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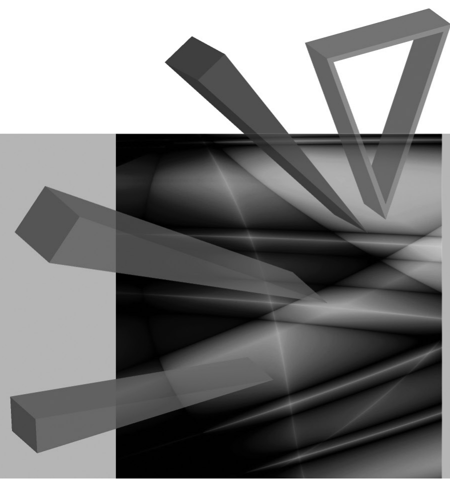

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FOREIGN DIRECT INVESTMENTS IN NEPAL. STRATEGY AND PROMOTION

Summary: The structure of an effective industry promotion package is outlined. It is based on industrial estates (with a 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: (1) involvement of private industrial estate development so that estate developers have a natural incentive to promote their facilities and attract investors; and (2) enabling private developers of industrial estates to enhance their offers to manufacturing investors by: (a) permitting a partial private operation of telecommunications and other facilities so as to improve quality; and (b) offering an attractive package of incentives to manufacturing investors who find location in these industrial estates.

Keywords: tourism, FDI, export, manufacturing joint venture, Nepal, India, Japan.

1. Introduction

Nepal has the potential to attract far more FDIs. Compared with the majority of other very poor countries, it has a surprisingly long list of advantages. These include a large and well-disposed neighboring 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 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 required reforms are not just policies but also 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. Their creation will entail the formulation of Industry Promotion Packages. Thus, Nepal should adopt a deliberately myopic strategy for FDI.[1]

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 as well absorb some existing agencies. However, it should also have the ability to structure selected FDI opportunities.

The further discussion will conclude with the three themes of Nepal's FDI strategy:

– immediate and high-level start of 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.

2. Overview of FDI potential and constraints

Figure 1 shows in a 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 inner circle represents the possibilities given by the current framework plus (as represented by the bubble) the conditions created by special opportunities. It will be appreciated that the current small inflows of FDI (see Figure 1) constitute the inner circle – created by the existing dysfunctional framework plus special conditions created for FDI in electricity generation.

The key proportion is the small relative size of the innermost circle, which reflects the severity of the existing constraints but also 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). Conversely, a strategy for Nepal, which focused on expanding the outer circle, would have little payoff unless the inside circles expanded in a commensurate fashion. Such a strategic focus is more relevant in a country that is optimising its inflows of FDI and

[1] T. Sporek, The foreign direct investments in Nepal, [in:] B. Skulska (Ed.), *Asia – Europe. Partnership or Rivalry?*, Research papers of Wrocław University of Economics, No. 126, Publishing House of Wrocław University of Economics, Wrocław 2010, pp. 294–303.

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).

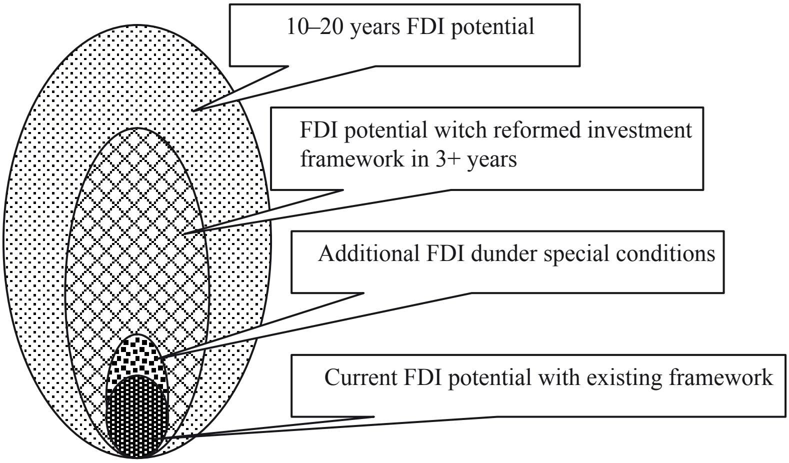

Figure 1. Representation of FDI potential

Source: author's own work.

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

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

– tourism, especially on 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 potential in the aforementioned areas could be realised 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;
– privatisation-related opportunities in utilities and 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 present a 10–20-year vision 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.

3. 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 the sectors where FDI can be accelerated if Industry Promotion Packages are created.

4. 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 and possibilities of religious and therapeutic tourism. The Government recognises the contribution that tourism can make in national economic development. So far its strategy has appeared to focus strongly on maximising 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 newest tourist attractions under development there are eco-tourism and Buddhism tourism.[2] 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 for these and related services.

The Product Development Strategic Plan of the Nepal Tourism Board (NTB) includes creation of new tourism hubs and "sub-hubs" throughout the country. These should open up additional investment opportunities and also help distribute 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.

Lumbini, the birthplace of the Buddha, holds much potential in attracting Buddhist pilgrimages with its archaeological ruins, meditation centres and old palace. Yet very little tourism development is occurring there at the moment. Lumbini has many needs before it becomes a tourism hub, and therefore investors have a wide variety of opportunities in infrastructure development, renovation of cultural attractions and ruins, and meditation centres. Investment opportunities in Lumbini derive mainly from the Master Plan of the Lumbini Development Trust, a non-governmental organisation 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 the 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.

[2] T. Sporek, Stosunek głównych religii do globalizacji i ich wizje przyszłościowe, *Studia Europejskie* 2009, nr 2, pp. 50–54.

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 a potential to attract FDI from major hotel groups which see health-related activities as an additional revenue-earning aspect of their operations.

With all these plus points, the recent performance of Nepal is somewhat disappointing compared with that of other LDCs. Nepal remains among the top five LDCs in relation to visitor numbers. It almost doubled tourist arrivals between 2000 and 2005. But other leaders have grown much faster and their tourism expenditure has substantially improved.[3]

Nevertheless, there is a 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 agreed to a ceasefire and that discussions are underway for a possible negotiated settlement. More fundamentally, foreign investment has been marginalised 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 now absent from Nepal;
– the lack of resolution of a long-standing taxation dispute with the major foreign investor in the sector.

5. Recommendations to promote FDI in tourism

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

5.1. 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

[3] R.D. Kaplan, The geography of Chinese power, *Foreign Affairs* 2010, Vol. 89, May/June, pp. 26–30.

Nepal as a tourist destination. Proposals by established national investors to form joint ventures should also be given favourable consideration.

5.2. 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:

a) 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 development 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;

b) assignment of special units in the revenue collection authorities to ensure professional attention to tax compliance and prompt customs clearance;

c) adequate numbers of key positions for expatriate staff for whom work and residence permits will be granted;

d) exemption from uncompetitive or inflexible elements of the labour law.

5.3. Structuring of tourism development zones

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

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

a) a tourist development certificate on standard terms as already described;

b) an option to negotiate a package of obligations and benefits which are specific to the site on a case-by-case basis, including:

- obligations to provide certain public infrastructure requirements (e.g., transport or sanitation) and/or undertake conservation of natural or historic features of the site;
- benefits such as duty-free shopping, a share of visitor fees to sites and (in the case of foreign investors) relaxation of restrictions on foreign investment in ancillary tourist activities.

6. Export manufacturing under trade preferences

Nepal will not in the foreseeable future attract large inflows of FDI in manufacturing based on the classic determinants of domestic market size or efficiency gains. Manufacture accounts for roughly 10% of GDP and firms are mostly small-scale business involved in serving the Nepalese market. The population is not small, but purchasing power is rather low owing to the fact that over a third of the population lives 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 the industries offering natural import protection (cement, beverages and popular branded consumer goods).[4]

Poor infrastructure, relatively low technological competence and the lack of a seaport are other limitations which 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 a 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 in terms of technological upgrading and international market promotion.[5]

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, Nepal benefits from two trade preference schemes, which offer distinct advantages in attracting FDI:

– the Nepal–India trade treaty;
– apparel trade preferences.

6.1. 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 Generalised 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 USD 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

[4] W. Mroczek, Indie – ważny partner handlowy Unii Europejskiej, *Wspólnoty Europejskie* 2010, nr 6, pp. 3–7.

[5] UNIDO, *Industrial Development Perspective Plan: Vision 2020*, September, Kathmandu 2005, p. 193.

China, which are more competitive and have the bonus of large domestic markets, will be more attractive.[6]

Nepal has two slender opportunities at best to maintain some attractiveness for FDI in the apparel sector:

a) The first one is to 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) The second one is an attempt to negotiate customs duty concessions with the United States and/or Europe on Nepalese imports, which are not available to main competitors. Nepal would appear to have little leverage to negotiate such a bilateral deal. It would presumably need to join a regional initiative.

The first option would be required in any case in order to take a better advantage of the Nepal–India trade treaty (see the next section).

6.2. 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.

The key changes in the new treaty include the following aspects:

a) Nepalese manufactured items must have at least 25% Nepalese and/or Indian content for the first year of the new treaty and 30% 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 classification. These rules of origin are favourable, as a 50–60% local content requirement is common in other treaties.

b) Vegetable ghee, copper wire, zinc oxide and acrylic yarn from Nepal will be allowed duty-free entry to India but subject to quotas.[7]

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.

[6] A. Lubowski, Nowa mapa świata, *Wprost*, 14–20.02.2011, pp. 68–69.

[7] S. Bobowski, Indie – narodziny drugiego azjatyckiego giganta?, [in:] B. Skulska (Ed.), *Procesy integracje w regionie Azji i Pacyfiku*, Prace Naukowe Uniwersytetu Ekonomicznego we Wrocławiu, nr 13, Uniwersytet Wrocławski, Wrocław 2008, pp. 237–246.

Nepal's exports to India increased considerably after the 1996 treaty and India now accounts for nearly half of Nepal's exports (see Figure 1). Nevertheless, there is in principle a considerable potential in manufacturing as Nepal supplies less than a tenth of 1% of India's market for manufactured goods.

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.

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 manufactured products may not face excessive market hurdles in India. The idea is not far-fetched. Already a US 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% of the joint-venture products to India. Such a scheme has a double benefit of exploiting the terms of the Treaty as well as expanding the technology base of Nepalese manufacturing.[8]

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.[9]

7. Conclusions 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 which is needed should:

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

For the reasons set out in the introduction to this paper, it is not feasible to expect, in the short term, these reforms to be engendered throughout the national framework. An economy-wide shift from the red tape to the red carpet is too much to expect in

[8] Alcoa CSI.
[9] Bard of Investment, Sri Lanka.

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:

a) **Special zones.** The first choice is to 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. Such zones are widely used in Asia and elsewhere if the national investment framework is poor or deemed unsuitable for the particular incentives required by a sector.

b) **"Enhanced" industrial estates.** The second option is to invite developers to build industrial estates that provide good business facilities on condition that manufacturers operating within the estates are 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 already proposed. Their location would be a decision of the private developers of the estates. Industrial estates in proximity to the dry dock development at Birgunj 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 has not been operational yet.

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ZAGRANICZNE INWESTYCJE BEZPOŚREDNIE W NEPALU. STRATEGIA I PROMOCJA

Streszczenie: Zarysowano strukturę pakietu efektywnej promocji przemysłu, która opiera się na parkach przemysłowych (z perspektywą możliwości rozwoju stref), stanowiąc podstawę zastosowania i zarządzania dla najlepszych podatków (first-class tax) i warunków regulacyjnych. Nepal ma już kilka stref przemysłowych (ponoć niefunkcjonujących optymalnie). Ważnymi elementami nowego pakietu są: (1) zaangażowanie w rozwój prywatnych parków przemysłowych, aby projektanci tych stref mieli naturalne zachęty do promowania swoich obiektów i przyciągania inwestorów; (2) umożliwienie prywatnym deweloperom stref przemysłowych poprawy swoich ofert skierowanych do inwestorów produkcyjnych, pozwalając na częściowo prywatne działania w zakresie łączności i innych udogodnień, aby poprawić jakość, i oferując atrakcyjny pakiet zachęt skierowanych do inwestorów realizujących produkcję, którzy usytuowani są w strefach przemysłowych.

Słowa kluczowe: turystyka, ZIB, eksport, wspólne przedsięwzięcie w zakresie produkcji, Nepal, Indie, Japonia.