

## Contribution of Foreign Direct Investment in Nepal

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### Abstract

*The purpose of this paper is to analyze the foreign direct investment status and environment in Nepal. There is significant contribution of foreign investment in economic development of developing countries like Nepal. Foreign investment attraction in a country like Nepal increases the foreign capital and technology transfer. Since 1990s inflow of foreign direct investment (FDI) has been increasing in Nepal due to the adoption of liberal economic policy by the government of Nepal. The Foreign Investment Technology Transfer Act (FITTA) has made better foreign investment environment in Nepal. This paper examines and analyses the contribution of FDI in Nepal. For the analysis, simple linear regression model has been applied to measure the impact of FDI on GDP and employment. Because FDI inflow has been recorded after 1990s, the impact of FDI has been analyzed in this paper over the period of 1990/91-2018/19. This study finds a positive impact of FDI on GDP and other macro variables.*

**Keywords:** FDI, foreign investment, economic development, import substitution and multinational companies.

### Introduction

Nepal had entered into industrial journey with the Indian capital and management after 1936 BS. The Company Act, 1936 BS, largely encouraged the people to invest their saving in industries. This law provided the facility of importing machines and essential raw materials from foreign countries free of custom duty. It also protected the foreign investment and created a congenial atmosphere for industrialists. As a consequence of this Act, a good number of industrialists had been attracted towards industrial development of Nepal.

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The emphasis on foreign investment was given since the Sixth Plan (1980-1985). Favorable rules and regulations and attractive incentives had been arranged for the foreign investors since 1981. To stimulate and forward overall economic development of the country, Government of Nepal had decided to accept the foreign investment as the major components of economic instruments. For the attraction of foreign direct investment in Nepal, the Foreign Investment and Technology Transfer Act 1992 was enacted. The objective of that Act was to promote foreign investment and technology transfer making the economy viable, dynamic and competitive through the optimum mobilization of capital, human and natural resources (MoF, 1992).

The policy reforms had become one of the important issues of economic development. After the middle of the seventies, there had been remarkable changes in trade reform in the most of developing countries in terms of import substitution strategy to an outward export oriented approach. The globalization of the world economy had changed the economic landscape. Multinational companies had played a key role in this transformation and created international production and distribution networks in the world. The relationship between economic openness and economic growth in developing countries had been a topical issue in a large number of empirical studies. The economic liberalization process had been expected to expand not only trade but also foreign direct investment. Causos et. al.(2001) had tested existence and nature of causal relationship between output level, inward FDI and trade of Argentina, Brazil and Mexico from the middle seventies to 1997. They had analyzed the extent and sources of international linkages between openness and economic performance in these developing countries, and found a significant impact of FDI on economic growth and trade. The literature of FDI, trade and economic growth generally points to a positive trade and FDI growth relationship. Theoretically, the economic growth might induce FDI inflow, and trade and FDI might also stimulate economic growth. There had been a significant contribution of industrial sectors in the economy. One of the major components of industrialization of a country was the foreign direct investment and it is the same in the present time. In the context of developing countries like Nepal, there has been a significant contribution of FDI to GDP and other variables.

### **Literature Review**

Foreign direct investment is one of the major instruments for industrialization of a host country. FDI has a significant contribution to a host country's economy. Foreign direct investment can facilitate economic growth through direct and indirect channels (Blomstrom et al, 2000; Enderwick, 2005). FDI promotes growth through the generation of productivity spillovers. Furthermore, foreign investors can contribute to economic growth because they tend to be more productive than local firms.

Caves (1996) conducted an empirical assessment of the role of FDI on the host country's export performance. This research was important because exports had been for long viewed as an engine for economic growth. There was a widely shared view that FDI promoted exports of host countries by augmenting domestic capital for exports, helping transfer of technology and new products for exports, facilitating access to new and large foreign markets and providing training for the local workforce and upgrading technical and management skills.

The benefits from FDI rely on the technical capability of a host country's firms. It is argued that the reason behind it is that FDI contributes to economic growth only when a sufficient absorptive capability of the advanced technology is available in the host economy (Blomstrom & Kokko, 2000). The beneficial impact of FDI is enhanced in an environment characterized by an open trade and investment regime and macroeconomic stability. In this environment, FDI can play a key role in improving the capacity of the host country to respond to the opportunities offered by global economic integration (OECD, 1998).

Sheikh & Sheikh (2012) presented an empirical link between FDI and economic growth in Pakistan in presence of the total trade of Pakistan with the rest of the world for 30 years during 1980-2009. Their studies suggested a weak but significant and negative association between FDI and economic growth in Pakistan whereas the trade impact on GDP growth was positive and significant.

Many researchers have found trade and productivity linkages by using sectoral or firm level data. Lee (1960) found that trade protection reduced both labour and factor productivity by using industry level data for the Republic of Korea. Soto (2000) remarked that FDI contributed positively to growth through the accumulation of capital and transfer of technology. The empirical results traced a strong long-run equilibrium relationship between GDP growth rates and the explanatory variables with unidirectional causal flows. The volume of FDI and level of capital formation were found to have significant positive effect on changes in real GDP.

Adhikary (2011) pointed that the degree of trade openness unleashed negative but diminishing influence on GDP growth rates in Bangladesh. Jayachandran & Seilan (2010) investigated the relationship between trade, FDI and economic growth for India over the period 1970-2007. Their studies suggested that economic growth, trade and FDI appeared to have been mutually reinforcing under the open-door policy. Many studies suggested that growth of imports results in growth of FDI inflows. In turn, growth of FDI causes growth of exports. Then the growth of exports further leads to the growth of imports. Hence, the synergy between the three variables is observed in the economy. There has not been conducted a comprehensive research study towards the

linkages between trade and foreign direct investment and probable channels establishments.

The view of the diverse findings by many studies as well as the apparent weak linkages observed in the Nepalese context, a closer examination of linkages between trade and investment is critically important.

### **Research Questions**

Foreign investors in their efforts to secure profitability look carefully the macro-economic conditions such as strong and stable economic indicators, relatively developed capital markets, fiscal and tax policies with favorable price stability, open market regimes etc. Many economic and non-economic parameters are responsible for attracting foreign direct investment of a host country. In the context of Nepal, the foreign direct investment environment has been disturbed by weak information base and absence of effective monitoring mechanism. There is not sufficient information on actual inflow of foreign direct investment into the country. There has not been a comprehensive research study to assess the contribution of foreign direct investment in the economy. This paper has tried to find answers to the following research questions:

- i. What is foreign direct investment environment in Nepal?
- ii. What is the contribution of FDI in Nepal?

### **Research Objectives**

The general objective of the study is to analyze the foreign investment situation of Nepal. The specific objectives of this research are as follows:

- i. To discuss the foreign direct investment climate in Nepal.
- ii. To examine the impact of FDI on GDP and employment of Nepal.

### **Methods and Materials**

The paper is primarily based on secondary sources of data which have been collected from published documents by various government and non-government organizations such as Economic Survey published by Ministry of Finance, Department of Industry and statistical year book and other reports published by Central Bureau of Statistics and quarterly economic bulletins published by Nepal Rastra Bank. This study covers the study period between 1990/91 to 2018/19. The published as well as unpublished relevant literature has been used to review the linkages of FDI on economic variables.

The present paper is descriptive and analytical in nature. For this, different tables and examples have been presented as necessary. Similarly, simple linear regression model has been applied to measure the impact of FDI on GDP and employment of Nepal.

## Discussion and Results

### Environment for FDI in Nepal

As per the various global reports, Nepal is improving the investment environment to attract more inflows of foreign direct investment. Among 190 economies, Nepal slid five places in the World Bank's Doing Business Index, landing at 110<sup>th</sup> position in 2018 from 105<sup>th</sup> position in 2017(Doing Business 2019). Nepal, with its free market policy, is open to foreign direct investments (FDIs) and has been developing an institutional and legal framework to attract FDIs since 1980s. Having advantages like a favorable demographic structure, cheap labour force, strategically beneficial geographical location, comparatively low tax and improving business indicators, Nepal has potential to be appropriate investment hub for small as well large scale investors.

In order to encourage more quality FDI, the government of Nepal has introduced some Acts, including the Public-Private Partnership and Investment Act (PPPIA)-2019, Foreign Investment and Technology Transfer Act (FITTA), 2019 and Special Economic Zone Act. The PPPIA provides one-stop service for any foreign investment of more than Rs. 6 billion or a hydropower project over 200 Mw capacity. The smooth and effective implementation of this Act enforces the government to reform, empower and improve the human resources of the bureaucracy and make them investment friendly. Similarly, FITTA ensures national treatment for any foreign investment and the incorporation of an automatic route system which makes the FDI related processes simple and practical to the provisions. FITTA specifies that the multinational companies (MNCs) can hire other firms only to produce accessories and supporting goods, but not to produce finished goods. Presently, many foreign investment firms are hiring contract manufacturers to produce finished goods for them. This provision has given the multinational companies a comparative advantage including cheap labour which lowers the production cost. While FITTA allows the Investment Board to issue production licenses for hydropower projects with a capacity above 200 Mw, the Ministry of Energy will issue licenses for hydropower projects regardless of their production capacities as per Electricity Act.

Till the date, Nepal has conducted three investment summits in the past, first summit was in 1992, the second summit was in 2017 and third summit was held in March 2019. Nearly 77 projects that the government had showcased for investment in the 2019 summit, only 17 applications for the projects were filed. For these commitments to become reality, the government needs to do regular follow ups.

Currently, the investors are keeping close watch on what steps the government will take in providing investment security and removing the administrative bottlenecks.

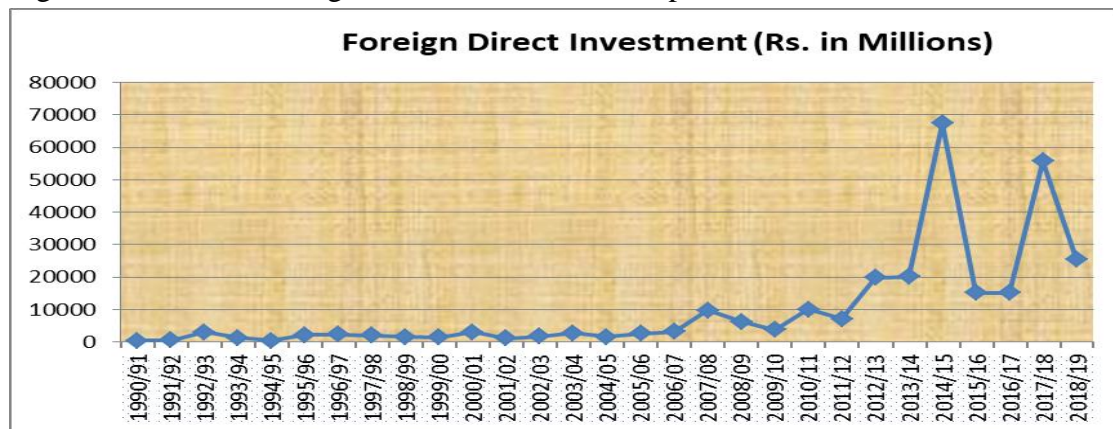
Foreign direct investment involves a long-term commitment to a business endeavor in a foreign country. The management of foreign investment needs to be satisfied with the principal requirements of a successful investment such as sustainable profitability and acceptable ratios of risk and profitability. Foreign investors in their efforts to secure profitability watch carefully the macroeconomic situations such as strong and stable economic indicators, open markets regimes, etc.

For the attracting more foreign direct investment and making production competitive, it is urgent that government should bring down the cost of doing business since the production cost in Nepal is one of the highest in South Asia. The investors expect profit opportunities. For improving the foreign investment environment, government of Nepal needs to focus forcefully on creating a much more investment friendly environment which will facilitate higher and more sustainable growth in GDP.

### Pattern of Foreign Direct Investment in Nepal

The inflow of foreign direct investment of Nepal increases while the country has adopted the open economic policies. The open liberal economic policy has attracted the foreign investors. There has been significant progress in FDI after 1990s. There were altogether 4,696 FDI projects upto mid-March 2018/19 with foreign collaboration approved so far. Many of these projects involved service and tourism as well as manufacturing industries. Among 4,696 projects, the foreign investment was Rs.279883.00 million which covered approximately 8.10 percent of GDP in 2018/19. Till the date mid-March 2018/19, 2 lakh 51 thousand 4 hundred and 84 people had been employed in these projects. The growth of FDI showed variability at different fiscal years. The foreign direct investment of Nepal from 1990/91 to 2018/19 has been shown in Appendix-I.

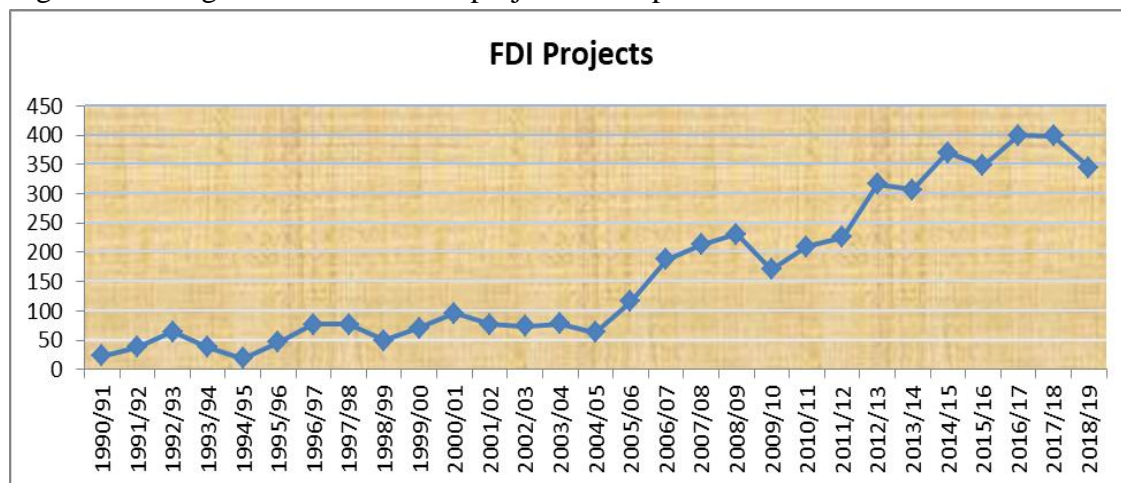
Figure 1: Pattern of foreign direct investment of Nepal from 1990/91 to 2018/19.



Source: *Appendix-I*.

It is evident from the Figure-1 that total investment under joint ventures has been added every year. The highest FDI was Rs.67455 million in 2014/15 and starting FDI was just Rs.406.28 million in 1990/91.

Figure 2: Foreign direct investment projects of Nepal from 1990/91 to 2018/19.



Source: *Appendix-I*

Figure-2 depicts the FDI projects from 1990/91 to 2018/19. During the study periods, there were all together 4,733 projects in Nepal. There has been increasing trend of FDI projects in the study period.

**Table 1**

Sector wise classification of FDI projects

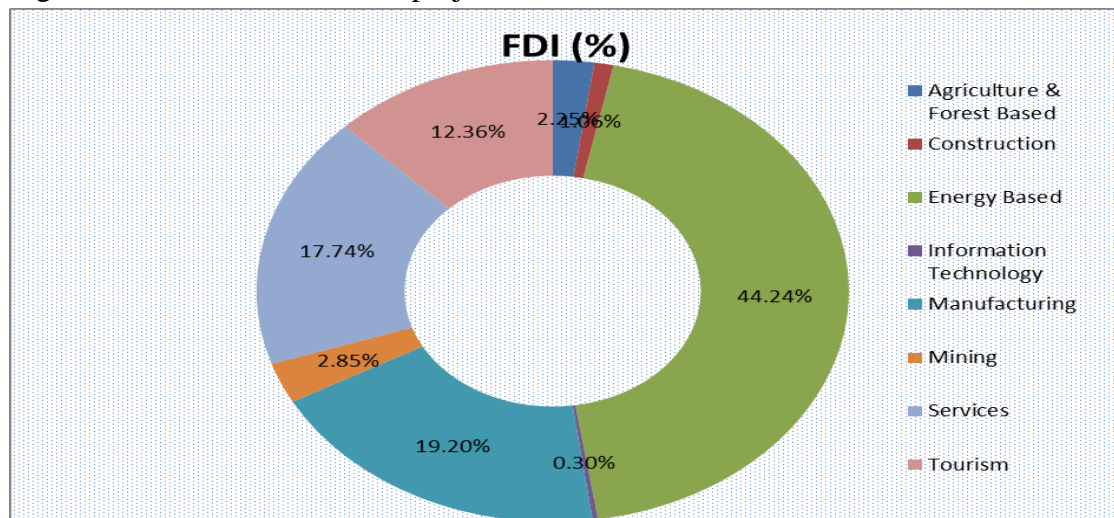
Classification	No. of Projects	FDI (Rs. in million)	Employment
Agriculture & Forest Based	275	6287.0	9916
Construction	46	2983.0	3226
Energy Based	81	123823.0	11595
Information Technology	50	850.0	1808
Manufacturing	1156	53745.0	101016
Mining	72	7981.0	8786
Services	1575	49660.0	64487
Tourism	1441	34555.0	50650
<b>Total</b>	<b>4,696</b>	<b>279883.0</b>	<b>2,51,484</b>

Source: Economic Survey 2018/19.

Table-1 depicts the foreign direct investment on the basis of classification upto mid-March 2018/19. In analyzing the foreign direct investment by classification, the largest number has been registered in service-based industries where there were 1,575 and the lowest number has been registered in construction industries. The manufacturing industries have contributed the largest number of employment opportunities whereas

information technology based industries generated the least number of employment opportunities in Nepal. The foreign direct investment on the basis of classification has been shown in the Figure-3:

Figure 3: Classification of FDI projects



Source: Table-3.

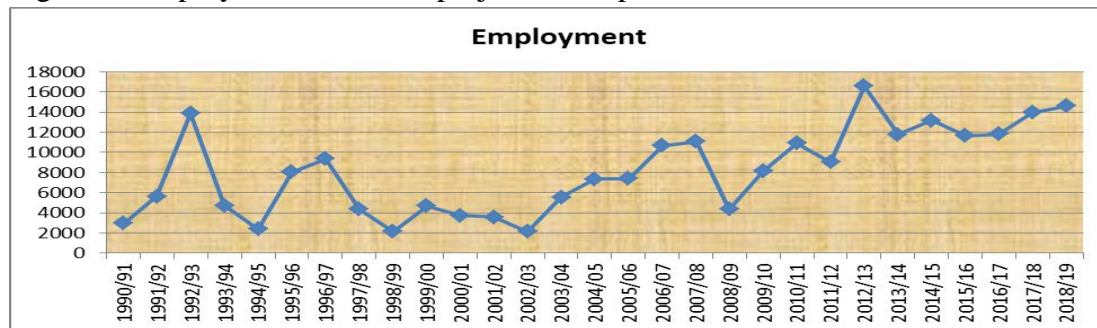
Figure-3 depicts the foreign direct investment on the basis of sector-wise classification where the highest percentage was invested in energy based projects which covered more than 44 percent and the lowest investment was on information technology projects where there was just 0.3 percent investment among the classified.

Similarly, on the basis of country-wise, Chinese industries had occupied the largest share in both the project numbers and investment amount with 31.1 percent and 39.88 percent respectively. Indian industries had been 16.4 percent and 33.4 percent respectively.

### Contribution of FDI on Employment

In principle, FDI increases employment opportunities in the host country. There has been a significant contribution of FDI to employment of Nepal. The employment generation from FDI projects from 1990/91 to 2018/19 is shown in Appendix-I.

Figure 4: Employment from FDI projects of Nepal from 1990/91 to 2018/19.





**Source: Appendix-I.**

Figure-4 depicts employment generation from FDI projects from 1990/91 to 2018/19. The highest number of employment was 16,569 which generated in 2012/13 whereas the lowest employment was 2,144 in 2002/03.

**Table 2**

Regression between FDI and employment

Model Summary										
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.620 <sup>a</sup>	.385	.362	3399.2810754	.385	16.888	1	27	.000	
Coefficients <sup>a</sup>										
Model	Unstandardized Coefficients			Standardized Coefficients		t	Sig.			
	B	Std. Error		Beta						
1	(Constant)	6476.363	747.951			8.659	.000			
	Foreign Direct Investment	.166	.040	.620		4.109	.000			

a. Dependent Variable: Employment Level  
 b. Predictors : (Constant), Foreign Direct Investment

**Source:** Calculated by Author based on Appendix-I

There is mostly positive relationship between FDI and employment generation. There is very low positive relationship between FDI and employment. The data of FDI and employment during 1990/91-2018/19 were analyzed by using linear regression model, FDI as independent variable and employment as dependent variable. The regression was found a nominal fit ( $R^2 = 0.385$ ), and  $p < .05$ . The overall model is statistically significant (Table-2).

**Contribution of FDI on GDP**

There is significant contribution of FDI on GDP. The overall model is statistically significant ( $R^2 = 0.556$ ,  $p < 0.05$ ). Similarly, R-square value states that 55.60 % change in GDP is due to independent variable FDI. A change in FDI moderately improved the position of GDP. The finding of the regression analysis between FDI and GDP indicates that FDI is a significant predictor of GDP (Table-3).

**Table 3**  
Regression between FDI and GDP

Model Summary										
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.746 <sup>a</sup>	.556	.540	641380.73710	.556	33.850	1	27	.000	
a. Predictors: (Constant), FDI										
Coefficients <sup>a</sup>										
Model		Unstandardized Coefficients			Standardized Coefficients		t	Sig.		
		B	Std. Error		Beta					
1	(Constant)	574195.682	141124.411				4.069	.000		
	FDI	44.337	7.621	.746			5.818	.000		
a. Dependent Variable: GDP										

**Source:** Calculated by Authors based on Appendix-I

There is positive correlation of FDI on GDP and employment in Nepal during the study period. On both variables, there were moderate correlations.

**Table 4**  
Correlations of FDI, GDP and Employment

Correlations				
		Employment	GDP	FDI
Employment	Pearson Correlation	1	.715**	.620**
	Sig. (2-tailed)		.000	.000
	N	29	29	29
GDP	Pearson Correlation	.715**	1	.746**
	Sig. (2-tailed)	.000		.000
	N	29	29	29
FDI	Pearson Correlation	.620**	.746**	1
	Sig. (2-tailed)	.000	.000	
	N	29	29	29
**. Correlation is significant at the 0.01 level (2-tailed).				

**Source:** Calculated by Authors based on Appendix-I

Table-4 depicts that there has been positive relationship of FDI on GDP and employment. It is statistically significant to have the positive relation of foreign direct investment on GDP and employment. It signifies that an increase in FDI results in positive impact on GDP and employment of Nepal.

**Conclusions**

The foreign direct investment environment was moderate in the context of Nepal. There had to be significant improvement in the policy matters for greater attraction of

foreign investors in Nepal. The contribution of foreign direct investment in Nepalese economy seemed to be remarkable. Analyzing the relations of foreign direct investment, there was positive relationship between FDI and GDP and Employment. Nepal needed strategies to become selective in its efforts to bring FDI successfully. FDI environment in Nepal was also disturbed by weak information base and the absence of effective monitoring system.

Despite the liberal economic policy and attractive incentives provided by the government, overall scenery of foreign direct investment was not encouraging. The pattern and trends of FDI suggested that liberal economic policy framework was no longer adequate to attract foreign investment. Even today, the business environment for foreign investors is not comfortable and friendly in comparison to neighborhood countries. Besides that, there is neither any information on actual inflow of FDI into the country, nor any comprehensive research done to examine the actual impact of FDI on the overall economy. Hence, it is a high time to conduct an in-depth study for evaluating the impact of FDI and its contribution to the GDP and employment as well as mobilization of revenue, promotion of export and development of entrepreneurship among others.

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## Appendix

**Appendix-I: FDI Projects, FDI, GDP and Employment from 1990/91 to 2018/19.**  
(Rs. in Million)

Year	FDI Projects	FDI (Rs. in Billion)	Gross Domestic Product (GDP)	Employment
1990/91	23	406.28	120370.27	2974
1991/92	38	597.84	149487.14	5615
1992/93	64	3083.67	171473.89	13873
1993/94	38	1378.76	199272.00	4734
1994/95	19	477.59	219175.00	2386
1995/96	47	2219.86	248913.00	8032
1996/97	77	2395.54	280513.00	9347
1997/98	77	2000.28	300845.00	4336
1998/99	50	1666.42	342036.00	2146
1999/00	71	1417.61	379488.00	4703
2000/01	96	3102.56	441519.01	3731
2001/02	77	1209.65	459442.81	3572
2002/03	74	1793.77	492231.28	2144
2003/04	78	2764.80	536748.44	5559
2004/05	63	1635.77	589411.55	7358
2005/06	116	2606.31	654084.00	7389
2006/07	188	3226.79	727827.00	10677
2007/08	213	9811.00	815658.00	11068
2008/09	231	6245.09	988053.00	4368
2009/10	171	3746.98	1192774.00	8116
2010/11	210	10053.00	1366954.00	10902
2011/12	226	7138.00	1527344.00	9035
2012/13	317	19819.00	1695011.00	16569
2013/14	307	20132.00	1964540.00	11790
2014/15	370	67455.00	2130150.00	13167
2015/16	348	15254.00	2253163.00	11663
2016/17	400	15206.00	2674493.00	11842
2017/18	399	55760.00	3044930.00	13940
2018/19	345	25484.00	3458790.00	14594

Source: Various Economic Surveys (1992/93-2018/19) from Department of Industries (DOI), 2018/19, Kathmandu.