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An analysis of the determinants of Foreign Direct Investment (FDI) inflow in Nepal

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Abstract

Foreign Direct Investment (FDI) is widely recognized as a crucial factor in fostering economic growth and development in both developed and developing countries. Identifying major bottlenecks to FDI and promptly addressing them is crucial for creating an investment-friendly environment. This study aims to comprehensively review the key determinants influencing foreign direct investment (FDI) inflows in Nepal. Political stability emerges as a significant determinant affecting FDI inflows in Nepal. The study finds that an improvement of one point in the political stability index results in a 61.1% increase in FDI inflows. Conversely, increases in taxes on goods and services have a negative impact on FDI inflows. Furthermore, the analysis demonstrates a positive correlation between FDI inflows and infrastructure development. However, there is no substantial evidence of significant impacts from changes in minimum wages and trade openness on FDI inflows in Nepal.

***Keywords**: Foreign Direct Investment, FDI, Determinants of FDI, Nepal, FDI in Nepal.*

Background

Foreign Direct Investment (FDI) is widely recognized as a crucial factor in promoting economic growth and development for both developed and developing countries. FDI serves as a vehicle for technology transfer, managerial skills enhancement, augmentation of foreign exchange reserves, and globalization of the economy. It has a positive impact on knowledge transfer and technical advancement in host countries by introducing new technologies, skilled workers, and diverse experiences. Governments in developing nations are increasingly competing for foreign direct investment due to globalization and liberalization.

Numerous empirical studies on the relationship between FDI and economic development have concluded that the effects of FDI are multifaceted. From a macroeconomic perspective, FDI is often viewed as a source of enhanced productivity, competitiveness, job creation, and technology spillovers. It also serves as a significant source of funding that can substitute for bank loans, boost exports, and facilitate access to other markets and currencies, especially for the least developed nations (Denisia, V. 2010).

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The IMF defines Foreign Direct Investment (FDI) as "the category of international investment that reflects the objective of a resident entity in one economy obtaining a lasting interest in an enterprise resident in another country" (IMF, 1993, p.86). Examples of FDI include establishing a new business, acquiring an existing business, or increasing one's capital abroad. Investment decisions are influenced by a country's growth performance, as well as political and economic risks.Top of Form

Despite being a landlocked nation between the two giant nations of China and India, Nepal possesses significant potential for international investment. Nepal has implemented a variety of legislative, regulatory, and institutional frameworks aimed at attracting Foreign Direct Investment (FDI). Although Nepal receives less FDI compared to its neighbors, recent trends indicate a growing pattern (Nepal Rastra Bank, 2018). Identifying and promptly addressing major FDI bottlenecks through thorough research, effective implementation, and diplomatic efforts are crucial steps towards creating an investment-friendly environment.

Objective of the Study

The main objective of this study is to conduct a comprehensive review of key determinants that affect foreign direct investment (FDI) inflows in Nepal. Identifying prominent variables that attract foreign investors is crucial for policymakers, corporations, and other stakeholders in Nepal. The research will involve a thorough analysis of several factors that influence FDI inflows in Nepal.

Literature Review

Foreign Direct Investment (FDI) and Its Forms

FDI is defined as when a foreign investor controls ten percent or more of the common shares or voting power of an incorporated business or the equivalent in an unincorporated business. These investments can take the form of branches, associates, or subsidiaries (IMF, 1993). Mullins (2020) also highlights that FDI typically involves investing at least ten percent in ordinary shares.

The forms of FDI have evolved over the past decade. Initially, a majority of FDI was directed towards fixed assets such as machinery, equipment, and buildings. However, in recent years, there has been a notable increase in technological startups, driven by the growing popularity of the Internet, leading to a shift in foreign investment patterns. Many of these startups, unlike traditional manufacturers, do not require extensive manufacturing facilities or large warehouses to store goods (Páez & Páez, 2011).

General FDI Theory and Main Determinants for FDI Inflow

Up until the 1960s, foreign direct investment (FDI) was primarily perceived as the transfer of capital across borders, justified by investment theories and portfolio concerns. The fundamental rationale for foreign investment was that it occurred due to differing rates of return across countries (Dirk et al., 2015). Salette & Tinbergen (1965) introduced a gravity model for trade, directly inspired by Newton's Law of Gravitation, where economic size and distance between trading partners were significant control variables.

The internalization theory, proposed by Buckley and Casson (1976), asserts that firm-specific advantages are crucial determinants of FDI flows. Hymer (1976) argued that FDI is not merely a financial decision based on capital markets but rather a strategic choice at the firm level. Professor Dunning formulated the eclectic theory (O-L-I framework), which integrates ownership (O), location (L), and internalization (I) advantages to explain FDI flows. This theory posits that FDI flows are driven by advantages such as monopolistic control, technological superiority, and economies of scale (Dunning, 1988).

Anderson & Van Wincoop (2003) refined the gravity model by proposing a theoretical framework that combines global supply (production) and demand considerations, incorporating anticipated shipping costs. Their model also accounts for multilateral (inward and outward) resistance, acknowledging that demand and supply are influenced by the entire spectrum of market participants rather than just bilateral interactions. Since then, advancements in the model have included log-linear estimators for panel data (Baldwin & Taglioni, 2006; Martínez-Zarzoso, 2013), the incorporation of country and dyadic fixed effects (Anderson, 2011; Head & Mayer, 2014), and the adaptation of Poisson Pseudo Maximum Likelihood (PPML) techniques.

Some policy factors mentioned as determinants of FDI include political and investment stability, as well as financial incentives like corporation tax. Although the latter typically have a significant impact on FDI, the magnitude is often modest. The author suggests that researchers use these factors more as controls rather than as the primary policy variables (Baier, 2020).

The gravity theory of trade predicts a positive relationship, as larger economies with substantial populations are capable of satisfying a greater share of global demand (Nielsen et al., 2017). Theoretical models, particularly the classical OLI approach, emphasize that a combination of ownership advantages, market size and characteristics, factor costs, transport costs, protectionism, and other factors including infrastructure, property rights, and industrial relations, influence FDI inflows (Faeth, 2009, p. 174).

The factors influencing FDI flows to 15 Latin American emerging economies from 1991 to 1998 were examined by Nunes et al. (2006). FDI inflows were analyzed as the dependent variable, while openness, market size, infrastructure, macroeconomic stability, wages, human capital, and natural resources served as independent factors. The data revealed a positive relationship between the economy's openness, infrastructure, and market size, and a negative relationship between FDI and inflation, wages, or labor costs.

In the context of factors influencing FDI in Nepal, several studies have been conducted. Shrestha (2022) concluded that Nepal lags behind in diplomatic capabilities, technology transfer, market access, investment promotion, identification of promising investment regions, capacity development of the current workforce, and assistance for foreign investors in making investment decisions. The study utilized regression analysis on a 10-year dataset for trend analysis.

Sahoo (2012) asserts that infrastructure availability and the motivation for economic development are primary determinants of FDI inflows in the South Asian context. Other influencing factors include labor relations, trade openness, reforms, and macroeconomic stability. In the Asia-Pacific region, which includes Nepal, GDP, trade openness, and political stability positively affected foreign

direct investment inflows, while the inflation rate had a negative effect. Among these factors, political stability had the most significant impact over the long term (Rashid et al., 2017). There is evidence of a positive correlation between FDI and political stability in the Nepalese context, particularly since 2015 following the implementation of the new Constitution, which coincided with increased FDI inflows (Pant et al., 2018).

Conceptual framework

Benchmarking the aforementioned theoretical and empirical reviews, FDI and its proxies can be modeled. A synthesis of the literature has led to the formulation of a research model that encompasses key determinants of FDI. The significance of FDI is crucial for both developed and developing countries. Identified through the literature review, potential determinants of FDI include market size, labor costs and productivity, political risk, infrastructure, economic growth, and taxation (Rudra, 2006). Therefore, FDI and its determinants can be modeled as follows:

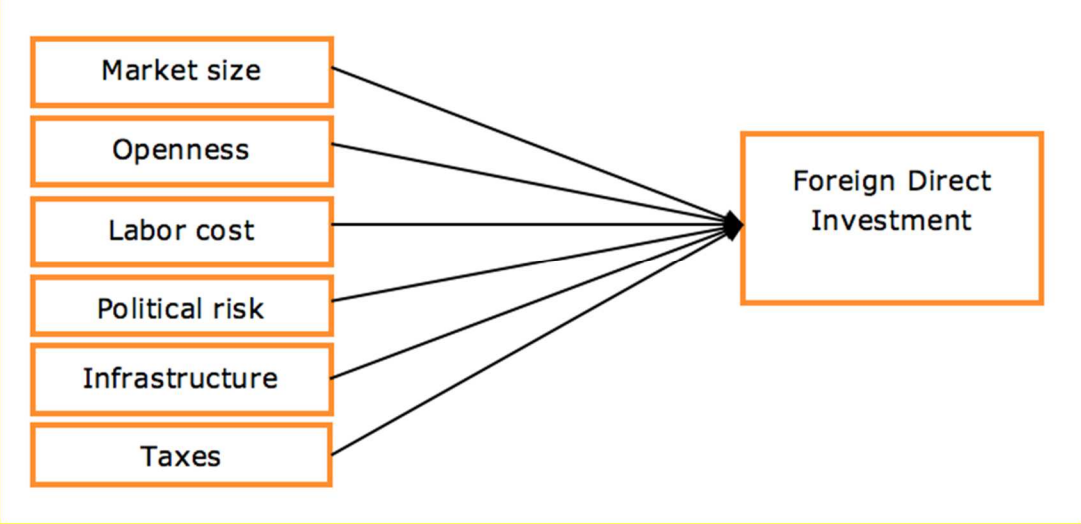


Figure 1. Foreign direct investment and its determinants.

Source: (Rudra, 2006).

Data and Methodology

This study aims to identify factors influencing foreign direct investment (FDI) inflows in Nepal using an empirical research design. The analysis focuses on developing an econometric model based on a comprehensive literature review to analyze the determinants of FDI inflows.

Initially, the trend of foreign direct investment inflows will be analyzed using data sourced from the Department of Industry (DOI). Following this trend analysis, empirical analysis will be conducted. Predictors from both groups will be incorporated into the model. The model seeks to encompass the

key factors affecting FDI in Nepal, drawing from various literature sources to establish the theoretical framework, expressed as follows:

(1) $$\textbf{\textit{Foreign Direct Investment}} = Market\ Size + Growth + Taxation + inflation + Openness + Labour\ Costs + Political\ stability + Infrastrucure + Corruption\ control + Others\ control\ variables$$

Proxy variables for each determinant have been utilized for the analysis. These variables are presented below.

Table 1 Determinants of FDI and proxy variables

Determinants	Proxy variables for analysis
Market Size, and Growth	Log of GDP, Population growth
Taxation	Taxes on international trade, Taxes on goods and services
Inflation	Inflation of Nepal
Labor Cost	Minimum wages of Nepal
Political Stability and Corruption control	Political Stability index, Corruption control index, Number of corruption control institutions.
Openness	Openness index (total trade to GDP)
Infrastructure	Road access in KM, Electricity consumption
Other control variables	Source Country's GDP, Inflation of source country

Data and Sources of Data

Secondary data were collected for the analysis. The first dataset consists of country-wise FDI inflow data obtained from the Ministry of Industry, the nodal government department directly responsible for FDI inflow. This dataset covers annual flows from 93 countries spanning the period from 1990 to 2022, comprising 868 observations. FDI flows from these source countries exhibit significant irregularity.

In addition to FDI inflow data, this study utilizes various indicators sourced from the World Bank's databank, including GDP, population growth, school enrollment rates, source country GDP, inflation rates, remittances per capita, average taxation rates, and trade openness indicators. The World Governance Indicators are employed for indices such as the rule of law, control of corruption, and political risk assessments.

Minimum wage data were sourced from Rudra (2006) and various government announcements in Nepal. Similarly, data on road access (in kilometers) and electricity consumption were gathered from reports published by the Ministry of Finance (MOF).

Econometric Models

OLS Model

The Ordinary Least Squares (OLS) regression model for the logarithm of FDI inflows and its determinants can be formulated as follows:

(2) $$ln(fdi)_{it} = \beta_0 + \beta_1 ln(gdp)_t + \beta_2 \ln(gdpsource)_{it} + \beta_3 (inflation)_t + + \beta_4 \ln(inflationsource)_{it} + \beta_5 popgrowth_t + \beta_6 openness_t + \beta_7 polstability_t + \beta_8 cocindex_{it} + \beta_9 cocnoofsource_t + \beta_{10} minwage + \beta_{11} (roadaccess)_t + \beta_{12} electricity\ consumption_t + \beta_{13} tot_t + \beta_{14} togs_t + \varepsilon_{it}$$

In equation (2), iii and ttt represent the source country for FDI and the time period, respectively. The natural logarithm of FDI (outcome variable) is denoted as ln (FDI)(.)\ln(\text{FDI})_{(.)}ln(FDI)(.). The control variables ln (GDPsource)\ln(\text{GDP}_{\text{source}})ln(GDPsource) and ln (GDP)\ln(\text{GDP})ln(GDP) represent the logarithm of GDP of the source country and Nepal for the given year, respectively. Inflation and Inflation source_{\text{source}}source denote the inflation rate of Nepal and the source country, respectively, for the specified period. Pop growth and Openness represent the population growth rate and openness of Nepal, respectively. The variables Palatability, Cocindex, Cocnoofsource, and Min wage denote the political stability index, corruption control index, number of corruption control agencies, and minimum wages in Nepal for the specified period. Similarly, Tot and Togs represent taxes on international trade and taxes on goods and services, respectively.

Fixed Effect Model with time trend

The fixed effects method is employed to estimate the relationship between the dependent variable and predictors while controlling for time-invariant variables. Each source country for FDI is assigned a unique intercept in the equation to account for invariant factors. Additionally, a time trend is included in the model. The equation can be formulated as follows:

$$ln(fdi)_{it} = \beta_0 + \alpha_i C_i + \gamma trend + \beta_1 ln(gdp)_t + \beta_2 \ln(gdpsource)_{it} + \beta_3 (inflation)_t + + \beta_4 \ln(inflationsource)_{it} + \beta_5 popgrowth_t + \beta_6 openness_t + \beta_7 polstability_t + \beta_8 cocindex_{it} + \beta_9 cocnoofsource_t + \beta_{10} minwage + \beta_{11} (roadaccess)_t + \beta_{12} electricity\ consumption_t + \beta_{13} tot_t + \beta_{14} togs_t + \varepsilon_{it}$$

where, Ci represents the dummies for country i. α_i is the fixed effect capturing all behavioral differences between countries.

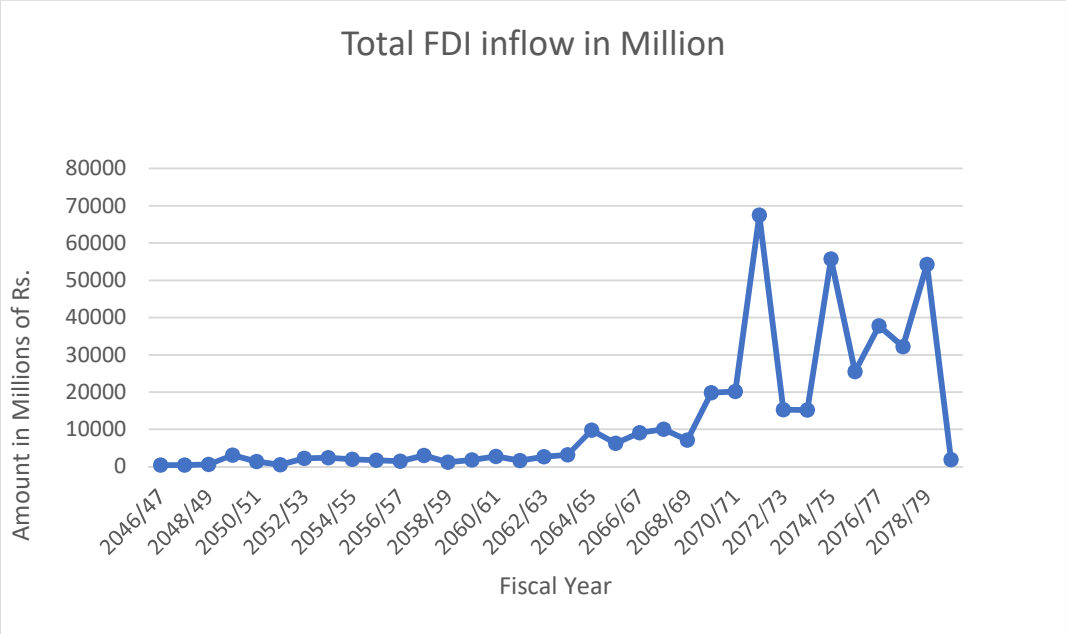
Data Presentation and analysis

Foreign direct investment trends in Nepal

Nepal has received commitments of FDI from 93 countries and territories since 1990 (2046/47 B.S.). The total FDI commitment stands at Rs. 417,969.9 million as of 2022 (FY2078/79), averaging Rs. 13,061.56 million per annum. Over the past 10 years, the average annual FDI inflow has increased to

nearly Rs. 34,334.95 million. The growth in FDI inflows has been characterized by high variability and fluctuations, as illustrated below. However, the overall trend in FDI inflows from 1990 to 2022 has been positive.

Figure 2 Total FDI inflow in million



China is Nepal's largest FDI partner, having invested Rs. 186,152.1 million over the past 32 years. China's FDI commitment constitutes approximately 44 percent of the total FDI inflows into Nepal during this period. Similarly, India has committed nearly Rs. 100,890.6 million, making it the second-largest source of FDI for Nepal. Following them are Hong Kong, the United States, the Republic of Korea, the British Virgin Islands, among others. The top fifteen countries in terms of FDI partnerships with Nepal are listed below.

Table 2 top FDI partner countries for Nepal

S.N.	Countries	Total FDI inflow (in Millions of Rs.)	No. of Employment
1.	China	186152.1	94643
2.	INDIA	100890.6	69844
3.	Hong Kong SAR, China	29447.67	5277
4.	United States	15516.67	18797
5.	Korea, Rep.	12799.98	11767
6.	BRITISH VIRGIN ISLANDS	11064.28	2326

7.	SINGAPORE	8484.29	4112
8.	United Kingdom	7994.33	10132
9.	SPAIN	6970.25	718
10.	UNITED ARAB EMIRATES	3810.57	1931
11.	CANADA	3620.18	2683
12.	MAURITIUS	3434.7	1055
13.	JAPAN	3396.72	9778
14.	SWITZERLAND	2962.03	1600
15.	Netherlands	2100.7	4473

Results and Discussion

Based on the empirical strategy, the results are presented in Table 3. The dependent variable, the logarithm of FDI inflows, has been regressed against various independent variables as shown in the table. Column (1) displays the results of the OLS regression between the logarithm of FDI and its determinants without controlling for the time trend. Column (2) includes the results with the time trend controlled. Additionally, Column (3) introduces a country-fixed effects model to control for time-invariant factors that influence FDI flows but do not change over time. Column (4) further includes the time trend, alongside the country-fixed effects model.

Table 3. results: determinants of FDI inflow

Outcome Variable: Log of FDI inflow in Nepal	(1)	(2)	(3)	(4)
Log of GDP of Nepal	0.237	2.294	0.0711	1.075
	(0.496)	(1.596)	(0.420)	(1.302)
Log of GDP of Source Country	0.963***	0.966***	1.137**	1.174**
	(0.0921)	(0.0921)	(0.510)	(0.512)
Inflation of Nepal	-0.0167	-0.0317	-0.00969	-0.0170
	(0.0160)	(0.0197)	(0.0127)	(0.0159)
Inflation of Source Country	0.000580*	0.000403	0.00184***	0.00176***
	(0.000338)	(0.000379)	(0.000396)	(0.000426)
Population Growth of Nepal	-0.0160	0.146	-0.0118	0.0670
	(0.285)	(0.314)	(0.234)	(0.266)

Openness of Nepal	0.00734	0.00861	0.0212	0.0218
	(0.0163)	(0.0163)	(0.0143)	(0.0144)
Political Stability Index	0.636*	0.578*	0.641**	0.611**
	(0.325)	(0.328)	(0.260)	(0.261)
Control of Corruption Index	-0.996	-0.959	-0.930	-0.908
	(0.704)	(0.700)	(0.573)	(0.569)
Corruption Control: No. of Sources	-0.0437	0.0580	-0.0134	0.0355
	(0.0988)	(0.122)	(0.0797)	(0.0989)
Minimum Wages of Nepal	-0.000101	-8.66e-05	-5.90e-05	-5.19e-05
	(0.000102)	(0.000103)	(8.12e-05)	(8.11e-05)
Road Access in KM	6.91e-05	7.95e-05	9.44e-05**	9.91e-05**
	(5.23e-05)	(5.28e-05)	(4.75e-05)	(4.81e-05)
Total Electricity Consumption	0.000329**	0.000414**	0.000138	0.000180
	(0.000158)	(0.000173)	(0.000114)	(0.000126)
Tax on International Trade	-0.0486	-0.0710	-0.0853	-0.0956
	(0.0693)	(0.0720)	(0.0629)	(0.0652)
Tax on Goods and services	-0.120	-0.124*	-0.149**	-0.151**
	(0.0732)	(0.0732)	(0.0613)	(0.0615)
Observations	830	830	830	830
R-squared	0.254	0.256	0.586	0.587
Fixed Effect	No	No	Yes	Yes
Time Trend	No	Yes	No	Yes

Robust standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

Table 3 illustrates that political stability is a significant determinant of FDI inflows in Nepal. In column (1), the coefficient of the stability index is 0.636, highly significant at the 5% level. This

suggests that a 1-point increase in the political stability index leads to a 63.6% increase in FDI inflows. This result is derived from an OLS regression between the logarithm of FDI and its determinants without controlling for the time trend. Controlling for the time trend in columns (II) and (IV) still shows a significant impact similar to the result without controlling for the trend.

Columns (III) and (IV) introduce a Fixed Effects (FE) model, revealing that political stability remains a prominent factor affecting FDI inflows. Specifically, a 1-point increase in Nepal's political stability index leads to a 61.1% increase in FDI inflows, with the coefficient being significant at the 5% level.

Another influential factor affecting FDI inflows is taxation on goods and services. A 1% increase in this tax rate is associated with a 15.1% decline in FDI, as indicated by the coefficient significant at the 5% level. This suggests that FDI inflows in Nepal are highly sensitive to changes in the tax rate.

Access to roads also plays a significant role in enhancing FDI inflows, although the coefficient of road access in kilometers relative to FDI inflows is relatively small.

Factors originating from the partner country also influence FDI inflows in Nepal. The table further reveals that GDP growth in the source country positively impacts FDI inflows in Nepal, with a 1% increase in GDP leading to a 1.74% increase in FDI inflows. Similarly, the inflation rate of the source country positively affects FDI inflows in Nepal, whereas there is no evidence of a significant impact of inflation within Nepal on FDI inflows.

Furthermore, there is no significant evidence showing the impact of changes in minimum wages and openness on FDI inflows in Nepal.

Conclusion and Recommendation

Identifying the determinants of FDI in Nepal is a broad and complex task. This study aims to identify the variables affecting Nepal's foreign direct investment (FDI). A fixed effects model is used to estimate the relationship between the dependent variable and predictors while controlling for time-invariant variables. The analysis demonstrates that political stability and infrastructure quality positively influence FDI inflows. Specifically, FDI inflows increase by 61.1% if Nepal increases its political stability index by 1 point, with the coefficient significant at the 5% level. On the contrary, the negative relationship highlighted by higher taxes on products and services underscores the need to reconsider the application of heavy taxing regimes. A 1% increase in taxes on goods and services in Nepal is associated with a 15.1% decline in FDI inflows, indicating that FDI inflows are highly sensitive to tax rates. Furthermore, there is no evidence suggesting a significant association between wage levels and FDI.

Given that political stability forms the bedrock of a country, it is crucial for leaders to find common ground. Therefore, formulating and implementing reliable, efficient, and stable FDI policies through political consensus is paramount. Fiscal policies should be carefully crafted to attract investments, particularly in infrastructure sectors such as roads, electricity, and telecommunications. Additionally, reviewing existing policies on indirect taxes like import duty, excise duty, and value-added tax rates is recommended. In conclusion, promoting political stability, enhancing infrastructure development,

and reviewing tax policies are essential steps to improve the investment climate and attract more FDI to Nepal.

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Appendices

Appendix 1

Summary statistics of Variables

VARIABLES	(1) N	(2) mean	(3) sd	(4) min	(5) max
Log of FDI inflow in Nepal	868	3.527	1.975	0	10.75
Log of GDP of Nepal	863	27.70	1.033	25.36	29.23
Population Growth of Nepal	863	1.139	0.732	0.186	2.799
Inflation	863	8.414	5.163	3.070	26.40
Openness	863	46.13	5.893	32.19	64.04
Tax on International Trade	863	18.07	4.469	14.46	25.95
Tax on Goods and Services	863	9.994	3.437	6.37	16.91
Road Access in KM	863	21,103	8,898	7260	33,871
Minimum Wages	863	6,256	4,250	931	15,000
No of Corruption controlling agencies	863	9.598	3.585	1	13
Corruption control index	863	-0.636	0.199	-0.953	0
Inflation of source country	837	5.992	43.23	-2.079	891.2
Log GDP of Source Country	848	11.71	0.763	8.381	13.41
Total Electricity Consumption	863	2,369	1,602	713	7,268
Political Stability Index	863	-1.006	0.650	-2.149	-0.0711

Appendix 2

Correlation of different variables with Log of FDI inflow in Nepal

VARIABLES	Correlation
Log of GDP of Nepal	0.296
Log of GDP of Source Country	0.39
Inflation of Nepal	-0.09
Inflation of Source Country	-0.022
Population Growth of Nepal	-0.04
Openness of Nepal	-.012
Political Stability Index	0.17
Control of Corruption Index	0.23
Corruption Control: No. of Sources	0.12
Minimum Wages of Nepal	0.33
Road Access in KM	0.18
Total Electricity Consumption	0.34
Tax on International Trade	-0.23
Tax on Goods and services	0.13