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REVISITING FOREIGN DIRECT INVESTMENT IN NEPAL: PROBLEMS AND PROSPECTS

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ABSTRACT

The concern of foreign direct investment (FDI) has been receiving remarkable attention from many developing countries such as Nepal, given the fact that economic development in these countries is largely reliant on FDI through the establishment of multinational enterprises (MNEs). The major challenges for a host country are to carry out effective measures that ensure a favorable investment climate to foreign investors. In recent years, Nepal has been devoting efforts for attracting inward FDI by offering a lot of lucrative investment incentives and benefits to MNEs. Though many attempts were taken to increase inward FDI to Nepal, the result achieved is not appreciable enough. This study investigates inward FDI established by MNEs since 1996 and addresses causes and reasons of low-inflow based on intensive analysis from the primary and secondary sources of data. The analysis is based on the typical four outcomes, which are policy analysis, comparative growth analysis, problems analysis, and potential analysis. The findings show that the political instability is the major driving force to disrupt the smooth flow of FDI for the last two decades. The findings also show that low inward FDI to Nepal might be caused by poor implementation of existing policy and subjective targeted business exploration. This study suggests a solid guideline for the practical amendment of the existing flaws in policy along with stable politics. This study further suggests that there are the tremendous opportunities to invest in Nepal for some targeted sectors.

INTRODUCTION

Foreign direct investment (FDI) has become an essential source of economic development growth for many developing countries. Asian countries continue to greatly influence the global economy. However, the South Asian countries are comparatively lagging behind, among which Nepal is one of the least beneficiaries of inward FDI. Surprisingly, Nepal is one of the liberalized countries in the South Asian region, but it does not attract much FDI despite policy reforms initiated in the early 1990s to attract inward FDI. This is partly because a small, least developed, landlocked, mountainous country has little to offer to foreign investors. However, this could not be a good excuse because other similarly situated countries and some of South Asian countries have continued to receive much more investments than Nepal. This study investigates what caused Nepal to experience low inflow of FDI and how it can improve its FDI performance, given that Nepal has some competitive advantages to attract inward FDI from multinational enterprises (MNEs).

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Nepal provides access to a friendly and rapidly growing two neighboring economies with huge market with a low wage, trainable labor force, and a booming local entrepreneurial culture in business, as well as well-known tourist landmarks. Moreover, Nepal's moderate climate is also best for cultivating medicinal herbs, whose market is getting larger day by day. These advantages can boost Nepal's status as an attractive FDI host country. However, there are serious flaws in the investment framework that deserve priority consideration. Regardless of hindrances, Nepal seems to provide several unexplored opportunities, and it could stand as the next most desirable target for FDI. Accordingly, this study explores the real causes behind the low inflow of FDI, regardless of the fact that Nepal has embarked the liberal economic policies on 1990s. Right after introduction of economic policies, Nepal has successfully attracted good amount of FDI flow, but it could not sustain the momentum for a long. This paper aims to find out the determinants, impediments, favorable environment and potential of FDI for Nepal. Specifically, this study investigates whether the geographical disadvantage (land locked) is the main cause for the poor FDI performance. In addition, we examine the effects of politics, policy implementation, and prospective sectors on

FDI. The following sections review the relevant literature and provide an analytical framework and an overview of the FDI inflow to Nepal. We continue to explore prospects and constraints about inward FDI. Lastly, this study presents the findings and recommendations.

Literature Review

Foreign direct investment and development of host countries

The results of existing studies on the effect of FDI on economic growth vary according to the analytical approach of the researchers. These results are separated into microeconomic and macroeconomic studies depending on the insight from industry-level and from the nation as a whole. The microscopic studies from industrial viewpoint emphasize the limited effect of FDI on economic growth, whereas macroeconomic studies generally conclude that FDI contributes to economic growth under host country's certain threshold conditions. Some studies contend that FDI has a positive effect on economic growth by contributing to the accumulation of human capital and management skills (Borensztein, De Gregorio, and Lee, 1998; Blomström and Kokko, 2003). Similarly, some other studies conclude that the effect of FDI on economic growth has been widely acknowledged in the international business and regional development literature (Akinlo, 2004; Buckley, Clegg, and Wang, 2002; De Mello, 1999).

Using panel data for Latin America, for example, Bengoa and Sanchez-Robles (2003) found that FDI has a significant positive effect on a host country's economic growth. Choe (2003) also found the dual causal relationship between economic growth and FDI.FDI is not just a means to form capital in host countries but also the mechanism to fight against poverty and breakdown the viciousphase of underdevelopment through generating knowledge and improving management and technology, as well as labor skills in the host country (Hayami, 2001). In addition, FDI contributes to transfer technology and can contribute to income, production, prices, employment, economic growth, development and general welfare of the host country (Kok and Ersoy, 2009). However, FDI can be considered as a contributing factor to economic growth when the capital import country's economic condition has the ability to grip the investment.

In other words, the effect of FDI on economic growth may vary according to FDI's pattern by industry and the capital import country's developmental stage (Blonigen and Wang, 2005; Kim and Bang, 2008). Agiomirgianakis (2003) and Johnson (2004) also found that FDI contributed to the host country's economic development but the magnitude depends on a host country's conditions. Using Granger causality analysis based on the sample data for 11 developing countries in East Asia and Latin America, Zhang (2001) found that if the host country is capable of giving threshold conditions such as trade regime and microeconomic stability, then the FDI has a positive effect on country's economic growth. On the other hand, Rodrik (1999) points out that even the FDI had the effect on economic growth, it would be negligible. Carkovic and Levine (2002) also argue that FDI cannot have an autonomous effect on host country's economic growth.

Investment Policies, Incentives, and FDI Inflow: A Comparative Study

FDI has gained much attention as an effective cure to solve the economic problems of a host country. Developing countries are always in shortage of domestic investment and suffering from high unemployment rate, unhinged development of local areas, trade deficit and so on. To overcome these serious economic problems a developing country needs to welcome foreign investments from MNEs. In order to become a suitable destination for foreign investors and to maximize the positive FDI impact, a host country's government must articulate and implement best FDI policies and strategies.

Investment laws, incentives and policies in Nepal

Looking back the history of Nepal before 1990s, so called pre-liberalization period, the investment during this period was more preventive and restrictive. It was very tough to acquire a government license before undertaking any production and business activities. There was no FDI inflow before 1980. Nepal accepted the fact and the importance of FDI for the nation's economic development. So, Nepal has started its determination to attract foreign investment since early 1980s. To reach the international standards and warrant both domestic and foreign investment, the Government embraced several liberal policies: the Industrial Policy, 1992; the Foreign Exchange (Regulation) Act of 1962; Industrial Enterprises Act, 1992 (first amendment, 1997), Foreign Investment and One-window Policy in 1992 allowing and accepting the investment forms for foreign shares up to 100 percent in business areas were not on its "negative list," starts currency repatriation guidelines, and frameworks visa arrangements, negotiation guidelines, and a special "one window committee" for foreign investors; the Foreign Investment and Technology Transfer Act (FITTA), 1992, which was revised in 1996, 2000, 2002, and 2010 removed the minimum investment requirement, while opening legal, management consulting, accounting, and engineering services to foreign investment, with a 51-percent ownership limit and also explained rules concerning to business and resident visas.

The Customs Act and the Industrial Enterprises Act, revised in 1997 established invoice-based customs valuations and eradicated many investment tax incentives, replacing them with a lower, uniform rate; the Finance Act of 2002 to summaries customs, duties, export service charges, sales, airfreight and income taxes, and other excise taxes that affect foreign investment, the Immigration Rules of 1994; the Customs Act of 1997; the Industrial Enterprises Act of 1997; the Electricity Act of 1992 defines special terms and conditions for investment in hydropower development; The Privatization Act of 1994 authorizes and defines the procedures for privatization of state-owned enterprises to broaden participation of the private sector in the operation of such enterprises; the Patent, Design and Trademark Act of 1965 and the Copyright Act in 2002 in the terms and conditions of intellectual property protection. However, it does not meet the standards for trade-related intellectual property rights required by the World Trade Organization. The Government of Nepal is working to revise its intellectual property rights legislation to meet international standards. After Nepal joined the World Trade Organization (WTO) in

2004, the Industrial Policy has been revised in 2010 to get optimum benefits from world trade. The 2004 Competition Law, which controls anti-competitive practices, protects consumers against monopoly rights of trading enterprises, encourages fair competition for the growth of trade and commerce, and includes provisions for the control of mergers and acquisition of two or more firms that have the potential of gaining dominance in the market and acquisition of monopoly rights. The Competition Law also comprises special provision for controlling black marketing and misleading advertisements. Although some attempts to liberalize the investment policy were made from the beginning of the 1980s, it was actively implemented only after 1990. Government of Nepal has adopted most of the acts, policies, and amendments, governing foreign and private investment in the potential sectors during the last decade to accelerate economic and social development of the country. However, implementation and prosecution of these laws and policies remain a challenge.

Moreover, the unstable political atmosphere results in the investment climate in Nepal ambiguous. Especially in the field of industry and trade, the government policy is aimed at giving the private sector a dominant role. The private initiatives and enterprises are expected to increase efficiency and productivity. The government's role will be that of a facilitator providing infrastructure and creating conducive environment for investment. Overall, under the FITTA all agreements related to foreign investment are governed by Nepali law and subject to arbitration in Kathmandu under United Nations Commission for International Trade Law rules. However, foreign law can be applicable to cases where the foreign investment surpasses USD 6 million and where the parties make this choice clear in their agreement. Violators also have to pay compensation claimed by the copyright holder.

Arrangement of institutions

Government of Nepal has established a high level investment board in August 2011. The investment board is established to create an investment-friendly environment and to stimulate the economic development of the country. The investment board created the one window facility to all foreign and domestic investors pursuing projects more than USD 115 million in priority areas of investments such as highways, hydropower projects over 500 MW, medical, colleges, bridges, tunnel roads, cable cars, international and domestic airports, urban solid waste management, Chemical fertilizers, and petroleum refinery plants. The prime minister as a chairperson of the investment board has a right to articulate investment policies and a responsibility to enrich the collective goals for the economic development of the country by means of mobilizing and managing public-private partnership, providing financial and nonfinancial facilities, cooperatives, domestic and foreign investments. Moreover the board is to make the practice of industrialization procedure more systematic in order to assure the development of infrastructure and to create employment opportunities along with offering the contribution in poverty alleviation. The investment board has authority to overrule any regulations in the existing laws to promote investment, and it also registers and classifies the foreign investment and manages the income tax and duty drawbacks granted to some foreign investments. In sum, the investment board aims to reduce the bureaucratic red-tape and fulfill the necessity of one window service for potential investors to navigate inside Nepal. However, investments outside of the priority areas and investment projects under USD 115 are taken care by the Department of the Industry. The Industrial Promotion Board (IPB) is being formed under the chairmanship of Minister in Industry, in order to increase the pace of the industrialization in the country. It is the primary government agency to formulate the policy regarding industry and investment. The IPB has also the authority to render necessary co-ordination in formulating and implementing policies, laws, rules and regulations affecting to the industrialization of the country. To make industrial sector competitive and fair the IPB creates guidelines in achieving the objectives of liberal, open and competitive economic policies. The IPB also approves foreign investment proposals and determines applicable investment incentives. IPB has no involvement in approving the small project investment that is less than USD 25 million.

However, the Department of Industry takes action for these small projects. According to the existing administrative procedures investors are required to take license individually for each manufacturing or service sector investments. Such as The Department of Electricity Development is responsible for licensing all investments related to hydropower under the ministry of energy. Whereas the nation’s central bank “Nepal Rasta Bank” (NRB) is accountable to provide license to run financial institutions and commercial banks. The Nepal Telecommunication Authority (NTA) is providing license for any kind telecommunications and information technology services. The civil Aviation Authority (CAA) is charged with the liability of granting license to all domestic and foreign investors to operate international and regional airline business.

Performance requirements and incentives

In general, the objective of performance requirements is primarily to lead FDI into serving specified development objectives. Given the small size of the economy and its land-locked nature, it is clear that incentives in Nepal would have to be linked to exports. The government of Nepal provides several incentives to industries that are set up in certain priority areas such as tourism, hydropower and civil aviation for export purposes. Such incentives include an income tax exemption on export income, exemption on foreign investor’s interest income earned abroad. Most tax incentives were eliminated under the Nepal Law Revision Act of 2000.However, the government of Nepal encourages investors by giving tax incentives to locate outside of the Kathmandu Valley in order to lessen pollution and overpopulation in the Valley and, it also benefits investors with an interest in developing poorer parts of the country. Nepal does not apply tariff quotas on imports.

To facilitate the import of specific goods, the government provides tariff exemptions and reductions. The government of Nepal doesn’t differentiate foreign investors with respect to trade policies and non-tariff barriers. There is no requirement for local content or export performance. Technology can be transferred without any requirements and there is no requirement that nationals own the shares of foreign investors that the share of foreign equity be reduced over time. There is no responsibility to any foreign investors of disclosing propriety information to those government agencies. Any kind of research and development programs are sponsored by government, and foreign firms can participate without any requirements. However, there is some limit drawn by government agencies to Nepalese in participating such programs depending upon the nature of the job and expertise required.20 percent tax was levied on profits that are earned from export. Customs, value added tax (VAT), and excise duties on raw materials used in the production of export items are supposed to be reimbursed within 60 days. However, in practice, these duty paybacks are often extensively delayed. And to promote joint ventures with Nepali nationals, foreign investment in the service sectors is limited, ranging from 51 to 80 percent. Foreign investment in cottage industries is still not allowed.

Policy analysis

In this section we introduce the existing policies and compare Nepal's foreign investment policies with those of a few representative counterpart countries in both South Asian and land locked areas, as shown in Table 1.

Table 1shows that the existing investment policies of Nepal seem as liberal as other South Asian countries and a land locked country except for the taxation policy. Although tax rates are not so high, the compliance requirements are cumbersome and time-consuming. Nepal promised to reimburse the tax through the policy such as duty draw back and bonded warehouse facilities, but it's not happening in practice. However, the overall inflow of FDI into Nepal is so low that it has not been significant development catalyst, although Nepal witnessed an increase in inflow of FDI in the 1990s following the introduction of liberal policies. It is evident that, in general, the Nepalese policy regime is compared very favorably with some of the high FDI recipient South Asian countries such as India and Bangladesh and other land locked country Mongolia. There are two Nepalese regimes with peculiarities. First, after the 1997 amendment to the Foreign Investment Act, Nepal does not provide tax holiday for foreign investments. Second, Nepal has not build export processing zones (EPZs) to promote export oriented FDI (Athukoralaand Sharma, 2006).

Table 1. Comparing Incentive and Policy, Source: Compiled from various country sources

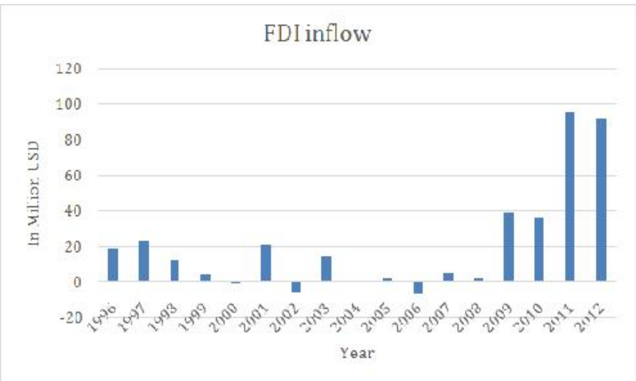
Region	Bangladesh	India	Nepal	Mongolia
Government Agency Dealing with FDI	Board of Investment	Foreign Investment Promotion Board and council	Investment Promotion Board	Foreign Investment and Foreign Trade Agency (FIFTA)
Limits on foreign equity participation	100% up to 24% in small scale	Up to 51% in most industries: or joint venture in all industries and 100% in export oriented industries and software technology parks	100% foreign owned permission of the sectors, except for a negative list industries	100% foreign owned permission of the sectors
Fiscal Incentives	1.Tax holiday for industries in central city for 5 years and others for 7 years. 2.Tax exemption on royalties, interest on foreign loans and capital gain from the transfers of shares. 3. 5% import duty on capital equipment and spare parts for initial installation.	1. Income tax holiday of 10 year for EPZ firms and 5 years for other investors. 2. Access to finance for export-oriented industries at concessional interest rates. 3. Tax relief under avoidance of double taxation agreements.	1. 10 years tax holidays and 50% rebate thereafter on EPZs located in Hilly regions, 5 years tax holidays and 50% rebate thereafter on EPZs located on other special zones. 2. Corporate tax rate for export-oriented industries is 8% of profit or 20% export earnings. 2. Corporate tax rate for import competing industries is 20%. 3. 2.5% duties on imports of M/E and spare parts. 4.5-10%duties on most industrial intermediate inputs refunded to export-oriented industries under the duty drawback scheme.	1. Tax holidays 2. Foreign invested companies engaged primarily in the following fields will receive ten years of complete income tax exemption and a 50% tax exemption in the following five years. 2. Foreign invested companies engaged primarily in energy, chemical, mechanical and electronics will receive five years of complete income tax exemption and a 50% tax exemption during the following five years.
Repatriation of Profit and tax on expatriates income.	100% repatriation of capital and dividends is allowed.	100% of repatriation of capital, profits and dividends is allowed after payment of tax.	100% of repatriation of dividend and capital is allowed.	100% repatriation of profits and dividend is allowed.
Infrastructure	Provision of EPZ and Industrial estates.	Provision of EPZ. Non-Resident Indians allowed to acquire any property, except agricultural land, Farm house and Plantations.	Provision of 11 industrial estates. 2. Self-arrangement of land utilities. 2. No provisions of EPZs, any industry exporting 90% or more get tax exemption, no duty fee.	Provision of EPZs
Protection of foreign investment	Guarantee against nationalization. International convention for dispute settlement.	Settlement of disputes is governed by the Indian Arbitration Act 1940.	UN convention for the recognition and enforcement of foreign arbitral awards.	Guarantee against nationalization.

The government of Nepal, however, has offered tax holidays and reimbursement on those firms that are located in hilly regions and some other special zones. The Nepalese authorities admit that there is little need for EPZs, given the significant reduction of import tariffs in recent years and the existence of the wide-ranging import duty rebate scheme. Mongolia has given more favorable external and internal legal environment to provide free regime to do business through the incentives such as tax exemption, deduction, export encouraging policies and consistence policies. Nepal totally lacks such commitment in practice. Changes in taxation policies like abolishing the tax holidays and increasing tax rate and changing it more rigidly are negatively affecting the existing FDI project and inflow of FDI in the future. In sum, the analysis suggests that an impressive growth of investment after policy liberalization could not continue for long term. The excessive bureaucratic burden was found to be weakening the investment and business environment (World Bank Report, 2005).

FDI growth analysis

FDI scenario in Nepal

The volume of FDI inflows into Nepal has not been satisfactory, averaging only about $8 million per year. The inevitable consequence is that FDI is a significant mechanism for economic development of country like Nepal. However, a comparison with different Asian countries brings out the poor performance of Nepal in terms of attracting FDI inflows, and its influence on economic development also seems to be minimal. As Nepal has comparative advantages in sectors such as tourism and hydro power capability, country offers some potential sectors to attract FDI. A though Nepal has opened most sectors to FDI, there is requirement of consistent implementation of existing polices to meet up the global standard. There need to be overall improvement in a business climate to assure the investor-friendly environment.



Source: UNCTAD, World Investment Report 2012.

Figure 1. FDI Inflow in Nepal

Before 1990s, in the pre-liberalization period the FDI inflow in Nepal was almost negligible. In 1990, with the restoration of multiparty and parliamentary democracy, democratically elected government initiated the most of the market-oriented reforms. The investment climate was dramatically changed resulting distinctive acceleration in FDI inflow. The inflow was quite small averaging $8.3 million per annum during 1996-2000, which reached highest at $23 million in 1997.The reason explaining this significant increased FDI inflow in the 1990s was caused by the introduction of liberal trade policy. The import tariff rate was drastically cut up to 16 percent in 1992 from 111 percent in 1989. Moreover, the introduction of a duty drawback scheme and establishment of several bonded warehouses abridged the prior trade policy's anti-export bias. Bilateral Trade treaty with India was concluded in 1996 which complemented the overall trade reform program. The Nepal-India trade treaty provided free access to India if the products were manufactured in Nepal without any import duty and restrictions. Most of the joint venture with Indian firms was attracted to Nepal especially in manufacturing sector targeting Indian markets. The currency conversion became fully liberalized in February 1993. All entities and firms were permitted to open accounts in major convertible currencies with domestic banks. Furthermore, the period between 1996 and 2002 could be termed as the economic turnaround phase as one of the political parties (Communist Party of Nepal, CPN). This phase had enormous negative impact on the country's economy as it started to ruin all the advantages receiving from new policy liberalization process and by slowing down the most strategic period.

The country's general investment climate was absolutely unsecured and risky that aroused from uncertain political environment. So, India withdrew the provision of bilateral trade treaty with Nepal. However, the treaty was revised in 2002 with several restrictions such as the fixed quota in export to some items by India. Most of the Indian manufacturing industries were closed because they were based on export oriented to India, and the fixed quota was so low compared to industries' capacity. Despite Nepal's proactive FDI policy, there was a major decline in FDI in 2002 and 2003, due to increased complexity of India's policy towards Nepal, and India's flexible policy towards FDI. The period 2004 was the most frustrating investment environment caused by political instability. However, the flow was positive and considerable in the context of Nepal in 2005. But the poor coordination between political leaders and their capability to cope the policies with foreign policy decreased the FDI inflow and even negative in the year 2006. After intense negotiations with the CPN (i.e., Maoist), which had conducted a violent insurgency in Nepal since February 1996, the government of Nepal and the Maoists signed a comprehensive peace agreement on November 21 in2006. Under the peace agreement, the Maoists declared to stop violence and respect the democratic process resulted from the formation of interim government with Maoist ministers.

After promulgation of a new interim constitution and interim parliament, the country was focused on a Constituent Assembly election in 2007. However, agreement with Maoist on the necessary electoral framework was made and election was successfully held in 2008. Finally, the country was able to establish new government expecting that nation will have brighter future. Thereafter, the inflow of FDI has been increasing in the following years as the politics and government goes stable. We can clearly see here the negative effect of political instability on FDI. Extreme risky and uncertain environment in the whole nation was caused by political instability and its negative effect on economic development, and incapability of officials to implement those strategic national policies of economic diplomacy due to administrative instability cost nation a lot. Remittance through manpower export was the only strong mechanism to maintain economic growth, financial stability, and stable exchange rate in that period of heightened insurgency and terrorism. The lack of coordinated economic policies with its foreign policy by political leaders, conflict between political parties, and impotent leadership have been constraining factors on business climate of Nepal. That has also resulted in chronic mal-governance and created environment full of risks and uncertainties where risks becomes very challenging to compute rationally. Comparison of FDI growth (with Mongolia and Bangladesh).In this section we highlight Nepal's performance in attracting FDI compared to other country. We compare the FDI inflow of Nepal with Mongolia, a representative land locked country, and Bangladesh, one of representative South Asian countries. Our basic motivation in this section is to analyze FDI growth between Nepal and counterpart countries.

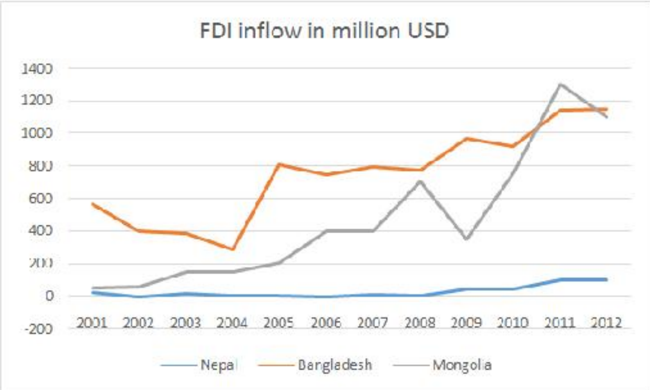


Figure 2. Comparative FDI inflow

Regardless of the policy measures the Nepal government took, its receipt of FDI remained low, compared with Mongolia and South Asian country Bangladesh, as Figure 2 shows. No countries are entirely alike, but Mongolia can be a good counterpart country, given that it shares the same nature of being landlocked country in Asia. However, Mongolia has received significant FDI in gold mining. Nepal, though not abundantly endowed, offers some minerals and other natural resources, as well as much larger market size, but its total GDP was five times larger than Mongolia in 1999. In the year 2002, Mongolia has opened several opportunities under Stability Agreement for the biggest investors to work on stable taxation policy which motivated investors to increase FDI. In year 2002 Mongolia has also established two Free Trade Zones and one free economic Zone which had positive effects while attracting FDI as incentives given to investors. In the Figure 2, we can see positive growth in the inflow of FDI in Mongolia after economic liberalization. It might be because Mongolia has given the stable politics that result in effective implementation of all foreign laws and policies. Nepal has seen 17 different governments in last one and half decade. Bangladesh offers the growing availability of both skilled and unskilled labor sources at relatively low wages and large capacity in the industry sectors and stands out as hotspot in providing human resource. However, working environments and other labor problems are still a major concern, and a number of devastating tragedies recently underline the frightening challenges facing the booming garment industry in the country. Bangladesh provides eight EPZs that offers tax breaks, secure and sufficient power source, duty free import of capital machinery, ware house, and the other benefit of 100% export oriented industries. Nepal has no foreign trade zones (FTZs) and export processing zones (EPZs). However any industry exporting 90 percent or more of its products is permitted to import raw materials and capital goods without payment of custom duties, excise taxes or sales taxes. Bilateral Investment treaties (BITs) and Double Taxation Treaties (DTTs) are the most important factors due to the long term consequence of Investment. The government of Mongolia has been paying a great attention to this issue and since 1991 the country has concluded Bilateral Investment Treaties (BIT) with 37 counties and Double Taxations Treaties (DTTs) with 17 counties while Nepal has settled Double Taxation Treaties (DTTs) with 17 counties and Bilateral Investment treaties (BITs) with only 5 countries.

Prospects and Problems

The awareness that the recent outpouring in FDI has enhanced the prospects for inviting more FDI has found grasp amongst bureaucrats (Ghimire and Poudel, 2012), multilateral organizations (Afram and Del Pero, 2012) and scholars (Adhikari, 2012a). However, these analysts seem to touch on the fact that Nepal faces huge challenges not only to attract FDI in long term but also to make investment climate and meet up the global competitiveness along with country's economic development. The discussion below provides both potential prospects and real constraints.

Prospects

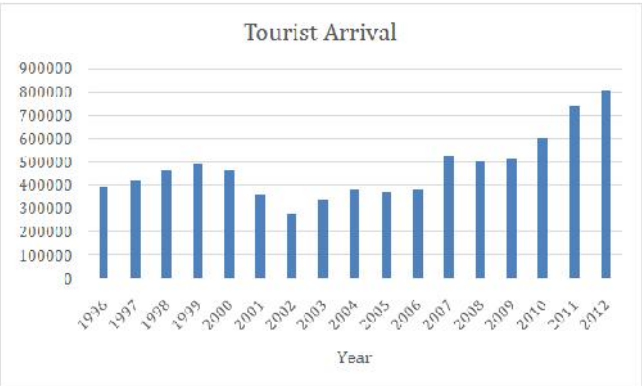
Market size

The market size of Nepal, compared with its neighboring countries China, India, and Bangladesh, is relatively small in that it still provides the market of 28.11 million people with a growing middle class. However, on the basis of 2004 survey conducted by Asian Development Bank (ADB) in 2010, showed that the country had middle and higher class population of 23.36 percent carrying the capacity of combined yearly expenditure of USD 10.72 billion in purchase power parity terms. Nepal's Central Bureau of statistics had a survey on Nepal Living standard showing 133 percent growth in the annual income of richest percent of population from 2004 to 2011. The survey shows that 20 percent population in the country had combined income of USD 7.26 billion in the year 2011.Converted in PPP terms, however, this would translate into a combined annual income of US$ 14.68 billion. Although this is not the disposable income, it still indicates that the country has an immense purchasing power. Nepal has worthy bilateral relation with its two very flourishing neighboring countries such as China and India. Nepal also has an opportunity to export all products without any restrictions (except for some products in the negative list including alcohol, tobacco) manufactured in Nepal in zero tariff under the Indo-Nepal Trade Treaty Agreement which was renewed on 2009. The treaty between Nepal and China provided an easy access for Nepalese goods to Chinese market. Nepal as the first least developing country that acceded to the world Trade Organizations in 2004. Moreover, Nepal is also a member country of two regional trade frameworks: the South

Asia Free Trade Area (SAFTA: Afghanistan, Bangladesh, Bhutan, India, the Maldives, Pakistan and Sri Lanka) and Bay of Bengal Initiative for Multi-sectorial Technical and Economic Cooperation (BIMSTEC) under these agreements the country has entered out of its geographical boundary due to such trade integration arrangements. Nepal has also the advantage of being a least developed country (LDC) on duty free quota free market access in most countries belonging to Organization for Economic Cooperation and Development (OECD). Undoubtedly due to these favorable and wide market access arrangements, the most recent Global Enabling Trade Report (World Economic Forum, 2012) considered Nepal as the third best indicator in destination markets' among 132 countries based on margin of preference. Nepal's score was 67.9 out of 100 against the country with the highest score Malawi (93.8 out of 100) and the second highest score of Mauritius (72.4 out of 100), respectively. This score shows that Nepal offers remarkable prospects for using trade-investment relationship by playing the role of transit country. Two factors explaining the interest of Indian investors to establish their companies in Nepal are the signing of a relatively more favorable Indo-Nepal Trade Treaty in 1996, and the economic liberalization reforms in Nepal. The target was indeed to hit the vast Indian market (Adhikari, 2012b).

Tourism

Tourism sector is the Nepal's most important sector with an intrinsic comparative advantage. Tourism already contributed a lot to the economic development of Nepal. Tourism sector remains one of the country's most promising ones for attracting FDI because of its various tourist attractions, incomparable natural assets, scenic beauty, and religious sites. Nepal, which has been known as home to12 world heritage sites and eight out of the ten highest peaks in the world, offers diverse tourist attractions to its visitors. The government realizes the fact that tourism can make numerous contribution in national economic development. Tourism from neighboring countries such as India and China is the most in terms of volume, followed by Sri Lanka, the United States, and the United Kingdom.



Source: Nepal Tourism Board 2013

Figure 3. Tourist Arrival in Nepal

The touristic appeal of Nepal is not only because of natural beauty but also the various activities offered such as mountaineering, trekking, mountain biking, mountain marathon, rock climbing, rafting, kayaking, fishing, paragliding, and skydiving. Thanks to its ancient and diverse culture, city tours, heritage sites, museums, as well as Buddhist and Hindu sites provide attractions for a wide range of visitors. We can see the growth in the number tourist arrival since 1996 to 2012 which clearly shows that Nepal has the potential to be an inviting tourist destination that attracts investment in the tourism sector as well.

Hydro-power

Water resource has been one of the most important natural resources for the Nepal's economic development. Availability of abundant water resources and geo-physical features provide myriad opportunities for hydropower production in Nepal. Hydropower is a sector full of enormous possibilities to attract FDI. The estimated volume of generation production is 83,000 megawatts, more than half of which has been identified as economically feasible to develop. Nonetheless, Nepal has been successful to generate only about 652 MW. The demand for electricity continues to upsurge faster than country's generating capacity. The Nepalese government opened the hydropower generation sector to private development and allowed foreign ownership. In August 2011, the Ministry of Energy proclaimed the new Hydropower License Management Procedure. Hydropower projects with capacity to generate more than 10 MW through competitive process are assured to obtain award licenses by the government. According to a new investor friendly Electricity Act in the current Parliament, all hydropower projects are allowed to have an income tax holiday for the first ten years.

The value added tax regime is also aiming towards the "zero" goal line rapidly. Besides these, corporate tax rate is only around 20 % and 1% customs duty levied on the import of any hydropower equipment into the country. Government even allows 100% repatriation on foreign investments on hydropower projects and also signed the agreement of double taxation treaties with several countries. Environmental Impact Assessments on projects 50 megawatt and below has been completely waived. New board of Investment has been formed under the chairmanship of Prime Minister to facilitate foreign investors to make large scale investments safely into the country. Hydropower sector has been declared as top-most priority sector of the nation by all political parties and intellectual community such as an autonomous body of the Confederation of Nepalese Industries (CNI) which is Nepal's leading chamber of commerce, and The Energy Development Council (EDC).

Constraints

There is no doubt that Nepal faces most of common challenges as each post conflict least developed countries in terms of attracting and holding investment. Moreover, significant factors such as changes in investment regime, global economic downturn and financial instability are always affecting inflow of investment in Nepal. There is no doubt that conflict and turmoil political situation have been the crucial cause that sliding down its once rising FDI. This situation seems to prove that FDI in the country is extremely challenged by war and political instability. The followings are major challenges:

Political situation and governance

Government policies can be the most crucial in motivating FDI location by altering the relative attractiveness of the host country to foreign investors (Brewer, 1993). Foreign investments in Nepal are to large extent constrained by regulatory and legal frameworks, poor accounting practices and strategic policies, and political uncertainty. The World Investment Prospects Survey reports 2007-2012, indicates "war and political instability" as most highlighted factor that have been the most critical threat to investors in Nepal. During the last two decades, Nepal has had 20 different governments since the democracy regime was introduced in 1990. Nepal has witnessed the signing of a peace agreement between the former Maoist rebels and the state, a new interim constitution, a Constituent Assembly, the abolition of monarchy. The 2013 International Finance Corporation (IFC) "Doing Business" report excuted by World Bank said that Nepal seems to have a sort of heightened political instability and political corruption is common. In fact, unexpected political transition discouraged both domestic and foreign investors from making investment decisions in Nepal. Given this political situation, foreign investors are less likely to increase their investment (Ghimire and Poudel, 2012).

Lack of human resource

Availability of the human resource plays an important role in hosting FDI into Nepal. But the situation associated with the issue had been very discouraging in Nepal. So, human resource constraints should be seriously looked at and must be taken into consideration. First, Nepal lacks well educated human resources endowed with skills required in manufacturing and services sectors. Although there has been some improvement in the general level of literacy due to higher levels of investment made in the education sector, Nepal has still a big responsibility to achieve the quantitative as well as qualitative targets on education. The more skilled workers have already migrated abroad. The 2008 Nepal Labor Force Survey shows that 29.1 percent of household had at least one household member living abroad. In 2009 more than 2 million Nepalese were estimated as working abroad (among whom96% migrants are male).Second, the most of the industries are lack of sufficient skilled labor and already set out scale down its production capacity or even operating below capacity. Third, skilled labor scarcities have raised wages too high that Nepal stands on position of having highest wage overhead in South Asia (Based on IMF World Economic Outlook Database), the rest of the workers are deeply unionized and they only demand higher wages and facilities without making acceptable increases in productivity. However, they are highly influenced and motivated by political parties (Shakya, 2009; Viswanathan, 2012).

Infrastructure and transportation

A host country's infrastructure represents the investment environment of a country by the means of transportation system, port facilities, utilities, energy. Adequate infrastructure facilities influence the investors while making investment decisions (Rolfe and White, 1992; Guisinger, 1985; Asiedu, 2002). As far as transport infrastructure is concerned, due geo-physical features of high mountains and hills and the most difficult terrain caused the underdeveloped infrastructure of Nepal, which have been reported in diverse global reports such as the Enabling Trade Report, Global Competitiveness Report and Logistics Performance Indicators. Nepal as a LDC is suffering from difficult geographical terrain, uncompetitive transport sector, unreliable transport infrastructure and weak telecommunication services, and weak industrial infrastructures, and due to these problems the transaction costs have increased far greater in Nepal than other neighboring countries. The IFC enterprise survey in 2009 suggests that these two main infrastructure-related problems, energy and transport, were the major constraints to the Nepal's economic development (Adhikari and Sapkota, 2012; Viswanathan, 2102). Some researchers also confirmed that these are major problems (Adhikari and Kharel, 2011; Ghimire and Poudel, 2012). These constrains such as lack of infrastructures and high transportation cost caused by Nepal's difficult geographical terrain are diminishing investors' self-assurance and discouraging foreign investment decisions in Nepal. Because these factors heavily and seriously put negative impression on the competitiveness of enterprises due to greater transaction cost they cause on industries (Ghimire and Poudel, 2012).

Policy implementation

Policymaking is considered relatively negligible in Nepal's politics due to several reasons. Important policy decisions are frequently subject to fierce distributional battles between different ministries, either at the political or even the upper administrative level. Furthermore, the critical bottleneck lies less in formulating of effective policies than in their coordination and implementation. Because of weak institutional arrangements and overlapping and often contradictory laws, the growing gap between policies and their actual implementation is responsible for the worsening in the quality of investment climate in Nepal. However, these facts are not emphasized openly as the serious obstacles by the IFC enterprise survey, but they are deeply discussed in other literature and are deep-rooted as serious difficulties by stakeholders (Pandey, Adhikari, and Sijapati, 2012). For example, a joint initiative of Ministry of Finance and Asian Development Bank to evaluate the implementation of FDI policies shows that the fiscal incentives including income tax relief provided by the Foreign Investment and Technology Transfer Act in 1992 and Industrial Enterprises Act in 1992 are abolished by the provisions of the amended Revenue Act and New Income Tax Act.

Likewise, foreign investors get duty draw back facility who export their products, but to acquire such facilities they have to go through long wait and face several snags. Sometimes they get Government Bond which has no value to them, instead of cash (Rana and Pradhan, 2005). The two major problems on the policy side are considered as serious issue. First, there is no stable policies in Nepal, due to the continued political conflict. Second, even those existing so called sound policies that have been articulated are rarely implemented (Ghimire and Poudel, 2012). The study focused on South Asian LDCs including Nepal highlights the combination factor that leading the gap between policy and its implementation. First, those strategic policies themselves could be defective.Second, either the will or intention of related officials not to implement as they don't 'own' these policies or they are not able to do so (Adhikari and Kharel, 2011).

Findings and Recommendations

After the economic liberalization of the 1990s, the inflow of FDI was increasing but just averaging USD 8 million annually which was comparatively very low with other south Asian countries and even with least developed land locked countries in Asian region. Although Nepal is one of the liberal countries in Asian region and continuously invites FDI, Nepal's performance still remains low than other countries. Even when comparing with other countries based on its geographical character like Mongolia, Nepal's performance is considerably low. So, it will be unfair to conclude that her nature of land locked is matter for Nepal's low volume of FDI inflow. In Table 1, we show that the policies and incentives given by host countries to foreign Investors to attract FDI inflow Nepal seem to be comparatively one of liberal and investment friendly, but, as our comparative analysis based on different parameter shows, Nepal has been always ranked down as one of low FDI recipient.

So, what are the reasons behind this stumpy level of FDI inflow in Nepal? It's certainly not that Nepal lacks potential nor it is because landlocked in nature. The reason is that Nepal has failed to deliver satisfactory standards of policy and its consistent implications to the domestic and foreign investors. Nepal also lacks high tech and adequate infrastructure (resulting in high transportation cost), sufficient energy source. The administration of taxes and their regulations are inefficient and cumbersome followed by corruption and non-transparency. Majorly political instability is being the strong reason behind this low FDI inflow. Schneider and Frey (1985) and Mnieh and Frimpong (2004) found adversarial relation between FDI inflow and political turmoil such as incursions and unrests in the host countries. An unreliable political atmosphere weakens the confidence as it makes the investor feel unsure and insecure (Hakro and Ghumro, 2007). According to 1991 World Investment report, ''political stability is one of the key factors in the policy framework of the Government to aid FDI in host countries''. However, there should be mutual understating and intention to move together between political, business, bureaucratic leaders and act in a chorus to offer investors friendly business climate.

It is not possible to meet the challenges that arises from international competitiveness without adequate infrastructure. It is the obvious duty of the State to provide an investment friendly environment to domestic and foreign investors. This can be achieved only when nation has stable politics, financial stability, and better implementation of existing policies. These are vigorous components required to invite more foreign investment and accelerate regional economic development (World Bank, 2005). Government should provide necessary infrastructural facilities to the government agencies facilitating FDI flow (such as IT and well trained human resources) to accomplish effective implementation of FDI policies. Monitoring and Evaluation system can also be an active mechanism to perceive the efficient functioning of these agencies. Moreover, frequent feedback from investors can also be initiative measure to improve the service delivery system of these agencies/ departments and ministries and help to make their function more transparent. The tourism industry in Nepal is still in its infant stage, but there is no doubt that it has major contribution to the growth of economic development of the country so far. However this sector is also constrained by the combination factors such as political transition, unbalanced regional development, inadequate and inefficient carriers, and poor transportation facilities. Enormous sceneries offer huge opportunities to invest in tourism sector where the country has intrinsic comparative advantage. FDI has an important contribution to make through investments by foreign tourism operators and hoteliers, and enhanced links to improve local supply sourcing, as well as through investments in the tourism infrastructure. Attaining this requirements of extensive reform of the industry, starting with a cautiously created long term tourism development plans and a robust and active institutional setting. These factors are fundamentals for improving the marketing of the 'tourism product', and rousing tourism demand especially from developed countries like Nepal.

Conclusion

With the introduction of market oriented policies in 1980s, Nepal embarked an intensive economic liberalization policies in early 1990s. The fact is that Nepal, in terms of taxation policies and openness, is currently one of south Asia's open economies. The introduction of highly liberal investment policies aimed at encouraging investment, including FDI has made this possible. Investment grew rapidly after its trade became liberalized in 1990. However, the momentum could not be maintained over years. This is probably the reason for Nepal's inability to sustain growth in investment and economy. Policy and FDI growth analysis in this paper and experiences among other countries indicate inflow of investment, including domestic and FDI, only when there is suitable investment climate and business environment. Investment policy requires strong market institutions which include a guarantee of property rights and a stably policy environment backed by stable politics and efficient bureaucracy. Government should seriously consider the reformed through appropriate and effective measures.

On the whole, a friendly investment and business environment must be provided. This has to be supplemented by the better policy coordination to ensure timely and not cumbersome procedures in obtaining the services and the other facilities laid down in the rules or policies. Most of studies have found the investment and business environment indicate that under taking business in Nepal is very challenging and complicated task despite the liberal policies. The requirements of supportive services such as, political stability, policy certainty and efficient administrative mechanism have an equally-perhaps even more important role in delivering secured and confidential business climate to both domestic and foreign investors. Nepal obviously has disadvantages arising from its geography in attracting FDI. However, comparative international experience suggests that her lackluster record as a host to foreign investors cannot be explained in terms of geography alone. The overall investment climate does matter.

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