

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

INVESTMENT POLICY REVIEW

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# NEPAL



UNITED NATIONS

**United Nations Conference on Trade and Development**

# **Investment Policy Review**

## **Nepal**



**UNITED NATIONS**  
**New York and Geneva, 2003**

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## **Preface**

The UNCTAD Investment Policy Reviews are intended to help countries improve their investment policies and to familiarize Governments and the international private sector with the investment environment in those countries. The Reviews are considered by the UNCTAD Commission on Investment, Technology and Related Financial Issues.

The Investment Policy Review of Nepal was initiated at the request of the country's National Planning Commission. In preparing the Review, UNCTAD received the full support and cooperation of the Vice-Chairman of the National Planning Commission, officials of the Ministry of Industry, Commerce and Supplies, the Inland Revenue Department, the Department of Customs, the Department of Labour, the Nepal Tourism Board and the Department of Immigration, as well as the Permanent Mission of Nepal to the United Nations in Geneva. The findings and recommendations were discussed at a national workshop held on 25 March 2003 in Kathmandu, in cooperation with the Department of Industry and the Nepal Chamber of Commerce.

The views of the international donor community in Nepal and the international and domestic private sectors were sought at various stages of the project and are reflected in the report.

The report was prepared by a team that included Rory Allan, Diana Barrowclough, Azizul Islam and Joseph Mathews, headed by Khalil Hamdani. The team benefited from the contributions of experts within and outside Nepal that included David Oldfield, Peter Brimble, Bishwambher Pyakuryal and Rajiv Bhatnagar. Lang Dinh provided research assistance and Deborah Wolde-Berhan provided production assistance.

The United Nations Development Programme provided funding for the project.

It is hoped that the analysis and recommendations in this Review will contribute to an improvement in policies, promote awareness of investment opportunities and serve as a catalyst for increased investment in Nepal.

UNCTAD has also produced *An Investment Guide to Nepal* in cooperation with the International Chamber of Commerce, intended for prospective investors in Nepal.

Geneva, January 2003



## NEPAL

### Key economic and social indicators

Indicator	2000	2001
Population (million)	23.0	23.6
GDP at market prices (billions of current dollars)	5.5	5.6
Annual GDP growth (percentage)	6.2	4.8
Inflation (percentage)	3.4	2.4
GDP per capita (dollars)	238.7	237.4
GDP by sector (percentage):		
Agriculture	40.7	39.1
Industry	22.1	22.0
of which: Manufacturing	9.4	9.3
Services	37.2	38.9
FDI inflows (millions of dollars)	-0.48	19.3
Exports of goods and services (percentage of GDP)	24.2	24.3
Imports of goods and services (percentage of GDP)	32.4	32.0
Gross domestic investment (percentage of GDP)	24.2	24.3
National poverty line (percentage)	42.0	42.0
Human development index <sup>a</sup>	0.48	0.50
Adult illiteracy rate (percentage of people aged 15 and above)	58.0	57.0

*Sources:*

UNCTAD (World Investment Report (2002)), Human Development Report, 2001 (UNDP). World Bank (2001).

<sup>a</sup> HDI value, 1999.

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## **ABBREVIATIONS**

BIT	-	bilateral investment treaty
DTT	-	double taxation treaty
DWT	-	dividend withholding tax
EU	-	European Union
FDI	-	foreign direct investment
GDP	-	gross domestic product
GFCF	-	gross fixed capital formation
GSP	-	Generalized System of Preferences
ICSID	-	International Convention on the Settlement of Investment Disputes between States and Nationals of Other States
IPB	-	Industrial Promotion Board
IPP	-	independent power projects
MFN	-	most-favoured nation
MIGA	-	Multilateral Investment Guarantee Agency
NGO	-	non-governmental organization
ODA	-	official development assistance
R&D	-	research and development
SMEs	-	small and medium-sized enterprises
SOE	-	State-owned enterprise
S&T	-	science and technology
TNC	-	transnational corporation
UNCITRAL	-	United Nations Commission on International Trade Law
WTO	-	World Trade Organization

## **INTRODUCTION**

Nepal does not attract much foreign direct investment (FDI) in spite of policy reforms initiated in the early 1990s to attract it. This is partly because a small, least developed, landlocked, mountainous country has little to offer to investors. Nevertheless, other similarly situated countries are receiving more investment than Nepal.

Can Nepal improve its FDI performance? Yes. Nepal's advantages include privileged access to a well-disposed neighbouring country with a large market; a low-wage, trainable workforce; a flourishing local entrepreneurial culture in both small and large business; and established international recognition thanks to tourist landmarks. Nepal's temperate climate is also ideal for cultivating medicinal herbs, whose market has seen phenomenal expansion in recent years. These advantages can make attractive investment packages. However, there are serious weaknesses in the investment framework that warrant priority attention.

This report considers how Nepal can improve its FDI performance. In brief:

- Chapter I examines FDI trends and performance. Nepal has attracted modest FDI in niche sectors such as tourism, light manufacturing (apparel) and mineral deposits (limestone). The investment is mainly in low-technology, labour-intensive production. The impact of FDI has also been modest, primarily in job creation. Foreign affiliates have imparted skills to local employees, and in a few instances have introduced new export products and upgraded technology.
- Chapter II reviews the investment framework. While the 1992 Foreign Investment and Technology Transfer Act liberalized the entry of FDI and guaranteed repatriation of profit and capital, investors still face obstacles. There is scope for tax, regulatory and administrative reforms. The challenge for Nepal is to put in place an investor-friendly business climate that will complement its small bureaucracy. There is a need for an economy-wide shift from red tape to red carpet.
- Chapter III considers FDI strategy. In the short term, as regulatory and administrative reforms are put in place, Nepal can attract more FDI in its niche sectors – such as tourism and production of herbs – with special investment packages. Also, Nepal has to be proactive to take further advantage of the Trade Treaty with India and its LDC trade preferences with developed countries. In the longer term, FDI can play a role in telecommunication and electricity if appropriate regimes are put in place. There is also a need to improve the human resource base in order to attract high-technology FDI.
- Chapter IV highlights main conclusions and recommendations.



## I. FDI TRENDS AND PERFORMANCE

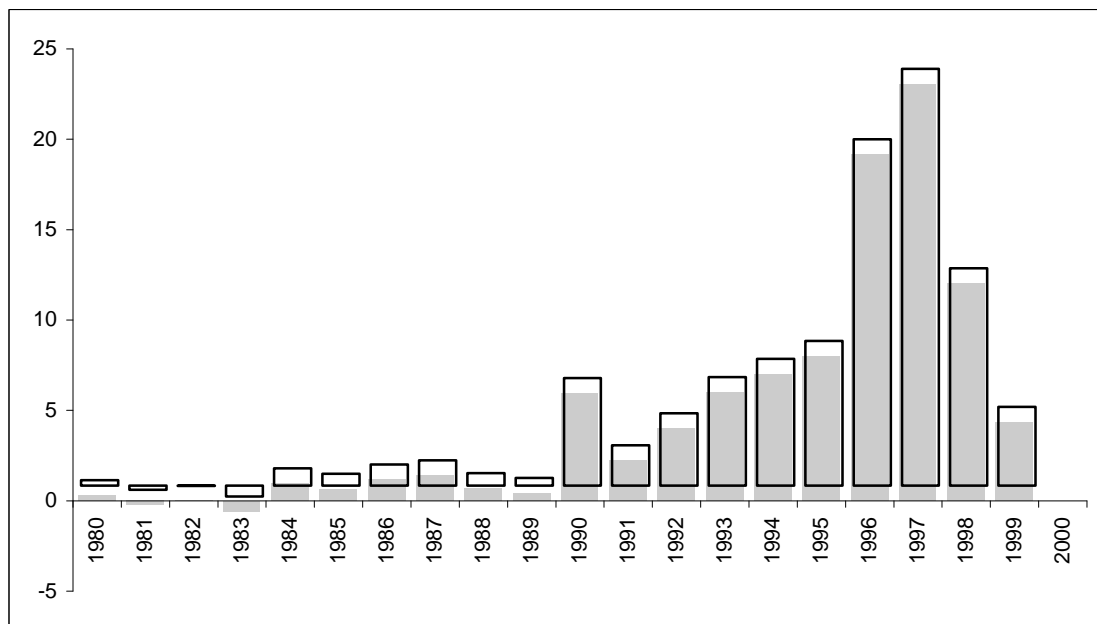
The volume of FDI inflows into Nepal has been small, averaging only about \$8 million annually. The inevitable consequence is that FDI has not been an important source of aggregate investment finance and its impact on economic development has also been minimal. A comparison with selected high and low performing Asian countries brings out the underperformance of Nepal in terms of FDI inflows. As Nepal has some niche sectors such as tourism and herbal products, potential exists for the country to attract FDI in such sectors. Even though most sectors are open to FDI and the standard of treatment has been fairly good, the FDI potential has not materialized. An overall improvement in the business climate is called for to make it more investor-friendly.

### A. Trends

#### 1. FDI size and growth

During 1980-1989, FDI flows to Nepal were minimal or even negative, with an annual average of \$0.5 million (figure I.1). There was a distinct acceleration during the 1990s, although total flows remained small: averaging \$8.3 million per annum during 1990-2000, which peaked at \$23 million in 1997.

**Figure I.1. FDI inflows into Nepal, 1980-2000**  
(Millions of dollars)



Source: UNCTAD, FDI/TNC database.

One factor explaining the increased FDI in the 1990s is Nepal's more liberal trade policy. For example, the unweighted average rate of import tariff was drastically reduced from 111 per cent in 1989 to 16 per cent by 1992; and the number of tariff slabs fell from

more than 100 in the 1980s to only 5 in 1996 (RIS, 2002). In addition, the establishment of bonded warehouses and the introduction of a duty drawback scheme reduced the previous trade policy's anti-export bias. Complementing this overall trade reform programme was a bilateral trade treaty with India concluded in 1996, which allowed India to import goods from Nepal free of import duty and quantitative restrictions if the goods were manufactured in Nepal (except those on the negative list). This has been cited as an explanation of the considerable expansion of Indian investment in Nepal after 1996 (RIS, 2002).

Another factor was the liberalization of the exchange rate regime. The currency was made partially convertible in the current account in March 1992 and fully convertible in February 1993. Since 1994 all individuals and firms have been allowed to open accounts in major convertible currencies with domestic banks after showing evidence of the source of foreign exchange.

However, in spite of these policy measures, Nepal's receipt of FDI remained low, compared for example with the Lao People's Democratic Republic (PDR) and Mongolia (table I.1). No countries are entirely alike, but Lao PDR and Mongolia are useful comparators given that they share the feature of being landlocked in Asia. The Lao PDR is endowed with water resources, as is Nepal; the former possesses some mining and petroleum resources, but this sector accounts for less than one fifth of FDI in that country. Mongolia has received considerable FDI in gold mining. Nepal, though not richly endowed, has some minerals and other natural resources, as well as much larger market size; in 1999 its total GDP was three times larger than that of the Lao PDR and more than five times that of Mongolia.

**Table I.1. FDI inflows into three Asian landlocked countries, 1989-2000<sup>a</sup>**

Country	Per capita GDP, 1999 (\$)	Population, 1999 (Thousands)	FDI 1989-1994 (\$ million)	FDI 1995-2000 (\$ million)
Lao PDR	259	5 297	19	72.2
Mongolia	345	2 621	6.9	25.6
Nepal	210	23 385	4.3	11

*Source:* UN and UNCTAD, 2001.

The low volume of annual inflows also translates itself into meagre FDI stock in Nepal, compared with Mongolia and the Lao PDR (table I.2). A comparison of Nepal's FDI inflows per \$1,000 GDP with those of other Asian countries, high – and low – performing, points to a poor performance (table I.3).

**Table I.2. FDI stock in three Asian landlocked countries during the 1990s**  
(Millions of dollars)

Country	FDI 1990	FDI 1995	FDI 1999	FDI 2000
Lao PDR	13	204.8	515.9	549.8
Mongolia	-	37.7	127.9	181.6
Nepal	12	38.8	97.4	96.9

*Source:* UNCTAD, World Investment Report 2001.

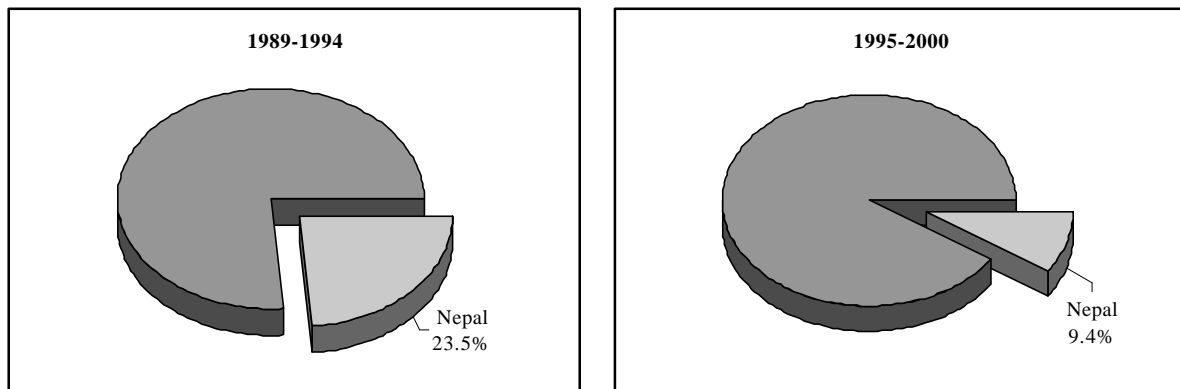
**Table I.3. FDI inflows per \$1,000 GDP for selected Asian economies**

Economy	1990	1995	2000
Bangladesh	0.1	0.1	5.9
Hong Kong (China)	43.8	44.6	380.8
India	0.7	6.1	5.1
Malaysia	59.3	65.5	42.2
Nepal	1.6	1.8	-0.1
Philippines	12.4	19.7	16.6
Singapore	152.0	105.4	58.6

Source: UNCTAD.

Compared with South Asian LDCs also, Nepal does not fare well in attracting FDI (figure I.2). This is mainly because Bangladesh, a much larger country, experienced a major acceleration of FDI inflows during the second half of the 1990s, but is also due to Nepal's inability to sustain the momentum of its flows of 1996-1997.

**Figure I.2. Nepal's share of FDI inflows into South Asian LDCs**  
(Annual average)



Source: UNCTAD, World Investment Report 2001.

## 2. Form of FDI

Many of the foreign investors in Nepal are individuals, rather than corporate entities. In mid-July 2001, there were 234 enterprises in operation with foreign equity participation,<sup>1</sup> with foreign ownership held by individuals in nearly 50 per cent of these. All except nine of the firms were small in size, with authorized capital of less than \$1 million. In the nine larger firms, the share of foreign ownership ranged from 36 per cent to 99 per cent, with individuals having majority ownership in eight of them. Reflecting the overall pattern of sectoral distribution of FDI, four of the nine enterprises were in the tourism (hotel) industry and three were in the textiles/garments industry.

<sup>1</sup> FNCCI, 2001.

The second feature is the preponderance of joint ventures. This occurs despite the fact that 100 per cent equity ownership by foreign investors is allowed in almost all the sectors (except for a short negative list that includes cottage industries, retail business, industries related to arms and ammunition, and security printing). Fewer than 36 of the 350 firms are wholly foreign owned. Most of these 36 firms are relatively small, but they include seven of the nine firms with capital exceeding \$1 million. The preponderance of joint ventures may be seen as an effort by the foreign investors to minimize non-commercial risks by taking on local partners.

Thirdly, most FDI in Nepal has been “greenfield” as there is no significant incidence of acquisition. Even the privatization process has attracted little FDI, although 16 enterprises were privatized between 1992 and 1999,<sup>2</sup> and there is no bar to foreign investment. Two well-known exceptions are a European acquisition of 22 per cent of the privatized Lube Oil Company, and the establishment of Nepal Grindlays Bank (which later became Standard Chartered Bank Nepal).

### 3. Distribution by sector, origin and geographical location

FDI is most highly concentrated in the manufacturing sector, which accounted for 50 per cent of approved FDI projects, over 40 per cent of foreign investment and 65 per cent of total employment in 2001 (table I.4). Two industries stand out in the sector. Firstly, the food, beverages and tobacco industry accounts for 25 per cent of total investment in all approved manufacturing projects, the share of FDI being 24 per cent. Secondly, the textile and garment industry accounts for 24 per cent of total investment in all approved manufacturing FDI projects. Tourism also attracts significant FDI. It accounts for almost a quarter of total FDI projects, a fifth of total FDI and about a sixth of employment in all approved FDI projects.

FDI is reasonably concentrated in its source, with seven countries accounting for over four fifths of cumulative FDI (table I.5). India alone accounted for one third, followed by the United States and then China. In total, investors from 40 different countries have invested in Nepal, but the scale and number of projects in most cases is small. Finally, the factor intensity of investments tends to reflect each home country’s comparative advantage: comparing the share in FDI with share in employment, Indian investments are most labour-intensive, while those of Norway and the United States are more capital-intensive.

**Table I.4. Sectoral distribution of all approved FDI projects until 2001**  
(Percentages)

Sector	Number of FDI projects	Amount of FDI <sup>a</sup>	Employment in FDI projects
Agriculture	1.7	0.4	1.0
Manufacturing	50.3	43.3	64.9
Tourism	23.9	21.0	16.0
Services	21.5	20.8	11.0
Others <sup>b</sup>	2.6	14.4	7.1

*Source:* Compiled from Department of Industries' data.

<sup>a</sup> Defined as foreign investors' equity.

<sup>b</sup> Includes construction, energy-based and mineral-based projects.

<sup>2</sup> Ministry of Finance, December 1999.

The United Kingdom is not a significant investor despite its historical links with South Asia. Similarly, some of the Asian developing economies which are emerging as notable outward investors do not have a significant presence in Nepal. Annex I gives the sectoral and home country distribution in dollars.

**Table I.5. Home economy distribution of FDI in Nepal**  
(Percentages)

Home economy <sup>a</sup>	Share in the number of enterprises	Share in total FDI	Share in employment in FDI projects
India	35.0	35.8	40.0
USA	10.3	17.1	8.1
China	7.7	10.9	7.8
British Virgin Islands	0.6	6.4	1.4
Norway	0.7	4.9	0.2
Japan	10.5	4.2	5.5
Republic of Korea	3.9	3.5	2.8

Source: Compiled from Department of Industries' data.

<sup>a</sup> Ranked by share in total FDI.

The geographical distribution of FDI within Nepal is strongly concentrated in the Kathmandu Valley (UNIDO, 2002), which includes the capital city, Kathmandu, and offers the best infrastructure (transportation, power and telecommunications) and proximity to administrative decision centres. Fifty-seven per cent of total FDI-related projects are located in this region, accounting for 63 per cent of total project cost and 48 per cent of employment. Little FDI is found in Nepal's hilly and mountainous region, which hosts only 12 per cent of projects in operation and 14 per cent of employment, although it is inhabited by more than half of Nepal's population. The remainder of FDI projects are located in the Terai region, which runs along Nepal's southern border.

#### 4. Profile of the largest enterprises with FDI

The common feature of the nine largest of Nepal's 250 foreign affiliates (defined above in section A.2), is that they are joint ventures, with India as the most frequently occurring home country (table I.6). Foreign investors have majority ownership in only four out of the nine firms, and only one is wholly owned. The firms also stand out from the bulk of foreign affiliates in Nepal for reasons other than their greater authorized capital. Firstly, individual owners play a much less significant role than is typically seen in overall FDI. This is understandable, given the size of the enterprise. Secondly, not one of the nine firms is not in the textile and garments sector, although this was the second largest form of FDI in Nepal. This reflects the sector's lack of integration.



**Table I.6. The largest enterprises with FDI in operation, mid-April 2001**

Name of company	Authorized capital (\$ million)	Product	Share of foreign ownership	Status of foreign partner	Home country/economy
Suriya Tobacco Company	28.02	Cigarette	51	Corporate	India
Taragaon Regency Hotel	20.15	Hotel	36	Individual	India
Bhrikuti Pulp and Paper Industry	14.64	Paper, paper box, board	20	Corporate	Bermuda
Bashu Linga Sugar	12.02	Sugar, molasses	60	Individual	India
Hotel Yak and Yeti	11.57	Hotel	60	Corporate	Australia/India
Nepal Orient Magnesite	11.03	Refractory bricks	50	Corporate	India
Gorakhali Rubber Udyog	9.01	Tyre and tube	44	Corporate	China
Shree Ram Sugar Factory	7.46	Sugar processing	20	Corporate	Bermuda
Colgate Palmolive (Nepal)	7.20	Toothpaste Toothpowder	100	Corporate	India

Source: FNCCI, 2001.

## B. Impact

The amount of FDI that Nepal receives is small and therefore its impact on the economy meagre. This section provides a qualitative assessment of the other benefits that Nepal seems to have enjoyed from its links with TNCs.

### 1. Access to export markets

Total merchandise exports from Nepal grew by 170 per cent between 1990/91 and 1999/00, compared with a mere 12 per cent in dollar terms from the fiscal years 1980/81 and 1989/90. The annual average growth of exports was 14.3 per cent for 1990-1999,<sup>3</sup> compared with 3.9 per cent for the period 1980-1989. This astounding export growth and the increase in FDI in the 1990s are more than coincidence.

Much of the growth in exports has been concentrated in textiles and garments, the second largest FDI manufacturing sub-sector. By the fiscal year 1999/00, ready-made garments were the largest single merchandise export, contributing nearly 60 per cent of convertible foreign exchange earnings from merchandise exports. Foreign investment in this sector may have been motivated by the quota restrictions faced by investors' home countries. Garment exports are also known to have benefited through non-equity links with foreign affiliates, particularly in the form of subcontracting. In the process, domestic producers were able to secure assured markets and advice on design and quality.

In at least one case a foreign investor introduced an entirely new product with 100 per cent export orientation (Box I.1). Another enterprise, with majority FDI, producing personal care consumer goods such as soap, shampoo and skin care products, now exports about 50 per cent of its output (Box I.2). These sorts of exports from Nepal did not exist before. Dabur Nepal Private Limited (Box I.3) exports honey bee equipment to Australia, the United Kingdom and the United States; honey and queen bees to Europe; and more recently, fruit juice to Maldives. It is currently exploring other export markets. Alcoa of the United States, a

<sup>3</sup> World Bank (2001).

global leader in the beverage closure industry, is setting up a 100 per cent foreign-owned export-oriented enterprise jointly with Nilkamal Plastics of India. Production is expected to begin in the near future, and the company expects to sell 95 per cent of its output to India.

### Box I.1. Nepal Bayern Electric Company: A unique exporter

Nepal Bayern Electric (NBE) is a joint venture, owned 51 per cent by Wüst (a German family-owned business) and 49 per cent by a well-known Nepalese business conglomerate (Narayani Group). It is a small company with an authorized capital of under \$700,000. It assembles micro transformers (for use in the telecommunications industry) that permit speedier data, speech, text and image transmissions. Its special significance in the context of Nepal is that it produces products that no other Nepalese company either produces or would normally consider producing, all of which are exported.

NBE started operation in May 1993 with only 16 employees and has now grown to employ about 250. Most of the production-level workers are women. The company receives technology back-up from its German partner; and its engineers, all of whom are Nepalese, make regular visits to foreign customers, sometimes spending weeks training in their facilities. NBE customers include Macom Euvotec of Ireland, Matsushita, Siemens and the German partner, with all of which it has subcontracting arrangements. The customers provide the design specifications and the required materials.

NBE illustrates the potential for the electronic product assembly in Nepal. In this case, the combination of Nepal's low labour costs and German technology has opened up an entirely new avenue of production in and export from Nepal.

Source: UNCTAD interview.

### Box I.2. Nepal Lever Limited

Nepal Lever Limited is a 10-year old joint venture, 80 per cent owned by the Indian public limited company Hindustan Lever Limited. Its range of personal care consumer goods includes soap, shampoo, laundry detergents, toothpaste and skin care products.

The company once had a strong export orientation, primarily focused on the Indian market. However, as shown below, the share of exports in total turnover has been declining since 1998, and there was an absolute fall in exports in 2000. According to the company's annual reports, this was caused by changes in India's import duty structure, which caused a loss of competitiveness in the market for toilet soaps and toothpaste.

Fiscal year	1998/99	1999/00	2000/01
Domestic turnover	7.69	10.01	12.14
Exports	18.22 (70)	19.78 (66)	14.43 (54)
Total	25.91	29.79	26.57

Note: All values in US\$ million.

Numbers in parenthesis show percentage shares of exports in total turnover.

The company directly employs about 200 Nepalese citizens and estimates that it generates employment in Nepal over 10 times that number through its network of suppliers, distributors and subcontractors. Nearly 100 distributors and stockists service over 24,000 retail outlets.

Source: UNCTAD interview and company's annual report.

At the product level, a sector that is experiencing high export growth to India, fast-growing items include toothpaste, vegetable oil, soap and Ayurvedic health care products. This is largely attributed to Indian joint-venture enterprises operating in Nepal.

The tourism sector is a good example of the important role of FDI. Tourism is Nepal's second largest source of FDI, and an important source of foreign exchange earnings. It is unlikely that foreign exchange earnings from this sector could reach their current levels without FDI. Foreign investors in this sector bring strong marketing links, particularly when part of a chain of international hotels. For instance, one of Nepal's hotels with majority FDI, Hotel Yak and Yeti, actively arranged sales through offices located outside Nepal and through its website. This cannot easily be rivalled by domestic investors.

## **2. Technology transfer and linkages**

Obtaining improved technology is one of the most important reasons why developing countries wish to attract FDI. The "hardware" aspect of technology embodied in machinery and equipment has to be imported into Nepal, which has virtually no capital goods industry. However, other aspects of technology transfer through FDI are also particularly relevant, including (a) the transfer of skills to the employed labour force; (b) the diffusion of technology outside the affiliates/subsidiaries; and (c) the introduction of new products.

Methods by which FDI can develop and transfer skills through FDI would likely be formal in-house training programmes, including on-the-job training; replacement of foreigners by local nationals at progressively higher levels of responsibility; and sponsorship of off-the-job training through provision of scholarships and support for technical and professional personnel.

Training of employees by FDI enterprises is quite common in Nepal. In some instances, professionals have been trained abroad. In others, training has been imparted through employer-sponsored programmes in local universities and management institutions. Sometimes, foreign trainers are invited to the enterprise. (For example, see box I.1) Nepal Lever, in addition to continuous on-the-job training, puts all its employees through at least five days of training annually to upgrade their productivity, skill and personal effectiveness.

The majority of employees in the professional category in FDI enterprises are Nepalese. For example, Nepal Bayern employs one general manager and six engineers, all of whom are Nepalese. Hotel Yak and Yeti employs about 50 professionals, only 11 of which are expatriates. In the case of Himal Power Limited, there are five management staff members of whom two are Nepalese, while of the nine engineers, six are Nepalese. Of the 35 officers in the Indo-Suez Bank, all are Nepalese except the Chief Executive Officer. Similarly, the Standard Chartered Bank employs a total of over 250 full-time staff, among whom there are only two expatriates. There are also instances of progressive localization at the professional level. For instance, when Dabur Nepal started, nearly all its professionals were Indian; a decade later the share of Nepalese professionals had risen to about 70 per cent.

Some enterprises run internship programmes to train the local workforce. For example, Hotel Taragon Regency runs an internship programme – the "Learn and Earn Programme" – under which some 200 people have been given training. Himal Power has provided training for many employees of other companies.

There appears to be little mobility of employees from foreign to local enterprises because the former generally pay higher wages and offer better benefits. However, the first private Nepalese bank was set up with the help of a number of professionals who were previously employees of a joint venture bank.

Technologies can be diffused beyond the foreign affiliates and subsidiaries in a number of ways. Linkages with suppliers may lead to the upgrading of the latter's product quality. A second channel is through the training of personnel employed in domestic enterprises by foreign investors. A third likely source of diffusion is a kind of "demonstration effect": the presence of foreign affiliates enables local enterprises to become aware of the existence of improved product and process technologies and then to adopt them, where profitable. Some of the mechanisms of technology transfer and diffusion through FDI have clearly been in operation in Nepal. Although their economy-wide impact cannot be quantified, some illustrations include:

- A construction joint venture between Ansal Buildwell of India and Chaudhary group of Nepal introduced multi-storied apartment complexes and earthquake-proof technology. This had a demonstration effect on local producers, who are emerging as competitors. The company is also contributing to the skill development of local contractors by providing construction-related technical advice.
- Nepal Lever created a distribution infrastructure (box I.2) and introduced new advertising techniques. Once the market for personal care products had been created, domestic producers started engaging in the production of similar products.
- Dabur Nepal (box I.3) introduced plastic boxes as a wood-saving technology for raising honeybees.
- In the financial sector, joint venture banks pioneered computerization, automatic teller machines, telephone banking and consumer loans. One such bank, Standard Chartered Bank, introduced a system under which exporters to India can have their cheques cashed within three days; this used to take three to four weeks before.
- The manufacturer Nepal Bayern Electric (box I.1) introduced an entirely new export product.

Linkages between foreign investors and the linked Nepalese enterprises can also be mutually beneficial. The former can benefit from low-cost supply of inputs and specialization in the production of final outputs. The local suppliers receive an assured market; this helps them increase their output and employment. They are likely to receive technical advice from the foreign investors, who have a strong interest in the high quality of the supplies they procure. In view of the data limitations it is not possible to generalize about the extent to which linkages actually exist between foreign-invested enterprises and the local suppliers or the kind of benefits gained by them. There is, however, at least one case in which the linkage effect has been strongly positive for the Nepalese economy (box I.3).

**Box I.3. Dabur Nepal Private Limited: An example of backward linkage**

Dabur Nepal Private Limited (DNPL) is a joint venture, 80 per cent owned by the foreign investor Dabur India Limited. The company was established in 1989, construction of plants began in April 1992, and commercial production began in November 1992. The company started by producing herbal hair oil, tooth powder and other powders. It has now diversified its product range to include Glucose-D, confectionery, fruit juice, perfume compounds, honey processing and medicinal products.

Two projects have particular significance for backward linkage. DNPL has an unique apiary project which is rearing farmer bees and queen bees as well as fabricating wood-saving plastic apiary boxes. The company sells these to farmers with a guarantee that it will buy back honey. It has already started exporting honey.

More importantly, it has a medicinal plant project. Medicinal plants have historically contributed to the Nepalese economy through the generation of income and employment for the farmers, collectors, traders and processors. However, owing to indiscriminate exploitation, premature harvesting, lack of post-harvest technology and poor collection methods, the natural reserves of the plants have been rapidly depleting. In view of this situation, the project seeks to accomplish the following:

- To conserve and propagate threatened medicinal plants and thereby provide employment and income to the local people;
- To provide technical assistance, seeds and planting materials to Nepalese farmers for the cultivation of medicinal plants;
- To carry out scientific studies and research for the sustainable cultivation of medicinal plants;
- To produce value-added products for domestic and export markets.

DNPL has set up a “state of the art” greenhouse with the capacity to produce three to four million saplings of medicinal plants per annum. It supplies the saplings to the farmers directly or through development agencies and national/international non-governmental organizations at cost price. The farmers are given training and technical assistance for plantation, cultivation practices, plant protection measures and harvesting, as well as post-harvesting technology. DNPL guarantees purchase of the final produce at prevailing market prices to produce herbal products in Nepal.

The project is a concrete step to developing sustainable cultivation of Nepal’s medicinal plants on marginal and often unused land. It will help generate employment and income for people in the remote regions.

*Source:* UNCTAD interviews.

There are also other examples of beneficial linkages between foreign affiliates in Nepal and local producers. For example, Nepal Lever is concentrating on manufacturing relatively higher value-added products, shifting the production of other items to ancillary local enterprises. A local company, M/s. National Soaps Industries, now meets its entire detergent powder requirements; and two other local enterprises manufacture detergent bars,

and pack blended tea. Thus, Nepal Lever is developing partnerships with local industries, although it does not source many of its inputs from within Nepal (local sourcing is only around 10 per cent). In contrast, Hotel Yak and Yeti sources about 50 per cent of its inputs locally, while the construction joint venture between Ansal Buildwell of India and Chaudhary group mostly uses local construction materials (except cement, which the consortium believes is not of adequate quality).

### **3. Employment generation**

The contribution of FDI to employment in Nepal is particularly significant in the manufacturing sector, where UNIDO (2002) estimates that FDI generated 27 per cent of employment. This figure may be an overstatement, because it is calculated as a ratio of FDI-generated employment in manufacturing sector projects to total manufacturing sector employment, and more than half of the approved FDI projects do not materialize. This overstatement may be balanced, however, by the lack of accounting for numerous jobs indirectly generated by FDI in related support and service industries.

## **C. Overall assessment**

The sectoral distribution, with light manufacturing and tourism as the principal recipients, suggests that the pattern of FDI largely conforms to the country's comparative advantage. The positive impact is most apparent in the case of exports. FDI has undoubtedly played a major role in garments and tourism – Nepal's two most important foreign-exchange-earning industries. FDI has also enabled the country to export non-traditional manufactured products, such as micro transformers and personal care consumer products, illustrating its potential to open up new export horizons. In addition, FDI has played a beneficial role in Nepal's development through employee training, the establishment of backward linkages, development of infrastructure and the "demonstration effect" on local entrepreneurs.



## **II. INVESTMENT FRAMEWORK**

“In view of the effective role that foreign investments can play in the economic development of a country like Nepal, it is time for us to realize the need to make foreign investments attractive by framing a timely, liberal and open policy.”<sup>4</sup>

The excerpt above is from an FDI policy statement in 1992 that introduced a new policy of openness to FDI. In that year a new foreign investment law was passed and a single window system was introduced to facilitate FDI.

Ten years later, the ambition of a more liberal and open policy remains an important policy goal. As will be shown below, Nepal's investment framework compares less favourably with practices in other countries, many of which have also liberalized their investment regimes.

### **A. Norms applicable to foreign investors**

#### **1. Entry and establishment**

FDI is permitted in all industries in Nepal except for those reserved exclusively for national investors and in statutory State monopolies. This reflects the caveats in the 1992 policy statement, which despite its stated goal of introducing an “open policy”, provides that 100 per cent foreign ownership will be permitted only in large and medium-scale enterprises.

All agreements entailing the transfer of technology from abroad also require government approval. This includes non-equity relationships such as franchising as well as other form of services. Foreign individuals are not permitted to own land, but resident companies may do so even if foreign-owned. A further ad hoc restriction is that foreign ownership of commercial banks is limited to 66 per cent (recently increased from 50 per cent).

Formally, the entry of FDI is governed by the Foreign Investment and Technology Transfer Act of 1992 (“the foreign investment law”). FDI is permitted except in industries contained in the “negative list,” which is in two parts:

- Part A is a list that only Parliament may change. It includes industries sensitive to national security; cottage (i.e. craft) industries; personal services of a kind that would normally be performed by self-employed people; and real estate business.
- Part B is a list that may be amended by the Government: It includes retail business; travel agencies; cigarette, tobacco and alcohol production other than for export; a range of small tourist-related activities, including tourist lodging but not hotels; some small-scale farming; and consultancy services. This list has not been altered by the Government since 1992 except to specify four activities that fall within the above broader categories.

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<sup>4</sup> Ministry of Industry, *Foreign Investments and the Single Window System*, 1992.



The most unusual inclusion on the negative list is consultancy services, which explicitly include management, accounting, engineering and legal services. In effect, international accounting and law firms, and other professionals, cannot practise from an establishment in Nepal. If a Nepal business wishes to engage such services from an offshore provider, this would fall within the “transfer of technology” provisions of the law and require government approval. In combination these features add up to a protectionist regime – if applied zealously they have the potential to make it difficult for foreign investors to access “brand” international services or indeed head office services. There is no indication that the regime is applied so dogmatically. Nevertheless, it does not maximize service provision and professional skill development within Nepal to exclude major firms.

The other inclusions on the negative list are not so unusual in FDI regimes elsewhere except that there is no flexibility to approve FDI in any negative list industry on a case-by-case basis where it may be in Nepal’s interests to do so. For example, it cannot be helpful to the tourist industry to prevent major travel agencies from establishing a base in Nepal, although undoubtedly they will have agency relationships with Nepalese firms. Similarly, FDI is not allowed in retail trading. Strict application of this rule, one consumer products company complained, prevented import of its own products from its parent company abroad.

There are 39 public enterprises in Nepal, as a result of which the entry of some FDI is barred or inhibited. Nepal has a privatization law and programme, but it appears that only 16 firms have been privatized. Of the 39 remaining public enterprises there are four statutory monopolies:

- Nepal Oil Corporation (monopoly on the import of refined petroleum fuels);
- Nepal Drinking Water Corporation;
- Nepal Telecommunication Corporation;
- Nepal Electricity Authority.

Within the ambit of these corporations some private investment, including FDI, is possible. Private investors may operate value-added network services in telecommunications and the industry regulator is separate from the Nepal Telecommunications Corporation. Private investment is encouraged in electricity generation, whilst a monopoly of domestic transmission and distribution is retained by the Nepal Electricity Authority. Also, water reticulation and sanitation are municipal services, but it may be possible to contract them out to private operators.

There are many State-owned enterprises (SOE’s) in manufacturing, trading, services and banking. They do not have market exclusivity and are not a statutory barrier to FDI. But in some cases foreign investors may feel inhibited by their presence. For example, there are three State-owned cement companies in poor financial health employing over 2,000 workers. Foreign investors might foresee considerable political risks in a greenfield investment and only consider investing through privatization of the existing operations. In other cases there is active competition – for example, other carriers now compete with Royal Nepal Airways in domestic services and a prominent foreign investor is promoting the smallholder cultivation of medicinal herbs in competition with the Herbs Production and Processing Company, which

is State-owned. A further source of risk to private investors is the inadequate separation of the regulatory function of a line ministry and its links with an SOE in the sector concerned. For example, the Ministry of Forest and Soil Conservation regulates forest access but also has links to SOEs which utilize forests.

Prior approval is required for all FDI. Technically, even reinvestment requires approval and so do all loans from abroad. All applications are processed by the Department of Industries irrespective of the sector involved. The Department may itself approve FDI applications for projects with an investment cost of under the equivalent of about \$12.5 million. Applications in respect of larger investments are decided by the Industrial Promotion Board (IPB). The IPB is a high-level group, chaired by the Minister for Industry, which comprises heads of several ministries and the central bank and representatives of the private sector.

The Department of Industries' procedure is structured as a “Single Window” system. Investor queries and FDI applications are channelled through a single source intended to ensure coordinated attention by line ministries. The Department appears to play a pivotal and useful role in the system for securing secondary approvals. For example, applications for work permits and visas and for investment-related foreign exchange control approvals need the prior sanction of the Department, and its confirmation of the *bona fides* of the application is important to the line agencies.

The foreign investment law lays down no criteria under which applications for approval of FDI are considered. Nevertheless, the applicant is required to submit extensive information on inputs and output, financing, sources and uses of foreign exchange and commercial agreements entered into. In part this provides benchmarks for subsequent secondary permitting applications (e.g. for exchange control approvals or for employment). But the law does not require any explanation of a rejection and there is no right of appeal. The law requires a decision to be made within 30 days, but some cases can take considerably longer. In the case of one foreign investor interviewed it took six months to obtain approval. The Department of Industries does not keep statistics on the FDI approval process, and it is thus not possible to verify these concerns.

There is no explanation in the foreign policy statement as to why government approval is required for *every* proposed foreign investment. Sensitive industries are covered by the negative list. This approval requirement in a market economy appears to be an unnecessary and intrusive hurdle for foreign investors.

Most foreign investors will wish to conclude agreements for the transfer of technology as an integral part of their operations. These include agreements for the use of intellectual property for management, marketing and other services from abroad. All such agreements require approval under procedures similar to those for FDI applications through the Ministry of Industries. It is not clear what objectives the requirement for government approval is meant to serve. Certainly, the foreign investment law does not state any criteria under which such agreements will be assessed. Perhaps one objective is to protect local service providers. If, on the other hand, the objective is to promote the transfer of “know-how” to Nepal this is in conflict with the prohibition of FDI in areas such as consultancy services. If the key concern of the authorities is to avoid transfer pricing this is best handled through anti-avoidance provisions in the income tax law. There are many anti-avoidance provisions in the income tax law.

Modern international practice is not to require prior approval of such agreements.

## **2. Treatment and protection of foreign investors**

The foreign investment law is weak in relation to some of the conventional norms of foreign investor treatment and protection usually contained in such a law. Moreover, Nepal has concluded relatively few bilateral investment treaties (BITs). Surprisingly, there is no BIT with India, Nepal's major investment and trade partner, although there has been a treaty of friendship in place since the 1950s. But Nepal's practice in relation to treatment and protection of specific relevance to foreign investors, which is more important, is of a very good standard. However, this comment does not extend to the general operating conditions under which business is conducted. As discussed extensively in section B below, there are serious problems facing all business, whether foreign or nationally owned.

In summary:

*National treatment.* The foreign investment law does not give foreign investors, once established, the right to be treated on an equal basis with national investors. However, the BITs do provide for national treatment except in the (usual) area of fiscal incentives. In practice there is generally equal treatment, including in relation to fiscal incentives. There are some exceptions in relation to investor support schemes, including non-fiscal incentives.

Instances of non-national treatment of foreign investors in Nepal include:

- The assets of electricity operations owned at least 50 per cent by foreign investors must be transferred to the Government after an agreed period i.e. the projects are build-operate-transfer (BOT) schemes. The foreign investor may buy back the assets and continue to operate them. Asset transfer is not required of operations that are less than 50 per cent foreign-owned. The operator need only renew the operations' licence.
- A foreign investor pays double rate to register a trademark.

*Non-discrimination.* The foreign investment law does not provide that foreign investors will be treated equally regardless of their home country, although this principle is provided for (with standard exclusions) in the BITs. In practice there appears to be no such discrimination. A minor and arguably positive exception is that Indian nationals do not require work permits and visas. Registration with the Indian Embassy in Nepal is sufficient.

*Expropriation.* Again, the foreign investment law is silent and so is the Constitution on this matter. The Industrial Enterprises Act states unconditionally that no "industry" (most non-financial services businesses in effect) will be nationalized. The Land Acquisition Act empowers the Government to acquire land for any public purpose and sets out procedures for determining compensation and for appeal. But no law sets out any of the conventional rights of a foreign investor to receive compensation promptly and in convertible currency. Only those foreign investors protected by BITs have rights of an international standard in this regard.

There has as yet been no case of expropriation of a foreign investment in Nepal.

*Transfer of funds.* The foreign investment law guarantees repatriation of dividends, technology transfer payments, debt service payments and proceeds of disinvestments. No conditions are attached to this guarantee. Wide and unconditional assurances of this kind are further entrenched in Nepal's BITs. The only exception noted is a (mutual) right to spread the repatriation of disinvestments proceeds over five years as set out in the Nepal/Germany BIT in the event of exceptional balance-of-payments difficulties.

Nepal operates exchange controls. Thus transfer of funds is subject to the Exchange Control administrative requirements of the central bank in order to establish that the requests for transfers are *bona fide*. In practice the central bank relies on documentation on the investment and its financing established when the foreign investment or technology transfer is approved by the Department of Industries. The Central Bank believes that transfer of funds operates smoothly except when this documentation goes awry. Nevertheless, the perception among investors is that the process in investment-related transfers is slow and bureaucratic.

There is a current case in which the central bank is declining to transfer funds arising from commercial bank disinvestments. This does not appear to be a classic blockage of transfer of funds; there is a commercial dispute in relation to the transaction and the central bank believes that it is legally restrained until the dispute is settled.

See section B. 2 below for a more general discussion of the foreign exchange regime.

*Dispute settlement.* If investors have problems with third parties or with the Government, the preferred method of solving them is negotiation and conciliation. International arbitration to settle a dispute with the Government is available to foreign investors protected by a BIT or those (larger investors) with the clout to negotiate with Government an investment agreement providing the right to international arbitration. Otherwise the foreign investor has recourse only to the Nepalese courts. But the court system is regarded as slow and unpredictable by investors, who prefer to stay away from the courts, especially when claims against the Government are involved.

Conciliation and arbitration under a BIT are referred to the International Centre for the Settlement of Investment Disputes.

The foreign investment law is strongly interventionist concerning disputes between a foreign investor and a national. It appears to be mandatory for the Department of Industries to be present at talks between the parties aimed at resolving a dispute. More significantly, where a dispute is referred to arbitration the latter is conducted under UNCITRAL rules but must take place in Nepal, with Nepalese governing law for all investments under about \$7 million. This provision is intended to protect national parties that might be disadvantaged by arbitration abroad. Larger investors can choose their own preferred mode of arbitration.

In practice, parties most often prefer to settle their differences by negotiation. None of the private sector investors interviewed took the route of arbitration. The Department of Industries is perceived as being very helpful in settling disputes or differences amicably.

### **3. Incentives and performance requirements**

Very few incentives are offered to foreign investors. However, there are no specific performance requirements imposed on them as an inducement or condition of investment.

## **B. Operating conditions**

The general operating conditions for business form an equally important part of the investment climate for foreign investors. Those offered by Nepal are a profound drawback to accelerating the entry of FDI.

This section evaluates each of the major areas of business operating conditions in Nepal. These are divided into two categories (box II.1) of priority for attention. There is no aspect of operating conditions that could be described as best practice. Some, whilst not of a high standard, are workable and do not constitute obstacles to FDI. But others are so poor as to constitute impediments to a greater flow of FDI.

### **Box II.1. Overview of business operating conditions**

Operating conditions which must be improved:

- Business taxation;
- Labour regulation;
- Government administration in most areas affecting business.

Operating conditions which could be improved:

- Foreign exchange regulation;
- Regulation of the employment and residence of non-citizens;
- Corporate and commercial laws;
- Intellectual property protection;
- Competition law;
- Environmental protection regulation;
- Individual industry regimes.

### **1. Taxation**

Business taxation is a serious impediment to attracting FDI to Nepal. General rates of tax appear to be reasonable. But Nepal's taxation is not competitive when account is taken of additional burdens imposed by statutory payments to or on behalf of employees. Moreover, many countries offer tax incentives in selected sectors. Income tax incentives in Nepal were withdrawn from most sectors in the new Income Tax Act adopted this year.

Poor tax administration imposes additional burdens and uncertainties. Uncertainty is heightened by increasing recourse to taxation through flat charges without direct regard to the profitability of investment. From a taxation standpoint, the foreign investor may not feel that there is a welcoming environment.

The principal taxes that impact on business are income tax, customs duties, excise and value-added tax (VAT). Nepal has few double taxation treaties (table II.2).

When economic liberalization was launched in 1992 Nepal introduced wide-ranging fiscal incentives.<sup>5</sup> For virtually all non-financial enterprises the income tax rate was capped at 20 per cent and dividend income was exempted from tax. Tax rebates were offered on export

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<sup>5</sup> Industrial Enterprises Act, 1992, especially section 15.

income. There was customs and excise duty relief on raw materials used to produce exports. Other tax rebates were available for income derived from remote and disadvantaged areas, for significant employment generation and for specified national priority industries.

The 1992 initiative was a major although not precisely targeted effort to make the fiscal regime attractive. Clearly it did not stimulate large additional FDI. What went wrong?

- (a) The 1992 changes did not address the whole statutory burden on investors. This includes a mandatory 10 per cent bonus distribution to employees of gross profit and an employee housing assistance levy of an astonishing 5 per cent of gross income.
- (b) The incentive measures were thwarted by poor administration. For example, customs duty relief on export manufactures was provided through the duty drawback system, but duty refunds are not reliable. The later introduction of VAT<sup>6</sup> appears to be administered better, especially for exporters. Exports are zero-rated, but the system of claiming refunds of excess VAT paid on capital purchases and supplies proved burdensome in design. Problems in tax administration are detailed in box II.2.

The Government acknowledges the problems with tax administration and has made some effort to address them. But tax administration remains adversarial and foreign investors will see it as capricious.

The statutory burden on investors (tax plus mandatory labour payments) has worsened since 1992. The mandatory labour payments have not been reformed. And the original 1992 incentives have been eroded over the years. New special taxes have been introduced in successive budgets. Corporate income taxation was fully overhauled with the passage of a new Income Tax Act in 2002. Much attention has been given to improved compliance provision. But the 1992 incentives have largely been eliminated for all sectors except for manufacturing and export producers. Most sectors will pay an increased rate of profits tax of 25 per cent, up from 20 per cent (to which a 1 per cent special fee was added in 2001). Some rates of capital allowances have been improved but except in manufacturing these are offset by the elimination of accelerated allowances provided in the 1992 regime.

Exports remain favourably treated for corporate taxation. A tax rebate is still available and profits tax is capped at 0.75 per cent of turnover. It appears that this will continue in its present form. Table II.1 summarizes income tax changes introduced in 2002.

Does Nepal today provide a competitive tax regime for investment? Figure II.1 presents the results of a comparative analysis of Nepal's fiscal regime for investors. It includes the impact of taxes on profits and dividends as well as import duty on operating and capital items. The analysis compares the tax burden in sectors of potential FDI interest in Nepal with the fiscal regimes facing investors in other countries that have successfully attracted FDI. These worldwide comparisons are presented to show where Nepal stands in relation to other countries, which have aggressively and successfully attracted FDI in the sectors concerned. Annex II contains further information on the methodology of this analysis.

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<sup>6</sup> Value Added Tax Act, 1996.

### Box II.2. Tax administration: Investors' views

Tax administration has a poor reputation among investors. In interviews, investors consistently reported the following problems:

*Income tax assessment.* Income tax assessments are arbitrary. Tax inspectors assume that there is underreporting of income and do not believe that taxable profits can be lower in one year than the previous year. Appeals made to the Revenue Tribunal appear to be settled only after years of delays. A sum of 25 per cent of the disputed amount and assessed penalties is payable and the track record is that this would never be refunded even if the investor's appeal is successful. This acts as a deterrent to the appellant. Recourse to the courts also entails years of delay. For example the accounts of one public company (a foreign investor) for 2001-2002 show outstanding claims on appeal to the Revenue Tribunal back to 1995-1996 for amounts now equivalent to over \$300,000, against which a deposit of \$250,000 has been paid.

*Refund of excess advance income tax.* Advance corporate income tax is paid on the basis of an estimate of taxable income made by the authorities. Where the advance payment exceeds the estimate a refund of the excess is due and payable within six months. Such refunds are rarely made. If not paid within 2 years the Government's obligation to repay lapses. A large number of unpaid refunds have built up and the Government's reputation among business is that refunds will never be paid.

*Customs duty drawback.* Duty relief on raw materials used to manufacture exports is applied through a drawback or refund system. The 2001-2002 Budget speech acknowledged that there is a backlog of years in such refunds. The Government decided recently to issue five-year debentures in lieu of prompt payment. Apparently, exporters have been able to discount these with finance houses but at 50 per cent of face value.

*Customs duty assessments.* Nepal's largest foreign investor believed that it was denied some of the duty relief agreed with the Government as a condition of its investment. This was settled in 1999 but notes to its accounts ended July 2001 show that of a total of approximately \$1.4m to be repaid it was still awaiting government approval for payment of about \$400,000.

*VAT refunds.* Under the law excess VAT paid in one month cannot be promptly refunded except where exports exceed 50 per cent of sales. Excess VAT must be adjusted against VAT payable for up to the following six months. Despite this ungenerous statutory treatment the Government is slow to make refunds. This creates cash flow burdens for exporters and investors, both of whom will experience high levels of excess VAT.

*Reneging on incentives.* Both of the tax dispute cases referred above relate to a claim for incentives granted to attract investment. Such cases, or the delay in their resolution, can cause investors to believe that incentives have not been offered in good faith.

*Source:* Investor interviews and company annual reports.

These comparisons suggest that Nepal does not offer a highly competitive fiscal profile for investors. The results can be summarized as:

- Nepal's taxation is *potentially competitive* only in export manufacturing, hotels and agriculture. But the hotel sector result does not include the tourist service fee introduced in the 2001/02 Budget. Also this conclusion for export manufacturing assumes that investors benefit from customs duty draw back on operating inputs. As box II.2 makes clear, this benefit cannot be relied upon. Poor administration of this scheme largely nullifies the incentive intended by the tax rebate for exporters.

**Table II.1. Income tax regime, 1992 and 2002**

	Regime from 1992	Regime from 2002
Corporate tax rate	- standard 25 per cent - financial services 30 per cent - “industries” 20 per cent	- standard 25 per cent - financial services 30 per cent - only manufacturing qualifies for 20 per cent- special fee of 1 per cent on all the above
Corporate tax rebates	- 10 per cent for high local content - 10 per cent for local employment > 600 in any industry - 50 per cent for “national priority industries” for 7-10 years - 20-30 per cent in disadvantaged areas	- removed - 10 per cent for manufacturing only - improved to 10 years but apply only to manufacturing - 20-30 per cent for manufacturing only in disadvantaged areas
Investment allowances	- 40 per cent for reinvestment in significant expansion or modernization	- removed
Capital allowances (depreciation)	- 5 per cent buildings; 15-20 per cent other assets - 1/3 <sup>rd</sup> acceleration for all “industries”	- 5 per cent buildings; 15-25 per cent other assets - 1/3 <sup>rd</sup> acceleration for manufacturing industry (only), power sector and infrastructure BOT
Withholding tax	- no tax on dividends from “industries” - 15 per cent on foreign service fees and royalties	- 10 per cent - same

Source: Industrial Enterprises Act 1992; Income Tax Act 1974 and 2002.

Note: “industries” is defined in the Industrial Enterprises Act to include nearly all non-financial enterprises.

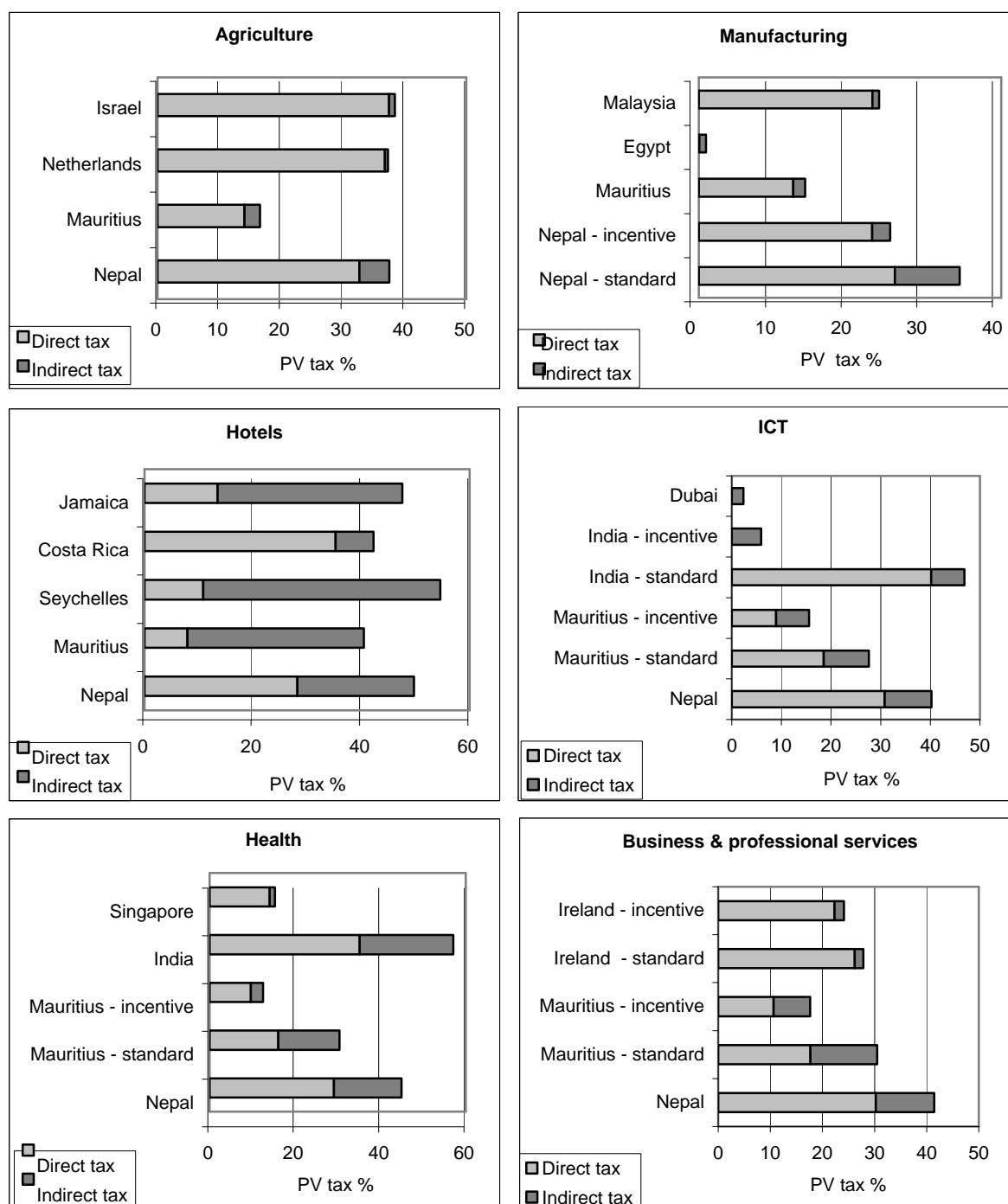
- Nepal is probably *regionally competitive* in terms of taxation at standard rates in India (see the ICT and health sectors). Nevertheless, the ICT incentives offered by India are especially aggressive as they are keyed to fiscal incentives offered by India’s competitors or would-be emulators.
- Nepal’s taxation is *probably uncompetitive* in its fiscal terms for investment in manufacturing for domestic sales and in business and professional services.
- To this picture must be added the additional burden on investment resulting from mandatory payments to labour. Box II.3 summarizes the mandatory employee bonus and the housing assistance levy. These are quasi-taxation if their incidence falls on business.

Furthermore, Nepal has a penchant for the frequent introduction of new taxes in the form of fees and flat charges. For example in 2001-2002 the export tariff on processed oil, vegetable ghee, plastic products and copper wire was raised. This track record increases



uncertainties for investors, especially since new taxes can be introduced in forms which have no bearing on profitability and hence ability to pay.

**Figure II. 1. Comparative taxation and fiscal incentives for investment**



Source: UNCTAD.

Note: The analysis on tax burden is expressed as the present value of the total fiscal take (“PV tax”) (including major direct and indirect taxes) as a percentage of present value of the project pre-tax.

**Table II.2. Withholding taxes in Nepal's double taxation treaties**

Partner	Dividends	Interest	Fees	Royalties
India (1987)	10 per cent	10 per cent/15 per cent		15 per cent
China (2001)	10 per cent	10 per cent		15 per cent
Pakistan (2000)	10 per cent	10 per cent/15 per cent	15 per cent	15 per cent
Mauritius (1999)	5 per cent/10 per cent	10 per cent/15 per cent		15 per cent

## 2. Foreign exchange regulation<sup>7</sup>

Nepal maintains a formal foreign exchange control regime that requires the surrender of foreign currency export proceeds. Current account transactions are delegated to the commercial banks whilst capital account transactions require the approval of the Central Bank. One useful concession is the ability of exporters to maintain foreign currency accounts at commercial banks – although at interest rates controlled by the Central Bank. Investors wishing to retain funds abroad in order to satisfy international project loan requirements must put a case to the Central Bank. It is understood that in larger investments (e.g. the large hydro-power generation investments) these arrangements have been given contractual force in agreements between the investor(s) and the Government.

At present the Nepalese currency is pegged to the Indian rupee and is convertible with no evidence of a grey market.

It should be noted that the foreign exchange provisions of the foreign investment law do not suffice to remove convertibility risk. The foreign investment law provisions cover convertibility only for capital<sup>8</sup> and dividend repatriation and foreign debt service. They do not cover normal import and foreign services payments. Moreover, the foreign investment law provisions could be overturned by a subsequent law and are often deemed not to provide adequate protection for large, long-term foreign investment. The BITs contain wide assurances of convertibility in respect of foreign transfers in relation to debt, equity, service fees and royalties but not of course in relation to import payments. BITs, even with the provisions as widely drawn as those in the Nepal treaties, do not provide bankable foreign exchange arrangements for large foreign investments requiring limited recourse debt finance.

From an FDI attraction standpoint, the regime is thus of a traditional kind which falls below best practices of an increasing number of developing countries which have abolished exchange controls. The foreign investor faces more risks under an exchange control regime and certainly more bureaucracy. For example, the need for case-by-case approval for capital transactions can leave the investor vulnerable to a change of policy over the course of investment and to slow, arbitrary treatment or even corruption.

Practice in Nepal is reasonably good. The present arrangements are workable and do not deter motivated foreign investors. But a new approach would be a very positive signal to foreign investors and a strong drawcard in attracting regional FDI (i.e. from or to service

<sup>7</sup> See also the earlier discussion of transfer of funds.

<sup>8</sup> Although this appears to be contradicted by the Central Bank, which explicitly states that it does not guarantee convertibility on the capital account.

India), which has unattractive foreign exchange arrangements. Excellent practice would entail:

- Abolition of exchange controls;<sup>9</sup>
- Stability agreements with selected foreign exchange provisions for large or strategic investments.

The latter could take several forms, but at their core is the contractual right to continuity of bankable foreign exchange arrangements. The investor would have legal recourse if its provisions were violated.

### 3. Labour law

The Labour Act was overhauled as recently as 1992 but remains a highly restrictive code from an investor standpoint. By modern commercial standards it impedes business flexibility in many instances:

- The labour office can direct a business as to job classification;
- The new owner of a business may not change the conditions of service of employees;
- Labour Department permission is required in order to retrench workers if the business is in slowdown or ceases production. The Department is entitled to take up to two months to decide. Severance pay is set by statute, not by employment contract;
- Permanent employees have a mandatory minimum annual pay rise;
- There are lengthy procedures for dismissal for misconduct;
- There is no provision for departmental review of a decision by the labour office on wage or bonus issues. The only recourse is appeal to a court, which can be time-consuming;
- Statutory minimum pay rates apply even to highly skilled occupations (box II.3).

#### **Box II.3. Mandatory labour payment**

Nepal law mandates both minimum wage payments as well as a range of employee benefits:

- *Minimum wages* and related allowances are set for all categories of labour from unskilled to skilled.
- *Retirement contribution* of 10 per cent of wages is payable by the employer to each employee's retirement fund.
- *Annual bonus* of 10 per cent of net profit must be distributed to employees.
- *Employee housing levy* – employers must set aside at least 5 per cent of gross profit for employee accommodation.

*Source:* Labour Act, 1992, as amended; Labour Rules 1993; Regulation on Wages, 1963; Regulation On Minimum Wages, 2000; Bonus Act, 1974 as amended; Bonus Rules, 1982.

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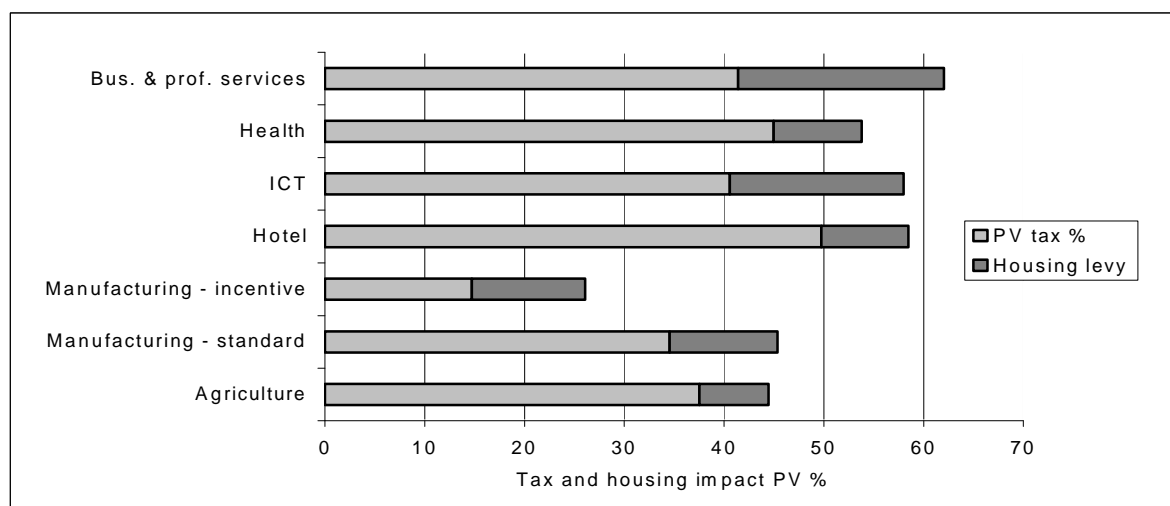
<sup>9</sup> The Central Bank considered this step in the late 1990s but it was shelved when the "Asian financial crisis" emerged in 1998. The crisis was attributed in part to the liberalization of foreign exchange controls in the region.

The wellspring of such a protective code is the notion that business is prone to exploit employees rather than regard them as an asset to be nurtured. The Department responsible for labour believes that poor labour relations are much more common in locally owned businesses. Management of foreign-owned business is regarded as more “enlightened”.

Some of Nepal's standard welfare provisions for employees are compatible with international norms, such as the mandatory employer contribution fixed at 10 per cent of pay towards an employee’s retirement fund. But the other elements singly and together are unattractive and distorting for investment:

- Minimum wages are set across all skill categories rather than being used to protect only the most poorly paid unskilled workers;
- Unless minimum wages are fixed taking into account the mandatory bonus the incidence of the latter is likely to fall on profit rather than employee remuneration. Furthermore, it is payable on fixed ratio to all employees regardless of individual performance. It would be preferable for investors to have a more consensual and performance-related approach to bonuses;
- The set aside for employee accommodation is not based on numbers employed or actual housing needs. It is therefore a very clumsy instrument and likely to negatively affect employment. Moreover, it is a very expensive imposition on business because it is levied on *gross* profit (presumably to minimize the opportunities for avoidance). It amounts to a form of super tax on top of the existing relatively high burden of taxation on investment. As such it also creates a strong incentive to underreport sales and purchases for income tax purposes. Assuming that the full incidence falls on business (and none on labour owing to lower wage settlements) it amounts to an additional 30 per cent of the tax burden in the sectors modelled in figure II.1. The impact by selected sectors is shown in figure II.2.

**Figure II.2. Housing levy burden**



Source: UNCTAD.

This combination of regulations is well meaning in the sense that it tries to address social responsibility. However, it is exceptionally poor policy in both rationale and design. The regulations are costly and inflexible and do not promote job-creating FDI.

It is suggested that Nepal should change labour policies towards a more market-driven approach under which wages and benefits are more consensual and flexible, with safeguards as appropriate for all parties concerned.

The Government holds the view that it has to accommodate the interests of all stakeholders, not just business stakeholders. A Tripartite Committee appointed by the Government, consisting of one representative each from the labour unions, employers, organizations and the Government, is currently looking into possible ways of reforming the labour laws.

#### **4. Employment of expatriates**

Foreign personnel intending to work in Nepal must obtain a work permit and a visa to reside in Nepal.

The *work permit* procedure is reasonably straightforward. Non-citizens may be employed if the Labour Department has ascertained that no eligible Nepalese citizen is available (i.e. there is a labour market test). There appear to be no written criteria under which the labour market test is applied, although advertisement of the post is one requirement. Non-citizens may be employed for two-year renewable periods but not more than five years in total (seven years for “highly skilled” and “specialized” positions although again there appears to be no written benchmark established). There is an expectation that training will be given to localize such positions. On the recommendation of the Department of Industries, a work permit is issued by the Department of Labour. There is no automatic quota or limitation except to demonstrate a need to recruit abroad on a case-by-case basis. On paper, Indian nationals are not required to obtain work permits. However, Indian employers feel under pressure to obtain work permits and they report bureaucratic difficulties in securing renewals of work permits. There are no published data or reports on the processing of work permit applications, including timeliness of decisions.

There are two main types of *visa* – one more flexible than the other. Employees are required to obtain a “non-tourist visa”. This must be renewed annually and is not therefore keyed to the work permit cycle. A renewable five-year “business visa” is available for approved foreign investors which includes nominated representatives and, presumably, owner-managers and their dependants. If operated flexibly, this could be comparable to the key personnel schemes operated in other countries whereby a designated number of senior positions are available automatically to non-citizens. In addition to the above visa, Nepal can offer permanent residence to foreigners investing over \$100,000.

There are two areas where these schemes could be improved. The first is to harmonize the best features of the visa system with those of the work permit rules. Holders of business visas should not be required to obtain a separate work permit. Major foreign investors and smaller owner-operators alike will naturally want the unfettered right to have their own people in key positions. It is a question of setting reasonable rules as to the number of such key positions in each case, although good practice is to designate a minimum number of positions. Also, the duration of non-tourist visas and work permits could be harmonized to minimize administrative hassles.

Secondly, fees for non-tourist visas are expensive. They cost \$60 per month for the first year and \$100 per month for subsequent years, which is presumably well above their cost of administration. This is a not so subtle message that a Nepalese workforce is preferred. Yet business visas cost only \$100 annually.

The work and residence rules make an overly sharp distinction between foreign investment (flexible via the business visa system) and foreign employment (the expensive and restrictive non-tourist visa and work permit system). The Government should recognize that FDI is a *package* of foreign capital and skills, and should consequently harmonize its approach.

## 5. Corporate and commercial laws and standards

*Enforcement of contract.* Theoretically, the court system works well and the terms and conditions of business contracts can be enforced in court. The highest court in the country is the Supreme Court, under which there are 14 Appellate Courts and 75 District Courts. Generally, the adjudication of a case can take a few years. This is not worse than what is prevalent in the neighbouring countries. While the rule of law is generally accepted, instances were cited where people of influence could evade the long arm of the law. But the private sector agreed that judgements can be rendered and enforced even against the Government.

The unpredictability of judicial decisions and the temperamental nature of the judges were the subject of some private sector complaints. Change of judges from hearing to hearing was cited by one complainant, such change necessitating re-argument. In general, private sector officials expressed the view that they would rather avoid the court system and settle the dispute through informal methods.

*Commercial law.* Company and allied laws are barely adequate for business purposes. They do not compare with accepted international standards. For example, dissolution of a corporation can be effected in certain circumstances, but there are no provisions for reorganization. Also absent are laws on secured transactions.

*Accounting standards.* Nepal has not adopted international accounting standards, and these do not appear to be a requirement even for listed companies. Many foreign investors will of course use international standards. As and when Nepal enters the mainstream of international financial transactions, it may become necessary to adopt international standards.

## 6. Land law

Nepalese land law enables investors to obtain suitable title to land, and banks report no legal impediments to registering mortgages or repossessing under mortgage. There are some restrictions in landlord/tenant law, but they appear to relate only to agricultural land and smallholder tenancy.

There are ceilings on the area of land that any person may own and the Government may compulsorily acquire excess land holdings. Businesses requiring land in excess of the ceilings must obtain government approval. These ceilings can impact on investment in large-scale property developments such as housing estates and industrial estates. There is a need to modernize the law to enable parcels to be acquired more efficiently for industrial and

commercial projects and for private investment in infrastructure. In all of these there is scope for FDI.

## **7. Intellectual property protection**

Nepal is not yet a member of WTO. Therefore, whether the laws dealing with the protection of intellectual property rights are TRIPS-compliant is a moot issue at this point in time. However, if and when Nepal does become a WTO member, the laws need to be modified, both in the coverage of the subject matter and in the level of enforcement.

With the level of industrialization so low, patents are not so much a matter of priority for investors. There is a patent law providing protection for an initial period of seven years, renewable twice for a total of 21 years. Only process patents are protected and not product patents. There are no provisions for punitive damages for infringement. Thus penalties are not a deterrent against infringement. The law has no provisions on civil damages that can be imposed on the violators.

Trademarks and copyright may be of more relevance for the Nepalese market. Trademarks, both foreign and domestic, may be registered with the Department of Industries. While there are laws for the protection of trademarks, infringements are not uncommon. The court system and the administrative bodies are ill-equipped and understaffed. An official of a company interviewed stated that the company loses quite a large amount in sales on account of trademark infringement.

Copyrights also face similar problems. A bill was recently introduced in the Parliament to accord greater protection for copyrights. But critics complain that it is still far from being adequate.

## **8. Competition law**

Nepal has consumer protection legislation but no competition law or authority to monitor restrictive business practices and regulate investment effected through corporate acquisitions. The Government itself is a dominant force in some industries through SOEs (e.g. in cement and in its statutory monopoly on the import of petroleum products) and in the utilities.

## **9. Environmental protection law**

Since Nepal is a small country with a unique ecosystem, the Government is sensitive to the environmental impact of industries. Projects must go through environmental impact assessments and initial environmental examinations. The environmental regulations and consequent requirements are not perceived by the private sector as being excessively burdensome.

## **10. Individual industry regimes**

Those areas of sectoral regulation reviewed seem reasonably modern and appropriate. They do not put an undue regulatory burden on business by excessive regulation, although overzealous administration in the tourism sector could easily have that effect. Poor administration can easily defeat well-designed regulation and Nepal is plagued by poor

administration. For example, banking (not reviewed in detail) has been poorly regulated in the past.

Regulation of two sectors of particular interest for FDI is reviewed below.

*Tourism* is regulated under the Tourism Act, last amended in 1997. Almost all tourism related activities require licences and certain specialized activities, for example ascent on major mountains, require permits. The regulations are designed principally to maintain Nepal's tourism reputation for quality and transparent prices. Special attention is given to safety and environmental protection in more extreme activities such as mountaineering and trekking in remote areas. There are some elements of protection of local participation in tourist-related activities.

*Electricity* regulation was revised in 1992 to set up the framework for private investment. So far only generation has been available for private investment. The Government can issue private investors survey licences and full licences for up to 50 years in generation, transmission and distribution. BOT schemes are available for projects over 50 per cent foreign-owned and build-own-operate (BOO) schemes are available for projects less than 50 per cent foreign-owned. The Act sets out a commercial and fiscal regime, including:

- A guarantee of foreign exchange availability for debt service and capital repatriation. Notably this does not extend to underwriting power purchases in hard currency although the individual agreements, e.g. for purchase of power, might do so;
- Generation projects pay a royalty at a rate of about \$1.30 p.a. per installed kWh plus 2 per cent of the power sales price for the first 15 years and 10 per cent thereafter;
- Investment in BOT generation is exempt from income tax for at least 10 years;
- Operation or ownership of former government assets qualifies for a five-year tax holiday;
- A generator may sell to the national grid or directly to users. In the latter case, the price is controlled so as to give a 25 per cent simple return on capital;
- An exporter of power must pay export tax.

This regime has enabled FDI to enter into power generation for the domestic market, wherein the price terms in the power purchase arrangements are the key commercial variable. It has yet to be tested whether tax on export value rather than on profit is appropriate for generation projects geared to export. Nepal will be a price taker in the export market.

### **C. Overall assessment: Open or liberal?**

The introduction to this chapter quoted a 1992 policy statement that Nepal aimed to have a “liberal and open” policy towards FDI. How well has Nepal succeeded? Nepal can say to foreign investors that they will be welcomed in most sectors and *fairly* treated on a par with national investors. But there are areas where the treatment of investors, foreign as well as domestic, needs improvement.

Those foreign investors interviewed were certain that treatment of investors in Nepal is no worse, and perhaps marginally better, than in neighbouring countries. Rather than taking this as a compliment, Nepal should take it as a clear opportunity to create a distinctively “best



in the region” investment framework to attract investors to base operations in Nepal to supply its large neighbouring markets and beyond.

What are the key policy and institutional changes that would elevate Nepal to a “best in the region” host for FDI? Recommendations are set out below. They are by no means unique to Nepal or uniquely generous to foreign investors. They are based on good international practices among countries seeking substantial inflows of FDI that is consistent with public interest.

The suggested actions begin with revisions of the foreign investment law. At the same time, the key elements of the business climate also need to be improved – including taxation and labour regulation and their administration in particular. Improvement in these key elements should be the priority. Once this has been done and a new FDI law is in place, Nepal would be able to consider policy enhancements such as abolition of exchange controls. High-level attention will be needed within the Government to achieve changes of the breadth required.

### **1. Revise the foreign investment law**

A best-in-the-region objective would entail substantial revision of the Foreign Investment and Technology Transfer Act of 1992. A decade of experience is an appropriate amount of time for reflection and to take into account the general trends of liberalization of FDI policy among other developing countries. Attention should be given to the following areas of the foreign investment framework:

### **2. Selectively relax entry restrictions**

Many countries restrict FDI in areas of small-scale businesses, particularly personal services, to protect local business and/or to guard against economic migration in the guise of foreign investment. At least two areas on Nepal’s “negative list” should be reconsidered. First, it is unusual to prohibit FDI in professional services (such as legal, accounting, engineering and management services) of a kind that should operate to open and competitive international standards. This rule is not a helpful signal to the investment climate and does not help to transfer international professional standards and skills to Nepal. Secondly, the ban on the establishment of international travel agencies cannot be in the interests of promoting Nepal to the global tourist market.

Doubtless the major international services firms have been able to establish relationships with national firms that enable them to sell services to Nepal. But these relationships are unlikely to motivate foreign firms to expand services into Nepal.

More generally, a blanket prohibition on FDI in the negative list industries is questionable policy. It prevents national investors from exercising their business judgement to bring in foreign partners to expand their businesses. Secondly, it prevents, without recourse to wider considerations of national interest, large-scale or strategic foreign investments in the negative list industries, for example in retail business or restricted agro-industries. The policy is too inflexible. Nepal appears to have a critical mass of national businesses. Linkages should be encouraged.

**(a) Confine entry screening to the negative list**

Currently all FDI requires prior government approval. Technically, even re-investment of earnings must be approved according to the foreign investment law. However, if a sector is legally open for FDI there is no strong reason why a prospective investment should require approval. Normal regulatory concerns will be dealt with in the secondary permitting stage, as with any other business.

Better practice would be to introduce flexibility in the negative list as suggested in (a) above and require prior approval of FDI applications in respect of the negative list industries only. The practical effect should be to speed up establishment of foreign investments in unrestricted activities and enable government resources to concentrate on the special issues involved in applications for FDI on the negative list.

If desired, the Government could establish a simple notification procedure for FDI in open activities. It could, and should, also continue to offer investor facilitation services to foreign investors through the Department of Industries. The Single Window system is reasonably successful and its facilitation services should be available to investors who request them.

**(b) Abolish dual screening of foreign technology transfer and foreign loans**

The foreign investment law is duplicative and therefore unnecessary for approving these transactions. The essential public interest in foreign technology transfer is to guard against transfer pricing; but this can be done through the ample tax avoidance provisions of the Income Tax Act.

The approval of foreign loans is already an exchange control function of the Central Bank. Thin capitalization issues – which are separate regulatory matters – are also dealt with in the Income Tax Act.

**(c) Improve investor treatment and protection provisions**

The terms of Nepal's BITs provide high levels of assurance to foreign investors from treaty countries in relation to issues of national treatment, non-discrimination, funds transfer, expropriation and settlement of disputes with the State. The provisions for funds transfer provide particularly wide assurances. Moreover, Nepal has good standards. The current foreign investment law, on the other hand, does not have provisions on all these issues except for funds transfer. Nepal should thus consider two actions: (a) if changes to the foreign investment law are being made it could take the opportunity to modernize the treatment and protection provisions to reflect the BIT terms; and (b) it could develop a wider BIT network to entrench these assurances.

It should be a priority to conclude a modern BIT with India.

**(d) Intrude less into dispute settlement terms between commercial parties**

The current foreign investment law strays too far into the commercial area in its restrictions on venue and governing law for settlement of disputes between commercial parties.

**3. Improve the administration and design of business taxation**

Business taxation is administered badly and is amended frequently. The Government's actions are extremely damaging to the investment climate and there seems to be no urgency or priority to attending to the problems.

The following remedial actions, in order of priority, are needed in order to present a credible profile to foreign investors:

**(a) Clear urgently the backlog of revenue appeals and outstanding refunds**

The Government must adopt radical solutions to clearing up the backlog of cases – probably by a combination of forgoing all claims over, say, two years old and appointing more resources (possibly with international donor assistance) to hear current cases. The issue of discountable bonds in lieu of cash settlement does not go far enough to paying tax refunds. The concept should be extended by the issue of transferable vouchers which can be accepted as payment of taxes, duties and VAT.

**(b) Change the administration of duty drawback**

The existing duty refund system for exporters is not working as intended. It should be changed to a system of registering exporters who will be permitted to import raw materials and semi-finished goods free of duty.

**(c) Establish large taxpayer administrative units**

Thorough administrative reform of income taxation and customs will take a long time. As a practical start the Government should consider establishing special units to deal with larger taxpayers, both national and foreign. The aim of these units would be to provide “best in the region” professional standards. Access to these channels for tax and duty could be offered to foreign investors as an “incentive.”

**(d) Abolish advance income tax**

Since the Government appears unable to process and to refund excess advance tax and similar withholdings, this feature of tax compliance should be removed.

**(e) Stop the tax creep**

The last 10 years have seen a continual erosion of fiscal incentives and annual introduction of new taxes on business, often in the nature of flat charges. Business tax policies are no longer competitive in every sector, and the incentives for job creation and poverty reduction have been reduced. The Government should redesign business taxes to ensure that

they are internationally competitive on a sectoral basis and represent the “most attractive in the region”.

Once business taxation is redesigned, the Government should commit to maintaining stable tax structure for several years. Since hitherto the Government’s track record in maintaining tax stability has been poor, it could be desirable to offer contractual stability of taxation for large or strategic investments. This device has proved a useful form of incentive in countries emerging from a period of policy instability.

#### **4. Reform labour regulation**

This review has concluded that aspects of labour regulation are incompatible with attracting investment and creating employment. The following reforms are recommended for making conditions of employment more market-driven and consensual.

##### **(a) Replace the employee housing set-aside with an incentive**

The 5 per cent housing set-aside is a clumsy instrument and adds to the financial disincentives for investment. It should be abolished and replaced with compulsory provision of accommodation only in special situations, for example, in remote locations. Beyond these special situations, if the Government attaches such high importance to employer-provided staff accommodation, it should offer an incentive in the income tax code.

##### **(b) Reduce the labour bonus**

A 10 per cent mandatory labour bonus appears to be high unless the Government has grounds to believe that it is reflected in wage determinations.

It would be a much better signal in the investment climate if the bonus were either reduced or made consensual.

##### **(c) Reduce the scope of minimum wage determination**

The scope of minimum wage determination and mandatory inflation indexing means that investors have significantly reduced control over a major business cost. Minimum wage determination should apply at the most only to unskilled and vulnerable categories of workers.

##### **(d) Remove rigidities in the labour law**

The labour law allows the Government to be far too intrusive in setting job classifications and in regulating conditions of employment and dismissal. This is likely to be a deterrent to job creation and should be brought into line with modern international standards.

##### **(e) Establish an independent industrial relations tribunal**

A modern industrial disputes resolution mechanism should be established to resolve disputes quickly and fairly. This would be a move away from the departmental "labour officer" approach.

## **5. Appoint a champion of investors' rights**

It would be useful if a central Government agency (e.g. the Single Window facility of the Department of Industries) were charged with addressing investor complaints, collecting and publishing information on the difficulties encountered by investors and functioning as a forceful advocate of change. Such an agency could well be set up under a new foreign investment law.

### III. FDI STRATEGY

#### A. Introduction

Nepal has the potential to attract significantly more FDI. Compared with most other low-income countries, it has a surprisingly long list of advantages. These include a large and friendly neighbouring country that offers market potential, a flourishing local entrepreneurial culture in both small and large business and established international recognition and image.

But this potential is severely constrained – wasted, to put it bluntly – by the poor investment framework, as discussed in the previous chapter. In these circumstances the usual elements of an FDI strategy, including general programmes of investment promotion, linkages with national firms, and longer-term plans to improve competitiveness, will have a limited impact on Nepal's ability to attract FDI and benefit from it. Nepal's FDI strategy must consist first and foremost of a firm and orderly process of relieving the constraints in the investment framework.

However, the Government's capacity to engage in a quick and comprehensive upgrading of the investment framework is limited. The reforms required are not just of policies but also of deep-seated administrative practices and attitudes towards business. This will take time. Accordingly, special measures should be created to tap immediate FDI potential wherever it exists. These special measures should facilitate FDI whilst the difficulties in the overall investment climate are being tackled. The creation of these will entail the formulation of Industry Promotion Packages.

Thus Nepal should adopt a deliberately myopic strategy for FDI.

*Institutionally*, the approach will need to be unconventional. A nucleus of talent reporting at a high level should be assembled within the Government to push the reforms forward through the ministries and to structure special conditions needed to gain early winners. Such an agency will be less concerned with general investment promotion, and much less with image building, than is typical of investment promotion agencies. It might well absorb some existing agencies. However, it should also have the ability to structure selected FDI opportunities.

The discussion below will conclude that the *three themes of Nepal's FDI strategy* should be:

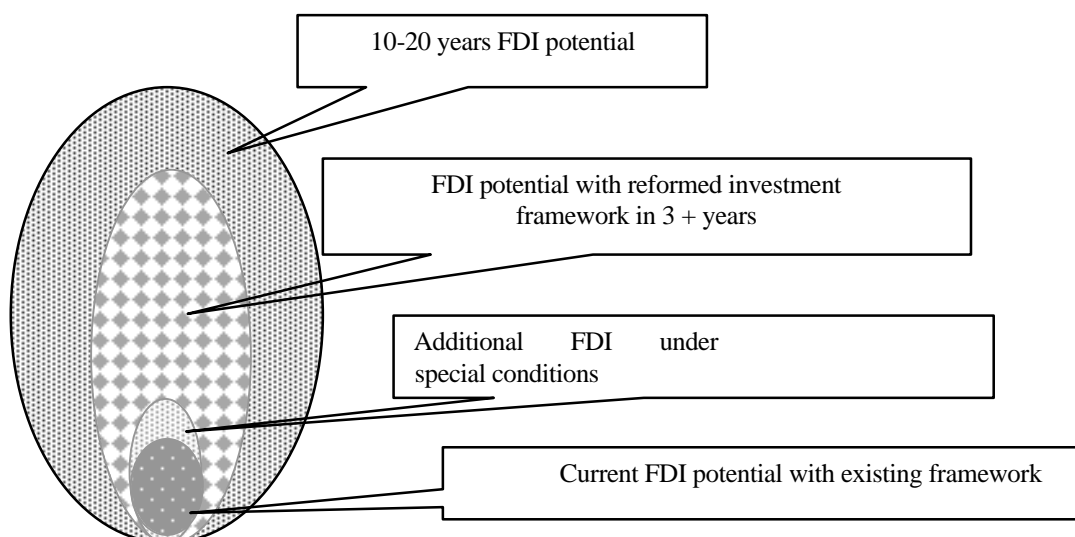
- Immediate and high-level start on improvement of the investment framework;
- Creation of Industry Promotion Packages to gain early winners;
- Formation of an atypical investment agency within the Government.

Restoration of political stability is also of great importance to foreign investors. The identification and implementation of FDI projects are effectively on hold until Nepal's risk profile improves.

## B. Overview of FDI potential and constraints

Figure III.1 shows in conceptual form the conclusions of this review as to Nepal's FDI potential and constraints. The outer "circle" represents the universe of 10- to 20-year potential reflecting the impact of investment in human and physical capital and private sector development in a sound investment climate. The intermediate circle represents the FDI potential if the investment framework is reformed to a good standard as recommended in chapter II. The inner circle represents the possibilities given the current framework plus the conditions, represented by the bubble, created by special opportunities. The current small inflows of FDI (see chapter I) make up the inner circle – created by the existing dysfunctional framework plus special conditions created for FDI in electricity generation.

**Figure III.1. Representation of FDI potential**



The relatively small size of the innermost circle reflects both the severity of the existing constraints and the payoff from a successful reform effort. (Sri Lanka is an example of a country which is poised to make rapid gains in this respect and to reduce recourse to special investment conditions.) For Nepal to focus on expanding the outer circle would have little payoff unless the inside circles were expanded in a commensurate fashion. Such a strategic focus is more relevant in a country that is optimizing its inflows of FDI and needs to make strategic shifts such as assisting its industries to move up the value-added chain or to develop clusters of mutually reinforcing businesses. (Mauritius is an example of a country that is closer to this position.)

Utilizing the conceptual approach in figure III.1 facilitates a short-, medium- and long-term view of Nepal's potential to attract FDI.

*Short-term.* Increased FDI in areas of demonstrated potential, provided that special Investment Promotion Packages are introduced to cater for:

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

*Medium-term (3+ years).* In the medium term more of the potential in the above areas could be realized by major improvement in the investment framework. In addition there could be opportunities for FDI in:

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

*Long-term (10-20 years).* A long-term effort to produce the best investment framework in the region, substantial infrastructure improvements and good programmes of skill development and linkages with national investors would include measures for Nepal to attract FDI into the following additional areas:

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

### **C. FDI potential in the short term**

In spite of the difficulties that Nepal experiences in attracting FDI in any appreciable amount, there are some sectors where FDI currently comes in. These are sectors where FDI can be accelerated if Industry Promotion Packages are created.

#### **1. Tourism**

Tourism already plays an important role in Nepal's economy. It remains one of the country's most promising sectors for attracting FDI because of its incomparable natural assets, religious sites and therapeutic treatments. The Government recognizes the contribution that tourism can make in national economic development. So far its strategy appears to have focused strongly on maximizing local participation at the expense of a complementary strategy to harness FDI.

Nepal offers a variety of tourist attractions and activities in addition to mountain trekking. Among the newer tourist attractions under development are eco-tourism and Buddhism tourism. Nepal is promoting its own brand of eco-tourism by combining the natural scenery and trekking with other activities such as rafting, yoga and meditation, and investors are encouraged to provide these and related services.

The Product Development Strategic Plan of the Nepal Tourism Board (NTB) includes the creation of new tourism hubs and "sub-hubs" throughout the country. These should open up additional investment opportunities and also help distribute the economic benefits of tourism more broadly. Basic infrastructure needs such as roads and, solid waste processing should be addressed before these plans can leapfrog into reality.



### Box III.1. The Nepal investment guide

UNCTAD launched *An Investment Guide to Nepal* in March 2003, at the same time as the draft Investment Policy Review (IPR) was presented at a national workshop in Kathmandu. The project on investment guides and capacity-building for LDCs is a joint venture between UNCTAD and the International Chamber of Commerce (ICC) intended to furnish LDCs with an attractive and informative marketing tool.

The *Guide* lists FDI opportunities in agriculture (food crops and oil seeds, plantation, floriculture, leather goods, livestock), hydropower, tourism, health services, light manufacturing, ready-made garments and information technology. This is a larger list than that in the IPR. The differences between the contents of the *Guide* and the IPR are best explained by noting that the former is a *marketing tool* while the latter is *policy advisory document*. While both the *Guide* and the IPR talk about opportunities, the former describes them at greater length in order to bring all opportunities of any significance to the attention of investors, who may have heard of few of them. The IPR treats opportunities much more briefly, for its focus is on specific changes in policy that would make the opportunities easier to exploit. Considering the time lag in achieving the policy improvements, the FDI opportunities are categorized as short-, medium- and long-term. Again, while the guide makes some distinction between major opportunities and those not so major, its emphasis is not analytic but descriptive.

There is no genuine inconsistency between the *Guide* and the IPR. The differences can be found in emphasis, deriving from differences in purpose. The IPR differentiates the opportunities on the basis of policy implementation. Both documents, in fact, point to poor policy implementation as the overriding concern of investors.

*Source:* UNCTAD.

Lumbini, the birthplace of the Buddha, holds much potential in attracting Buddhist pilgrimages with its archaeological ruins, meditation centres and the old palace. Yet very little tourism development is occurring there at the moment. Lumbini needs many improvements to evolve into a tourism hub, and therefore investors have a wide variety of opportunities in infrastructure development, renovation of cultural attractions and meditation centres. Investment opportunities in Lumbini derive mainly from the Master Plan of the Lumbini Development Trust, a non-governmental organization dedicated to the restoration of Lumbini and its development as a pilgrimage site. This is a long-standing plan to transform three square miles of land into a sacred place of gardens, pools, buildings and groves. The development will include a Monastic Zone and Lumbini Village, where investors have additional opportunities for hotels, restaurants and other tourist facilities. This could be an important opportunity to target FDI from the Japanese hotel industry.

Another reason for attracting tourists is the cultural affinity of people in the region. Nepal is the only predominantly Hindu country outside India and its myriad temples attract Hindu pilgrims from neighbouring India.

Health tourism is another niche product that can attract tourists. Nepal's temperate climate and availability of herbal products are ideally suited for the "rejuvenation therapy" that lures tourists to Kerala in India. This is a fast-growing area of world tourism. There is potential to attract FDI from the major hotel groups who see health-related activities as an additional revenue-earning aspect of their operations.

With all these assets, the performance of Nepal compared with that of other LDCs is somewhat disappointing. Nepal remains among the top five LDCs in relation to visitor numbers. It almost doubled tourist arrivals between 1990 and 2000. But other leaders have grown much faster and their tourism expenditure has substantially improved. Table III.1 compares Nepal's performance with that of two other LDC tourism leaders – the United Republic of Tanzania and Cambodia.

**Table III.1. Comparative tourist arrivals, 1988-2000**

Countries	Arrivals of tourists (Thousands)			Tourism expenditures (Millions of dollars)		
	1990	1995	2000	1990	1995	2000
Cambodia	17	220	466	..	100	228
Nepal	255	363	464	64	117	167
Tanzania	153	285	459	65	259	739

Source: UNCTAD Handbook of Statistics 2002.

Indian tourists regularly comprise nearly one third of all visitors to Nepal, but the figure dropped in 2000 to 20.7 per cent of total tourists as a result of the 1999 Indian Airlines hijacking incident. The number of Indian tourists fell even further in 2001, with only 65,329 visitors compared with 95,915 the previous year.

In contrast, there was a palpable increase in Indian tourists to other Asian destinations in 2000 over the previous year (see table III.2).

**Table III.2. Tourism from India to selected Asian countries**

Countries	Tourist arrivals	
	1999	2000
Indonesia	30 081	34 982
Malaysia	46 537	132 147
Singapore	288 383	346 356
Thailand	163 980	202 868

Source: ASEAN National Tourism Organization.

The number of tourists registered an increase in 2002. In the first three months of 2003, the number of Indian tourists to Nepal has shown an increase of 33 per cent over the same period in 2002.

One drawback to faster tourism development is the lack of basic infrastructure, especially in transport and sanitation services. Tourism infrastructure is slowly being addressed with assistance from the donors. The Asian Development Bank is providing funding for upgrading heritage sites, renovating airports around the country, and road construction, but there are still many other infrastructure needs.

Nevertheless, there is potential to attract FDI to promote more upscale tourism based on first-class hotel and leisure facilities (with self-contained facilities) as a component of the current markets for trekking, eco-tourism and religious and health-based markets. The royal tragedy and the current insurgency have put investor interest on hold. It is a welcome change that the Government and the insurgents have since agreed to a ceasefire and that discussions are underway for a possible negotiated settlement. More fundamentally, foreign investment has been marginalized in the Government's strategic thinking for development of this sector. This is evident from:

- The restrictions on foreign travel agents and tour operators and on foreign participation in most ancillary tourist services;
- The scarcity of major chain hotels. Even the internationally prominent Oberoi hotel group from neighbouring India is presently absent from Nepal;
- The lack of resolution of a long-standing taxation dispute with the major foreign investor in the sector.

The Government should not view tourism as a finite profit centre in which participation of foreign investors will be at the expense of national investors. On the contrary, there appear to be substantial growth and diversification opportunities in the sector as indicated above.

### **Recommendations to promote FDI in tourism**

Three initiatives are recommended to generate more effective promotion of FDI in this important sector:

#### **(a) Removal of the ban on overseas tour operators' and travel agencies ownership of operations in Nepal**

This will be an important signal that the tourism sector will be opened more to foreign involvement. If there are sensitivities, as a first step these activities should be opened to major operators and agencies that have the capacity to enhance the marketing of Nepal as a tourist destination. Proposals by established national investors to form joint ventures should also be given favourable consideration.

#### **(b) Formulation of a tourism development certificate**

The certificate should be offered for significant hotel development by either national or foreign investors (or joint ventures) and contain:

- (i) An attractive and stable tax and customs duty incentive regime – including a competitive tax rate and depreciation regime for establishment and refurbishment, zero customs duties on key imported inputs, and moderate withholding taxes on management fees paid abroad. These should mirror the general tax and duty arrangements to be developed under a general fiscal reform;
- (ii) Assignment of special units in the revenue collection authorities to ensure professional attention to tax compliance and prompt customs clearance;

- (iii) Work and residence permits for adequate number of key positions for expatriates;
- (iv) Exemption from uncompetitive or inflexible elements of labour law;
- (v) In relation to foreign investment, guarantees to transfer funds for dividends, management fees, debt service and disinvestment proceeds.

The certificate should take the form of an agreement between the Government and the investor. Thus any breach by the Government of the terms of the certificate would trigger dispute resolution provisions, including the right to international arbitration in the case of foreign investors.

A model tourism development certificate should be prepared. If prepared with good advice and industry input, it should set uniform terms for all prospective investors and be used as a key promotional tool.

### (c) Structuring of tourism development zones

Sites which have strong potential for tourist development but weaknesses such as poor infrastructure should be designated as tourism development zones. Lumbini is an example in which a mutually beneficial partnership between national goals and private investment could be forged.

In designated tourism development zones, important hotel or other commercial leisure investment projects should be offered the following:

- A tourist development certificate on *standard* terms as described above; and
- The option to *negotiate* a package of obligations and benefits which are specific to the site on a case-by-case basis. These could include:
  - Obligations to provide certain public infrastructure requirements (e.g. transport or sanitation) and/or undertake conservation of natural or historic features of the site; and
  - Benefits such as duty-free shopping, a share of visitor fees to attractions and (in the case of foreign investors) relaxation of restrictions on foreign investment in ancillary tourist activities.

## 2. Export manufacturing under trade preferences

Nepal will, in all probability, not attract large inflows of FDI in the foreseeable future in manufacturing based on the classic determinants of domestic market size or efficiency gains.

Manufacture accounts for roughly 10 per cent of GDP and firms are mostly small-scale business catering to the domestic market. The population is not small, but purchasing power is rather low owing to the fact that over a third of the population is living in absolute poverty and most people live in rural areas which are often poorly connected to the metropolitan economy. The mass market is small and market-seeking FDI will tend to be confined to industries offering natural import protection, such as cement, beverages and name brand consumer goods.

Whilst labour costs are low, a recent study of manufacturing productivity in Nepal concluded that "there are very few competitive enterprises, while most of the manufacturing value-added is still produced under rather high effective rates of protection".<sup>10</sup> Poor infrastructure, relatively low technological competence and lack of a seaport are other limitations Nepal has to contend with in presenting an attractive profile to efficiency-seeking FDI. It can safely be concluded that Nepal currently does not have the package of attributes that offers strong potential to attract efficiency-seeking FDI to manufacturing.

The Nepalese carpet industry is an exception. It has established a valuable export niche (principally to Europe) in distinctive carpets and ranks with the garment industry as easily the largest manufacturing exporter. The industry is nationally owned and appears to see no need and have no desire for FDI involvement. It would prefer to look to the Government for financial assistance for technological upgrading and international market promotion.<sup>11</sup>

For these reasons current FDI-in-manufacturing potential has to reside in export manufacturing based upon privileged market access. Aside from general LDC preferences, which offer no advantages over many competing manufacturers,<sup>12</sup> Nepal benefits from two trade preference schemes, which offer distinct advantages in attracting FDI:

- The Nepal-India trade treaty; and
- Apparel trade preferences.

The Nepal-India trade treaty is a bright prospect for attracting Indian and third country FDI. Apparel trade preferences are a diminishing prospect for retaining, let alone attracting, FDI. But in both cases there are concrete steps that Nepal can take to optimize the opportunities.

### **Apparel trade preferences**

Nepal is a beneficiary of quotas granted by major apparel importers, especially the United States, which regulate the amount on imports permitted under the concessional duty scheme of the Generalized System of Preferences.

Nepal has attracted FDI in apparel assembly from producer countries that have exhausted their own quota allocations. India, which is a leading cotton producer and textiles and garments manufacturer, is the principal source of this FDI. Nepal exports substantial volumes of low- to medium-value garments to own-label retailers and major department store chains. For example, annual apparel exports to the United States have been as high as \$175 million.

These quotas must be phased out by the end of 2004 in accordance with the WTO Agreement on Textiles and Clothing. Despite low labour costs Nepal has not established a highly competitive industry. It cannot therefore expect to attract additional FDI in the new era of equality of access to the major markets. India and China, which are more competitive and have the bonus of large domestic markets, will be more attractive.

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<sup>10</sup> UNIDO: Industrial Development Perspective Plan: Vision 2020, Kathmandu, September 2002, p. 193.

<sup>11</sup> Investor communication.

<sup>12</sup> The status of an LDC confers upon Nepal tariff preferences in export to industrialized countries under the Generalized System of Preferences. Included among these is the "Everything But Arms" (EBA) initiative adopted recently by the European Union. Under this scheme, all manufactured products originating from LDCs enjoy tariff preference (except arms and ammunition).

Nepal has two slight opportunities to attract FDI into the apparel sector:

- (a) Lure some export manufacturing for world markets from India by creating a superior business environment. In the short term this could only arise from implementation of the investment promotion package proposed below.
- (b) Negotiate customs duty concessions with the United States and/or Europe on Nepalese exports which are not available from main competitors. Nepal would appear to have little leverage to negotiate such a bilateral deal and would presumably need to join a regional initiative.

Option (a) would be required in any event in order to take better advantage of the Nepal-India trade treaty (see below).

### **Nepal-India trade treaty**

Ongoing developments in Nepal's regional trade relations should help overcome many of the disadvantages inherent in Nepal's economy. One of the most important developments is the recent renewal of the Nepal-India trade treaty. The bilateral trade treaty of 1996 provided generous concessions for Nepalese products, namely duty-free access. The treaty was renewed in 2002 with amended terms in response to concerns in the Indian business community, which felt that the treaty enabled some third-country products with minimal Nepalese value added to enter India via Nepal owing to lower import tariffs in Nepal. These concerns regarding value addition, certificates of origin and export surges of certain commodities have been incorporated into the new treaty.

Among the key changes in the new treaty are:

- Nepalese manufactured items must have at least 25 per cent Nepalese and/or Indian content for the first year of the new treaty and 30 per cent in subsequent years to qualify for duty-free access to India without quantitative restrictions. The final manufacture must be in Nepal and the process must be of sufficient substance to bring out a change in product classification at the 4-digit level of the HS<sup>13</sup> classification. These rules of origin are favourable, as a 50-60 per cent local content requirement is common in other treaties.
- Vegetable ghee, copper wire, zinc oxide and acrylic yarn from Nepal will be allowed duty-free entry to India but subject to quotas.

The new terms of the treaty will require investors to do more than simply import goods and raw materials and offer little or no value added before re-exporting them to India.

Nepal's exports to India increased considerably after the 1996 treaty and India now accounts for nearly a half of Nepal's exports (see figure III.2).<sup>14</sup> Nevertheless, there is in principle considerable potential in manufacturing as Nepal supplies less than a tenth of 1 per cent of India's market for manufactured goods.

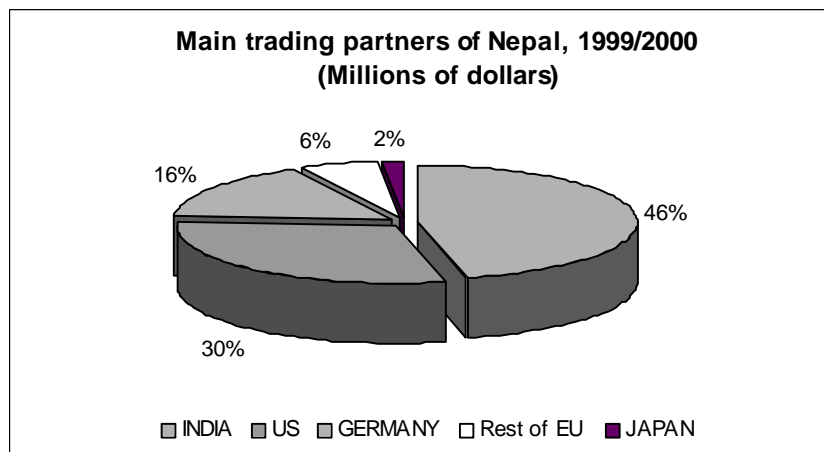
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<sup>13</sup> HS – Harmonized Commodities Description and Coding System.

<sup>14</sup> Major exports of Nepal to India include vanaspati (vegetable oils), toothpaste, jute goods (sacking, twines, etc.), polyester and acrylic yarn, pulses, hides and skins, herbs, cardamom, ricebran oil, ginger, oil cakes and noodles.

Initially, the principal source of this opportunity would be Nepal's ability to exploit tariff differentials on finished products and/or on imported inputs. Nepal would need to offer a policy regime that takes full advantage of its ability to offer itself as a location of lower-cost inputs. Otherwise, it would not seem to have an edge in competing with Indian firms.

**Figure III.2. Direction of Nepal's exports**



Source. Federation of Nepalese Chambers of Commerce and Industry, *Nepal and the World: A Statistical Profile*.

The UNCTAD survey of foreign investors points to a trend for Indian investors locating production in Nepal to serve the Nepalese domestic market. This is probably explained by the preponderance of investors in the survey serving the domestic market (see annex IV). On the other hand, the UNCTAD survey of *prospective* investors reveals the potential for export by virtue of the Nepal-India Trade Treaty (see box III.2).

The investment potential from the Treaty is not yet tapped to the fullest extent. With the treaty's recent renewal, Nepal can offer prospective *non-Indian* investors improved access to the immense market potential of India. Nepal can actively seek out non-Indian FDI to invest in Nepal (but meeting the requirements of value addition). Finding Indian firms to go into joint ventures with them is also attractive because this way the products manufactured may not face excessive market hurdles in India. The idea is not far-fetched. Already a United States company, ALCOA Closure Systems International (Alcoa CSI), has teamed up with an Indian firm, Nilkamal Plastics, to manufacture beverage caps in Nepal and is planning to export 95 per cent of the joint-venture products to India (see box III.3). Such a scheme has the double benefit of exploiting the terms of the Treaty as well as expanding the technology base of Nepalese manufacturing.

A further illustration of the potential is provided by the energy with which Sri Lanka and third country investors are taking opportunities arising from Sri Lanka's trade treaty with neighbouring India (see box III.4).

### **Box III.2. Indian firm perspectives on investing in Nepal**

A survey of potential Indian investors revealed that while a number of them were interested in investing in Nepal, most of the projects contemplated were small to medium size entailing investment of less than \$100,000. Many large business houses felt that the limited market size of Nepal did not justify the location of production in Nepal.

Of the 63 business houses that responded, 33 currently trade with Nepal, 17 expressed willingness to invest in Nepal, and 11 would do so in a time frame of 12 months.

Predictably, the foremost concern among them was that of political instability. The quality of local partners, the quality of road transport, corruption, the low skill level of labour and shortcomings of the dispute settlement mechanism were also cited as major concerns.

Access to market (local as well as regional) was the most important consideration for investment in Nepal. Around two thirds of the respondents felt that the recently renewed Trade Treaty was important for their operations. One positive factor they appreciated in the new Treaty was specific value-addition norms that would prevent importing and re-exporting products made in China and other South-East Asian countries. One criticism many of them voiced was of the short period (five years) after which the Treaty may be renegotiated, thereby injecting uncertainty into business plans.

The investors had a few suggestions for the Government of India as well. They felt that the Government should simplify import formalities by establishing, for example, a single window facility. Also, they felt that Indian investors should be exempted from the quota restrictions imposed on selected items.

*Source:* UNCTAD survey, 2002.

### **Box III.3. The Alcoa/Nilkamal joint venture**

Alcoa CSI, a US-based transnational, has teamed up with an Indian firm, the Nilkamal Plastics Group, in a joint venture to produce plastic closures to serve the growing beverage markets in India and Nepal. Plastic closures are used to bottle soft drinks, mineral water, fruit juices and the like and have traditionally been imported into India from Gulf Closures-Bahrain, which is also a subsidiary of Alcoa CSI.

Alcoa CSI is the global leader in the supply of beverage capping systems and in providing technical support to bottlers. Nilkamal Plastics is the largest manufacturer of moulded plastic crates and furniture in Asia and is an expert in plastic manufacturing, engineering and design. It has developed close ties with the Indian soft drink industry through its position as a leading supplier of plastic beverage crates.

The joint venture is a \$7 million project in which Alcoa CSI will hold a 76 per cent equity stake and the Nilkamal Group will hold the remaining 24 per cent.

The new venture was granted foreign investment approval in 2001 from the Nepal Department of Industries. This venture is based in Nepal partly because of the FDI restrictions in India. The plant has been set up in Hetauda, a town approximately 60 km from the Indo-Nepal border. Alcoa CSI Nepal Pvt. Ltd. began operations in 2002, with the first commercial order shipped in July 2002.

This venture allows Alcoa CSI to better serve its customers in an important region that is experiencing a double-digit growth rate. For Nilkamal, partnership with Alcoa CSI offers global resources, technical expertise and marketing network. The joint venture hopes to rapidly expand its presence in the beverages industry throughout India and in the surrounding regions.

*Source:* Alcoa CSI.



#### **Box III.4. Sri Lanka sees FDI potential in its trade agreement with India**

The Free Trade Agreement (FTA) between Sri Lanka and India was signed on 28 December 1998 and came into force on 1 March 2000. The FTA envisages complete or phased elimination of tariffs on a large number of selected items by both countries. The FTA also provides Rules of Origin criteria to ensure minimum local content.

While the FTA is expected to be a boon to both countries, Sri Lanka sees great trade and investment potential based on the proximity of the (South) Indian market and has been promoting FDI inflows on this premise. It is estimated that it is cheaper, easier and faster to source South India's market from Sri Lanka. It takes approximately four days for a truck to transport goods from New Delhi to Chennai, whereas shipments from the Colombo Port to Chennai take half the time.

Even during the remainder of 2000 (April–December), Sri Lanka achieved an overall 33 per cent growth in exports to India, of which 71 per cent (\$7 million) accounts for items exported under the FTA. Some of the new products that entered the Indian market under FTA include value-added tea, sausages, biscuits, chocolates, ceramics, furniture, metal products, footwear, wooden toys, memory chips, machinery and mechanical appliances, and herbal products.

For the same period under the review, the total value of imports to Sri Lanka (from India) accounted for \$405 million, of which 8 per cent (\$33 million) was under FTA. The major products include chemicals, electrical machinery and equipment, iron, steel, cement, vehicle parts and plastic products.

The Board of Investment in Sri Lanka has initiated 41 projects based on the benefits granted under the FTA, pledging investments to the value of \$100 million. The FTA offers investors many vistas: (a) preferential tariffs granted by India will allow existing Sri Lankan industries to enter the Indian market; (b) foreign investors can consider the manufacture of intermediate goods in Sri Lanka which are currently attracting high import tariffs into India; and (c) Indian investors may manufacture in Sri Lanka and export back to India and third countries.

Six projects have already been signed under the agreement, one of which has already commenced commercial operations (a joint venture between Sri Lanka and Malaysia to produce stainless steel water Tanks). Two are being constructed (Merbok Hilir Berhad, Asia's largest manufacturer of medium-density fibre board and Raymet Indo-Lanka (Pvt) Ltd., in steel marketing). Another four projects are awaiting approval. There are about 31 projects in various stages of negotiation.

*Source:* Board of Investment, Sri Lanka.

#### **Recommendations to promote FDI in export manufacturing**

A decisive break with past ways of thinking is needed in order to attract FDI in manufacturing commensurate with the opportunities provided by trade preferences. A package of measures is needed which:

- Ceases to rely entirely on government, donor and parastatal provision of business facilities (infrastructure, utilities and premises) in favour of private development of these facilities;
- Shifts the focus of export manufacturing investment promotion to private sector providers of business facilities;
- Provides an internationally competitive tax and regulatory regime and efficient administration thereof.

For reasons set out in the introduction to this chapter, it is not feasible to expect in the short term these reforms to be engendered throughout the national framework. An economy-

wide shift from red tape to red carpet is too much to expect in the short term. A more manageable approach based upon creating havens of good facilities and practice for investors is needed. In this respect there are two choices:

- **Special zones.** Create special zones with substantial administrative autonomy under the control of a zone authority. These would enable private investment in business facilities and offer manufacturing investors a package of tax advantages, streamlined regulation and efficient administration.<sup>15</sup> Such zones are widely used in Asia and elsewhere if the national investment framework is poor or deemed unsuitable for the particular incentives required of a sector.
- **"Enhanced" industrial estates.** Invite developers to build industrial estates that provide good business facilities on the basis that manufacturers operating within the estates will be offered a competitive tax and regulatory package and hassle-free administrative procedures. The estates would be smaller than zones (and more likely to attract private development capital) and would not be controlled by a separate authority with delegated regulatory powers. However, they would be given special attention by the proposed Investment Agency and by the Single Window facility for compliance and administrative services.

At this juncture the creation of large, separately administered zones could be too ambitious. It might be more feasible to aim for the latter option of industrial estates whose attractiveness will be enhanced by special measures. These would be privately developed under conditions set out in the Industry Promotion Package, as proposed below. Their location would be a decision of the private developers of the estates. Industrial estates in proximity to the dry dock development at Birgunj<sup>16</sup> would be a logical place to start given the extensive investment in container facilities and rail connection to India. In due course this area might be a suitable location for a special zone and for the present administrator, the Nepal Intermodal Development Board, to form the nucleus of a future zone authority. This latter development is in the distant future as the overall project is not yet operational.

### **Industry Promotion Package in manufacturing**

The structure of an effective industry promotion package is outlined in figure III.3. It is based on industrial estates (with the future possibility of zones) so as to provide a manageable basis for the application and administration of first-class tax and regulatory conditions. Nepal already has some industrial estates (apparently not functioning optimally). Important elements of the proposed new package are:

- Involvement of private industrial estate development so that estate developers have a natural incentive to promote their facilities and attract investors; and

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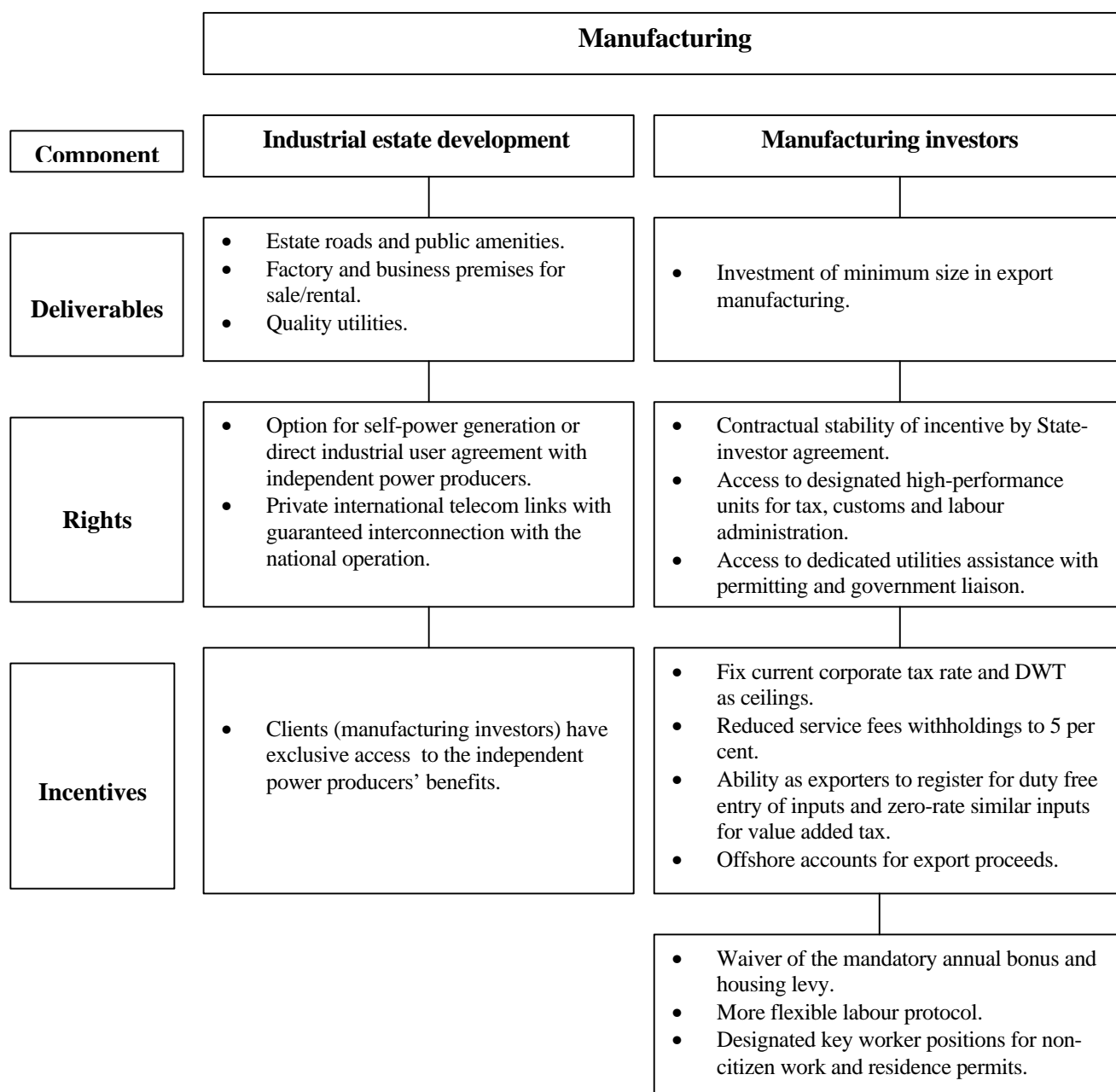
<sup>15</sup> An example is a so-called multi-facility economic zone. A substantial area (e.g. 1,000 hectares) is set aside in which private and/or public investment is deployed to assure users of excellent infrastructure (e.g. electricity, telecommunications, water and waste treatment, and roads). These facilities can extend to a small township providing accommodation to executives and workers and hotel and recreational facilities to attract personnel. It is administered by a special authority and provides or ensures best practice procedures and approvals at all levels – from project approval to production facilities and operating conditions. The authority has regulatory powers and its officials are trained to offer best practice standards of administration. Developers and investors within the zone are assured of high-quality administration of income tax, VAT customs duty, labour and other procedures.

<sup>16</sup> The Government has completed a \$28.5 million project to develop road and rail-linked container facilities on the border with India. India has provided a rail connection through to Indian ports. The aim is to facilitate the smooth transit and customs clearance of Nepalese goods.

- Enabling private developers of industrial estates to enhance their offers to manufacturing investors by:
  - o Permitting partial private operation of telecommunications and other facilities so as to improve quality; and
  - o Offering an attractive package of incentives to manufacturing investors who locate in these industrial estates.

The tax and regulatory recommendations mirror those proposed as national standards in chapter II.

**Figure III.3. Industry Promotion Package**



### 3. Herbal products

Herbs and herbal products are showing great promise thanks to ideal growing conditions in the hills and mountain regions. Nepal has hundreds of plants with medicinal and aromatic properties. Demand for herbal products for cosmetic and health uses is increasing in key markets such as India and in other Asian, Middle Eastern and Western countries as well. Nepal trades most of its medicinal and aromatic plants in crude form because cultivation and processing are currently limited in Nepal (Asia Invest, *Guidebook for European Investors in Nepal*, 2001). Nepal's export of herbs and essential oils in 1998/99 amounted to only about \$320,000, a tiny fraction of the world market.

A recent study by the Export Import Bank of India highlights the prospects for export of herbal remedies, such as ayurvedic medicines that originated in India (see box III.5).

#### **Box III.5. The growing world market for herbal products and remedies**

The global market for all herbal products (which include medicines, health supplements, herbal beauty and toiletry products) is estimated at \$62 billion. World demand for herbal products has been growing at a rate of 10 to 15 per cent per annum.

The global market for the herbal remedies segment (i.e. medicines and supplements) is estimated at \$16.7 billion (1997). Out of this, the market for herbal medicines alone is estimated at around \$5 billion (1997) and is expected to reach \$16 billion by 2005. The medicinal plants related trade in India alone is worth approximately \$110 million.

Europe and North America are the major international markets for herbal products and herbal remedies. They account for over 60 per cent of these markets. The European market for herbal remedies accounts for 45 per cent of the global market, and stood at \$ 7.5 billion in 1997. Germany and France are the most established markets with a share of 22 per cent and 11 per cent in Europe, respectively. China is the major exporter of traditional medicines to the world market.

By way of comparison, the global market value of processed and packaged tea is around \$3 billion.

*Source:* Export Import Bank of India, "Exporting Indian Health Care", October 2002.

The manufacture of herbal remedies is an old and highly fragmented industry. There are about 7,000 manufacturers in India alone. However, the leading Indian companies such as Dabur, Zandu, Baidyanath and Himalaya have been able to establish strong brands and have the expertise and financial strength to develop export markets in branded herbal remedies and toiletry products. Once a brand is established these can be attractive high-margin products. Herbal remedies can be exported as over-the-counter (OTC) medicines, tonics and food supplements.

The leading Indian companies have developed modern research and development facilities. These are aimed at gaining local and overseas regulatory approvals for herbal medicines aimed at specific illnesses such as cancer and Parkinson's disease. Depending on corporate strategy these may be marketed either as OTC products or as prescription pharmaceuticals.

At least one foreign firm, Dabur, a major Indian herbal products manufacturer has invested in Nepal to exploit the natural climate for growing such plants. Dabur has invested in the backward integration of the industry through plant breeding and distribution of cultivars to

growers. Most of its products based on Nepalese herbs are processed in Nepal and marketed overseas under the Dabur brand (see Box I.3).

Zandu, another leading Indian herbal products manufacturer, has established an ayurvedic clinic in Nepal. As discussed above, niche tourism in areas such as natural health related tourism is a fast growing segment in the industry. There is potential to develop a cluster of both herbal products and herbal services providers in Nepal.

The herbal products industry offers an outstanding opportunity to combine the strengths of foreign investment (R&D and export marketing expertise) with the special natural resources of Nepal in a way that brings income opportunities to poor areas. Their high value-to-weight ratio also makes the harvested plants more suitable for transport from remote areas than the traditional agricultural crops. There is significant potential for FDI in this industry and for Nepal to benefit from it.

Currently, there are constraints on the development of the industry. Herbal products need stable and predictable volumes of plants for processing. Current schemes rely on smallholder production. It would help processors to supplement these sources with their own estates, but these are currently difficult to access. For example, a prime area is owned by a loss-making parastatal, the Herb Production and Processing Company Limited. Furthermore, royalties are charged on natural products in addition to income tax. Royalty rates are not necessarily appropriate or stable. The overall fiscal regime is not competitive. These special issues are in addition to the general administrative issues that beset the industry.

### **Recommendations for promoting FDI in herbal products**

It is recommended that Nepal develop an Industry Promotion Package in order to grasp the opportunities for FDI offered by the fast-growing herbal products industry. The following elements should be contained in the package:

#### **(a) Access to a nucleus estate**

Case-by-case relief should be given to ceilings on individual land ownership so as to enable investors to acquire suitable parcels of land to cultivate plant species on a commercial scale. This is important in order to ensure that investors have adequate and reliable supplies of raw material. Estate production will supplement smallholder supplies so as to achieve a scale of manufacturing that justifies product and brand development.

#### **(b) Formulation of a herbal products investment certificate**

This certificate should be offered to investors proposing significant investment in processing facilities for export production, estate development and backward linkages with smallholders. It should contain the following:

- (i) A special fiscal regime in which plant royalties are set at reasonable and stable levels, income tax is highly competitive and key imported capital equipment and supplies enter free of duty. There should be additional deductions for R&D expenditure and for extension services provided free to smallholder growers.

- (ii) Similar rights in relation to tax and customs administration, work and residence permits, relief from certain aspects of labour law and special foreign investor rights as set out for the tourism development certificate. To facilitate customs clearance, holders of this certificate could also opt to establish processing facilities within an export-processing zone or export-oriented unit of the type recommended for export manufacturing.

This certificate would form an agreement between the Government and the investor. Thus a breach of its terms would enable either party to resolve disputes according to agreed provisions, including by recourse to international arbitration. The fiscal terms would be stabilized for a substantial period. Current investor experience has been that royalties have risen sharply after an investment has been made. One investor reports that the royalty for collection of *Taxus Baccata* leaves was the equivalent of about 1 cent (US) per kilogram when the project was initiated. When the project investment was completed the royalty jumped suddenly to around 30 cents per kilogram. The certificate would also rule out the imposition of significant new taxes such as export taxes.

It would be helpful for the Government to prepare a model development certificate, including a careful exposition of appropriate tax and royalty terms. As far as possible the fiscal terms should be the same for all investors, although some flexibility may be warranted as the industry is new and each investor could have a unique set of products.

## **D. FDI potential in the medium term**

### **1. Hydropower for the Indian and domestic market**

Nepal has some of the world's largest potential for hydropower generation. The country has an estimated 83,000 megawatts (MW) of hydroelectric potential, with 66 projects consisting of 44,000 MW having been identified as potentially economically viable. However, Nepal currently generates approximately 528 MW only.

The Nepalese Government promulgated the Hydropower Development Policy and the corresponding Electricity Act in 1992 to enhance the development of this rich resource. This has had some success in attracting private investment in power generation, including two large foreign investments. Power from private generation facilities now supplies 23 per cent of Nepal's total capacity. The recently revised Hydropower Policy now allows private sector entry into the full range of power sector activities — generation, transmission and distribution — with the objective of facilitating improved access to underserved areas. However, it appears that the parastatal Nepal Electricity Authority (NEA), which currently monopolizes transmission and distribution, will not be privatized. Instead its generation, transmission and distribution businesses will be "internally unbundled" and required to operate on a fully commercial basis.

There have been substantial and continuing efforts to create an appropriate regulatory framework and investment conditions to facilitate private investment in this industry.

Private investment is sorely needed to harness hydropower and would be useful in improving transmission and providing storage solutions. For example, in order to serve even domestic users, an estimated generation investment of \$1.8 billion is required by 2010. In

contrast, the Nepal Electricity Authority (NEA) spent a total of only \$730 million during 1991–1998, out of which \$490 million were loans.<sup>17</sup>

The Nepal Electricity Authority (NEA) is neither efficient nor sufficiently creditworthy to obtain private sector financing. By fiscal year 1999, its return on investment was only 0.3 per cent. NEA also has conflicting roles as a buyer of power and as a joint-venture partner in power generation.

The first step would be a possible reorganizing of the NEA, perhaps creating independent organizations for handling different functions, thus making private participation possible.

There is potential in the medium term in attracting FDI in power supply to India. Nepal does not necessarily have a generation cost advantage over Indian power producers. Hydropower development costs are higher because the mountains in Nepal are young and therefore lack hard rock.

Power export to India has its own problems. Most of the State electricity boards (SEBs) in India have financial problems and are not creditworthy. Power in eastern India is cheaper because of the abundant supply of coal. In an ideal situation, Nepal should be synchronized to the Indian grid and its system developed as part of the Northern and Eastern Indian regional power pools. That would pave the way for efficient development of Nepal's hydropower. This would reduce the cost of power because complementarity in seasonal production could be exploited. If that happens, it will be at some time in the future.

Nevertheless, Nepal has some advantages that India does not have. Being a small country, it does not have problems such as a complex centre-State relationship, inter-state water disputes and problems with resettlement of population. In the medium term, scope for the development of medium size (10–50 MW) hydropower generation facilities could emerge.

There are also encouraging developments on the Indian side. At least in some SEBs there are moves to reorganize and become more efficient. The establishment of the Central Electricity Regulatory Commission and the Power Trading Corporation will facilitate long-term marketing of power to India. However, rationalization of the Indian industry should also increase efficiency in the generation side of the industry.

Prospects will also depend on a change of attitude in Nepal. In Nepal, exploitation of water resources requires approval by a two-thirds majority in the Parliament. A recent power trading agreement with India still awaits Parliament's approval.

For these reasons further FDI in the Nepal hydropower generation industry – especially for the Indian market – can be rated as having potential only in the medium term.

## **2. Agro-based industries**

Agro-based industries are leading forces in Nepal's manufacturing sector, and are thus promoted as potential opportunities for foreign investment. With much of the country's GDP and labour force tied into agriculture, its prosperity is a major determinant of economic growth. Foreign investment could be pivotal in this process.

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<sup>17</sup> World Bank, Nepal Proposed Power Sector Development Strategy (March, 2001).

Nepal has potential for producing vegetable and flower seeds. It also has an ideal climate for cut flowers, strawberries, mushrooms and other crops.

This potential can be realised if (a) there are adequate transport facilities such as economical air linkages and (b) government policies that obstruct investment are removed. For example, the Government has conflicting roles as a regulator and as an owner of business in this sector as evidenced by ad hoc high import duties and quotas to protect SOEs. Another barrier is statutory price fixing for agriculture inputs in the food and beverage subsector above the market prices in order to support farmers. The current land law, which discourages large-scale cultivation, is also an impediment.

A clear role for FDI could emerge only after a fundamental liberalization of current agricultural policy.

### **3. Privatization**

Nepal's privatization programme officially began in the late 1980s, but not in earnest until the early to mid-1990s. As of early 2002, 16 SOEs had been privatized, but none since 1997.

The privatization programme is a non-starter at present and there is therefore little point in pursuing it in the present form. Many of the SOEs are either running at a loss or already defunct. A good number of the SOEs are overstaffed, and because of Nepal's strict labour laws, buyers before 1998 were obliged to take on all the existing staff. This requirement was changed in 1998, but the strong labour unions and other pressures on employers make it difficult for staff changes to be implemented by the new owners. Also, the existing workers must continue to receive at least the same level of benefits as they did before privatization.

The Government is reluctant to privatize SOEs that are profit-making and thus bringing revenue to the Government. For example, the three public utilities the Nepal Drinking Water Corporation, the Nepal Electricity Authority (NEA) and the Nepal Telecommunication Corporation (NTC) – are supposed to be privatized in due course. The Electricity Authority and the Telecommunication Corporation could appeal to investors. However, no steps have so far been taken in this direction. Ironically, these utilities are in need of an infusion of private capital and newer technology. The fact that NTC is effectively a government corporation means that it has only limited access to external financing. The lack of a strategic partner, even in the mobile field, has delayed the introduction of modern management techniques.<sup>18</sup> The case of NEA is similar.

In comparison, in the deregulated airline industry, there are 17 domestic airlines competing with Royal Nepal Airlines Corporation. The new airlines have succeeded in increasing domestic air travel by 400 per cent since the early 1990s. This example shows that private sector participation, under proper regulations, can work in Nepal.

Apart from the utilities, some privatization candidates may have high- volume/sheltered markets or established brands, which could attract FDI. In the light of these factors, the following

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<sup>18</sup> International Telecommunication Union, 2000.



SOEs appear to have the most potential for attracting foreign investors and could be prioritized for privatization:

- Hetauda Cement Industry Ltd.;
- Udayapur Cement Industry Ltd.;
- Royal Nepal Airlines Corporation;
- Rastriya Banjiya Bank;
- Dairy Development Corporation.

Unless there is a serious change of heart on the part of the Government in pursuing privatization and making crucial changes in the way that privatization is carried out, there is little scope for private capital (and FDI) to participate. The poor general investment climate also reduces the appeal of privatization to major investors and will be reflected in acquisition prices offered. Privatization thus should not be emphasized in FDI strategy until the medium term.

## **E. FDI potential in the long term**

### **1. ICT-based services**

At present the FDI potential in this sector is near zero. However, the presence of a low-wage trainable labour force and widespread use of the English language point to the possibility that this sector can be developed, with the adoption of farsighted policies. Personal computer ownership and Internet usage have grown quickly but are still modest. Nepal should be realistic about the limitations in this sector. With a large pool of engineers and technology institutions, India is a giant in the field of software development and offers stiff competition. Back-office processing, medical transcripts processing, insurance claims processing and so forth may offer initial potential. A more likely possibility is subcontracting with Indian firms once these firms gradually change their focus to high-value-added services in IT (see box III.6).

In order to achieve longer-term potential in the more knowledge-based areas of the IT sector, plans should be considered even now to give subjects such as science, engineering and technology greater prominence in Nepal's education system.

### **2. Regional services**

Nepal has the opportunity in the long run to be an offshore services centre for regional countries, especially India. These services could include offshore financial services for Indian residents and location of basic business and professional and back-office services focused on regional markets. Nepal's core attributes are a temperate climate, low wage costs, a smaller and more accessible bureaucracy, and an attractive expatriate lifestyle.

This is not an impossible goal. But there are serious challenges to be overcome and potential threats to this opportunity. These include:

- The need to create a superb investment framework. The reforms that are recommended in this report would be a necessary but not sufficient step. Best practices which are distinctively best in the region would be needed (e.g. the abolition of foreign exchange controls) plus

substantially improved bureaucratic practices and probably the creation of specific fiscal and sometimes regulatory regimes (e.g. for offshore financial services).

- The provision of much higher standard infrastructure and utilities and human resources (Nepal now lags behind on these importance determinants of investment potential, as shown in annex III).
- Regional competitors target the same opportunity and advance more quickly – the most likely is Sri Lanka, which also benefits from a trade agreement with India.
- India and other larger regional countries might liberalize financial and business regulations and cut red tape to reduce the motivation for offshore location of services.

#### **Box III.6. The phenomenal growth of the IT sector in India**

Back-office operations are the biggest growth sector in India in recent years. Such mundane business transactions as customer inquiries, credit card inquiries, invoicing, day-to-day accounting transactions, billing, medical transcription and insurance claims processing are now increasingly being relocated to various “call centres” in India. For example, a customer of J.C. Penney in Philadelphia calling the store to increase his credit limit will be answered by a trained operator in New Delhi. The customer probably never realises that he is talking to an operator continents away.

This sector has registered a growth of over 70 per cent in the past year. Currently, it provides employment for about 110,000 people and accounts for a tax revenue of \$1.47 billion. These figures are expected to reach 2,000,000 and \$24 billion respectively by 2008.

Some of the big names among the Fortune 500 companies that are relocating to India are General Electric, American Express, British Airways, HSBC, Citibank and AT&T. In addition to back-office operations, software development is another sector with great promise. Microsoft Corporation is already a big player in India.

There are many reasons for this phenomenal growth. The main reason is the savings in operational costs. For example, salaries for staff of comparable skills are almost 80 per cent cheaper in India while operational efficiency is higher. A yearly production of two million plus college graduates who speak fluent English is another attraction. Last but not least is the Indian legal system, which is similar to the British system. These advantages far outweigh the current deficiencies in infrastructure.

*Source: India Today, 15 November 2002.*

## **F. Implementation of the recommended FDI strategy**

The institutional implications of the proposed strategy are clear-cut:

- A new investment agency is needed with a twofold mandate to lead reforms of the investment framework and to prepare investment promotion packages to stimulate an immediate increase in FDI.
- The Privatisation Cell should be transferred to the new investment agency and refocused primarily on the selective promotion of *new* investment.

A new institution – an Investment Agency - is needed to propel the proposed FDI strategy. It must be created with a mandate quite unlike that of a typical investment promotion agency. First, it should have a strong policy mandate and skills. It would need to work vigorously with many ministries because the scope and extent of reforms needed to create a good investment framework are large. Secondly, it should not be an investment promotion agency. It should be skilled in preparing investment promotion packages in selected high-potential areas. This is where the skills of the Privatisation Cell are best redeployed. Actual investment promotion should remain with existing agencies. The Investment Agency should, however, have delegated powers to sign investment agreements that incorporate the terms and conditions in the Investment Promotion Packages and the project commitments of investors. Thirdly, it should not be an investment facilitator. This function should remain with the Single Window facility of the Department of Industries. Finally, and less unusually, it should be accorded sufficient status to be able to report across ministry lines to the highest levels of the Government.

The Investment Agency should be a secretariat of senior civil servants which reports at a high political level. Where the secretariat is housed (i.e. to which Department it is attached) and its exact lines of reporting should be developed by the Government if it accepts the recommendation in principle. The IPB may be a suitable reporting vehicle. The Investment Agency should be staffed by nominees from the civil service and supported by outside advisers as required. If it is successful it should work itself out of a job in three years and the nominees would return to their home departments.

The Investment Agency should involve the private sector in the formation of task forces to push through its work. The participation of committed private sector representatives (both national and foreign investors) will help ensure that recommendations are practical and well focused. There should be task forces for reform of tax policy and administration, for modernization of the labour law, for reform of foreign investment law and for the development of each of the proposed Industry Promotion Packages. The labour movement should also be involved in the task force charged with recommending a modernization of labour law. Box III.7 outlines the suggested mandate of the proposed Investment Agency.

It is emphasized that it is *not* proposed to create a typical investment promotion agency or board of investment as is common in most countries. The typical form of investment agency, which has extensive powers to promote and facilitate investment and to create special conditions for its clients, tends to thrive in a poor investment framework. It can too easily lose sight of the primary goal of creating a better climate for *all* investors.

## **G. Summary of the recommended FDI strategy**

Serious weaknesses in the investment framework dictate that Nepal's FDI strategy must focus on near-term tax, regulatory and administrative reforms. These reforms will take at least three years of committed effort. Meanwhile there is potential to attract more FDI in the short term only if the opportunities are presented to investors via the development of special investment conditions in selected sectors of high potential.

The opportunities and challenges of a 20-year vision are visible. But it is not yet appropriate to focus FDI strategy on a long-term vision. Government capacity would be fully absorbed by the twin challenges of improving the investment framework and attracting increased FDI in carefully structured situations.

**Box III.7. Mandate of the proposed Investment Agency**

1. Develop a road map of reforms of the investment framework and oversee and contribute to their implementation. Integrate the road map with the National Plan. Specific tasks will include:
  - (a) Identify and prioritize reforms and obtain government approval to initiate reforms;
  - (b) Undertake direct responsibility for preparing reforms of the Foreign Investment and Technology Transfer Act.
  - (c) Help ministries to undertake policy reforms by contributing to policy development and helping them to obtain expert advice as required.
  - (d) Monitor organizational reforms in key compliance and permitting agencies.
  - (e) Ensure that stakeholders are consulted on the reforms.
  - (f) Monitor and report progress of all reforms.
2. Develop and execute industry promotion packages in areas of high short-term potential. Specific tasks and powers will include:
  - (a) Prepare the industry promotion packages as recommended.
  - (b) Solicit, structure and facilitate investment in these areas.
  - (c) Execute investment agreements in accordance with approved model formats.
  - (d) Implement feasible privatization prospects.

It is recommended that the FDI strategy consist in:

1. Mounting a serious campaign to improve the investment framework to a standard of at least "best in the region". This will take a minimum of three years to bear fruit.
2. Creating Industry Promotion Packages to attract additional FDI quickly in areas of immediate potential for Nepal:
  - Tourism, especially in niche markets;
  - Export manufacturing, with special attention to the vast market available under the trade treaty with India; and
  - Herbal products.
3. De-emphasizing privatization for so long as these "old" investment opportunities come with the accumulated baggage of a poor investment framework. Exceptions should still be pursued.
4. Establishing a special type of investment agency to accomplish the following:
  - Monitoring of the implementation of this strategy through the National Plan;
  - Revisiting the shape of a long-term FDI strategy once element 1 is achieved. Such a strategy would lay the groundwork for diversifying FDI into services for regional and perhaps international markets.



## IV. MAIN FINDINGS AND RECOMMENDATIONS

Inflows of FDI into Nepal 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 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 per cent 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 picked up 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 sectors 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 FDI potential.

Political instability means that Nepal presents mainstream 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.

### 1. **Attack the key obstacle: The investment framework**

Major steps required, in order of priority, are:

- *Liberalize the foreign investment law*<sup>19</sup>
  - o Relax entry restrictions, especially in services;
  - o Abolish FDI screening except for negative list proposals;
  - o Regulate foreign technology transfer and foreign loan issues elsewhere – in tax and foreign exchange law;
  - o Improve foreign investor treatment and protection provisions, and remove the local arbitration restrictions; and
  - o Conclude a bilateral investment treaty with India.

<sup>19</sup> Foreign Investment and Technology Transfer Act, 1992.

- *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; and
  - Commit to reasonable stability in tax policy (and reinforce this with a contractual stability component in Industry Promotion Packages – see below).
  
- *Modernize labour regulation*
  - Adopt modern hire and fire provisions to aid investment and employment and reduce government intrusion in setting conditions of employment at economy and firm levels;
  - Introduce independent industrial dispute resolution mechanisms;
  - Abolish the burdensome employee housing set-aside; and
  - Reduce the mandatory labour bonus or make it consensual.
  
- *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;
- 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 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 actors that enhance the competitiveness of business and facilitate higher-value-added activities.

## Annex I

### FDI AND TRADE DATA

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

Sector	Number of enterprises	Total fixed investment	Foreign investment	Number of employees
		(\$ million)		
Agriculture	12	4.19	1.19	842
Manufacturing	351	319.55	116.45	55 442
Tourism	167	196.52	56.43	13 638
Services	150	123.61	56.00	9 470
Others	18	221.20	38.56	6 098
<b>Total</b>	<b>698</b>	<b>865.07</b>	<b>268.63</b>	<b>85 490</b>

Source: Department of Industries, Government of Nepal.

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

Country	Number of enterprises	Foreign investment (\$ million)	Number of employees
India	244	96.15	34 208
USA	72	45.88	6 909
China	54	29.34	6 628
British Virgin Islands	4	17.12	1 210
Norway	5	13.12	150
Japan	73	11.35	4 677
Republic of Korea	27	9.54	2 423
Others (include 32 countries/territories)	219	46.13	29 285
<b>Total</b>	<b>698</b>	<b>268.63</b>	<b>85 490</b>

Source: Department of Industries, Government of Nepal.



**Table 3. Major commodities exported from Nepal (\$ millions)**

	1997/98	1998/99	1999/00
<b>To India</b>	<b>105.47</b>	<b>127.24</b>	<b>203.10</b>
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
<b>To other countries</b>	<b>297.23</b>	<b>321.08</b>	<b>397.90</b>
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.

## **Annex II**

### **CRITERIA FOR TAX MODELLING**

Figure II.1 compares taxation on investment in several sectors in Nepal with taxation in selected other countries – neighbours and countries elsewhere that have succeeded in attracting FDI to the sectors concerned. These comparisons enable Nepal to assess the competitiveness of its taxation.

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 a 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 hypothetical 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.

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 per cent 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 cent 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.

## Annex III

### NEPAL'S WEAKNESS IN INFRASTRUCTURE AND SERVICES

#### 1. Infrastructure

Nepal's infrastructure is among the least developed in Asia, with most of it concentrated in the 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 per cent of the population has access to electricity, and other public works such as sanitation (only 6 per cent 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 per cent of the budget is for recurrent spending on infrastructure, which means little maintenance for the existing infrastructure and a loss in asset value (Nepal Government, *Nepal Country Paper*, 2001).

##### (a) 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. Eighty-eight per cent of Nepal's Strategic Road Network is situated in the hill regions (Nepal Government, *Nepal Country Paper*, 2001).

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.

##### (b) 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.

##### (c) 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 (Nepal Government, *Nepal Country Paper*, 2001).

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 a 1998 World Bank report (*Attracting Foreign Direct Investment to Nepal's Infrastructure*), the Government tends to rely heavily on investor initiatives for infrastructure development. Private sector initiatives in infrastructure are certainly welcomed, but the Government relies almost exclusively on such outside initiatives.

## **2. Weak financial sector and small capital market**

Despite the growth in the number of financial institutions over the past decade, all is not 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 (UNIDO, *Vision 2020*, 2002). The two large, State-owned banks are saddled with bad loans, and many small banks are having difficulties with their balance sheets.

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 per cent 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.

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 per cent of a 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, as noted in chapter I, are virtually absent in Nepal.

## **3. 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 per cent (52 per cent for men and 24 per cent for women) (ADB, *Country Strategy and Program Update: Nepal*, 2001).

Nepal's workforce generally lacks skill 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.

#### **4. Electricity**

Only 20 per cent of the population is currently supplied with electricity, centred mainly in metropolitan areas. The Government 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 entry into the full range of power sector activities — generation, transmission and 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.

#### **5. Telecommunications**

Telephone installation is far short of 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. There are about 13,000 mobile telephone subscribers currently.



## Annex IV

### SURVEY OF INVESTOR PERCEPTIONS

#### Introduction

In the second half of 2002, UNCTAD and UNDP conducted a survey of foreign affiliates in Nepal to identify key investment determinants, and the strengths and weaknesses of the country's business environment, as perceived by foreign investors operating in Nepal. The survey was based on a mailed questionnaire and interviews with 35 foreign affiliates, primarily in the manufacturing and services sectors. The response rate was around 70 per cent.

Few of the survey respondents were significant exporters, and hence the survey results reflect for the most part the views of foreign investors that deal with the domestic market. Therefore, the view that most investors relocate to Nepal to serve the domestic market has to be considered in that perspective.

#### 1. Profile of surveyed companies

Manufacturing firms accounted for seven of the 35 respondents. Two were garment manufacturers, the larger of which employed as many as 2,500 people; and the others included manufacturers of paint, electronic components, and steel products such as pipes and roofing sheets. Retail trade, focusing on food, beverages and cigarettes, accounted for another seven firms, and construction and power firms accounted for five respondents. Services firms included four in banking and finance, two in tourism, and the remainder in transport, consultancy, security and advertising. Another two services firms specialized in computing and IT skills. One sector that stands out in Nepal as compared with other countries is that producing herbal products, including herbal teas, soaps and ayurvedic products. These accounted for four firms.

The firms included eight from India, four each from Japan and the United States, and two from the United Kingdom. Other countries or territories cited included Bermuda, Denmark, France, Germany, Hong Kong (China), Italy, Pakistan, the Republic of Korea, Singapore, Thailand and the United Arab Emirates.

**Table A.1 Ownership structure of respondents**

Percentage foreign ownership	Number of firms
> 67 per cent	18
50–66 per cent	10
21–49 per cent	5
<20 per cent	2
<i>Total number of respondent firms</i>	<b>35</b>

Most firms were small, with the majority employing fewer than 100 people, and almost one third employing fewer than 50 people. (The Indian-owned firms in particular tended to be small, with the exception of one herbal products firm that employed 700 people). There were, however, one or two large firms in the sample, including a garment manufacturer that employed 2,500 people and a European-owned security firm employing 3,000. Of the 33 firms that provided information about employment numbers, manufacturing accounted for 39 per cent of total employment, services for 34 per cent (rising to 42 per cent when including banking and



finance), retail for 7 per cent and herbal products for almost 9 per cent. Firms in the construction sector, which would normally be expected to employ large numbers of people, did not provide information on this question.

The majority of firms planned to increase production over the next three to four years, but two firms planned no increase, two planned to decrease production, and one firm planned to pull out completely from Nepal. The three firms planning either to decrease production or to exit accounted for as much as 5 per cent of the total number of jobs provided by the surveyed affiliates, a significant proportion.

## **2. Imports and exports**

### **(a) Imports**

The firms surveyed imported on average around 40 per cent of their inputs, although this varied greatly within firms with some importing more than 90 per cent (mostly manufacturing and retail firms) and some not importing at all. Of the firms importing input materials, most (12) had not changed the percentage of imported inputs over the last five years, while 9 had increased their imports. Only two firms imported fewer inputs than before, and only 12 firms had stepped up their use of inputs purchased from local suppliers; this suggests that there is untapped potential for local suppliers to service the needs of affiliate firms.

### **(b) Exports**

Only 13 of the surveyed firms were exporters. These were for the most part manufacturing firms and producers of herbal products, although two services firms (producers of computer and IT services) were also exporters. Markets were primarily Europe, North America and Japan, and these firms tended to export 100 per cent of their production. A few firms served Indian and regional markets: with the exception of one herbal products exporter, all were small in terms of both employee numbers and revenue.

## **3. Reasons for investing in Nepal**

Firms were asked to rank the degree to which various factors had influenced their decision to invest in Nepal. Unsurprisingly, the most important factors (on average) included investment profitability; the ability to repatriate capital and earnings; transfer of technology; and economic stability. More interestingly, the next most important factors were, in decreasing order of importance, political stability; the regulatory and legal framework for FDI; growth of the local market; the low cost of doing business; the low cost of skilled labour; the size of local markets; and the low cost of unskilled labour.

The high degree of importance attributed to the size and growth of the local market was initially surprising, given the expectation that foreign affiliates would target regional and global, rather than local, markets. However, it is explained by the fact that very few respondents were exporters. Twenty firms claimed that the *size* of the local market was either "important" or "very important"; and 22 firms cited a similar ranking for its *growth*. One of these firms was in tourism while the others were involved in construction, finance and banking, consumer goods such as soft drinks and biscuits, and paint manufacture.

#### **4. Difficulties in the business environment in Nepal**

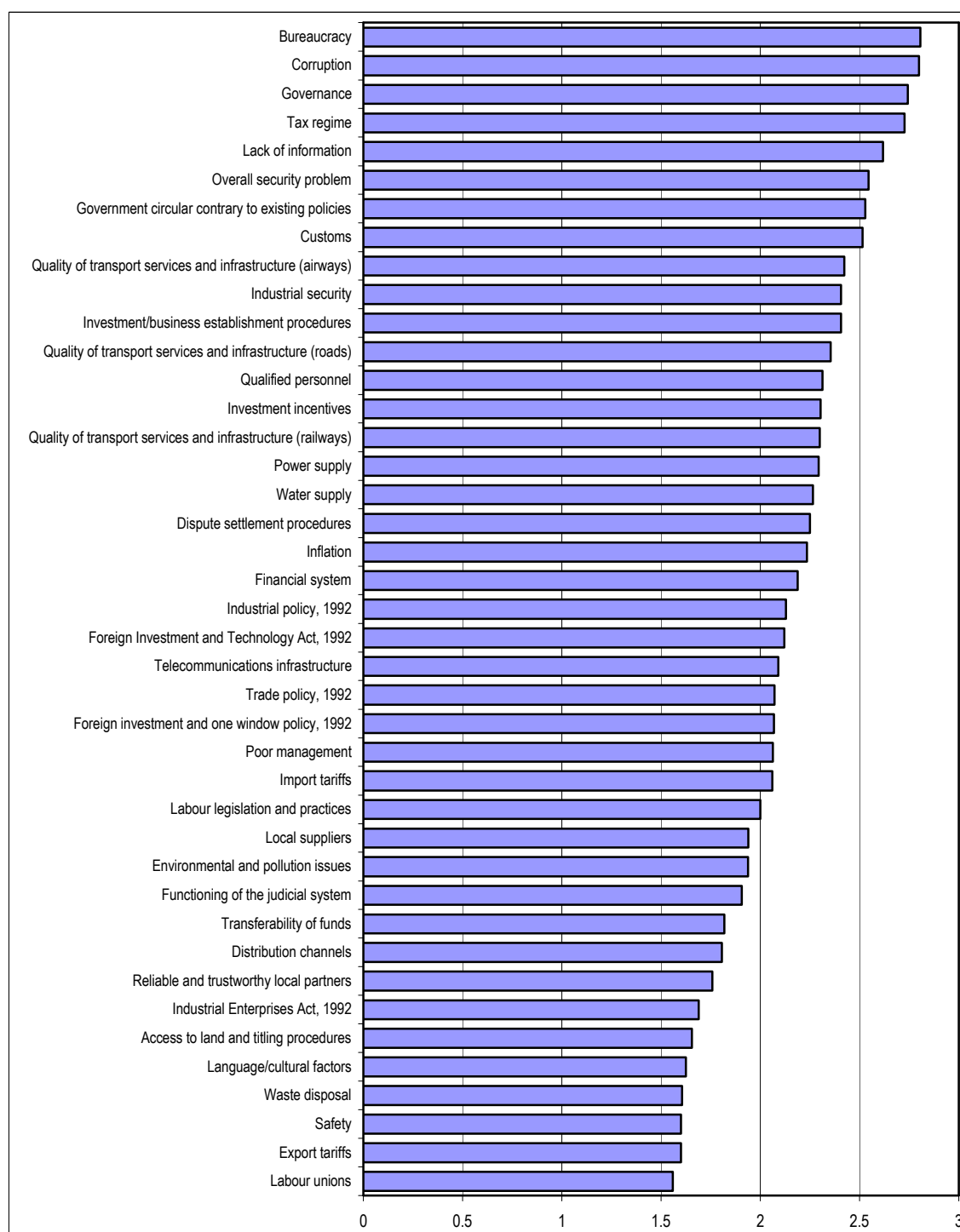
Survey respondents were asked to rank areas in which they encountered problems in their daily business operations, on a score from 1 ("never") to 4 ("almost always"). A clear pattern emerged, with the three most critical problems perceived to be Nepal's bureaucracy, its levels of corruption and its poor governance. These three features were ranked on average close to 3, or "frequently a problem" (figure A.1). The highest scores, in descending order, were bureaucracy (2.81), corruption (2.8) and governance (2.74.) Nepal's telecommunications infrastructure was considered to be the fourth worst problem, earning a mean ranking of 2.73. There were also low standard deviations to these responses, indicating uniformity of opinion amongst the various firms, despite their different sizes and natures, and their different markets.

The mean value of responses gives an idea of the degree of importance attributed to the various difficulties cited in the questionnaire. Additional insight can be gained from the frequencies with which particular problems were cited, as shown in figure A.2. Twenty-five of the 36 respondent firms considered that bureaucracy was "frequently" or "almost always" a problem, while 23 firms indicated that corruption and governance were "frequently" or "almost always" a problem. The fourth most frequently cited problem was Nepal's telecommunications infrastructure, with 21 firms ranking this above 3 or 4.

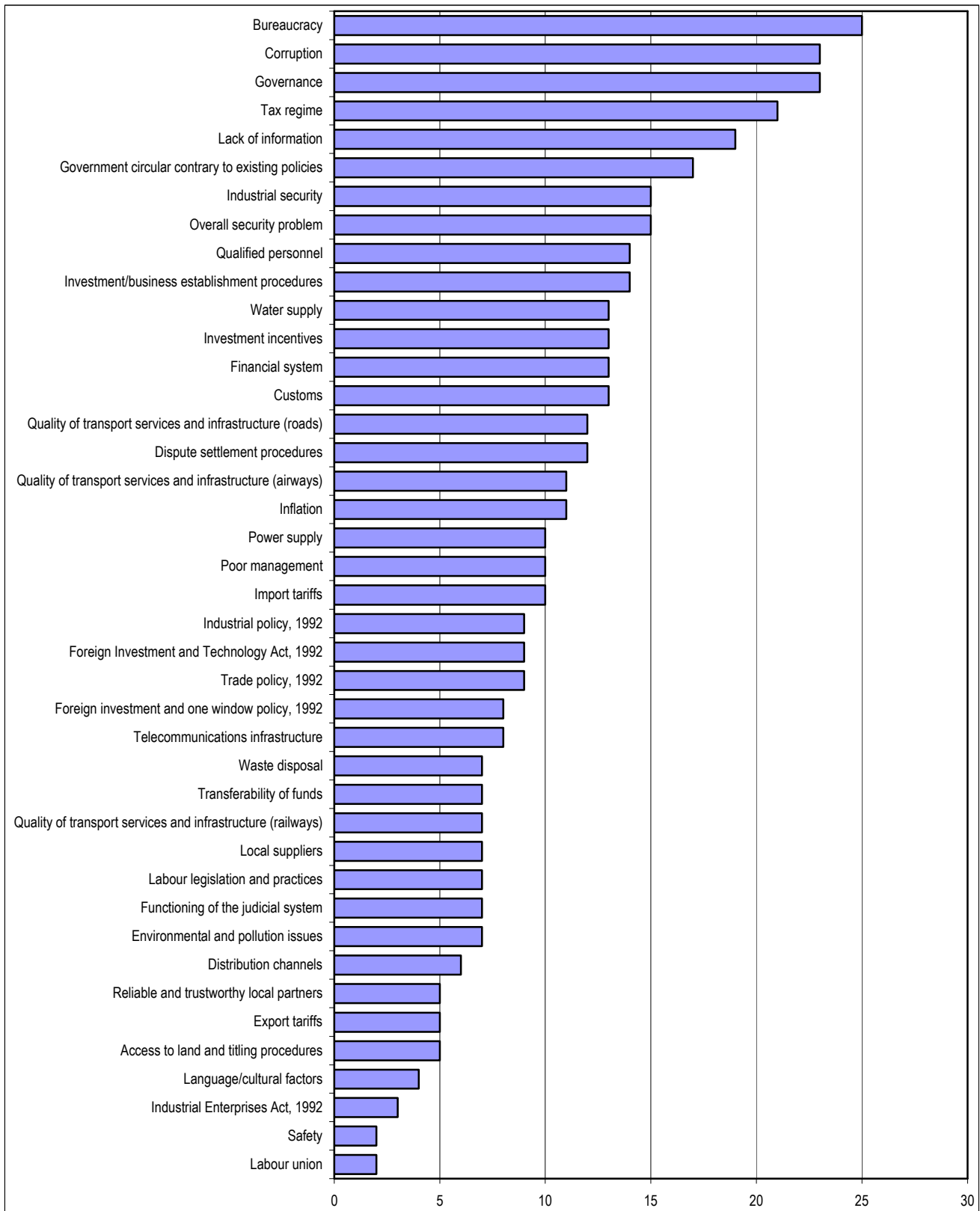
#### **5. Information and support institutions**

Most of the institutions providing information and support to foreign investors in Nepal were described as being moderately effective (figure A.3). None were considered on average to be "effective" or "very effective". There was, however, some variance at the level of the individual firm, where a small number of respondents (around 10) said they found business consultancy firms (including law firms), the Federation of Nepal Chamber of Commerce and Industries (FNCCI), the Chamber of Commerce and Industries, and the Ministry of Finance to be "effective". As many as 10 firms found that the Investment Promotion Board and the SAARC Chamber of Commerce and Industries were "not effective."

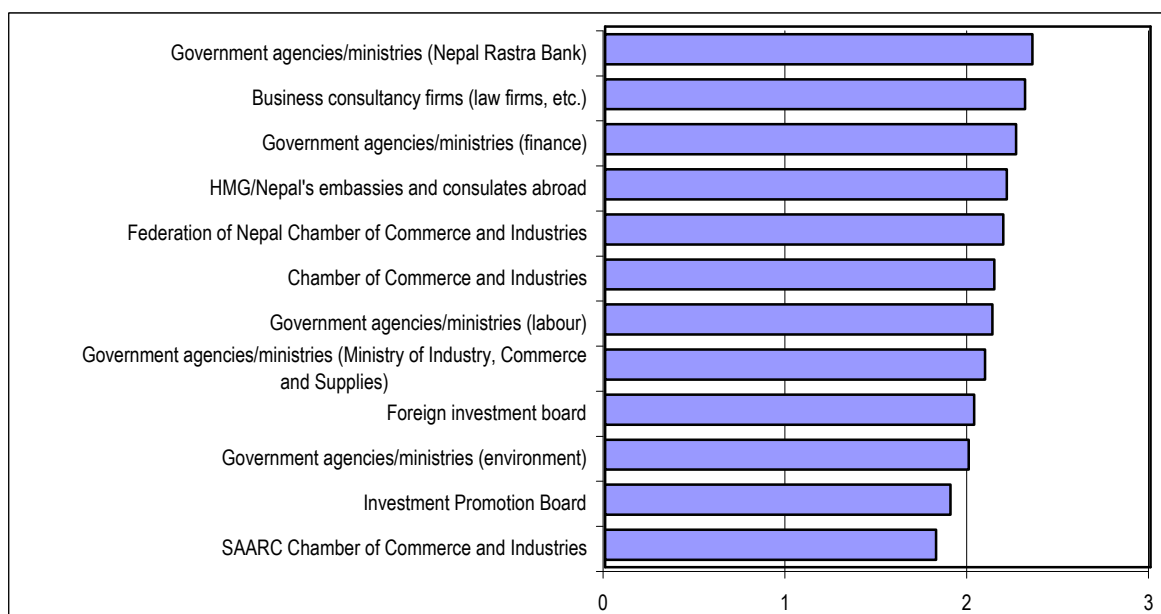
**Figure A.1 Mean rankings of areas in which foreign companies encounter difficulties in their daily business operation**



**Figure A.2 Number of companies which "frequently" or "almost always" encounter difficulties in their daily business operations**



**Figure A.3 Mean rankings for effectiveness of institutions providing Information and support to foreign affiliates in Nepal**

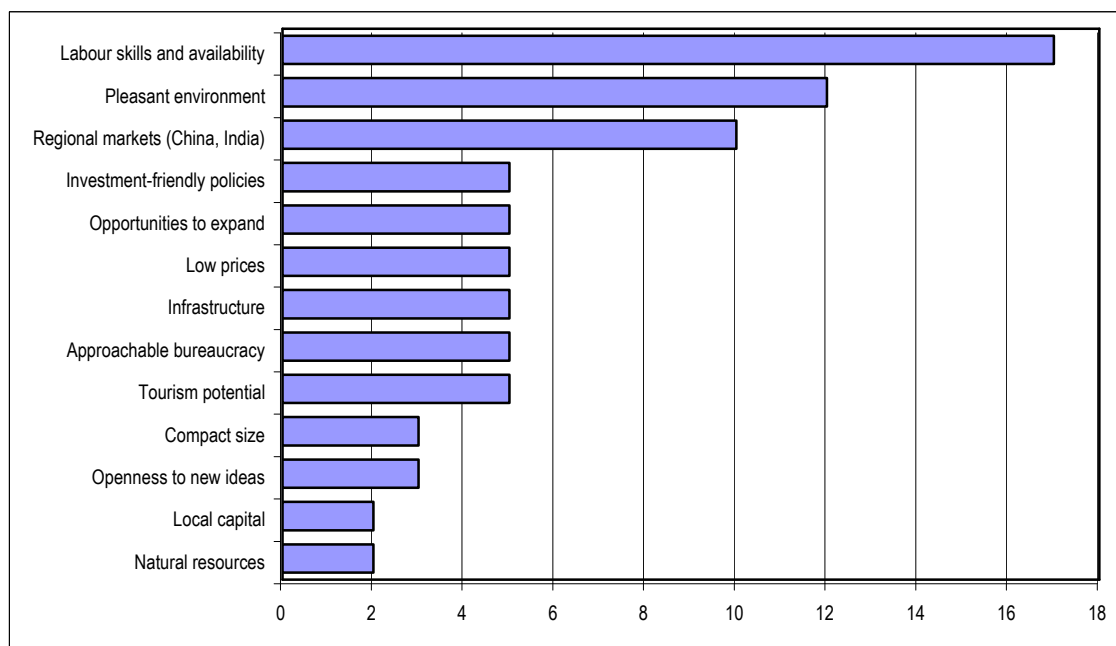


## 6. Strengths and weaknesses of the business environment

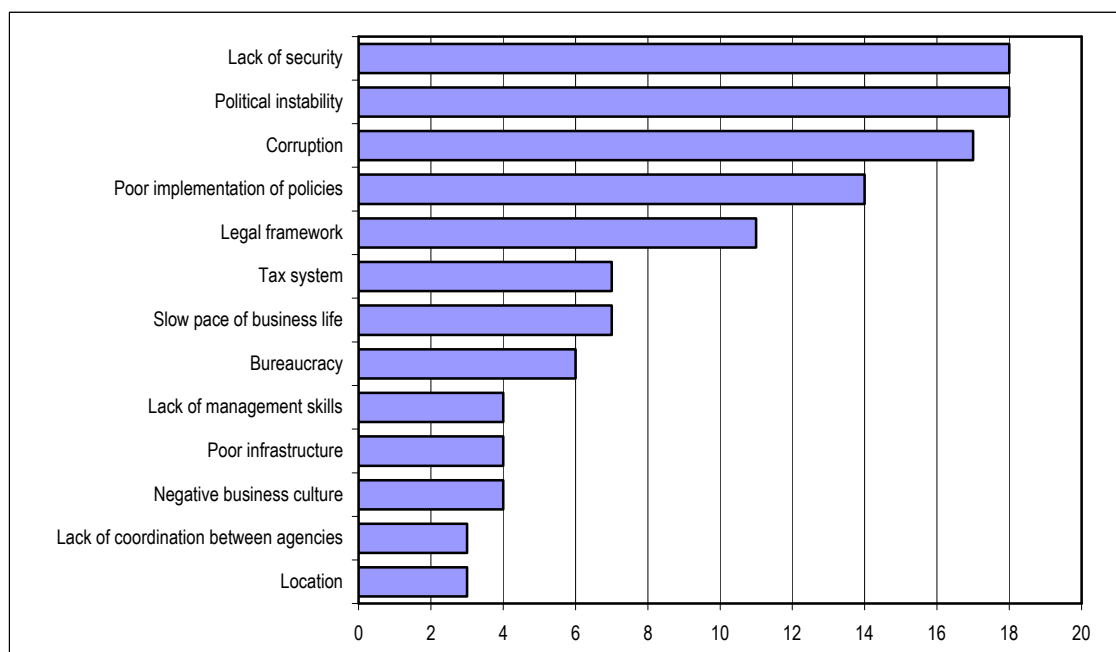
Firms were asked to describe, in their own words, the five strongest elements of Nepal's business environment. This open-ended form of question has the benefit of allowing firms to answer spontaneously rather than choosing amongst suggested responses. The most frequently cited strength was Nepal's labour force, its availability, skills, and relatively low price being mentioned by 17 firms. The second most frequently cited strength was less tangible, relating to the quality of life in Nepal. Twelve firms mentioned Nepal's beauty and comfortable climate, and the friendliness of its people (with another four firms praising the Nepalese entrepreneurial spirit, and openness to new ideas). Interestingly, the third most frequently mentioned theme was that of access to regional markets, in particular India and China, even though this had not been ranked highly when it appeared in earlier questions. Finally, Nepal's government policies, including investment-friendly laws, the opportunities it presented to firms wanting to expand, and its approachable bureaucracy were all in turn cited by at least five firms (see figure A.4).

There was less variety in the firms' descriptions of Nepal's weaknesses (figure A.5), with a large number of firms giving very similar responses when asked to identify, in their own words, the five weakest elements of Nepal's business environment. Political instability was mentioned by 18 firms, as was the lack of security (both industrial and personal). Another 17 firms complained of corruption, while 14 firms blamed the Government for lack of clear policy guidelines and for poor implementation of policy. Nepal's legal framework was criticized by 11 firms, with specific examples including Nepal's labour laws, its lack of intellectual property rights legislation and unsystematic application of law. The tax framework was criticized by seven firms, as was Nepal's slow pace of doing business.

**Figure A.4** Frequency of five strongest elements of Nepal's business environment (self-reported)



**Figure A.5** Frequency of five weakest elements of Nepal's business environment (self-reported)



## **7. Suggested policy improvements**

When asked what measures the Government could take in support of business and investment, the following were among the responses:

- More friendly FDI policy;
- Less restrictive work/residence permits;
- Stop corruption;
- Make the privatization programme work and should not have a stop-start approach;
- Investors' rights should be the same for Nepali and for foreign companies;
- Grant equality and recognition to foreign investors. We are not untouchables;
- Education should be more skills- and jobs-focused;
- Simplify investment and business establishment procedures;
- Establish free zones for industry;
- Simplify customs procedure;
- The tax regime should be more transparent.

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*China: WTO Accession and Growing FDI Flows.* 24 p. Free of charge. Available at:

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