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Foreign Investment in a Least Developed Country:
The Nepalese Experience

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Foreign Investment in a Least Developed Country: The Nepalese Experience

Abstract: This paper aims to contribute to the literature on the developmental role of foreign direct investment through an examination of the Nepalese experience during the period 1988-2001. Despite significant liberalisation of the foreign investment regime and the introduction of attractive investment incentives, Nepal's achievements during this period, both in terms of the volume of FDI and its developmental impact, failed to mach the national expectations. Nepal obviously has intrinsic disadvantages arising from its geography and other typographical characteristics in attracting FDI. However, comparative international experience suggests that her lackluster 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 liberalisation of the investment regime and introducing financial incentives are not a substitute for an all-encompassing effort to improve the investment climate.

1. Introduction

The past two decades have witnessed a profound shift in the policy emphasis on foreign direct investment (FDI) in developing countries (DCs). In a significant departure from the scepticism about the developmental role FDI that pervaded policy thinking in the nearly three decades following the end of the Second World War, more and more countries have become increasingly receptive to FDI as an integral element of outward-oriented policy reforms. Despite this notable policy shift, the literature on the role of FDI in developing countries still remains both sparse and lopsided. The few available analyses have focussed 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 latecomers because the role of FDI vary across countries depending on changes in the process of internationalisation of production and the nature and timing of policy shifts, and the initial conditions of the given host country such as the degree of industrial advancement and the stage of entrepreneurial development. This paper aims to redress this balance in the literature by examining the patterns and developmental implications of FDI in Nepal following the market-oriented policy reforms initiated in the mid 1980s.

The paper is structured as follows: Section 2 provides an analytical account of the nature, determinants, and developmental implications of FDI in latecomer countries in order to place the Nepalese case study in context. An overview of the foreign investment regime is provided in Section 3. Section 4 examines trends and patterns of FDI during 1988-2001[1], while development implications of FDI are discussed in Section 5. The key findings are summarised in the concluding section (Section 6).

[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.

2. Analytical Context

Foreign direct investment (FDI) originates from the decision of a multinational enterprise (MNE) to relocate part of its activities in a selected host country.[2] This decision is underpinned by the desire to reap benefits from its specific advantages (in the form of technology, managerial expertise, marketing know-how etc.), which cannot be effectively leased or purchased through 'arms length' market dealings with unrelated firms. In other words, FDI is a flow of long-term capital based on long-term profit considerations and a significant degree of influence by the investor on the management of the enterprise (Caves 1996). It is this specific element of 'influence and control' that distinguishes direct from portfolio investment and other forms of international capital flows.

The most obvious contribution of FDI and other forms of international private capital flows (such as portfolio investment, bank credit) to a capital receiving (host) country is to increase domestic investment beyond the level permitted by domestic saving. However, FDI is unique among other forms of capital follow because its role is not limited only to adding to investment in the capital receiving (host) country. FDI originates from the decision of a firm in a given country (a multinational enterprises, MNEs) to enter into international production; to relocate part of its activities in a selected host country. Thus FDI essentially brings 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 the host country. Affiliates of MNEs as part of the parent company's global network, have marketing channels in place, 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 costs of production. Moreover, MNEs may be better able to resist protectionist pressures in their home countries in such a way as to favour imports from their affiliates. On these grounds, it is often being said that FDI enables managers and workers in the country to acquire knowledge and technology faster than otherwise be possible. It may also allow new entrants to learn about export markets, stimulate competition with local firms, and provide training for workers. There is a consensus in the literature that cumulative impact of these various spill over benefits of FDI is far greater than the direct benefits in the form of augmenting domestic investment (eg. Markusen and Venables 1997, Borensztein *et a*l. 1998).

The attractiveness of a given country as a host to foreign investors is determined through a combination of its comparative advantage in international production and the domestic investment climate. The term 'investment climate' is sued here in a broader sense to cover both the foreign investment regime (rules governing foreign investment and specific incentives for investors) and the general investment environment which encompasses various considerations impinging on investment decisions such as political stability, macroeconomic environment and attitudes of host countries towards foreign enterprise participation. Most economists today accept the argument that tax concessions and other profit-related incentives do not generally work unless they are appropriately combined with other initiatives to improve the general investment climate. These specific incentives are relevant for an investment decision only if the general business environment is conducive for making profit. Moreover, as countries compete for attracting investment, the incentives offered by a given country are generally counter-balanced by similar moves by other competing countries. Thus

[2] According to the standard (United Nations) definition, the multinational enterprise (MNE) is an enterprise that owns and controls business ventures in more than two countries, including its home country. When this definition is adopted the bulk (if not all) of FDI in a given country can be considered as MNE investment.

investment incentives may matter only when other conditions are roughly similar as between alternative host countries (Wells 1986, Wellas and Allen 2001, Caves 1996).

Assuming a favourable investment environment, what are the typographical characteristics, which determine a country's comparative advantage in international production? In answering this question, it is important to emphasise that FDI is not a homogeneous phenomenon, but complicated and finely differentiated means of globalisation of production. For the purpose of discussing factors impacting on foreign firms' (Multinational Enterprises, MNEs) decision to locate production in a given country, it is important to distinguish between three categories of MNEs affiliates in terms of their operations in a given host country. These are, producers largely engaged in serving the domestic market ('market-seeking' investors), firms involved in extraction and processing of natural resources both for selling in the domestic market and exporting (usually for the latter purpose) (resource seekers), and those engaged in production for the global market ('efficiency seeking' investors).

When it comes to market-seeking investment in developing countries, the forces explaining the location decisions of MNEs are about the same as those explaining their presence in industrialised countries. The location decision depends primarily on the prevalence of production opportunities in the host country for meeting domestic demand. Given the scale economies and very small domestic markets in many developing countries, a major (if not the key) determinant of FDI is restrictions on international trade (known as 'tariff jumping' motive). The so-called 'life-cycle' investors who expand their production networks globally predominantly on scale-economy and efficiency considerations hardly find low-income countries as attractive investment locations under free-trade conditions. In theory, under certain circumstances, MNE affiliates originally set up to serve local markets could well develop competitive advantage over the years and penetrate markets in other countries without government support. But in the real world such cases are rare and limited predominantly, if not solely, to middle-income and upper-middle-income developing countries with sizeable domestic market.

The role of MNEs in 'efficiency seeking' investment is 'more distinctively a developing-country question' (Caves 1996, p217). For the purpose of identification of the potency of a given host country in attracting export-oriented FDI, it is important to distinguish between two different categories of export-oriented (EO) production, namely labour-intensive final consumer goods (clothing, footwear, toys, spot goods etc.), and assembly processes within vertically integrated global production systems.

For the typical developing economy, labour-intensive consumer goods are generally considered the natural starting point in the process of export-led industrialisation. However, the role of FDI in this area remains a controversial issue. In the spectacular export take-off of the East Asia NIEs in the 1960s, the key role was played by indigenous firms with the help of marketing services provided by foreign buyers - the Japanese trading houses and the large retail buying groups in developed countries (Nayyar 1978).

There are, however, strong reasons to argue that this 'early East Asian pattern' of local-entrepreneur dominance in exports may not be replicated in latecomer countries for two reasons. First, perhaps the most important factor behind the East Asian experience was the unique entrepreneurial background of these countries. Hong Kong, Taiwan and to some extent Singapore started with a stock of entrepreneurial and commercial talents inherited from the pre-revolution industrialisation in China. Hong Kong and Singapore also had well established international contacts based upon entrepot trade that involved exporting manufactured goods to begin with. Likewise, the considerable industrial experience that accumulated over the preceding five decades or so under the Japanese occupation was instrumental in Korea's export take off. Therefore, there was no such a large difference between domestic firms in these countries and foreign firms with regard to knowledge of and access to production technologies and market channels. However, the initial level of entrepreneurial maturation in newcomer countries is generally not comparable to that of the NIEs. In many of these countries, the import-substitution growth strategy pursued indiscriminately over a long period has thwarted the development of local entrepreneurship. Domestic firms are generally weakly oriented towards, and have limited knowledge of, highly competitive export markets.

Second, from around the mid 1980s, successful exporting firms in the East Asian NIEs have began to play an important role as direct investors in the latecomers' labour-intensive export industries.[3] A major advantage which investors from these new countries possess is that, unlike MNEs from developed countries they are familiar with and/or easily adaptable to the more difficult business conditions (eg. poor infrastructure, bureaucratic red tape, and unpredictable policy settings) in latecomers. Given that NIE firms have developed considerable specialised knowledge of small scale and labour-intensive production procedures in the manufacture of standardised products, they have a powerful competitive advantage over both local firms and MNEs from ICs in these latecomer environments. There are indications that, consistent with rapid structural transformations that are taking place in the NIEs prior to the recent economic crisis (and from which they have quickly recovered), this intermediary role of these "new" investors in linking latecomers to world markets may become increasingly important in years to come.

The production of relatively labour intensive components and their assembly within vertically integrated international industries ('international product fragmentation' or 'outsourcing') in developing countries has been an important feature of the international division of labour since about the late 1960s. The process was started by electronics manufacturing MNEs based in the USA in response to increasing pressures of domestic real-wage increases and rising import competition from low cost sources. The transfer abroad of component assembly operations now occurs in many industries where the technology of production permits the separation of labour intensive components from other stages of production. Assembly operations in the electronic industry (in particular assembly of semi-conductor devices, hard disk drives etc) are still by far the most important. The other industries with significant assembly operations located in developing countries are electrical appliances, automobile parts, electrical machinery and optical products, musical equipment, watches, and cameras. In general, industries that have the potential to break up the production process to minimise the transport cost involved are more likely to move to peripheral countries than other heavy industries.

The expansion of overseas assembly operations as an important facet of international production has been hastened by two mutually reinforcing development over the past few decades. First, rapid advancements in production technology have enabled the industry to

[3] Two main factors accounted for this trend: the erosion of international competitiveness of labour-intensive export products from their home countries as a result of rising real wages and exchange rates; and the imposition and gradual tightening of quantitative import restrictions (QRs) under the Multifibre Arrangement (MFA) by Industrialised countries on certain labour intensive exports (mostly textile, garments and footwear)

slice up the value chain into finer, 'portable', components. Second, technological innovations in communication and transportation have shrunk the distance that once separated the world's nations, and improved speed, efficiency and economy of coordinating geographically dispersed production process There is evidence that global assembly exports is growing much faster than total manufactured exports (Freenstra 1998).

While the availability of cheap and trainable labour is a prerequisite for attracting FDI into both these product areas, in worldwide assembly operations labour costs, generally take second place. The availability of a wider array of complementary inputs, including operator, technical and managerial skills (in addition to the availability of cheap operational labour), a good domestic basis of supplies and communication services, and high-quality infrastructure are crucial to make assembly operations efficient by world standards. Also, given the heavy initial fixed costs involved, MNEs are hesitant to establish assembly plants in a given host country without considerable experience and confidence in policy continuity and political stability in 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 operation.

Based on the above typology of FDI, what are the opportunities available for attracting FDI? Nepal does not possess readily accessible mineral resources to attract resource-based FDI. Her ability to attract 'natural' (purely market driven) import-substitution FDI is also limited given the limited domestic market. Enticing import-substitution FDI through erecting tariff barriers is a non-option given the palpable shift in overall development policy towards greater outward orientation. In the area of export-oriented FDI, Nepal is not an attractive location for assembly activities within vertically integrated global industries. Nepal opportunities in this area are basically limited to labour intensive consumer goods production. However, Nepal's attractiveness as a location of export-oriented FDI is significantly impeded by high transport cost arising from her 'landlockness'. Apart form the long distance to Indian ports (the Calcutta post is about 1000 kilometres at the closest route), inefficiencies of the Indian railway and ports add to Nepal's cost of transportations relating to international trade. It is also widely alleged that shipments from Nepal receive unfair treatments in priority order at the highly congested Indian ports.[4] The original market-oriented policy reform package contained a proposal to establish dry ports in Brigun and Bhairabha and to develop a railway line from these ports to the Indian border with a view to relaxing the transport cost constraint on foreign trade. This proposal has not yet taken off the planning stage.

3. Foreign Investment Regime and Investment Climate in Nepal

For over three decades until the mid-1980s Nepal continued to pursue import-substitution development strategy in the context of a highly protectionist trade and investment regime. During this period, FDI was allowed only in some selected industries. There were also stringent limits on share of foreign ownership. Dismal economic performance under the import-substitution regime, coupled with pressure by international lending agencies, paved the way for a decisive policy shift in favour of market-oriented, outward-looking, development strategy, starting with the Structural Adjustment Policy (SAP) package of 1985. These reforms emphasised the need to promote the role of private sector in the economy.

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

As a part of outward-oriented policy reforms, Nepal has made substantial changes in its trade and investment policies to promote private foreign investment as an effective means of promoting private-sector led growth. 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. A new Foreign Investment Promotion Division was created at then the Ministry of Industry to act as the central body for the approval and monitoring of foreign investment projects. Foreign investment was not allowed in small-scale industries while in medium-sized industries, foreign equity of up to 50% was permitted. In large industries with at least 90% export sales there would be 100% foreign ownership. In other large industries 80% was normally the maximum; if the remaining 80 per cent of equity was not taken by Nepalese, foreign shareholders were could subscribe up to 100%.

The Act contained a new set of incentives, which were similar to or even more attractive than those in other countries. Full remittance of profits from FDI ventures in convertible currency was permitted. Repatriation of capital was possible, but an annual limit of 20% of the initial investment was set (or 25% if shares are sold through the Securities Exchange centre). 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-emphasised the importance of FDI and technology transfer in the development process. In 1991 the tax holiday period was extended to10 years for investments in national priority activities. The priority sectors were defined to include industries producing goods that meet basic need (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 sectors excepting some industries such as defence, cigarettes, bidis and alcohol. Development of hydropower was also opened to foreign investment. The Act guaranteed 100% repatriation of equity invested, dividends obtained from foreign investment and amount received as payment of principal and interest on foreign loans in convertible currencies.

Under the Foreign Investment and One-Window Policy Act (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 attend to the provision of all institutional facilities and services (infrastructure-related and other) under one roof. As part of the FDI policy, the Nepalese government has entered into investment protection agreements with Germany, France and the UK. Agreements for avoiding double taxation have been signed with India, Norway and Thailand. Relating to the settlement of foreign-investment related disputes, the law of the country has made explicit provisions for arbitration within the framework of the United nation's Commission for International Law (UNCTRAL)

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. A 1996 amendment eliminated the fixed assets limit and expanded the scope of foreign investment in all industries except those few in the negative list. To expedite the approval process, the Dept of Industry was authorised to approve projects with Rs 500 millions or more fixed assets.

More recent changes in foreign investment law include, abolishing tax holiday (by the first amendment to the foreign investment act in 1997) and reduction of corporate tax rate for domestic marker-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 profit. A 5% tax was introduced on profit remittances by foreign firms by the 1999/2000 Budget. This new tax, introduced on balance of payments exigencies, is however at odds with the government commitment to promote foreign investment.

The key elements of the Nepalese FDI policy are compared with that of the other countries in South Asia in Table 1. It is evident that in general Nepalese policy regime compares very favourably with the other countries. However, it is important to note two peculiarities in the Nepalese regime. First, after the 1997 amendment to the investment Act, Nepal does not offer tax holiday for foreign investment project. Second, Nepal has not set up export processing zones(EPZ) as a means of promoting export-oriented FDI. The Nepalese authorities are of the view that there is little need for EPZ given the significant import tariff cuts in recent years and the existence of the wide-ranging import duty rebate scheme.

There is no doubt that Nepal has gone a long way in liberalising investment policy. However, very little reforms have taken in factor markets in particular the labour market. For example, under the Labour Act, 1992 firing a worker is extremely difficult and costly. Likewise, the existing policy does not encourage firm specific training programs despite the importance of such programs in the organised manufacturing sector. Electricity distribution is still regulated by the state own enterprises namely, Nepal electricity Authority which suffer from inefficiency and poor management. Despite considerable potential for producing hydro-electricity, the country suffers from chronic shortages of electricity. In the late 1990s, on average almost half of the production capacity in domestic manufacturing remained unutilised due to shortage of electricity (Sharma 2001).

4. FDI: Trends and Patterns

During 1988-2001, the Foreign Investment Board approved a total of 721 projects. Total capital commitment of these projects amounted to US$ 1153.6 million (Nepalese Rupees (NR) 65191 million) of which US$ 971.6 (26.3% of the total) came in the form of capital contribution by the foreign partners of the projects. It was envisaged (planned) that these investments will generate 86,425 jobs (Table 2). Foreign investment approval showed a steady increase from 1988 to 1996, with the exception of 1994 when there was a temporary dip in due to uncertainty in the political climate (with the formation of a short-lived communist government). Since 1997, foreign investment approval pattern has been erratic, with all years except 2000 recording a decline compared to the levels in the mid-1990.

The available data indicate that only about 37% of the approved projects are operational (Table 2). While it is a universal pattern across all developing investment-receiving countries that a significant number of FDI projects never reach the implementation stage, the Nepalese realisation rate is exceptionally low from a comparative perspective. For instance, the realisation rates in Malaysia, Sri Lanka and Vietnam (for varying periods during the decades of 1980s and 1990s) have been estimated as 80%, 75% and 70% (Athukorala and Menon 1996, Athukorala and Rajapatirana 2000, Kokko and Zejan 1996). This may be because of various administrative bottlenecks that the prospective investors have to confront in Nepal.

As discussed earlier, Nepal now allows full ownership in FDI projects, with ownership limits only in few areas. Despite this, the share of foreign capital in total approved investment during 1988-2001 has averaged to a mere 26.3%, with the share in annual approvals varying in the range of 8% to 54%. Based on the experience of other developing countries, the apparent inclination of foreign investors to settle for partial, mostly minority, ownership positions perhaps points to the unsettled nature of the investment environment in the country.

Table 3 places Nepal's performance in attracting FDI in international perspective. Among the South Asian countries, Nepal's performance both in term of the volume and the trends in FDI inflow is superior only to Bhutan. It is generally belied that Nepal is in a less advantageous position in attracting FDI because of its landlockedness. But even in a comparison with other land-locked least-developed countries for which data are available, Nepal stands 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 landlockness.

The geographic origin of FDI in Nepal is characterised by a clear developing country bias (Table 4). Among the developing country investors, India has been by far the most important largest investor in Nepal. Of the total number of approved projects, 249 are of Indian parentage. A large number of these firms are 'quota-hoppers; in the export-oriented garment industry, firms set up in order to circumvent quota restrictions imposed by importing developed countries on garment exports from India. A major inducement for the bulk, if not all, of the other Indian investors has been opportunities for profit making through 'import deflection'. Because of successive tariff cuts form the late 1980s, tariffs on many intermediate products imports in Nepal are much lower than in India. This, combined with virtual open border between the two countries, has made simple processing industries in a number of product area (including vegetable ghee, copper wires and some cosmetics) geared to the Indian market highly profitable.

An overwhelming number of projects with capital participation from developed countries are small-scale projects with the participation of individual (rather than business) investors. None of the well know MNEs from the developed countries appear on the approval list of the Nepalese investment authority. Moreover, FDI from developed countries are mostly in the service sector.

Data on the sectoral distribution of approved projects are summarised in Table 5. Manufacturing accounts for more than half of the approved projects and 65% of the total planned investment. Among the other sectors, hotel and tourism show a large concentration given the attractiveness of Nepal as a tourist destination. Only two foreign firms have so far entered the hydroelectricity sector where Nepal has immense potential for output expansion though foreign capital participation.[5] The government monopoly in electricity distribution and the compulsion for private-sector electricity producers to supply to the national supply grid (owned and managed by the Nepalese Electricity Authority is considered to be a major hurdle for FDI in this sector.

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

Despite the heavy emphasis placed on attracting FDI as a vehicle for export expansion, much of the realised projects are engaged in domestic-market oriented product sectors (Table 6). Of the 270 operational projects, 116 (43%) are in various services activities (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 predominantly for the domestic market. Thus, clearly Nepal's record in attracting efficiency enhancing FDI has so far been rather limited. Various deficiencies in investment climate, such as lack of flexibility in labour market and the low quality of physical infrastructure appear to be the main reasons (Sharma 2004). As can be expected, the export-oriented firms show a greater concentration in Kathmandu valley compared to domestic market oriented forms. None of the export-oriented firms are located in the hilly and mountain regions (Table 6).

The bulk of export-oriented FDI projects are in the clothing industry (about 95), driven by country-specific import quotas imposed by importing countries under the Multi-fibre Arrangement (MFA). Thus, the sustainability of these projects is in doubt when the quotas are abolished under the WTO Agreement on Textiles and Clothing. 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 effort to diversify into competitive non-quota markets. According to tentative estimates based on interviews conducted with some key informants in the business sector, in 2001 the non-quota exports accounted for only about 10 percent of total garment exports from Nepal (UNIDO 2002).

5. Developmental Implications

A systematic analysis of the developmental implications of FDI in Nepal is not possible because of data deficiencies. The Annual Survey of Manufacturing Establishments, which is the main source of data for analysing manufacturing performance, does not provide for cross-tabulation of data by ownership. The foreign investment approval authority has not so far undertaken any assessment of the operations of foreign investment projects. The following tentative inferences are made by combining the limited available data and inferences of the studies on the development role of FDI in developing countries.

Data from Foreign Investment Board records indicate that operational foreign firms have created 41,310 jobs during 1988-2001 periods, which amounted to a mere 0.06 per cent of the total labour force in the country. Of this 28,400 jobs were in manufacturing (or 70% of the total), while the rest were in services activities (12,910).

This lacklustre employment outcome is not only a reflection of the county's limited success in attracting a sizeable number of FDI projects but also of the *nature* of the projects that have been set up in the country. 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 high protection. Based on data relating to investment approval, total investment per worker in FDI projects is around US$ 14,000, which is extraordinarily high for a labour surplus 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 US$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 market-orientation of such production. As noted earlier, foreign firms in Nepal are overwhelmingly involved in import-substitution activities where as in Malaysia they are heavily concentrated in export-oriented production. Export-oriented (or efficiency seeking) FDI in developing countries, being driven mostly by relative factor cost differentials, naturally tends to be more labour intensive compared to market seeking FDI.[6]

The heavy concentration of foreign firms in Nepal in market seeking activities also suggests that national gains from FDI in productivity improvement and economic growth may have been limited. Firms set up to cater for the domestic market tends to have high costs and characterised by low productivity growth compared to those set up to produce for the global market in line with the country's comparative advantage in international production (Athukorala and Chand 2002, Balasubramanyam *et al* 1999).

Date 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, Kathmandu Valley alone has attracted 153 projects (57% of the total) and absorbs 48% of total employment. By contrast, only 32 projects (12%) accounting for 14% of total employment are located in the Hilly and Mountain regions where about 50 percent of the country's population live. An analysis of employment generated by FDI firms by region suggests that over 86% of jobs are created in Kathmandu Valley and Terai belt both of which have the basic physical infrastructure and the high purchasing than the rest of the country (Table 7). These two regions have together attracted 238 operational FDI (or 88% of the total). These special patterns of FDI location clearly points to the importance of transportation and other infrastructure facilities, and access to administrative services in determining investment location.

6. Conclusion

Nepal has made a promising start in implementing market-oriented reform and promoting FDI as part of it, but it has a long way to go in reaping the benefits from the greater global integration through FDI. There is no doubt that since the introduction of an outward-oriented strategy in the mid 1980s foreign firms have contributed significantly in carpets and readymade garment exports but their exports are largely motivated by the GSP and MFA quotas rather than the country's intrinsic comparative advantage. Also, a large number of foreign firms are based on a shaky foundation, motivated by import deflection opportunities created by vast tariff differential between Nepal and India (the major investor in Nepal). Foreign firms are relatively capital-intensive as compared with local firms. These firms employs only about 0.6% of economically active workforce which is not impressive in a labour abundant country like Nepal where about 20% of the work force is unemployed or underemployed. This lower level of employment intensity in foreign firms appears to be due the rigidity in labour market and shortage of semi-skilled workforce.

In the absence of basic prerequisites (namely, efficient and reliable physical infrastructure and access to semi-skilled work force), the geographic spread of gains from foreign firms has been rather lopsided. Most foreign firms are located in the Kathmandu Valley or in Terai belt while Hilly and Mountain ranges have failed to attract such investment due to poor physical infrastructure facilities despite liberalisation in trade and investment climate. An obvious, but important, inference coming from our analysis is that trade

[6] See Bhagwati (2004) Chapter 12 and the work cited therein.

liberalisation 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 a flexible administrative mechanism have an equally, and perhaps even more, important role to play. This is also reflected by the low realisation rate of FDI firms (about 46%).

Nepal obviously has intrinsic 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 geography alone. The overall investment climate also seems to matter.

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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 Foreign Equity Participation	100%	Up to 51% in most industries; Up to 24% in small scale industries; and 100% in export-oriented industries, power, electronic and software technology parks	100% foreign owned or joint venture in all sectors, except for a negative list industries	100% without any permission of the Govt.	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 sparse parts for initial installation	i) Income tax holiday of 10 year for EPZ firms and 5 year for other investors. ii) Access to finance for export-oriented industries at confessional 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 or 0.5% 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 refuded 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??? iii) Duty draw back 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 dividents and capital is allowed	100% repatriation of capital, dividend and profits is allowed	i) 100% repatriation of profits and dividend is allowed ii) expatriates income is taxed at a confessional rate of 15% for 5 years
Infrastructure	i) Provision of EPZs ii) Provision of industrial estates	ii) 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 depos in Biratnagar and Bhairawa are under construction	i) Provision of EPZs	i) Provision of EPZ
Protection of Foreign Investment	i) Guarantee against nationalisation ii) Internatioanl convention for settlement of industrial disputes	i) Settlement of disputes is govern by the Indian Arbitaration Act 1940 ii) UN Convention for the recognition and enforcement of foreign arbitral awards	i) Guarantee against national ii) Dispute settlement through mutual consultations and in accordance with the arbitration rules of UN Commission on International Trade Law	i) Guarantee against nationalisation ii) Settlement of dispute through the International Commission on Settlement of Investment Disputes	i) Protection against nationalisation under the bilateral investment agreements and constitutional guarantee ii) Internatioanl Convention for the Settlement of Investment Disputes

Source: Complied from various country sources.

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

Year*	No. of Projects	Total Investment (US$ million)	Total Fixed Investment (US$ million)	% Share of FDI in total investment	Employment
Operational	270	536.1	479.2	18.7	41310
Under-construction	49	82.0	73.1	30.3	6210
Licensed	135	214.1	172.7	31.9	15399
Agreement signed	183	182.6	126.0	39.9	13214
Closed	19	17.4	14.4	24.1	1798
Cancelled	65	121.4	106.1	27.1	8494
Total Approved	721	1153.6	971.6	26.3	86425

Note: * Nepalese fiscal year, from 16 July of the previous to 15 July in the reported year.

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

Table 3: FDI Inflows: Nepal in 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
Malavi	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

Notes: * Annual average
** Estimate
- Negligible
… Not available
LDC Least-developed country.

Source: UNCTAD, *World Investment Report*, Geneva: United Nations (various years).

Table 4: Approved FDI Project by Source County 1988-2001

	No. of Project	Total Investment (US$ million)	Fixed Investment (US$ million)	FDI share in total investment (%)	Employment
Developed Countries	309	425.9	380.5	25.6	27487
Japan	77	40.6	35.0	32.0	4842
USA	74	174.1	159.1	29.9	6915
Germany	31	9.1	7.6	37.4	2262
UK	26	27.7	23.8	8.1	5153
France	19	6.4	5.5	23.6	993
Other Developed Countries	82	167.6	149.2	22.0	7322
High Performing Asian Economies	119	197.5	169.6	29.9	14144
China	57	113.6	95.2	29.1	6716
S. Korea	29	22.6	18.7	49.1	2552
Hong Kong	12	18.2	15.9	35.8	2064
Singapore	8	23.9	23.1	20.7	1135
Thailand	7	14.2	12.1	9.5	1106
Taiwan	6	5.0	4.5	42.5	571
SAARC Countries	271	430.3	330.9	26.1	40301
India	249	419.7	324.9	25.9	34553
Bangladesh	9	4.9	2.6	29.9	3401
Pakistan	7	4.1	3.1	39.0	2166
Sri Lanka	3	1.2	0.8	47.3	83
Bhutan	3	0.4	0.3	13.2	98
Other Developing Countries	22	99.9	90.6	26.2	4493
Bermuda	6	29.8	25.3	5.9	1474
British Virgin Island	4	51.3	49.3	37.3	1210
Philippines	3	13.9	12.8	5.3	1329
United Arab E.	1	2.7	0.6	25.2	93
Others	8	2.2	2.6	29.0	387
Total	721	1153.6	971.6	26.3	86425

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

Table 5: Sectoral Distribution of Foreign Investment in Nepal, 1987- 2001

Product sector	Number of projects	Total investment (US$ million)*	Total fixed investment (US$ million)*	Share of FDI in total investment (%)	Total employment
1. Agriculture	12	5.2	4.7	25.5	842
2. Manufacturing	369	492.7	363.1	26.0	55996
2.1 Food, beverages and tobacco	61	124.4	109.2	19.3	…
2.2 Textile and wearing apparel	123	118.6	75.8	33.0	…
2.3 Wood & wood products	5	1.2	0.9	34.0	…
2.4 Paper & paper products	17	24.9	21.5	15.4	…
2.5 Chemical and plastic products	68	89.8	67.1	30.7	…
2.6 Non-metallic mineral products	13	46.6	27.7	20.9	…
2.7 Basic metal products	21	30.2	20.4	30.8	…
2.8 Fabricated metal products	48	44.8	31.6	25.4	…
2.9 Machinery and equipment	0	0	0	0	…
2.10 Other manufacturing	13	12.1	8.7	22.2	…
3. Electricity, water and gas	14	243.4	230.2	17.1	…
4. Construction	16	12.8	11.2	59.9	…
5. Hotel & resorts	168	228.6	217.3	27.3	…
6. Transport& communication	24	53.5	37.5	40.6	…
7. Housing and apartments	15	3.6	1.4	56.1	…
8. Services	104	103.6	96.1	33.2	…
TOTAL	721	1153.6	971.6	26.3	86425

…. Data not available.

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

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

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

Region	No of Project	Total Project Cost (US$ million)	Employment
Kathmandu Valley	153	303.85	20049
Terai	85	112.10	15612
Hilly and Mountain Range	32	63.35	5649
Total	270	479.30	41310

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