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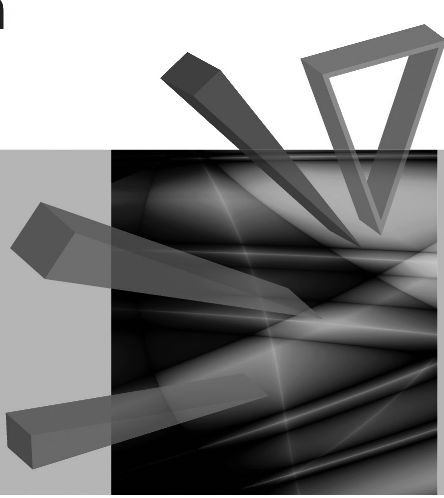
# Economical and Political Interrelations in the Asia-Pacific Region



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# REVIEW OF THE INVESTMENT POLICY OF NEPAL

**Abstract:** Nepal attracts much foreign direct investment because of policy reforms initiated in the early 1990s to attract it, although FDI and technology investors still face obstacles. This is partly because a small, poorly developed, landlocked, mountainous country has little to offer to investors. The challenge for Nepal is to create an investors-friendly business climate, export, import, infrastructure, transport, whole financial sector and education.

**Keywords:** Nepal, FDI, infrastructure, financial sector, education.

## 1. Introduction

Inflows of FDI into Nepal have accelerated after the economic liberalization of the 1990s but remain very low, averaging only about $8 million annually. FDI inflows are low also in relation to the size of the population and economic activity, even compared with other least developed landlocked states in the Asian region. Much of this FDI is concentrated in the Kathmandu Valley. FDI has contributed significantly to export diversification, and foreign investors may be providing up to 25% of manufacturing employment. But the overall inflows are so low that, all in all, FDI has not been a significant development catalyst.

Most FDI has been in manufacturing and tourism and much of it is small-scale. India has been the principal source. In the latter part of the 1990s private investment from OECD countries increased owing to FDI in hydropower generation projects.

Why has Nepal underperformed other very poor countries in attracting FDI? It is not necessarily a lack of potential. Nepal has had substantially free access to a large market on its doorstep since 1995, additional access to apparel quotas, an established name as a tourist destination, low wage costs and (by the standards of many very poor countries) an entrepreneurial culture. Nor is it because FDI has been excluded from most areas of the economy, although some restrictions at the margin should be reconsidered. The answer is that Nepal has failed to offer investors generally satisfactory standards of policy and administration of taxes and regulations 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 potential.[1]

Political instability means that Nepal presents mainstream of foreign investors with an unacceptably high level of political risk. Significant prospective investors will delay the identification and implementation of projects until the risk profile becomes acceptable.

Better performance in attracting FDI requires fundamental changes. A three-part plan is proposed.

## 2. Plan for attracting FDI

**1) Attack the key obstacle: The investment framework**

Major steps required, in order of priority, are as follows.

A) Liberalize the foreign investment law:[2]

- relax entry restrictions, especially in services,
- abolish FDI screening except for negative list proposals,
- regulate foreign technology transfer and foreign loan issues elsewhere – in tax and foreign exchange law,
- improve foreign investor treatment and protection provisions, and remove the local arbitration restrictions,
- conclude a bilateral investment treaty with India.

B) Improve administration and design of taxation, in particular:

- clear the backlog of revenue appeals and refunds more aggressively,
- change the broken-down duty drawback system to a duty-free registration system for recognized exporters,
- abolish advance income tax and similar withholdings,
- redesign corporate taxation to internationally competitive levels,
- establish large taxpayer administrative units in taxation and customs as a first step towards culture change,
- commit to reasonable stability in tax policy (and reinforce this with a contractual stability component in industry promotion packages – see below).

C) Modernize labour regulation:

- adopt modern hire and fire provisions to aid investment and employment,
- employment and reduce government intrusion in setting conditions of employment at economy and firm levels,
- introduce independent industrial dispute resolution mechanisms,

[1] T. Sporek, Foreign direct investment in Nepal. Strategy and promotion, [in:] B. Skulska, A.H. Jankowiak (Eds.), *Innovation Sources of Economics in Eastern Asia*, Research Papers of Wrocław University of Economics No 256, Publishing House of Wrocław University of Economics, Wrocław 2012, pp. 98–101.

[2] Foreign Investment and Technology Transfer Act, 1992.

– eliminate the burdensome employee housing set-aside,
– reduce the mandatory labour bonus or make it consensual.

D) Appoint a champion of investors' rights:
– create an office to assist investors in dealing with red tape and require it to publish cases.

**2) Create industry promotion packages to tap immediate FDI potential**
– Tourism – a tax and regulatory relief package and structuring of tourism development zones aimed at upscale and niche tourist market opportunities;
– Export manufacturing – enhanced industrial estates with a tax and regulatory relief package to attract developers and manufacturing investors. Give private estate developers the incentives to commit finance and to solicit new manufacturing investment;[3]
– Herbal products – a package including access to nucleus estate and tax and regulatory relief;
– Create the conditions to attract new investments and de-emphasize the offer of problematical "old" investments through privatization.

**3) Mandate a special investment agency to implement 1 and 2**
– It is crucial to establish a high-level policy-oriented agency to lead reform of the investment framework and develop and execute Investment Promotion Packages;
– Not to be a traditional investment promoter or facilitator.

Implementation of this plan will substantially increase the inflow of FDI (Table 1) and its contribution to Nepal's development. When it is executed it would be appropriate to turn attention to the development of the longer-term elements of an FDI strategy. These would include further enhancement of the investment framework with the aim of creating a superb "best in region" climate for business and directing attention to the factors that enhance the competitiveness of business and facilitate higher-value-added activities.

**Table 1.** Sectoral distribution of cumulative approved foreign investment in Nepal in 2001 and 2010

| Sector | Number of enterprises | | Total fixed investment (millions of dollars) | | Foreign investment (millions of dollars) | | Number of employees | |
|---|---|---|---|---|---|---|---|---|
| | 2001 | 2010 | 2001 | 2010 | 2001 | 2010 | 2001 | 2010 |
| Agriculture | 12 | 20 | 4.19 | 7.12 | 1.19 | 1.90 | 842 | 1 340 |
| Manufacturing | 351 | 562 | 319.55 | 531.00 | 116.45 | 190.00 | 55 442 | 88 362 |
| Tourism | 167 | 251 | 196.52 | 306.20 | 56.43 | 94.35 | 13 638 | 21 516 |
| Services | 150 | 220 | 123.61 | 258.20 | 56.00 | 81.11 | 9 470 | 20 115 |
| Others | 18 | 35 | 221.20 | 345.36 | 38.56 | 75.33 | 6 098 | 19 236 |
| Total | 698 | 1088 | 865.07 | 1441.88 | 268.63 | 362.79 | 85 490 | 152 569 |

Source: Department of Industries, Government of Nepal.

[3] T. Sporek, Foreign direct investment..., pp. 103, 104.

**Table 2.** Home economy distribution of cumulative approved FDI in Nepal in 2001 and 2010

| Country | Number of enterprises | | Foreign investment (millions of dollars) | | Number of employees | |
|---|---|---|---|---|---|---|
| | 2001 | 2010 | 2001 | 2010 | 2001 | 2010 |
| India | 244 | 386 | 96.15 | 160.1 | 34 208 | 61 031 |
| USA | 72 | 189 | 45.88 | 96.6 | 6 909 | 15 518 |
| China | 54 | 199 | 29.34 | 130.4 | 6 628 | 15 126 |
| British Virgin Islands | 4 | 15 | 17.12 | 28.4 | 1 210 | 2 066 |
| Norway | 5 | 12 | 13.12 | 21.8 | 150 | 196 |
| Japan | 73 | 128 | 11.35 | 19.5 | 4 677 | 7 661 |
| Republic of Korea | 27 | 51 | 9.54 | 17.4 | 2 423 | 3 662 |
| Others (include 32 countries/ territories) | 219 | 384 | 46.13 | 71.8 | 29 285 | 38 432 |
| Total | 698 | 964 | 268.63 | | 85 490 | 140 241 |

Source: Department of Industries, Government of Nepal.

## 3. Taxes

Taxation affects the cost of investment and its profitability and thus the return on investment. This impact is not just a question of looking at the headline rate of tax on profits. The tax burden on the investor depends on a number of factors and their interaction, including expenses allowed, rates of capital allowances (tax depreciation), the availability of tax credits, investment allowances and tax holidays, the loss-carry-forward provisions and the taxation of dividends. Moreover, customs and excise duties affect the cost of investment and operating margins. Together these make up the overall fiscal regime that affects the cost of and return on investment.

Comparative tax modelling is a method of taking into account the most important of these variables in the fiscal regime in a manner that facilitates comparison between countries. The tax variables included in the analysis are:

- corporate income tax,
- rate of tax, including tax holidays, if any,
- loss-carry-forward provisions,
- capital allowances, investment allowances and investment credits,
- tax on dividends,
- customs import duties and excise duties on business inputs.

VAT is not incorporated in the analysis because correctly administered VAT falls on the consumer and is not a tax burden on business.

Financial models of project investment and financing, revenues and expenses are utilized for a typical business in each sector. These are based on typical costs and revenues experienced in such businesses in a developing economy. The business models cover a selected business within each sector.

**Table 3.** Major commodities exported from Nepal (millions of dollars)

| Commodities | 1997/98 | 1999/00 | 2004/05 |
|---|---|---|---|
| To India | 105.47 | 127.24 | 203.10 |
| Salseed oil | – | 0.06 | 0.76 |
| Ricebran oil | 1.64 | 1.62 | 0.66 |
| Herbs | 0.88 | 0.48 | 0.63 |
| Ghee (clarified) | 2.88 | 0.59 | 0.26 |
| Dried ginger | 0.72 | 0.62 | 0.83 |
| Raw jute and jute cuttings | – | 0.00 | – |
| Jute goods | 12.42 | 13.21 | 16.18 |
| (a) Hessian | 2.68 | 2.32 | 1.52 |
| (b) Sackings | 4.61 | 4.52 | 5.91 |
| (c) Twines | 5.13 | 6.37 | 8.75 |
| Pulses | 3.43 | 4.26 | 14.03 |
| Mustard & linseed | 0.16 | 0.29 | 0.42 |
| Live animals | 2.81 | 0.82 | 0.36 |
| Ginger | 2.88 | 2.30 | 2.05 |
| Oil cakes | 2.14 | 2.50 | 3.15 |
| Biscuits | 0.92 | 1.07 | 1.29 |
| Cardamom | 3.93 | 3.54 | 3.04 |
| Rosin | 0.88 | 1.40 | 2.55 |
| Skin | 3.40 | 2.74 | 2.08 |
| Noodles | 1.38 | 1.89 | 1.83 |
| Marble slab | 0.88 | 0.64 | 0.63 |
| Toothpaste | 14.20 | 19.57 | 33.16 |
| Polyester yarn | 9.47 | 5.62 | 9.24 |
| Vegetable ghee | 27.24 | 47.69 | 39.72 |
| Soap | 9.81 | 11.04 | 15.86 |
| Medicine (ayurvedic) | 3.41 | 5.28 | 7.49 |
| Pashminas | – | – | 46.90 |
| To other countries | 297.23 | 321.08 | 397.90 |
| Woollen carpets | 146.27 | 148.56 | 144.22 |
| Tanned skins | 7.19 | 4.10 | 2.62 |
| Handicrafts | 2.33 | 2.63 | 3.06 |
| Readymade garments | 120.93 | 147.04 | 204.06 |
| Pulses | 14.80 | 13.88 | 1.28 |
| Nigerseed | 2.32 | 1.48 | 0.21 |
| Silverware and jewellery | 3.38 | 3.39 | 3.35 |
| Pashminas | – | – | 39.10 |

Source: Nepal Rastra Bank, Economic Report, 1999/2000, 2004/2005.

The fiscal regime in Nepal and the chosen comparator countries for each sector is applied to the standard business model for each sector over 10 years beginning with the initial investment. The financial models calculate net cash flow to the investor assuming that the company pays out all residual profits after tax (100% dividend payout) and that the investor gains the residual value of the company which is sold after 10 years for an amount equal to its balance sheet value.

The impact of the fiscal regime is presented as the present value of tax (PV tax). PV tax is the total of taxes and duties collected by government over the 10 years as a percentage of the project cash flow pre-tax and post-finance where both cash flows are discounted to a present value at a rate of 10% *per annum*. PV tax thus measures how much of an investor's potential project return is taken by the Government in taxes and duties. The higher the PV tax the more the fiscal regime burdens investors and reduces the incentive to invest.

## 4. Infrastructure

Nepal's infrastructure is among the least developed in Asia, with most of it concentrated in few urban areas of the country. Road density, for instance, is a mere 0.65 kilometres per 1,000 people and only 6 kilometres of road per 100 square kilometres of land area. Approximately 21% of the population has access to electricity, and other public works such as sanitation (only 6% of the population) and water supply are scarce. For every 100 people, Nepal has only 0.8 telephones.

Although Nepal spends approximately two thirds of its total budget on infrastructure, only 2% of the budget is for recurrent spending on infrastructure, which means little maintenance for the existing infrastructure and a loss in asset value.[4]

### 4.1. Land transport

Nepal has approximately 15,900 kilometres of roads, but only 4,600 kilometres are paved. During the monsoon season, many roads are impassable and are damaged by flooding. The potential for more major road arteries is quite limited because they would have to be built in the hills and mountains, where economic returns would be quite low. 88% of Nepal's Strategic Road Network is situated in the hilly regions.[5]

Even the current road system is underutilized and characterized by high construction and maintenance costs. Exacerbating these problems are the inconsistent standards in the construction of roads due to poor oversight and weak regulations by the government.

[4] Nepal Government, *Nepal Country Paper*, 2001.

[5] *Ibidem*.

### 4.2. Air transport

Nepal has only one international airport, and it has nearly reached its capacity and cannot expand its facilities. The government is studying the possibility of a second international airport in the Terai region, which will facilitate tourism and business travel.

Six additional airfields are under construction in the hill areas, which should greatly increase their accessibility.

### 4.3. Water

The country's water supply is well short of requirements, even in the Kathmandu Valley. The water supply system in the Kathmandu Valley is extended beyond its capacity and is unreliable in terms of both supply and quality. During the dry season, the water supply drops by nearly half of its monsoon-season levels.[6]

The government's budget constraints and shortcomings in mobilizing the private sector in infrastructure development have hampered efforts to make infrastructure a potentially important sector for FDI. According to the 1998 World Bank report[7] the government tends to rely heavily on investors' initiatives for infrastructure development. Private sector initiatives in infrastructure are certainly welcomed, but the government relies almost exclusively on such outside initiatives.

## 5. Weak financial sector and small capital market

Despite the growth in the number of financial institutions over the past decade, not all is well in the financial sector. The main constraint in the financial sector is not a shortage of commercial institutions or financial resources but rather institutional weaknesses and low standards of governance.[8] The two large, state-owned banks are saddled with bad loans, and many small banks are having difficulties with their balance sheets.[9]

In addition to corporate governance issues, commercial banks are also adversely affected by the compulsory lending to small borrowers in "priority sectors." Commercial banks must devote 12% of their lending to these loans, which entail interest rates below the market rate. However, compulsory lending is expected to be phased out within five years.

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[6] *Ibidem*.

[7] FIAS, *Attracting Foreign Direct Investment to Nepal's Infrastructure*, World Bank Group, June 1998.

[8] *Industrial Development Perspective Plan: Vision 2020, Strategy Paper*, United Nations Industrial Development Organization, Kathmandu, September 2002.

[9] T. Sporek, *Wpływ kryzysu finansowego na globalizację gospodarki światowej*, Akademia Ekonomiczna, Katowice 2010, pp. 208–229.

Nepal's capital market is still in a nascent stage of development, and therefore Nepal does not offer a wide array of options for investors. One measure to help develop the capital market is the Nepal Stock Exchange (NSE). As of early 2002, there were 118 listed companies, but only 25 firms traded their shares regularly. NSE's total market capitalization at the end of the fiscal year 2000/2001 was over 46 billion rupees, with over 31 billion rupees in the 10 listed banks alone.

Foreign-invested firms are allowed to list on the NSE, but they must be registered in Nepal. Foreign firms in Nepal are allowed to purchase a maximum of 25% of the company's shares on the stock market. A more highly developed stock exchange could open up opportunities for more FDI by means of acquisitions, which, are virtually absent in Nepal.

## 6. Education, HRD and local supplier capabilities

FDI in Nepal is further hindered by the country's low human resources base and the resulting limitations in local firms' capabilities. Nepal ranked 144th out of 174 countries in the United Nations Development Programme's 2000 *Human Development Report*. Poverty prevents many parents from sending their children to school and thus undermines efforts to promote human development. The current literacy rate for people aged six and above is only 38% (52% for men and 24% for women).[10]

Nepal's workforce generally lacks skills and education. Vocational and technical training is also poorly developed. The low levels of education and skills among Nepal's workforce limit firms' ability to move up the value chain and also affect firms' chances of becoming suppliers to larger firms, including foreign investors. In countries where the local firms have high levels of competence, backward linkages are more likely to flourish, as well as FDI, but in countries such as Nepal, the limitations of the workforce also limit the potential for linkages. There are some local suppliers in Nepal capable of meeting the needs of foreign firms, but the existing pool of local firms with these capacities appears to be small.

## 7. Electricity

Only 20% of the population is currently supplied with electricity, centred mainly in metropolitan areas. The government has opened the energy sector to private sector development, but only a few private projects have been launched so far or are under development. The recently revised Hydropower Policy now allows private sector's entry into the full range of power sector activities – generation, transmission and

[10] T. Sporek, The leading sectors in Nepal in the context of changes taking place in its economics situation, [in:] P. Skulski (Ed.), *Competitiveness of Economics in the Asia-Pacific Region – Selected Problems*, Research Papers of Wrocław University of Economics No 192, Publishing House of Wrocław University of Economics, Wrocław 2011, pp. 207–209.

distribution — with the objective of facilitating improved access to underserved areas. But systemic weaknesses persist and it will be some time before Nepal can realize its full potential in hydropower.[11]

## 8. Telecommunications

Telephone installation is far less than demand, serving mostly metropolitan centres. The Nepal Telecommunications Corporation (NTC) has a backlog of over 250,000 applications. Less than half of the 3,913 village development communities have telephone lines. There has been some liberalization in the telecom sector. However, the state-owned NTC still has the monopoly over fixed lines. Mobile telephone services were started in 1999. At present there are about 13,000 mobile telephone subscribers.

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### PRZEGLĄD POLITYKI INWESTYCYJNEJ NEPALU

**Streszczenie:** Nepal stał się atrakcyjnym miejscem dla bezpośrednich inwestycji zagranicznych od 1990 r. po przeprowadzeniu w tym kraju znacznych reform, zachęcających do przyciągania kapitału zagranicznego. Taka sytuacja utrzymuje się nadal, a do Nepalu napływają kapitał w formie BIZ oraz kapitał portfelowy przez realizację kilku specyficznych projektów finansowych powiązanych z kapitałem bankowym. Formy te, po wdrożeniu nowoczesnej technologii, wpływają pozytywnie na całokształt gospodarki, na BIZ, handel zagraniczny, infrastrukturę, transport, cały sektor finansowy i edukację.

**Słowa kluczowe:** Nepal, bezpośrednie inwestycje zagraniczne, infrastruktura, sektor finansowy, edukacja.

[11] *Ibidem*.