Samriddhi,The Prosperity Foundation

Policy Brief

What kind of signals are we sending to investors?

A look at Foreign Investment Policy and its implications to investors

History

With the promulgation of Foreign Investment and Technology Act, 1981, Nepal opened up avenues for foreign investments in Nepal. Later, the Foreign Investment and Technology Transfer Act (FITTA), 1992 opened foreign investment in any quantity and any sum of investment except in a few limited sectors included in its negative list. It has been 22 years since the promulgation of FITTA 1992 and current global economic trends require that Nepal embark on a process of introducing a "second generation" of reforms to the existing policy. It is against this background that the Ministry of Industry (MoI), Government of Nepal (GoN) floated a draft of Foreign Investment Policy, 2014.

Samriddhi, The Prosperity Foundation has attempted to evaluate the proposed Foreign Investment Policy to assess whether or not this policy sets the right tone for Nepal to lure foreign investments that are required for the overall development of the Nepalese economy in order to place Nepal among developing nations.

Introduction

As global markets become increasingly accessible, firms from rich countries will look for avenues of investment and resource rich countries will benefit to welcome such ventures. Such interactions may increase the profitability of incoming firms while the introduction of foreign capital will play vital role in enriching various factors of production of the host country. Hence, foreign investments are, in their own right, a trade and weighing down all trades are transaction costs. Nepal aspires to graduate into a Developing Nation category by the year 2022 and such goals demand that Nepal hasten its pace of industrialization and create a policy environment that allows for vibrant participation of the private sector from both domestic and foreign entities.

Effective and targeted investments have never been Nepal's forte and the decade-long civil war saw the rate of development activities slump even further. While the country holds immense potential as a hydropower developing country, as a religious, cultural, and adventurous tourism destination, as a breeding ground for Information Technology experts, or even as a regional hub for world-class education services, current trends do not provide evidence to guarantee efficient utilization of resources. The gross capital formation stands at 21.2% of GDP, of which, over 81% comes from the private sector and Asian Development Bank's (ADB) Macro-economic update Nepal (2014) forecasts that only 16.5% of the fiscal budget will be spent for capital formation, highlighting inadequate government attention to this crucial aspect. Fortunately, private parties will be able to fill the void (of inadequate capital) that governments cannot replenish. However, investments are not possible without an encouraging environment (Kohler, 2010). So, it is of utmost importance that GON communicate its intentions to welcome and encourage private investments from within and without its boarders by providing a clear picture of the terms and conditions, incentives, privileges, guarantees, and restrictions (if any) thereof.

The new Policy

1 Institutional arrangement for FI approval

The FIP draft calls for more institutions to be involved in the process of FI approval. Apart from DoI and a restructured IPB, in the form of a 20 member Industry and Investment Promotion Board (IIPB), Ministry of Industry (MoI), Ministry of Home (MoH), Department of Labor (DoL), Labor Office and Department of Immigration, Nepal Rastrya Bank, and Investment Board of Nepal (IBN) are involved in different phases. It is also not clear if the DoI would be designated as the one-window as mentioned in the 1992 one-window policy document. While exiting the country, investors have to request permission from the agency responsible for granting them entry in the first place.

Implications of the current arrangement

As already mentioned, investments are a form of trade and the biggest barriers to any trade are transaction costs. Transaction costs make it expensive for trading partners to come together and reveal information about one party's wants and the other's ability to provide. Moreover, all trade creates some kind of wealth. Meaning, trade allows for the fulfilment of wants and desires making the trading parties better off; in other words, makes them wealthier. Bhagwati, Brecher, and Srinivasan in their paper DUP (Directly Unproductive Profit seeking) Activities and Economic Theory, establish that when a transferable wealth is moved through the government budget instead of directly being transported to the hands of a consumer, transfer seeking lobbying (or rent seeking activity) occurs (Bhagwati et al 1984).

If we assume investments to be our "transferable wealth" and the money required to screen and regulate such investments (wealth) due to the establishments of various bureaucracies and agencies to reflect its "movement through the government budget," we can envision transfer seeking actions to occur from the hands of those who feel they have something to gain from allowing or disallowing investors to commence activities in the nation. Simply put, an individual working in any organization that has the ability to qualify or disqualify an investment can easily wield that power to achieve personal gains.

2 Visa, Entry Permit and Foreign Workers

The Foreign Investment Policy 2014 draft has made provisions of business visa for 5 years—subject to renewal, resident visa for investors investing over $ 1 million at once till investment is active, and non-tourist visas, according to need, for conducting feasibility study. FIP draft sets a condition that as long as a Nepalese citizen can do a particular job, he/she has to be preferred to an expatriate. Foreign workers may only be hired if individuals with such skills are not available in Nepal. Such approval is to be secured from the Ministry of Labour (MoL).

Relevance

For foreign firms looking to invest, the availability of human capital is an important issue. However, unlike physical capital—which may be imported to deal with the unavailability of the same in one geographical region, the stock of human capital in any region is accumulated over time (Glomm et al, 1992) because the effects of factors such as education and improved health facilities do not show immediately (Schultz, 1961). Therefore, it is important to allow foreign firms' participation as the lack of human capital and skills can be offset through spillovers and competition that arises due to FI involvement. Multinational corporations have knowledge about the global market and opportunities to work in such large businesses will help foster a new generation of entrepreneurs. Similarly, foreign experts and workers will be able to create jobs for Nepalese labourers, thereby, increasing employment opportunities and ultimately bettering the lives of the employees.

If markets could simply be classified as primitive and advanced, Nepal would, no doubt, fall into the primitive market category. However, Nepal would greatly benefit from the presence of advanced industries. Domestic (comparatively primitive) enterprises, then, would have the chance to learn about business practices that enabled the transformation of advanced industries and they would also be pressured to become more efficient at using resources and converting raw materials into finished goods. Once such voluntary or involuntary changes occur in the country, they persist, as sunk costs, and ultimately transform the face of the economy.

3 Facilities, Rebates, and Incentives

The policy offers both fiscal and non-fiscal incentives such as income tax exemptions and privileges on import tariffs, and permanent resident visas for investors and their dependents. Staying true to the act's goals of promoting technology transfer and utilizing Nepal's labour to establish the nation as a prominent exporter of goods and services, the proposed draft has provisions for: providing tax breaks on research and development activities (that benefit the nation), subsidies on projects that are harmonious to energy and infrastructure development, tax breaks for expansion activities financed from profits, and subsidies for utilization of local products that undergo value addition for export activities. The draft also recognizes "forward contracts" as a means of mitigating currency related risks. The policy also limits procedural requirements of investors looking to invest in SEZs and EPZs by simply having them register at DoI.

Implications

Research has shown that incentives do not particularly add to the attractiveness of nations if there are other restrictions in place (James, 2009). Clauses that call for limited employment of foreigners, the need to seek approval through various regulatory channels in order to hire foreign experts, and vague wordings regarding nationalization and price fixation do not signal a safe working environment to risk averse investors. Moreover, the incentives need to be addressed by the country's tax code so as to maintain congruity with other fiscal policies.

Investment security and the ability to easily enter and exit the market are necessities for foreign investors. While the rest of the world may be participating in providing fiscal incentives, these are not the biggest priority for investors. Incentives may prompt the creation of another regulatory agency, under the pretence of providing said incentives, and adding another channel for investors to cross without proving them anything of special importance. Moreover, the costs of incentives—say for instance the forgone tax revenue, can only be justified if the benefits of the incentives outweigh the costs.

With increasing globalization, and in light of Nepal taking steps toward reducing trade barriers by partaking in various bilateral and multilateral trade agreements, the size of Nepal's domestic market has become a less important feature for attracting FIs (Blomström et al 2003). Blomström and Kokko argue that firms make decisions on where to establish their enterprise based on the cost of production at the particular location rather than based on the size of the market at that location (2003). Therefore, we can conclude that firms will choose a particular country location if employing a particular nation's labour force and other available resources reduces its cost of production or at least provides some advantage to using similar resources in an alternative country. Firms are not necessarily swayed by incentives especially the ones that are often provided by one policy but refuted by another policy of the same country or ones that eventually increase the cost of doing business (simply the cost that investors have to spend in order to take advantage of those benefits).

4 Repatriation of Earnings

FIP 1992, had made provisions for a foreign investor to repatriate as much as 100% of the earnings from investment in Nepal and as much as 75% of the earnings made in the form of salaries and wages can be sent back in convertible foreign currencies. The FIP draft gives continuity to the same provision but in the meantime adds new terms whereby the expatriates have to take approval from MoL prior to repatriation of such salaries and wages.

Relevance

Branches of Multinational Corporations or other foreign firms will have been established with money that has been imported from other areas, therefore, keeping capital safe is an issue. Similarly, it is natural that after accounting for some expenses, investors would want to take back part of their earnings. Conclusively, we can imagine that foreign nationals who work in one country may also want to save some part of their income to take back with them. However, keeping capital safe is an issue only if it can be introduced in the first place. Hence, host country provisions and related policies are very closely scrutinized by foreign investors and a short, clear, and concise document will be advantageous to host nations. After all, no one wants their investments to be frozen in one country when there are numerous other locations that would be more than happy to accept the same.

While the provisions on paper of 100% repatriation of profit look good, the implications of having to verify earnings from several agencies and the endless processes that need to be followed to repatriate earnings are discouraging signals to investors. Therefore, streamlining repatriation and approval to one single agency and simplifying and clarifying the processes involved would be the next step for Nepal.

5 Nationalization, Confiscation, and Price Fixing

The FIP draft, under its "strategies" section, indicates that no industry established under foreign investment will be nationalized. However, the "guarantee and facilities" section mentions that under compelling circumstance related to public safety and benefit, (GoN) may nationalize investments by providing due compensation. Unfortunately, there is no hint of what such compelling situations may be. There are also provisions where the government can issue directives on matters concerning public interest such as public health. However, what such "public interests" or "public health" matters are is not detailed.

Implications

Vague wordings such as 'national interest' and 'public health concerns' are terms that are open to interpretation by any bureaucrat who wields the power to shut down foreign firms. This makes the investment policy rather arbitrary and creates uncertainty for the investors. Businesses once established also need protection and this could range from providing actual security to the physical establishment to allowing complete control of the assets to the owners. Investors will need assurance that their capital will remain in their own control once an investment is made, and any unforeseen nationalization or price controls will unduly disenfranchise firms. One of the best means of presenting investor-friendliness is through bilateral treaties. Such treaties "contain provisions on the admission and establishment of foreign investments, standards of treatment, expropriation or nationalization measures, transfer of income and capital, protection of investment agreements or contracts, guarantees granted to foreign investments by home state agencies, and dispute settlement mechanisms (Handbook 2010)."

As investments involve the efforts of many parties, disputes will likely arise and provisions should be in place to ensure a fair distribution of justice. Moreover, as court proceedings in most countries are long and tedious, alternate dispute resolution mechanisms will aid in swift reconciliation with comparatively little spent time and money.

(This policy brief is based on a detailed study titled 'Foreign Investment Policy and its Implication to Investors'. The study was conducted by Samriddhi, The Prosperity Foundation with support from The Friedrich Naumann Foundation for Freedom and is available at samriddhi.org)

Towards a Second Generation of Reforms

To truly assist foreign investors, and to assure potential investors of a receptive climate, ease of entry and exit should be prioritized, which seems to be overlooked by the currently proposed draft. It is important to initiate a new wave of macroeconomic reforms along with sectoral changes. Such reforms should be aimed at liberalizing the participation of private sector in the economy. An example strikes out in the case of visas for investors. Foreign investors doing business in Nepal need to acquire business visa, during which, the application has to pass through a number of channels, namely, Department of Industry (DoI), Ministry of Industry (MoI), Ministry of Home (MoH), Department of Labor (DoL), Labor Office and Department of Immigration. In regards to the institutions involved in the FI approval processes, the approach should definitely be "less is more."

Interdepartmental communication has never been Nepal's forte so new steps should be taken towards reducing the number of channels that any party has to go through to fulfil any procedure. Reducing the number of institutions involved will lead to less shirking and definite delegation of responsibilities. The proposed multitude of institutions does not live up to the policy's aim at reducing discrimination between foreign and domestic investments. FIs also have to request approval from the DoI, while by law having to register at the Company Registration Office. And this is only one instance where the policy does not really exhibit a non-discriminatory treatment towards FIs. A liberalized economy will see that such regulatory agencies are simply a barrier to the proper participation of entrepreneurs.

One of the best means of presenting investor-friendliness is through bilateral treaties. Such treaties "contain provisions on the admission and establishment of foreign investments, standards of treatment, expropriation or nationalization measures, transfer of income and capital, protection of investment agreements or contracts, guarantees granted to foreign investments by home state agencies, and dispute settlement mechanisms (Handbook 2010)." Nepal, however, is a poor performer in signing Bilateral Investment Treaties (BIT) with only 5 treaties in place.

In the case of Nepal, the liquidation process is long and requires many steps. According to the Nepal Economic Forum (2012) there are various contradictory points in the Company Act and Insolvency Act. The new FIP draft requires all investments intent on exiting the country to request for permission from the agency that granted them entry. An ideal policy would allow the dissolution of an enterprise through the Company Registration Office alone as extra channels of permission seeking simply add more procedure on the part of FIs and expose the government's segregated view towards FIs.

Labor laws and labor relations within a country are also matters of significant concern to foreign investors. While it is natural for firms to expect some degree of human capital development in host nations through the availability of basic needs such as education and health facilities, the ideologies of the collective is also an important point for foreign investors. With an increasing need of employees in large scale industries, it is natural for unionization to occur. However, the politicization of labour unions in Nepal does not in any form help the image of the Nepalese labour market.

A stand out feature of FIs is its ability to import capital to capital starved areas. Moreover, a few initial investments are needed to bolster the confidence of other potential investors. Simplified entry and exit of capital will greatly bolster the confidence of investors. Liberalizing the capital account is a convenient means of increasing access to money. Capital Account Convertibility, according to the Reserve bank of India (1997), allows "the freedom to convert local financial assets into foreign financial assets and vice versa at market determined rates of exchange." Moreover, CAC requires that economic activities are expanded and that the export base of the country is expanded in order to prevent unwanted expulsion of capital from the (host) country in times of shocks, an intent to liberalize the capital account will send positive signals about the economy's intent.

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AN INTRODUCTION
SAMRIDDHI, THE PROSPERITY FOUNDATION

Samriddhi, The Prosperity Foundation is an independent policy institute based in Kathmandu, Nepal. It works with a vision of creating a free and prosperous Nepal.

Initiated in 2007, it formally started its operations in 2008. The specific areas on which the organization works are:

- Entrepreneurship development
- Improving business environment
- Economic policy reform
- Promoting discourse on democratic values

Centered on these four core areas, Samriddhi works with a three-tier approach—Research and Publication, Educational and Training, Advocacy and Public Outreach.

Samriddhi conducts several educational programs on public policy and entrepreneurship. It is dedicated to researching Nepal's economic realities and publishing alternative ideas to resolve Nepal's economic problems. Samriddhi is also known for creating a discourse on contemporary political economic issues through discussions, interaction programs and several advocacy and outreach activities. With successful programs like "Last Thursdays with an entrepreneur" and "Policy Talkies" it also holds regular interaction programs bringing together entrepreneurs, politicians, business community, bureaucrats, experts, journalists and other groups and individuals making an impact in the policy discourse. It also hosts the secretariat of the 'Campaign for a Livable Nepal', popularly known as Gari Khana Deu.

One of Samriddhi's award winning programs is a five day residential workshop on economics and entrepreneurship named Arthalya, which intends to create a wave of entrepreneurship and greater participation among young people in the current policy regime.

Samriddhi is also committed towards developing a resource center on political economic issues in Nepal called Political Economic Resource Center (PERC) currently housed at Samriddhi office. It also undertakes localization of international publications to enrich the political economy discourse of Nepal. Samriddhi was the recipient of the Dorian & Antony Fisher Venture Grant Award in 2009, the Templeton Freedom Award in 2011 and the CIPE Global Leading Practice Award in 2012.

(For more information on the organization and its programs, please visit www.samriddhi.org)