The Economic Journal of Nepal, Vol.17, No.3, Issue 67, July-Sept., 1994 © DOE TU

Foreign Direct Investment : Benefits, Cost and Determinants

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INTRODUCTION

Over the last more than two decades, attitudes toward foreign direct investment (FDI) have changed significantly. During the 1970s, many developing country governments discouraged such investment on the grounds that foreign firms would reap "rents" (i.e., unearned profits) at the expense of the local economy. At the same time, the abundant supply of commercial bank credit crowded out FDI inflows. But, then along came the debt crisis, drying up the flow of bank credit to developing countries.

Consequently, during the 1980s, many countries were compelled to ease their restrictions on FDI and alter their policies to attract FDI. Over and above the lack of alternative financing, governments acknowledged that FDI could generate benefits that were crucial in an era of international competition and that could not be acquired in any other way : technology, new management methods, access to export markets, and generally a becoming better plugged into the global market place.

FDI could be defined as equity investment of multinational corporations in host countries. About 35,000 multinational corporations are operating around the world, with 150,000 foreign affiliates. They manage foreign direct investments and have become the driving force of the international economy.

From 1985 to 1990, global FDI grew four times faster than GDP and twice as fast as domestic investment. During 1991, 25 countries made 82 changes in foreign direct investment policy. Nearly all of these changes were in the direction of greater liberalization of FDI. FDI flows to developing countries totalled about US$ 38 billion in 1992, a four-fold increase since the mid 1980s.

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FDI has appeared attractive to developing countries that are encountering declining domestic investment and high costs of foreign borrowing and that are restructuring their economies to promote greater private sector participation. Unlike foreign borrowing, FDI involves a risk-sharing relationship with the investors. It can take place even in the absence of well developed domestic financial markets.

BENEFITS AND COSTS

Foreign-owned firms may stimulate local productivity through backward linkages to service suppliers and the labor force and by serving as a paragon of working practices and management techniques. It has been contended that the best measure of FDI's impact is not just the initial balance of payments transaction but also the foreign firm's local purchases from suppliers and sales to customers in the host market, because these are analogous to exports and imports.

The contribution which FDI can make to economic development is related to its ability to lower specific scarcities in the countries which receive it. On the one hand it supplies capital which might not otherwise be available due to a low level of domestic saving and because access to bond and other portfolio finance from developed countries has been limited. On the other hand, FDI carries with it a complementary package of inputs. These include managerial and marketing expertise, knowledge of technical processes not easily obtainable by other means, scarce labour skills and, in some cases, facilities for training local workers in variety of skills.

FDI is preferred to other types of flows. One convincing argument is that it consists of a package of capital, technology and market access which tends to go to manufacturing sectors which possess actual or potential comparative advantage. On the other hand, official flows and even commercial loans are often tied with social overheads and sectors which do not enjoy comparative advantage in the developing recipient countries. In manufacturing sectors which enjoy comparative advantage, the inflow of FDI would give rise to economies of scale and higher productivity and

create linkage effects. Moreover, there are a number of financial advantages of FDI over other types of flows for the developing recipient countries. For FDI, repayment is required only if the productive activity is profit making and repayment can, to a large extent, be regulated through tax policies and legislations. Incentives can be created to encourage reinvestment to minimize repatriation of profits. There is also a closer match between the maturing structures of earnings and repayments. For other types of flows, there is often the case of using short-term loans to finance long-term projects.

Since FDI involves capital flows into the host country, it is sometimes viewed as an alternative to other forms of capital inflows, such as foreign aid or foreign borrowing. This argument is correct, as far as it goes, but is not the complete story. First, because the additional capital associated with FDI is committed to a particular investment in productive facilities, like any such investment it demands complementary expenditure on infrastructure services, education, etc. Second, FDI almost always brings more than just financial resources with it. It usually involves (a) the transfer of some production technology; (b) some management and organizational know-how that includes the production process and such other aspects of the business as organization, accounting, marketing, etc.; and (c) export marketing channels or other aspects of access to export markets. For all these reasons, FDI is only in small measure an alternative to increased foreign borrowing or to increased domestic saving.

Nonetheless, FDI also possesses some limitations. One, it has been concentrated, historically, in a few countries and in a few sectors. About three-fourth of all FDI takes place between developed countries; tow-third of the remaining flows to developing countries have gone to only ten countries. With regard to sectors, in Bangladesh, FDI is responsible for a significant share of manufactures for the domestic market, such as pharmaceuticals, cigarettes and electrical goods, and export-oriented ready made garments.

Two, it is claimed that foreign firms create enclaves which have little relations with the rest of the economy and do not give rise

to any significant spillover effects on the local economy. Three, remittances of profits and capital could bring about severe balance of payments difficulties for the host countries. Four, it is argued that foreign firms often stultify the development of local enterprise. This could be because they preempt the best investment opportunities or because they borrow on the domestic capital market and shift funds away from domestic firms. Five, it is contended that foreign enterprises typically do not allow local participation in ownership. Finally, a host of criticism concern the oligopolistic nature of such foreign enterprise from which a number of disadvantages can emanate. For instance, the parent firm may not allow a subsidiary operating abroad to export and prices may be maintained much above the competitive level.

DETERMINANTS

For attracting FDI, political and economic stability are indispensable. Excluding the primary determinants - sound macroeconomic environment and growth potential, credit worthiness, export market access, and an adequate and transparent regulatory regime - there are a number of other factors that could attract or deter FDI flows. One set gives due importance to relative rates of return and portfolios choice. Still another set emphasizes market imperfections and suggests that FDI is the result of some firms posing particular skills such as technological and managerial advantages. Yet another set emphasizes important complementary variables, such as political stability, government regulations, and tax policy.

The chief determinants of FDI seem to be the firm-specific attributes that underlie the competitive advantages of transnational corporations, the ability of transnational corporations to gain from internalizing market relationship, the strengths of particular host countries as locations for foreign production by transnational corporations, and the policies of both the host and home countries.

Among these factors, certain firm-specific assets may be the principal determinants of whether FDI takes place, whereas locational factors-such as market size and the prospects for increased sales, labor cost, and tariffs-are crucial in determining

where the FDI takes place. Host country policies provide a necessary precondition for attracting FDI, although effective policies by themselves may not be adequate to stimulate large inflows of FDI.

Traditional factors that were responsible for FDI flows to developing countries in the 1970 and early 1980s, such as labor cost, product life cycle, and the servicing of a protected market have weakened. In many industries, the proportion of labor cost to total mnufacturing cost has fallen, and new patterns of the international product life cycle have emerged. Changes in technologies in some sectors have altered the economic scale of production, weakening the case for offshore production in low labor-cost countries. In this new environment, FDI flows generally have been attracted to developing countries possessing an efficient and dynamic private sector, followed by responsive institutions and a motivated skilled labor force. Over the past two decades, the pattern of incentives and the degree to which various incentives are employed to encourage FDI have undergone significant changes. Generally, in recent years there has been less frequent uses of microincentive measures. There has also been a realignment of investment incentives, with top priority accorded to protetive measures. A shift away from horizontal, sectorwise schemes to vertical ones - for instance, promoting the use of new technologies. - has been perceived.

As indicated earlier, a good macroeconomic environment is a key factor to attract FDI since marcoeconomic policies play an important part in shaping and changing the economic environment. For developing countries where economic conditions are less favorable than those in developed countries, microeconomic policies become a major tool to compete for foreign investment. Moreover, since there is no guarantee that FDI must benefit host countries, government policies play a crucial role in ensuring that foreign investment contributes satisfactorily to economic development and the benefits are maximized. Also important is a foreign exchange regime that affords ready access to foreign exchange for imported inputs and freedom to remit dividends and profits. Moreover, foreign investors are influenced by the quality of

infrastructure, the level of industrialization and the size of the existing stock.

FDI could be facilitated by a legal framework that advocates open admission policies, subject to certain clearly defined and permissible restrictions (for example, national security) recommends equal treatment of foreign and domestic investors, permit the free transfer of profits, other payments due from the investors to external creditors, and repatriation of capital; and legitimizes expropriation only in accordance with legal procedures in pursuance of public purpose, without discrimination, and against payment of appropriate compensation defined under detailed criteria to reflect market value. These principles would imply, for example, easing restrictions on the freedom to employ expatriates and on the number of prohibited sectors in the host economy.

NEPAL'S EXPERIENCES

Until the early 1980s Nepalese officials tended to regard FDI investment as exploitative and coercive. During the last couple of years, however, the Government has approached FDI in a pragmatic and experimental manner.

Foreign investments in Nepal are normally in the form of foreign currency or capital assists. Reinvestment of earnings from foreign investments also constitutes foreign investment. Together with this direct form of foreign investment, foreign loans, use of rights, specialization, formulae processes and patents relating to technology of foreign origin, use of foreign-owned trademarks and use of foreign technical, consultancy, management and marketing services also constitute foreign investment.

Nepal has liberalized its investment codes to provide a more hospitable environment for foreign companies. The Government enacted a Foreign Investment and Technology Transfer Act and the Foreign Investment and One Window Policy in 1992. The salient features were : (a) opening up for foreign investment all industries with a fixed investment of more than Rs. 20 million, except those related to defence, tobacco and alcohol and all cottage industries; (b) specification of terms and conditions for repatriation of profits by

foreign investors (c) provision of assurances against expropriation of foreign investment by the government; and (d) simplification of authorization procedures and institutional arrangements to provide one window services to foreign investors.

Various facilities have been provided under the Foreign Investment and One Window Policy, 1992 : (a) interest income on foreign loans would be taxed at a rate of 15 percent; (b) royalties, technical and management fees would be taxed at a rate of 15 percent (c) income received from exports would be free from income tax; (d) industries set up with foreign investment would receive all the facilities and incentives including income tax facilities given to domestic industries under the Industrial Enterprises Act, 1992; (e) customs duty, excise duty and sales taxes levied on raw materials and auxiliary raw materials of export-oriented industry would be reimbursed to the exporters depending on the volume of exports within 60 days from the date of the receipt of an application for such reimbursement; (f) industries that export 90 percent or more of their total production would be provided with the same facilities as those industries set up in the export processing zone; (g) government land and land within the industrial districts would be handed over to industries for the setting up of industries on a priority basis; and (h) there would be no interference from the government on the fixation of prices of the products of any industry.

A foreign investor making investment in foreign currency could repatriate the following amount out side the country:

> (i) the amount obtained from the sale of the share of foreign investment as a whole or any part there of; (ii) the amount acquired as the payment of the principal of, and interest on, any foreign loan, (iv) the amount received under an agreement for the transfer of technology, and (v) the amount received as compensation for the acquisition of any property.

However, such measures are not sufficient; complementary actions such as bilateral information and promotion services,

safeguard instruments (e.g., bilateral investment treaties and investment guarantee schemes), as well as trade measures, are necessary.

FDI in small economies normally concentrates on production for export. However, in Nepal's case, this is hampered by a lack of natural and human resources (as regards the latter, a scarcity of educated manpower and acute shortages of advanced managerial, accounting and technical skills). With regard to infrastructure, Nepal compares unfavorably with many other developing countries in terms of power and water supply, telecommunications and transportation. Morever, the country is geographically disadvantaged, being land-locked and cannot offer the cheap and efficient transportation links with other countries required by foreign companies. Institutional infrastructure is also less developed, e.g. with respect to financial services. As regards the level of industrialization, the share of industry in GDP is less than one fifth.

Various objectives have been vital in shaping Nepal's dealings with FDI. One reason, and objective of, could be the transfer of technology, in order to modernize the economy and make it more efficient. Moreover, the economic reforms begun in the early 1990s accorded top priority to increasing exports. FDI ventures were seen as away to do this, both through producing products of exportable quality and price, and because of skill or access in marketing such products overseas.

Nepal recently became a member of Multilateral Investment Gurantee Agency (MIGA), and has enhanced its access to FDI.

The multinational Investment Guarantee Agency, which was established in April 1998 as the new member of World Bank group by 42 World Bank member countries that subscribed 53 percent of the agency's authorised capital of US$ 1, 082 million, has the objective to stimulate private investment through insuring investment against non commercial risk, like political risk, and provides promotional and advisory services to help members and creates an attractive investment climate. As of April 1994, licences we granted for the setting up of 240 industrial projects on a joint-

venture basis,or 100 percent foreign investment and/or for the transfer of technology to these industrial projects.

RELATED ISSUES AND POLICIES

The Nepalese rupee is currently valued above the exchange rate that would prevail if there were no barriers, taxes, or subsidies on Nepalese imports or exports. This implies that exports are less profitable than they would be if trade were freer and, combined with other policies, has the result that Nepalese economic policy discriminates against exports.

Another adverse impact of the overvaluation of the rupee is the devaluation risk that may be associated with foreign equity investment. Potential investors may feel that if the ongoing economic reforms are successfully pursued to their logical end, the reduction of trade restrictions and export subsidies may demand a significant compensating devaluation of the currency. This would lower the foreign currency value of equity investment in Nepal. Worries about such a future could lead potential investors to reduce the value of their equity investment, or even to delay investment.

In the initial stages of investigation how a project should be structured, what its market would be, and what are the qualifications of possible Nepalese partners, information on thee are prerequisite but many potential foreign investors have faced difficulties in getting timely access to these important facts.

To attract FDI that is focussed on producing manufactured goods primarily for exports, Nepal must compete with other countries that are also strong to attract the same investments. For some products the competition is regional (e.g., South Asia), and for some it is world-wide, but the competition is explicit and it is very keen.

To obtain the maximum benefits from FDI, Nepal must implement policies to maximize the linkage effects created by foreign firms. This is to ensure a full integration of local firms into the foreign investment sector in the course of time to prevent the formation of a foreign enclave leading to an increasing degree of foreign dependency.

CONCLUSIONS

FDI policy cannot be formed or viewed in isolation, but should be regarded as an integral part of their overall economic and industrial development policy if foreign participation is to be in line with national development goals and objectives.

Nepal should create a stable macroeconomic environment with prudent and reasonable consistent macroeconomic policies. This is important if foreign investors are to take a long-term view in the investment in Nepal. Facing a stable macroeconomic environment, the foreign investors will be more willing to compromise their own global objectives with the needs of Nepal.

Although economic conditions, resource endowment and other indicators conducive to foreign investment are, generally speaking, less favorable in Nepal, this doesn't imply that their are no investment opportunities. However, their exploitation will require special efforts to create the conditions propitious for an increased inflow of FDI.

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