Foreign Direct Investment and BIPPA In Nepalese Economy: A Policy Issue Paper

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4 January 2011

FOREIGN DIRECT INVESTMENT AND BIPPA IN NEPALESE ECONOMY: A POLICY ISSUE PAPER

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Abstract:

This is basically policy issue paper which focuses particularly in BIPPA and FDI. This policy paper has major objective to understand BIPPA and assess its binding provisions, BIPPA's relevancy in Nepalese economy and to find potential implications of BIPPA provisions investment, industrial development, the growth of productivity and export trade promotion in short and long run. This paper has used qualitative assessment and discussion method. This paper finds BIPPA as an interesting legal arrangement having potentiality to create investment security and then business environment but it depends on stable politics.

Key words: FDI, BIPPA, Firm, Productivity, Nepal, etc

1. Context

Nepal has signed BIPPA with India in Oct, 2011(MoF, 2011). Unfortunately, the agreement has become a controversial within the country, whatever its policy provision and potential implication in Nepalese economy, particularly FDI and Export Trade Promotion. In fact, the Supreme Court gave the interim order to the government of Nepal for amending the agreement by the Parliament for its effectiveness. It raised a genuine query about the transitional government's right to sign the bilateral agreement. About the provision of investment protection and promotion, Nepalese people have shown concern of sensitiveness and suspiciousness about its potential threat to the national interest of Nepal. In this context, BIPPA is urgently needed to understand in depth for its potential policy implication in Nepalese economy.

This policy paper is a study of BIPPA between Nepal and India. This paper assesses BIPPA and its binding provisions, and BIPPA's relevancy in Nepalese economy. In fact, this paper just presents the linkage between BIPPA and FDI inflow in Nepal and further recommends the policy makers and the student of economics to discuss uncertain effects about BIPPA in FDI investment, industrial development, the growth of productivity and export trade promotion in short and long run.

2. About BIPPA

Bilateral Investment Protection and Promotion Agreement (BIPPA) is a bilateral agreement for Investment Protection and Promotion (MOC, 2011). In principle, BIPPA is based on the desire of the mother country of FDI to protect and promote their investment in the host country, where the mother country has suspicion about business environment and unknown potential risk and threats as well as safeguard. This policy provision can work as policy shield to reduce non economic cost and loss in the MNC firm's production cost in the host country. In addition, this makes aware to the government for maintaining and assuring business environment and investment friendly environment for ever. In fact, its positive implication can be seen in investment environment.

This is a legal agreement which creates special rights and obligations to foreign investors of mother country for achieving investment protection and promotion environment through provision of national treatment and compensation measures. This arrangement is a safeguard measure to the investor's rights to protect and promote investment. Under this agreement, the host country should be legally binding to provide compensation to internalize natural and unnatural externalities (*war, armed conflict emergency and riot).*

Box -1: Features of BIPPA

- Bilateral Agreement in Transitional period for 10 years
- Investment, intellectual property and share investment
- Investment protection and promotion by compensation to Investor (losses due to war or other armed conflict, a state of national emergency or insurrection or riots)
- Expatriation of profit and investment
- National Treatment to Indian Investor
- Commitment of Business Environment
- Dispute Settlement
- Nepal's first BIPPA but India's 80th BIPPA

BIPPA is the bilateral agreement between India and Nepal for Investment Protection and Promotion. The agreement was a desire of Indian Government in the context of eroding business environment and investment environment particularly to Indian Investors. Indian Investors have been targeted intentionally. For example: Maoist attacked GMR office for the Upper Karnali Hydro project which was scheduled to generate 900 MW by 2016(Bista, 2008 & Bista, 2011). The Maoist threatened a second power project undertaken by GMR with Nepali Partner in 2011. In order to protect and promote Indian investors investment in Nepal, the government of India proposed BIPPA and then, the agreement was signed by the government of India and the government of Nepal in India during Prime minister's India visit in Oct, 2011. Nepal has already signed BIPPA with Six countries such as France (1983), Germany (1986), UK (1993), Mauritius (1999) and Finland (2009) meanwhile India has signed such agreement with 80 countries, out of which 70 BIPPAS are in effective. In South Asia, India has such arrangement with Sri Lanka and Bangladesh.

BIPPA is not new to Nepal. Nepal signed first of all BIPPA with France in 1983. Then after, Nepal did BIPPA with Germany (1986), UK (1993), Mauritius (1999) and Finland (2009). There is query about any different issues and provisions in BIPPA with India. In general, this BIPPA is just like previous BIPPA with France, Germany, Finland, UK and Mauritius. In addition, the agreement is based on International provisions. Despite similar footage of the present BIPPA, the future of BIPPA is uncertain until the parliament will endorse the government's bilateral agreement. This uncertainty is due to BIPPA is not economic concern but also national concern of small country, Nepal. In order to understand its sensitiveness, this paper finds its basic features (Box No-1) through out BIPPA.

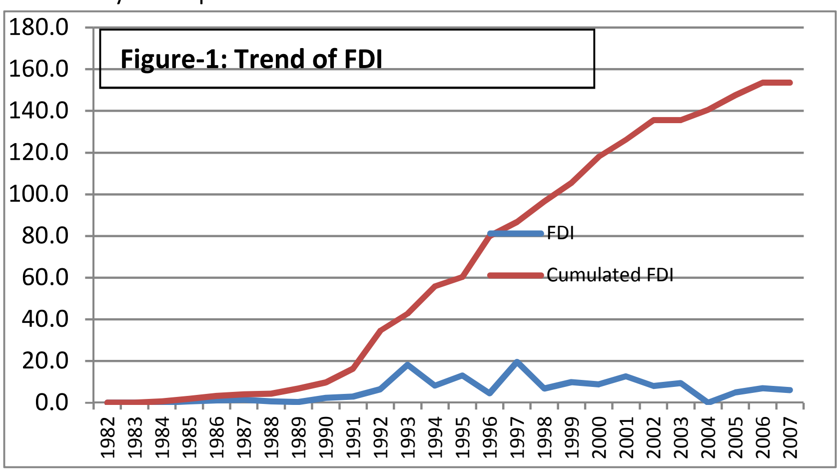
3. BIPPA AND FDI

The government of Nepal has an infinite desire to attract FDI for industrial growth and export trade promotion through BIPPA, although the government party with nationalism agenda has not clear political stand about economic liberalization policy and FDI. Literatures have indicated the gap between the policy decision of the government and the commitment and behavior of the government party. The gap can be seen negative implication in the past business environment and investment environment of the country. This can be reflected by FDI's status, trend and situation before BIPPA.

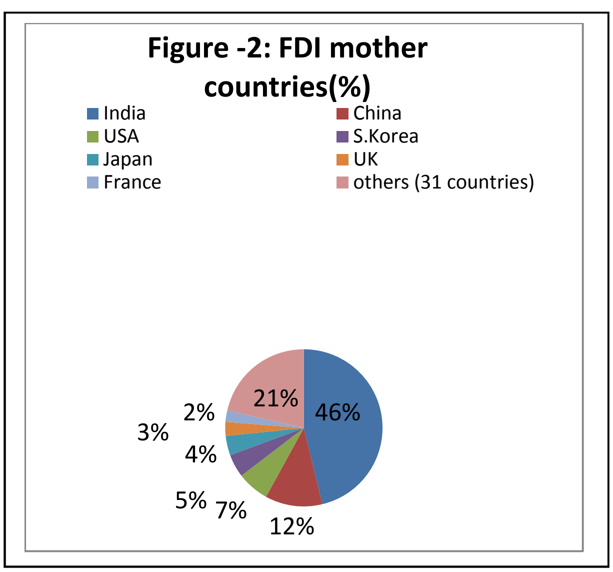
3.1. FDI inflow in Nepal: PRE BIPPA

In developing countries, Foreign Direct Investment (FDI) has become a prominent source of investment to expand export trade and industrialization for addressing poverty, inequality and unemployment issue because of a problem of bulk resource gap. Nepal has made FDI as a source of industrial investment to manage resource crunch through developing investment friendly policy environment since 1992 (Bista, 2004, Bista, 2005a, Bista, 2005b, Bista, 2005c, Bista, 2008, Bista, 2009 & Bista, 2011). The share of FDI in industrial investment has been expansionary but is found unexpectedly lower than the policy expectation. In 2010, FDI status was 39 million in US Dollar (Bista, 2005c, Bista 2008, Bista 2009, Bista, 2011, MoF, 2011, UNCTAD, 2011 & WEF, 2011).

FDI status and trend in Nepal are not much more changed. UNCTAD's FDI Performance Index in 2010 showed no change in Nepal's ranking. UNCTAD's WIR 2011 has placed Nepal at 134th position in the Inward FDI Performance Index. According to WIR, FDI inflow to the country in 2010 was same as that in 2009. The report says Nepal received $39 million in FDI in 2010. In accordance with WB (2007), such FDI size was less than 1 % in South Asia. Nepal's worsening image as FDI destination is further illustrated by the latest statistics of the Department of Industry (DoI). As per DoI statistics (2011), FDI commitment has declined by 48.35 percent in 2010-11



Despite liberal FDI policy and comparative advantage, Nepal has not been able to attract the expected FDI in different economic sectors (industry, energy, agriculture etc.)(Bista, 2004, Bista, 2005a, Bista, 2005b, Bista, 2005c, Bista, 2008, Bista, 2009 & Bista, 2011). In addition, as developing country, Nepal deserves most potential FDI destination of the world. However, direction of FDI in the World is market driven rather than deserving country. According to UNCTAD (2011), global FDI flows recovered from the post-meltdown $1.19 trillion to $1.24 trillion in 2010, with the United States being the largest recipient ($228 billion), followed by mainland China ($106 billion) and Hong Kong ($69 billion). It may puzzle to the policy maker what to do in the condition of possible FDI shock and its investment and technological multiplier effects.

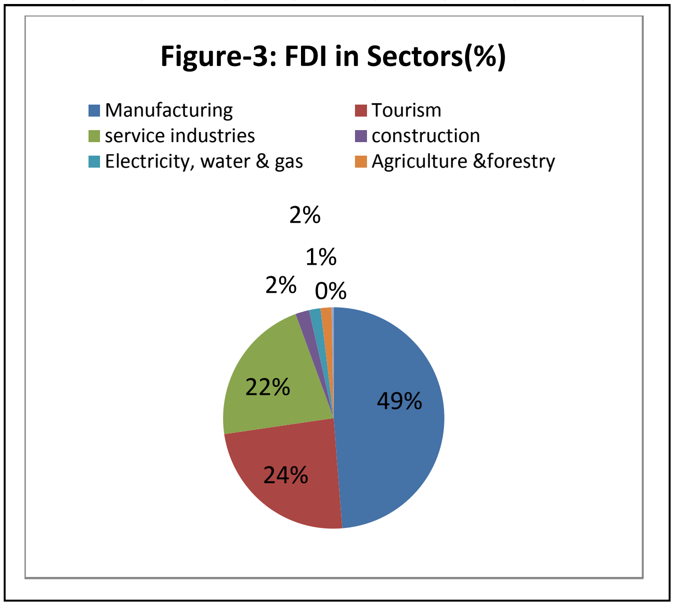


Trend of FDI inflow in Nepal from 1982 to 2010 is unexpectedly fluctuating line(Bista, 2004, Bista, 2005a, Bista, 2005b, Bista, 2005c, Bista, 2008, Bista, 2009, Bista, 2011, MoF, 2011 & MoI, 2011). If we divide economic reform I from 1982 to 1990 and economic reform II from 1990 to 2010, FDI inflow in the period I was inclining trend but in the period II it is found fluctuating in the beginning and then declining. In the economic reform II, there can be divided into two time periods: normal from 1990 to 1995 and insurgency from 1996 to 2006(*see its figure-1*). In the normal period, FDI trend was fluctuating, despite adopting liberalization and privatization policy, business environment and government commitment. In the insurgency, it could be expected. However, overall trend of FDI inflow in Nepal indicates something wrong and was quiet reverse with in South Asia inclining tend line.

3.1.1. FDI Type and Nature

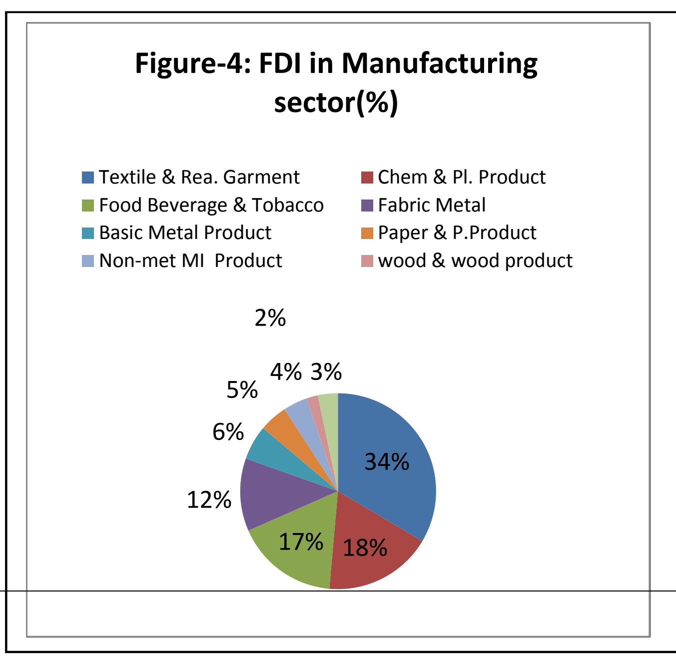
3.1.1.1. By source

FDI structure is an important indicator to understand which types of FDI firms and FDI mother countries are interested in which sectors, how much this preference of FDI firms is co integrated with national policy priority and whether this pattern of FDI structure is an optimal condition to Nepal. We can see the structure from mother countries, sector and manufacturing sector. In FDI mother countries, there was heterogeneity of approximately 37 countries (developed and neighbor countries) Bista, 2004, Bista, 2005a, Bista, 2005b, Bista, 2005c, Bista, 2008, Bista, 2009 & Bista, 2011).. Major mother countries are India, China, USA, Japan, France, South Korea and UK. Neighbor countries: India and China were top most FDI source countries for Nepal. Then, it was followed by USA, South Korea, Japan, UK and France *(see figure-2*). Thus, FDI incidence of India and China was relatively higher in Nepal. How many FDI of these countries might be beneficial to meet national expectation may be a serious issue.



3.1.1.2. By Sector

Nepal is potential for water resources and tourism but largest FDI firms are coming in manufacturing sector and then followed by tourism, service and others. Except manufacturing, tourism and service sector, FDI inflow in construction, electricity and agriculture was negligible having 2% or less than 2% (*see figure-3*). This sector structure indicated two major attractions: comparative benefits of Nepalese labor and market access in India and China under trade treaty preference. Thus, FDI in sector seems to be market driven as well as profit driven.



When we further classify manufacturing sectors, there are eight major areas: Textile and Rea garment, Chemical and

Pl. product, Food Beverage and Tobacco, Fabric Metal, Basic metal Product, Paper and P. product, Non-met MI product and wood and wood product Bista, 2004, Bista, 2005a, Bista, 2005b, Bista, 2005c, Bista, 2008, Bista, 2009, Bista, 2011& DoI, 2011).. FDI incidence was heterogeneous within manufacturing sector in which Textile and Rea garment receives largest share and was followed by Chemical and Pl. product, Food Beverage and Tobacco and Fabric Metal. All these manufacturing sectors are value added industries which are more domestic intensive than export, except textile and garment. In case of textile and garment, FDI from India and China came for getting US and Germany Textile Quota trade facility (*see figure-4*). Therefore, FDI inflow in Nepal from India has a good reason.

FDI's *negligible* size and *declining* trend shows poor performance of policy in Nepal. In addition, non economic factors have eroded Nepal's image as FDI destination. At present conflict trap and transitional period, business environment and policy environment to FDI are worsening. In stead of inflow of FDI, the outflow of FDI is unexpectedly increasing because of weak FDI protection and promotion. Therefore, there is a query whether the policy is effective to attract FDI as required and as expected for attracting FDI inflow and whether the required business environment can be created.

3.1.2. Basic determinant of FDI

FDI inflow (Bista, 2004, Bista, 2005a & Bista, 2009) is basically based on the following basic conditions.

- Comparative advantage and profit
- Market size
- Investment Protection and Promotion
- Tariff and Non tariff incentives
- Business Environment (macro, policy, law and order etc.)

In recent years, the conflict trap in Nepal has made above basic determinant of FDI inflow critical and weak. MNC has experienced with a potential risk because of poor business environment and lack of investment protection. Further, MNC are not motivated with comparative advantage and tariff and non tariff incentives. Indian FDI has been vulnerable in transitional environment. Therefore, FDI commitments are unexpectedly low.

3.2. Post BIPPA and Potential Implication

It is said that BIPPA is a milestone to address these issues for attracting substantial FDI in Nepal for expanding industrial led economic growth, employment and export promotion. In the context of poor performance of FDI status, trend and structure, eroding business environment, transitional politics, conflict trap situation, and poor performance of competitiveness (125th position out of 142 countries), this paper finds few queries to be discussed and answered as follows.

- What will be potential implications of BIPPA in National Economy?
- Can BIPPA create the political consensus of National Parties to make business environment by controlling non economic actors and activism?
- Does BIPPA secure Nepalese Private Sector's interest?
- Will BIPPA bring substantial Indian Investment in industrial sectors?
- Can BIPPA boost up the confidence of foreign investors?
- Will BIPPA contribute export promotion of Nepalese goods in Indian Market by eliminating tariff and non tariff barriers?

Naturally, these issues are quiet interesting to us as student of economics. In micro economic, theory of firm has a principle of investment related to profit motive through optimization: cost minimization and profit maximization (Colell, et al., 2010). Empirical literature of investment, particularly FDI and MNC shows profit motive characteristics and preferences to comparative advantage, market size and business environment for profit and investment security. Therefore, the expected profit in decision making of FDI is an important variable, rather than investment security. In this theoretical and empirical framework, we have a query whether BIPPA will be favorable in this regard.

Comparative Advantage

Why Indian and Non Indian FDI have to come in Nepal may be a good query. Either big or small investors follow theory of firm. It is nothing to make profit more than mother countries. In the literature of WTO regime, it is possible only when comparative advantage lies in Nepal more than other countries. Of course, water resources are identified potential areas which can give white gold to the investors by exporting in the energy deficit South Asian Region. However, Indian Market is highly competitive because of monopoly market's bargaining power. The market can be targeted when energy per unit will be least. Otherwise, the energy producer will have a commercial risk. Similarly, Nepal has cheap labor but these labor forces are unskilled and lower productivity one hand and another hand are politically influenced and organized. They are quiet conscious about their right more than their capacity and responsibility. In addition, a large size of labor force is in the outflow in different labor market destinations of the world. Domestic labor market in agriculture and industries may be believed not equilibrium because of excessive demand of skilled labor. In this critical situation, Nepal is not comfortable for comparative advantage, if the government does not work seriously to eliminate issues related to these identified comparative advantage.

Market

Market is another important attraction to Indian and Non Indian FDI. Nepalese market is realized a small of 3 crore population in comparison with Indian and Chinese domestic market. In fact, big MNC's investment will not be economically compatible and viable until Nepalese products will get easy access in Indian and Chinese market. Naturally, medium and small scale investment is economically compatible. However, we have a question, why should Indian and Non Indian FDI come here in this market? There may be argument that our fiscal policy is better than other countries in tax exemption and our business environment is fine. However, FDI inflow in Nepal is still less than 1 percent in South Asian Region. Our fiscal and monetary policy and the business environment have not been effective in this situation.

Above these two variables of profit has not strong theoretical and empirical ground to meet cost minimization and profit maximization of the firm. Except these facts, we can hope that BIPPA can first make investment security and then business environment. How much the variable to risk minimization in the abnormal situation can assure the investor without profit making environment. Let's discuss and present hopes of BIPPA.

BIPPA is an important measure to create first to investment security which is legal assurance of the government to Indian Investors can improve confidence of Indian investors to minimize non economic risks through compensation of loss. After the enforcement of BIPPA, Indian investors will be eligible to claim to compensation in any non commercial risk. It will be for 10 years. There is a lot of hope but the government is silent on FNCCI's claim for compensation of loss due to non commercial loss (conflict, strikes and uprising) during the period between 1996 and 2006. Therefore, BIPPA's performance will depend on the government's commitment and behavior.

There is an argument of FNCCI that this bilateral agreement has capacity to create obligatory situation to Nepal for investment security of present Indian investors. But it is a secondary element because investors should make their investment destination first in Nepal. If investment is not coming, there will not be relevancy about investment security. Therefore, the government should implement properly BIPPA to create business environment. FNCCI explains their concern with business environment as by product of BIPPA first and then welcome Indian FDI and Non Indian FDI because Nepalese private sectors are suffering from huge losses from eroding business environment and weak commitment of the government. Therefore, our expectation will be business environment for business within the country.

We have a query whether BIPPA attracts FDI, particularly Indian FDI. It is very difficult to say that BIPPA has capacity to attract substantially Indian FDI because profit and business are major determinants of investment. The 18^{th} hour's long load shedding per day and labor issues have been eroding business environment. In this context, energy based industries and labor intensive industries might be non motivational to Indian and Non Indian FDI until these issues will be settled properly. Possibly, investment can come in non energy and capital intensive industries including hydro projects, infrastructure, banking sector and hotels. It depends on business environment and potential profit. We can not ignore the aggressiveness of non state actors and its potential damages. Let's OK the government provides compensation but the government has not a strong capacity to control the aggressiveness of non state actors in the transitional politics where the government has a short life.

In this pessimistic situation, BIPPA will not have positive implication in the expected sectors through the expected investment.

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