, skills and tools;
- Make the industry and business sectors sustainable and reliable by utilizing the latest technology and environment-friendly production processes;
- Establish Nepal as an attractive investment site in South Asia and the world by developing the pool of human resources needed for industrial development, increaseing managerial capacity, and creating a foundation for solid investments; and
- Safeguard industrial intellectual property rights.

## Salient Features of the Industrial Policy:

- The policy provides for the following institutions: Investment Board, Industrial Promotion Board, Industrial Human Resource Development Academy, Industrial Sector Management Authority.This is in order to make policy implementation effective, promote the industrial sector, base regulatory works on efficiency and professional capacity and perform institutional strengthening works.
- Income tax exemption and other assistance is provided as per the nature of industry and business operation arrangements.
- Export-oriented industries and industries based in the Export Promotion House and Special Economic Zone are entitled to receive the declared facilities and assistance on customs duty, excise duty and VAT.
- Micro, cottage and small industries are entitled to receive the declared facilities and assistance on customs duty, excise duty and VAT.
- The policy establishes a high-level Investment Board in order to accord high priority to broad industrial investment, formulate integrated policies to protect, help and express commitments, manage necessary resources required for promotion works, and provide all types of required services and assistance to the investors from one single place.
- Industries established in the Special Economic Zone are entitled to receive the declared income tax exemption, VAT-related facilities and assistance, and exemptions on customs duty and local tax.
- A one-stop service centre will be constituted in the Department of Industry to provide facilities, assistance and infrastructure services as provided by the law.
- An Intellectual Property Protection Office will be created, incorporating all areas of intellectual property rights and responsibilities
- Special priority will be accorded to women industrialists wishing to establish industries inside an industrial area: the industry registration fee will be reduced by 35 %, and 20 % exemption will be made on the registration of industrial property patent, design and trademark.