Foreign investment in a Least Developed Country: the Nepalese experience

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This article aims to contribute to the literature on the developmental role of foreign direct investment (FDI) through an examination of the Nepalese experience. Despite significant liberalization of the foreign investment regime and the introduction of attractive investment incentives, Nepal's achievements, both in terms of the volume of FDI and its developmental impact, failed to match national expectations. Nepal obviously has intrinsic disadvantages arising from its geography and other typographical characteristics in attracting FDI. However, comparable international experience suggests that her lacklustre achievements as a host to foreign investors cannot be explained in terms of these factors alone. Policies that underpin the overall investment climate also seem to matter. Mere liberalization of the investment regime and the introduction of financial incentives are not substitutes for an all-encompassing effort to improve the investment climate.

Key words: foreign direct investment, liberalization, land-locked country, LDCs, Asia, Nepal

1. Introduction

The past two decades have witnessed a profound shift in the policy emphasis on foreign direct investment (FDI) in developing countries. In a significant departure from the scepticism about the developmental role of FDI, which pervaded

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policy thinking for over three decades during the post-war era, more and more countries have become increasingly receptive to FDI as an integral element of outward-oriented policy reform. Despite this notable policy shift, the literature on the role of FDI in developing countries still remains both sparse and skewed. The few existing studies have focused almost exclusively on the experience of the middle- and upper-middle income developing countries, in particular the high-performing countries in East Asia. Policy inferences coming from this literature are of limited value for late-comers, because the role of FDI varies across countries depending on their stage in the internationalization of the economy, the nature and timing of policy shifts as well as the initial conditions of the host country, such as the degree of industrial and entrepreneurial development. This article aims to redress this imbalance in the literature by examining the patterns of FDI in Nepal, following the market-oriented policy reforms initiated in the mid-1980s.[1] Nepal provides a particularly interesting case study of the subject, not only because of its least developed country (LDC) status, but also because of its geography, characterized by being landlocked and having a long open border with a large neighbour, India.[2]

The article is structured as follows. Section two provides an analytical account of the nature, determinants and developmental implications of FDI in late-comer countries in order to place the Nepalese experience in context. An overview of the foreign investment regime in Nepal is provided in section three. Section four examines trends and patterns of FDI during 1988-2001, while developmental implications of FDI are discussed in section five. The key findings are summarized in the concluding section.

[1] The time coverage of the study ends in 2001, because the escalation of the civil war has severely disrupted FDI inflows to Nepal in the subsequent years. Since then, most foreign investors have ceased their operations, as they became the target of a rebel group, known as the Maoists.

[2] Nepal is located between India and China. There is a road connection with China, but extensive trade contacts with or though that country are inhibited by the high costs and seasonal nature of road transport through the Himalayas. Thus, Nepal's foreign trade is conducted either through India or by air.

2. Analytical context

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, what are the characteristics that determine a country's comparative advantage in international production? In answering this question, it is important to emphasize that FDI is not a homogeneous phenomenon, but a complicated and finely differentiated means of globalizing production. For the purpose of discussing factors influencing TNCs' location decisions, it is important to distinguish three categories of foreign affiliates in terms of their operations in a host country. These are: producers largely engaged in serving the host-country market (market-seeking investors); firms involved in the extraction and processing of natural resources, both for selling in the host-country market and exporting (resource-seeking investors); and those engaged in production for the global market (efficiency-seeking investors).

When it comes to market-seeking investment in developing countries, the factors explaining the location decisions of TNCs are similar to those explaining their presence in industrialized countries. They depend primarily on the existence of production opportunities for meeting demand in the host country. Given the economy of scale considerations and relatively small markets in many developing countries, one of the key determinants of FDI in developing countries is the restrictions on international trade, which makes locating production in the host country the only available option for accessing its markets. Artificially high domestic prices under stringent trade protection usually ensure profits even if the domestic cost of production is higher than it would be under free trade. Under certain circumstances, foreign affiliates that are originally set up to serve local markets could subsequently develop competitive advantage and penetrate markets in other countries. But such cases are rare and limited predominantly, if not solely, to middle-income and upper-middle-income developing countries with sizeable host-country markets.

For a typical developing economy, labour-intensive, consumer goods manufacturing is generally considered to be the natural starting point in the process of export-led industrialization.[3] While the availability of cheap and trainable labour 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, 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.

Based on the above typology of FDI, what are the opportunities available for Nepal in attracting FDI? Nepal does not possess mineral resources to attract resource-seeking FDI.

[3] It is important to distinguish between two different categories of export-oriented production, namely traditional labour-intensive consumer goods (clothing, footwear, toys, sports goods etc.) and assembly processes within vertically integrated global production systems. Efficiency-seeking FDI tends to engage in the latter.

Her ability to attract market-seeking FDI is also limited given the size of the domestic market. Enticing market-seeking FDI through erecting tariff barriers is not considered an option, because of the general shift in overall development policy towards greater outward-orientation. In the area of export-oriented, efficiency-seeking FDI, Nepal is not an attractive location for assembly manufacturing for vertically integrated global industries. Therefore, Nepal's opportunities for attracting FDI are basically limited to labour-intensive consumer goods production and tourism.

High transport costs arising from its unique geography is 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 kilometres 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 labour-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).

[4] According to some tentative estimates, the additional cost disadvantage faced by Nepalese exporters compared to their counterparts in countries in the region is around 7% of the fob value. Nepalese clothing exporters claim that their overall cost disadvantage compared to their competitors amounts to 20 to 25% (Bagchi, 1998).

3. Foreign investment regime and investment climate in Nepal

After pursuing an inward-looking development strategy for over three decades, Nepal embarked on outward-oriented policy reforms in the mid-1980s. The Industrial Policy and Industrial Enterprise Act, promulgated in 1987 (Government of Nepal, 1987), marked the beginning of Nepal's attempt to attract FDI. The Act provided a legal framework for facilitating FDI in medium and large-scale ventures in every industry with the exception of environment and defence-related activities. The Act contained a new set of incentives that were similar to - or even more attractive than - those in other developing countries. For instance, full remittance of profits from FDI ventures in convertible currency was permitted and employment of foreign workers was allowed if domestic workers were not available. A five-year tax holiday was introduced for export-oriented projects.

The democratic government that came into power in 1990 re-emphasized the importance of FDI and technology transfer in the country's development process. 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 Investment and Technology Transfer Act of 1992, the approval and licensing procedures were simplified with a view to approving investment applications within a stipulated time period of 30 days following the receipt of the application. A One-window Committee was set up at the Ministry of Industries to take charge of the provision of all institutional facilities and services (infrastructure-related and other) under one roof. As part of the FDI policy, the Government of Nepal has entered into investment protection agreements with France, Germany and the United Kingdom. Agreements for avoiding double taxation have been signed with India, Norway and Thailand. Regarding the settlement of foreign investment related disputes, the law has made explicit the provisions for arbitration within the framework of the United Nation's Commission for International Law. The Foreign Investment and Technology Transfer Act of 1992 contained a ban on the entry of FDI into cottage industries and projects with fixed assets amounting to less than 20 million Nepalese rupees.

Recent changes in the foreign investment law include abolishing tax holidays (by the first amendment to the Foreign Investment and Technology Transfer Act in 1997) and the reduction of the corporate tax rate for domestic market-oriented manufacturing and services to 20%. Export-oriented ventures have the option of either paying corporate tax at the rate of 0.5% of export value (fob) or 8% of profits. A 5% tax was introduced on profits remitted by foreign firms in the 1999/2000 Budget. However, this new tax, introduced because of balance-of-payments exigencies, is at odds with the Government's commitment to promote foreign investment. The key elements of the Nepalese FDI policy are compared with those of the other countries in South Asia in table 1.

It is evident that, in general, the Nepalese policy regime compares very favourably with other developing countries. However, it is important to note two peculiarities in the Nepalese regime. First, after the 1997 amendment to the Foreign Investment Act, Nepal does not offer tax holiday for foreign investment projects. Second, Nepal has not set up export processing zones (EPZs) as a means of promoting export-oriented FDI. The Nepalese authorities are of the view that there is little need for EPZs given the significant reduction of import tariffs in recent years and the existence of the wide-ranging import duty rebate scheme.

Table 1. Foreign Investment Policy Regimes in South Asian Countries

Areas	Bangladesh	India	Nepal	Pakistan	Sri Lanka
Govt. Agency dealing with FDI	Board of Investment	Foreign Investment Promotion Board and Council	Investment Promotion Board	Board of Investment	Board of Investment
Limits on foreign equity participation	100% Up to 24% in small scale	Up to 51% in most industries; or joint venture in all industries;and 100% in export-oriented industries, power, electronic and software technology parks	100% foreign owned permission of the sectors, except for a negative list industries	100% without any government.	100%
Fiscal incentives	i) Tax holiday for industries located in Dhaka and Chittagong Division (for 5 years), and Rajshahi, Khulna, Sylhet, and Barisal District (for 7 years). ii) Tax exemption on royalties, interest on foreign loans and capital gains from the transfers of shares. iii) 5% import duty on capital equipment and spare parts for initial installation.	i) Income tax holiday of 10 years for EPZ firms and 5 years for other investors. ii) Access to finance for export-oriented industries at concessional interest rates. iii) Tax relief under avoidance of double taxation agreements. iv) 10 year income tax holiday for firms located in EPZ.	i) Corporate tax rate for export-oriented industries is 8% of profit or0.5% of export earnings. ii) Corporate tax rate for import competing industries is 20%. iii) 2.5% duties on imports of M/E and spare parts. iv) 5-10% duties on most industrial intermediate inputs refunded to export-oriented industries under the duty draw back scheme.	i) No custom duty on imports of plant, machinery & equipment for export-oriented and hi-tech industries. ii) Zero import tariff on plant and machinery (not available locally) used for agriculture.	i) Exempted from income tax on capital gains arising from share transfers ii) income tax holiday for 5 years iii) Duty drawback for export-oriented industries
Repatriation of profits and tax on expatriates' income.	100% repatriation of capital and dividends is allowed.	100% repatriation of capital, profits and dividend is allowed after payment of tax.	100% repatriation of dividends and capital is allowed.	100% repatriation of capital, dividend and profits is allowed.	i) 100% repatriation of profits and dividend is allowedii) Expatriates' income is taxed at a concessional rate of 15% for 5 years.
Infrastructure	i) Provision of EPZs ii) Provision of industrial estates.	i) provision of EPZs ii) non-resident Indians allowed to acquire any property, except agricultural land, Farm House and Plantations	i) Provision of 11 industrial estates. ii) Self arrangement of land and utilities.iii) Dry port in Birgunj, and international container depots in Biratnagar and Bhairawa are under construction.	i) Provision of EPZs.	i) Provision of EPZ.
Protection of foreign investment	i) Guarantee against nationalization. ii) International convention for settlement of industrial disputes.	i) Settlement of disputes is governed by the Indian Arbitration Act 1940. ii) UN Convention for the recognition and enforcement of foreign arbitral awards.	i) Guarantee against nationalization. ii) Dispute settlement through mutual consultations and in accordance with the arbitration rules of UN Commission on International Trade Law.	i) Guarantee against nationalization. ii) Settlement of disputes through the International Commission on Settlement of Investment Disputes.	i) Protection against nationalization under the bilateral investment agreements and constitutional guarantee. ii) International Convention for the Settlement of Investment Disputes.

Source: Compiled from various country sources.

There is no doubt that Nepal has gone a long way in liberalizing its investment regime. However, very few reforms have taken place in factor markets, in particular the labour market. For example, under the Labour Act of 1992, firing a worker is extremely difficult and costly. Electricity distribution is still regulated by the State-own enterprises, namely, the Nepal Electricity Authority, which suffers from inefficiency and poor management. Despite having a considerable potential for producing hydroelectricity, the country suffers from chronic shortages of electricity. In the late 1990s, on average, almost half of the production capacity in manufacturing remained unutilized due to the shortage of electricity. While some progress has been made over the years in developing the transport networks, many parts of the country are still not connected with major cities. Also, there are very few flight connections between the capital, Kathmandu, and places of tourist attraction. The eruption of civil war in the mid-1990s has slowed down the pace of reforms (Sharma, 2006). Many foreign firms have ceased their operations or indefinitely postponed implementation of newly approved projects as the security situation deteriorated rapidly.

4. FDI: trends and patterns

During the period 1988-2001, the Foreign Investment Board approved a total of 721 projects. Total capital commitment of these projects amounted to $1.15 billion (65 billion Nepalese rupees) of which 26.3% came in the form of capital contributions by the foreign partners of the projects. It was envisaged that these investments would generate a total of 86,425 jobs (table 2). The number of foreign investment approvals showed a steady increase from 1988 to 1996, with the exception of 1994 when there was a temporary dip due to uncertainty in the political climate (with the formation of the short-lived Communist government). Since 1997, the pattern of foreign investment approvals has been erratic, with all years except 2000 recording a decline compared to the levels in the mid-1990.

Only about 37% of the FDI projects approved during the period 1988-2001 were actually implemented (table 2).

While it is a universal pattern across all developing countries that a significant number of FDI projects never reach the implementation stage, the Nepalese realization rate is exceptionally low in comparison to other developing countries in Asia. For instance, the realization rates in Malaysia, Sri Lanka and Vietnam (for varying periods during the decades of the 1980s and the 1990s) are estimated at 80%, 75% and 70% (Athukorala and Menon, 1996; Athukorala and Rajapatirana, 2000; Kokko and Zejan, 1996).

Table 2. Status of Total Approved Investment Projects, 1988 - 2001

Status	No. of Projects	Investment: Total amount (millions of dollars)	Investment: Share of FDI (%)	Total Fixed Investment (US$ million)	Employment (number of workers)
Operational	270	536.1	18.7	479.2	41 310
Under-construction	49	82.0	30.3	73.1	6 210
Licensed	135	214.1	31.9	172.7	15 399
Agreement signed	183	182.6	39.9	126	13 214
Closed	19	17.4	24.1	14.4	1 798
Cancelled	65	121.4	27.1	106.1	8 494
Total Approved	721	1153.6	26.3	971.6	86 425

Source: Investment Promotion Board, Department of Industry, Commerce and Supplies, Kathmandu.

As discussed earlier, Nepal now allows full foreign ownership with the exception of a few industries such as cigarettes, bidis and alcohol. Despite this openness, the share of foreign capital in total approved investments during the period 1988-2001 averaged a mere 26.3%, with the share in annual approvals varying in the range of 8% to 54%. Compared to the experience of other developing countries, the apparent inclination of foreign investors to settle for partial, mostly minority, ownership, perhaps, points to the unsettled nature of the investment environment in the country.

Table 3 places Nepal's performance in attracting FDI in an international perspective. Among South Asian countries, Nepal's performance, both in term of the volume and the trends in FDI inflows is superior only to Bhutan. As already noted, Nepal is relatively disadvantaged in attracting FDI because of being landlocked. But, even in comparison with other landlocked LDCs for which data are available, Nepal turns out to be a below-average performer. While it is not possible to draw firm inferences from a simple inter-country comparison, the data reported in the table do suggest that Nepal's poor record in attracting FDI cannot be explained solely in terms of constraints arising from being landlocked.. While it is not possible to come up with hard empirical evidence, political instability, policy uncertainly and the slow pace of reform appear to have contributed to Nepal's inability to attract FDI.

Table 3. FDI Inflows: Nepal in the International Context, 1989-2002

	1989-94*	1995	1996	1997	1998	1999	2000	2001	2002
World	200145	331068	384910	481911	686028	179083	1392957	823825	651188
Developed countries	137124	203462	219688	269654	472265	824642	1120528	598379	460334
Developing countries	63021	127606	165222	212257	213763	-645559	272429	225446	190854
South Asia	817	2945	3685	4939	3504	3095	3092	3982	4581
Bangladesh	6	2	14	139	190	180	280	79	45
Bhutan	1	0	1	1	0	0	0	0	0
India	394	2144	2591	3619	2633	2168	2319	3403	3449
Maldives	6	7	9	11	12	12	13	12	12
Nepal	4	8	19	23	12	4	0	21	10
Pakistan	304	719	918	713	507	530	305	385	823
Sri Lanka	102	65	133	433	150	201	175	82	242
Land-locked LDCs									
Chad	13	13	18	44	21	27	115		901
Lao PDR	19	95	160	86	45	52	34	24	25
Lesotho	19	23	31	32	27	33	31	28	24
Malawi	12	25	44	-1	-3	46	-33	-20	
Mali	2	123	47	74	36	51	83	122	102
Mongolia	71	10	16	25	19	30	54	43	78
Niger	17	16	20	25	9		9	23	8
Paraguay	79	98	144	236	342	95	104	95	-22
Uganda	23	121	121	175	210	222	254	229	275
Zambia	90	97	117	207	198	163	122	72	197
Zimbabwe	13	118	81	135	444	59	23	4	26

Source: UNCTAD (various years).

* Annual average

The geographic origin of FDI in Nepal is characterized by a clear developing-country bias (table 4). Among the developing-country investors, India has been by far the largest investor in Nepal. Of the total number of approved projects, 249 are of Indian origin. A large number of these firms are "quota-hoppers". In the export-oriented garment industry, Indian firms set up production facilities in Nepal in order to circumvent quota restrictions imposed under the Multi-fibre Arrangement (MFA) on garment exports from India. 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.

In many other countries in the region, investors from the newly industrializing economies have played a key role in the expansion of garment exports. However, these investors have completely ignored Nepal despite the opportunities it offers for accessing lucrative developed-country markets, circumventing the quota restrictions (Athukorala, 1995; Wells, 1994).[5]

A majority of the projects with capital participation from developed countries are small-scale projects with the participation of individual (rather than business) investors. None of the well-known TNCs from the developed countries appear in the approval list of the Nepalese investment authority. Moreover, FDI from developed countries are predominantly in the services sector.

Data on the sectoral distribution of approved projects are summarized in table 5. Manufacturing accounts for more than half of the approved projects and 65% of total planned investment. Among other sectors, the hotel and tourism industry

[5] As a LDC, Nepal enjoys unlimited duty free access to garment markets in Canada and the EU. Exports to the United States from Nepal were subject to MFA quotas during the period under study, but less than a half of the annual quota entitlement was utilized throughout this period.

Table 4. Total Approved Investment and Foreign Equity Participation by County, 1988-2001

	No. of Projects	Investment* Total amount (millions of dollars)	Investment* Foreign Equity Participation (%)	Fixed Investment (millions of dollars)	Employment
Developed Countries	309	425.9	25.6	380.5	27 487
Japan	77	40.6	32.0	35.0	4 842
United States	74	174.1	29.9	159.1	6 915
Germany	31	9.1	37.4	7.6	2 262
United Kingdom	26	27.7	8.1	23.8	5 153
France	19	6.4	23.6	5.5	993
Other developed countries	82	167.6	22.0	149.2	7 322
High Performing Asian Economies	119	197.5	29.9	169.6	14 144
China	57	113.6	29.1	95.2	6 716
Republic of Korea	29	22.6	49.1	18.7	2 552
Hong Kong (China)	12	18.2	35.8	15.9	2 064
Singapore	8	23.9	20.7	23.1	1 135
Thailand	7	14.2	9.5	12.1	1 106
Taiwan Province of China	6	5.0	42.5	4.5	571
SAARC Countries	271	430.3	26.1	330.9	40 301
India	249	419.7	25.9	324.9	34 553
Bangladesh	9	4.9	29.9	2.6	3 401
Pakistan	7	4.1	39.0	3.1	2 166
Sri Lanka	3	1.2	47.3	0.8	83
Bhutan	3	0.4	13.2	0.3	98
Other Developing Countries	22	99.9	26.2	90.6	4 493
Bermuda	6	29.8	5.9	25.3	1 474
British Virgin Islands	4	51.3	37.3	49.3	1 210
Philippines	3	13.9	5.3	12.8	1 329
United Arab Emirates	1	2.7	25.2	0.6	93
Others	8	2.2	29.0	2.6	387
Total	721	1 153.6	26.3	971.6	86 425

Source: Compiled from data from the Department of Industry, Commerce and Supplies Kathmandu.

* This includes investment from Nepalese and foreigner investors.

attracted a large number of investments given the attractiveness of Nepal as a tourist destination. Although tourism has experienced a major setback in recent years because of the civil war,[6] this is certainly an area where Nepal has an intrinsic

[6] The number of tourist arrivals declined from 422,000 in 1997 to 270,000 in 2002 and foreign exchange earnings from tourism dropped from $174 million (3% of GDP) to $68 million (1% of GDP) during the same period.

comparative advantage. Only two foreign firms have so far entered the hydroelectricity industry, in which Nepal has immense potential for output expansion through foreign capital participation.[7] The government monopoly in electricity distribution and the compulsion for private-sector electricity producers to supply to the national grid (owned and managed by the Nepalese Electricity Authority) is considered to be a major hurdle for FDI in this industry.

Table 5. Sectoral Distribution of Total Approved Projects and Foreign Equity Participation, 1987- 2001

Product sector	Number of projects	Total Investment US$ million	Total Investment Foreign Equity Participation (%)	Total Fixed Investment (US$ million)*	Total employment
1. Agriculture	12	5.2	25.5	4.7	842
2. Manufacturing	369	492.7	26.0	363.1	55 996
2.1 Food, beverages and tobacco	61	124.4	19.3	109.2	..
2.2 Textile and wearing apparel	123	118.6	33.0	75.8	..
2.3 Wood & wood products	5	1.2	34.0	0.9	..
2.4 Paper & paper products	17	24.9	15.4	21.5	..
2.5 Chemical and plastic products	68	89.8	30.7	67.1	..
2.6 Non-metallic mineral products	13	46.6	20.9	27.7	..
2.7 Basic metal products	21	30.2	30.8	20.4	..
2.8 Fabricated metal products	48	44.8	25.4	31.6	..
2.9 Machinery and equipment	0	0	0	0	..
2.10 Other manufacturing	13	12.1	22.2	8.7	..
3. Electricity, water and gas	14	243.4	17.1	230.2	..
4. Construction	16	12.8	59.9	11.2	..
5. Hotel & resorts	168	228.6	27.3	217.3	..
6. Transport & communication	24	53.5	40.6	37.5	..
7. Housing and apartments	15	3.6	56.1	1.4	..
8. Services	104	103.6	33.2	96.1	..
TOTAL	721	1 153.6	26.3	971.6	86 425

Source: Compiled from data from the Department of Industry, Commerce and Supplies, Kathmandu.

.. Data not available.

[7] Total hydropower generation potential in Nepal has been estimated at 83,000 MW and 50% of this is considered commercially viable. However, the current installed capacity is only 253 MW, and only 25% of Nepalese households have access to electricity. Intermittent interruption of power supply is a major constraint on manufacturing and other business activities.

Despite the heavy emphasis placed on attracting FDI as a vehicle for export expansion, much of the realized projects are engaged in domestic market-oriented industries (table 6). Of the 270 operational projects, 116 (43%) are in various service industries (mostly those relating to tourism). Among 154 firms engaged in manufacturing, only 27 (18%) are in export-oriented industries, with the balance of 127 (82%) producing primarily for the domestic market. As can be expected, export-oriented firms show a greater concentration in the Kathmandu valley compared to domestic market-oriented firms. None of the export-oriented firms are located in the Hilly and Mountain regions primarily due to the lack of efficient transport networks (table 6).

Table 6. Number of Operational FDI firms by Region and Market Orientation as at 31.10.2001

Region	Manufacturing		Service	Total
	Domestic market-oriented	Export market-oriented		
Kathmandu Valley	53	21	74	148
Terai	64	6	15	85
Hilly and Mountain Range	10	-	27	37
Total	127	27	116	270

Source: Compiled by the authors from data provided by the Department of Industry, Commerce and Supplies, Kathmandu.

The bulk of export-oriented FDI projects are in the clothing industry (about 95%), attracted by the quotas system under the MFA. Perhaps because of the uncertain business climate, foreign firms in the export-oriented garment industry have largely focused on reaping easy, short-term gains in a quota-restricted market without making efforts to diversify into competitive non-quota markets. According to some tentative estimates based on interviews conducted with some key personnel in the business sector in 2001, the non-quota exports accounted for only about 10% of the total garment exports from Nepal (UNIDO, 2002). Quota-hopping foreign firms in the

Nepalese clothing industry have already begun to face severe difficulties following the abolition of the MFA from January 2005.[8]

5. Development implications

A systematic analysis of the development implications of FDI in Nepal is not possible because of the paucity of data. The Annual Survey of Manufacturing Establishments, which is the main source of data for analyzing the performance of the manufacturing sector, does not provide enough data for cross-tabulation by ownership. The Foreign Investment Promotion Board has not so far undertaken any assessment of the operations of foreign investment projects. The purpose of this section is to make some tentative inferences by analyzing the limited available information in the context of the general literature on development implications of FDI in developing countries.

One of the most obvious contributions of FDI to economic development is improved productivity by bringing with it 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 TNCs – 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. It may also allow new entrants to learn about export markets, stimulate competition with local firms, and provide training for workers. There is, however, a consensus in the literature that these various indirect beneficial effects ("spillover effects") of FDI depend crucially on the nature of the trade

[8] Following abolition of MFA quotas, clothing exports from Nepal to the United States contracted by a staggering 26% during January-September 2005 compared to the same period in 2004 (Ahmad, 2005, Table 1-A).

regime of the host country (Bhagwati, 2004, Chapter 12; Balasubramaniyan *et al*., 1996; Athukorala and Chand, 2002). A country with an outward-oriented policy regime has the potential to reap greater benefit from FDI than a country whose policy regime has a bias in favour of import-substitution. This is because, in contrast to an import-substitution regime, an export-oriented regime generally encourages FDI in activities where the host country has a comparative advantage.

The heavy concentration of foreign firms in market-seeking activities in Nepal (table 6) suggests that national gains from FDI in productivity improvement and economic growth may have been limited. Production facilities set up to cater for the small domestic market tend to have high costs and are characterized by low productivity growth compared to those set up to produce for the global market in line with the country's comparative advantage. As mentioned earlier, a systematic analysis of the productivity implications (and other spillover effects) of FDI in Nepal is not possible given the paucity of data for a sufficiently long period of time. However, available data suggest that total factor productivity growth of industries with greater presence of foreign affiliates (identified on the basis of the Foreign Investment Promotion Board approval list) are not significantly different from, and in most cases lower than, the average level of TFP growth for the entire manufacturing sector.[9] This finding is certainly consistent with the view that foreign investment drawn in by "easy profit" is unlikely to generate much benefit in the way of technological improvements.

During the period 1988-2001, the amount of total realized FDI expressed as a percentage of gross domestic capital formation was, on average, less than 1%.[10] The relative

[9] Using Sharma (2004) data set and the model developed therein we tested if FDI has any impact on inter-industry variations in productivity growth by adding FDI variable proxied at the two-digit level of industry classification. No statistically significant evidence was found between FDI and productivity growth.

[10] This estimate is based on data obtained from UNCTAD, *World Investment Report* (various issues).

contribution of FDI projects to domestic employment has also been small. According to the official records of the Foreign Investment Promotion Board, total employment in realized FDI projects during the period 1988-2001 was 41,320, which amounted to a mere 0.06% of the increase in the total labour force in the country during the same period.[11] The data on the sectoral distribution of FDI projects in manufacturing points to a high concentration of projects in relatively more capital-intensive sectors, which receive relatively greater protection.[12] Based on data relating to investment approval, total investment per worker in FDI projects is around $14,000, which is extraordinarily high for a labour-abundant and capital-scarce country like Nepal. For example, in Malaysia, a country which is at a much advanced level of development with virtually full employment from the early 1990s, average investment per worker in foreign firms is as low as $18,000. This vast difference in the degree of capital intensity of production by foreign firms in the two countries can be explained in terms of the nature of the market-orientation of such production. As noted earlier, foreign firms in Nepal are largely involved in import-substitution activities whereas in Malaysia, they are heavily concentrated in export-oriented production. Import-substitution (market-seeking) FDI in developing countries, driven mostly by high import tariffs and other entry barriers rather than relative factor cost differentials, generally tend to be more capital intensive compared to efficiency-seeking (export-oriented) FDI (Bhagwati, 1991).

Finally, data on the spatial distribution of operational FDI projects suggest that the benefits of FDI are heavily concentrated in Kathmandu and the surrounding areas. Of the 270 operating projects, the Kathmandu Valley alone has attracted 148 projects (55% of the total) and 48% of total employment. In contrast, only 37 projects (14%) accounting for 14% of total

[11] Of the total jobs, 28,400 were in manufacturing (or 70% of the total), while the rest were in services.

[12] Such industries include beer, distilleries, soft drinks, chemical products, radio and TV and electric apparatus.

employment are located in the Hilly and Mountain regions where about 50% of the country's population live. An analysis of the employment generated by foreign affiliates across regions suggests that over 86% of jobs are created in the Kathmandu Valley and the Terai belt, both of which have the basic physical infrastructure and higher purchasing power than the rest of the country (table 7). These two regions have together attracted 233 operational FDI projects (86% of the total). These special patterns of FDI clearly point to the importance of transportation and other infrastructure facilities, and access to administrative services in determining investment location.

Table 7. Employment and Investment in Operational FDI firms by Region as at 31.10.2001

Region	No. of Projects	Total Project Cost (US$ million)	Employment
Kathmandu Valley	148	303.85	20 049
Terai	85	112.10	15 612
Hilly and Mountain Range	37	63.35	5 649
Total	270	479.30	41 310

Source: Compiled by the authors from data provided by the Department of Industry, Commerce and Supplies, Kathmandu.

6. Conclusion

Nepal has made a promising start in implementing market-oriented reform and promoting FDI, but it has a long way to go in reaping the benefits from integration into the global economy through FDI. Under the new policy regime, foreign firms have played a role in carpets and garment exports, but their exports are largely motivated by the Generalized System of Preferences and MFA quotas rather than the country's comparative advantage. A large numbers of foreign investment projects are also based on shaky foundations, motivated by import deflection opportunities created by vast tariff differentials between Nepal and India (the major investor in Nepal). The overwhelming majority of foreign firms are involved in import-substitution activities characterized by high capital intensity. Consequently, the contribution of FDI to employment generation has been negligible. It seems that FDI attracted to “easy profit” activities (import-substitution manufacturing as well as the quota-protected garment industry) has failed to make a significant contribution to productivity growth in the Nepalese manufacturing sector. The foreign firms are located in the Kathmandu Valley or in the Terai belt, while the geographic spread of the gains from foreign investment has been rather skewed. Most participation of foreign firms in tourism – an activity where Nepal has a huge potential – has not been much due to the lack of efficient transport networks and the civil war since 1995.

An obvious, but important, inference coming from our analysis is that trade liberalization and generous investment *per se* in the absence of basic pre-conditions cannot achieve anticipated developmental objectives. The provision of required supportive services, political stability, policy certainty and efficient administrative mechanism have an equally - perhaps even more - important role to play. Nepal obviously has disadvantages arising from its geography in attracting FDI. However, comparative international experience suggests that her lacklustre record as a host to foreign investors cannot be explained in terms of its geography alone. The overall investment climate does matter. ■

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