A Study of the Impact of Foreign Direct Investment Policy of Rich Countries on Poverty Reduction of Developing Countries: A Case Study of Manufacturing Sector in Nepal

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1. Summary

The role of foreign direct investments (FDIs) has been crucial in spurring economic growth and poverty reduction in developing countries, especially in the context of globalization and liberalization. The increasing quantum of FDIs since early 1990s is attributed to the growing interdependence between economies. In recent years, developing countries have shown tremendous inclination towards attracting FDIs from high- and middle-income economies to accelerate the pace of industrialization by enhancing efficiency and competitiveness and fight against poverty. Therefore, it is imperative to review the policy of rich countries on poverty reduction in vulnerable economies by analysing the impact of FDIs on poverty reduction. The mobility of capital from private to private sector in the form of joint ventures has strong theoretical underpinning to sustain high-level and broad-based growth and drive efforts towards poverty alleviation in conformity with the Millennium Development Goals (MDGs). The bilateral and multilateral sources which are instrumental in supporting and implementing poverty reduction strategies in developing countries consider FDI as a tool kit, if not a panacea, for poverty reduction through contribution to pro-poor growth in a competitive market environment.

FDI contributes to development at least in three ways: (a) It is a perennial source for new investment capital, allowing countries to raise imports and accumulate capital faster, (b) It helps encourage technology transfer and increase human capital stock and thereby stimulates long-term productivity and growth of domestic firms, and (c) It is instrumental in expediting the process of economic integration and competitiveness by helping to link developing economies to global supply and production chains. Economic growth is a critical factor for poverty reduction. Recent studies suggest that growth tends to lift the incomes of the poor proportionately with overall growth. FDI, as a key vehicle to generate growth, is thus a most important ingredient for poverty reduction. FDI has the potential to improve the quality of growth by: (a) reducing the volatility of capital flows and incomes, (b) improving asset and income distribution at the time of privatization, (c) helping improve social and environmental standards, and (d) helping improve social safety nets and basic services for the poor

The main objective of the proposed research is to analyse the impact of FDI policies pursued by the rich countries on poverty alleviation efforts in Nepal, especially in manufacturing sector, which is defined as industries producing goods by utilizing or processing raw materials, semi-processed materials, by-products or waste products or any other goods (Industrial Enterprises Act 1992). Currently, Nepalese economy is passing through a critical phase of poverty and stagnation engulfed by conflict. With a diminutive GNI, poor growth and inordinately low GNI

per capita, Nepalese economy is a classic case of poverty which requires a big push, especially through FDIs and joint ventures to accelerate growth and combat poverty. Therefore, this study has strategic importance in the context of poverty reduction efforts of FDI destination countries. A conceptual and schematic framework has been designed to study the impact of the policy of rich country on poverty reduction. This exhibits that both pull and push factors are responsible in determining the quantum of private investment and the priority area for investment. The schematic framework also demonstrates the spectrum of impact that results from the FDI.

The research study will be mainly based on secondary data and information. However, primary data will be employed to measure the impact of FDI on poverty reduction in manufacturing sector. An analytical approach will be pursued to assess the link between the policies and decisions taken by rich countries and the degrees that affect the quantity, quality and impact of investment flows. In addition, determinants of private investment, employment elasticity to growth and linkage between income elasticity to poverty reduction will be estimated by using quantitative techniques.

The major expected outcomes of the study are: a) knowledge about the linkage between the rich country policies and the development of poor countries enhanced, b) development impact of rich country policy influenced FDI assessed, and c) Impact of FDI in manufacturing sector on poverty reduction measured.

2. Objectives, Test Hypotheses and Significance of Research

2.1 Objectives

The primary objective of the proposed research will be to analyse the impact of FDI policies pursued by rich countries on poverty alleviation efforts, especially in the context of manufacturing sector in Nepal. This study also includes the following objectives in consonance with the main objective, which are to:

i. Assess the impact of rich country FDI policy on poverty reduction in Nepal, especially in the context of employment;

ii. Analyse the structure, pattern, composition of FDI and its sources in the light of foreign investment policy of Nepal;

iii. Evaluate the impact of FDI on price competitiveness, quality enhancement, human resource development, export promotion and employment generation;

iv. Assess economic integration and competitiveness as reflected in global supply and production chains; and

v. Assess the direct as well as indirect impact of FDI in manufacturing sector on poverty reduction and derive policy implications for FDI from poverty reduction perspectives.

2.2 Test Hypotheses

i. There is a link between the policies of rich countries and the flow of FDI to developing countries. This link can be demonstrated by analysing the data of manufacturing sector of Nepal with reference to foreign investment policy of Nepal and source countries.

ii. There is a positive link between the FDI and poverty reduction via economic growth. This hypothesis is equally true with the role of FDI in the manufacturing sector of Nepal.

2.3 Significance of Research

The impact of rich countries' policies on the developing countries has been subject to considerable discussions and analysis, but often among researchers and policy advisers from developed countries. An in-depth and comprehensive analysis of the impact of FDI policy of rich countries on the development of developing countries with special focus on poverty reduction by researchers of poor countries is lacking. The understanding of linkages between the FDI policies and the impact is important for the following reasons:

Rich country policies have had significant bearing on the process of globalization and liberalization in Nepal. Under the circumstances, Nepal's development will further be conditioned to, and influenced by, the policies of the same rich donor countries. It is a widely accepted and known fact that rich country policies have impact on the development of poor countries. However, the knowledge about the way they impact is still inadequate. Moreover, the impact of individual policies on particular sectors of development is still to be identified, particularly by poor countries. A comprehensive understanding of the policy impact is important for three reasons: (a) It helps to quantify/qualify the development impact of rich country policy, (b) It helps to critically assess the barriers that prevent rich country policy to generate desirable development impact, and (c) It helps critically evaluate the rich country policy and lobby for more effective policy from them.

Rich country policies impact various socio-economic variables. More direct impact has been visualized in the areas of foreign aid, foreign direct investment, foreign trade and migration. FDI is a more reliable indicator of economic development than foreign aid. The quality and quantity of foreign trade in a capital- and technology-scarce economy mainly depend on the level of FDI. Understanding the relationship between private investment and development is essential for two reasons:

- First, it is clear that private capital will play an ever-increasing role in development and poverty reduction strategy. Understanding how to encourage greater quantum of private investment, how and when private capital might substitute for official flows, and how that capital might best be linked to desirable development outcomes will be a critical public question for both developed and developing countries.
- Second, issues related to private investment are on the global policy agenda and a better understanding of the dynamics at play is required.

3. Brief Survey of Relevant Literature

3.1 Review of policy and legal documents

After the restoration of democracy in 1990, Nepal liberalized its economy with the formulation and amendment of a series of legal and policy documents. Following the Constitution of the Kingdom of Nepal 1990 in letter and spirit, a number of policies have been designed to attract foreign capital and technology by inviting joint ventures to ensure growth and poverty alleviation in Nepal. The specific policy documents that came into existence after 1990 comprise: (a) Industrial Policy 1992, (b) Foreign Direct Investment and One Window Policy 1992, (c) Foreign Investment and Technology Transfer Act 1992 and (d) Industrial Enterprises Act 1992. These policies have been instrumental in providing ample opportunity to attract FDIs from rich countries and interest of foreign investors. His Majesty's Government of Nepal (HMGN) initiated the policy of globalization, liberalization and privatization during the Eighth Plan (1990-95) and subsequently in the Ninth Plan (1995-2000). The Tenth Plan (2002-07) envisages twin objectives comprising sustainable, high and broad-based growth and poverty reduction with special emphasis on the policy of increasing industrial competitiveness by attracting FDIs through inducting appropriate technology (Tenth Plan 2002).

3.2 Review of FDI, growth and poverty status of Nepal

As of July 2003, the available FDI statistics reflect that there were 835 foreign investment projects registered in Nepal comprising all categories of industries, with a total investment of US$1.1 billion, a total fixed capital equal to US$926 million and FDIs to the tune of US$300 million providing employment to 92,325 people (IIDS 2003). The magnitude of FDI is the highest in manufacturing sector, marking US$126 million (1988/89–2002/03), which was 42 per cent of the total. The manufacturing sector provides the highest level of employment, which is 63.7 per cent of the total employment generated through FDI (HMGN/DOI 2003).

During the current Plan, the quantum of FDIs is estimated to be to the tune of US$2.0 billion, which will help expand the base of industrial capital in Nepal. Nepal's accession to the World Trade Organization (WTO) as the 147th country has created a conducive and reliable climate for investment to foreign investors in the country. The programmes for economic reforms compatible with the provisions made by WTO, SAFTA and BIMST-EC are under implementation despite the ongoing conflict and recession facing the economy in recent years. The economic growth rate confined to –0.6 per cent in 2001/02, 3.1 per cent in 2002/03 and 3.7 per cent in 2003/4, and is projected to be 4.5 per cent in 2004/5 (Economic Survey 2003/04). More than 65.0 per cent deficit in the budget for FY2004/05 will be supplemented by bilateral and multilateral loans.

Nepalese economy is passing through a critical phase of low-level equilibrium trap circumscribed by poverty and stagnation. This is further engulfed by recession, conflict, inefficiency and mounting corruption, making Nepal one of the poorest countries in the world. The latest macro-economic indicators exhibit that Nepal's economic status is extremely vulnerable with diminutive size of GNI (US$6 billion), poor economic growth rate (3.7 per cent) and inordinately low GNI per capita (US$250), which is the lowest in the SAARC region. Recent trends reflect increasing fiscal deficits with more than 8.0 per cent of GDP, staggering magnitude of trade deficit as high as 27.0 per cent of GDP, and widening gap between savings and investment (Economic Survey 2003/04). The total foreign loan is estimated to exceed US$3 billion up to FY2003/04 (WDR 2004).

Poverty is acute, pervasive and widespread in Nepal and a majority of population lives in abject poverty. The population below income poverty line with less than US$1 a day was 37.7 per cent and with US$2 a day was 82.5 per cent of the total population during 1990-2000. Thus, poverty gap is widening. Life expectancy at birth is estimated to be 60 years for the period 2000-05, while infant mortality rate was 66 per 1,000 live births in 2002. Adult literacy rate was 44.0 per cent of ages 15 and above in 2002. In terms of human development index, Nepal ranks 140th in the group of 177 countries. The HDI value for Nepal, estimated to be 0.504 for 2002, is indicative of low level of human development in SAARC region (HDR 2004).

3.3 Review of linkage between FDI, growth and poverty reduction

There is a growing recognition in both developing and developed countries that private capital is an essential component of development finance and necessary counterpart to official donor assistance. FDI occurs when an investor based in one country (the home country) acquires an asset in another country (the host country) with the intent to manage that asset (UNCTAD 1999). FDI would contribute to development at least by three ways: (a) This is a perennial source for new investment capital, allowing countries to raise imports and accumulating capital faster; (b) It would help encourage technology transfer and increase human capital stock and thereby stimulate the long-term productivity and growth of domestic firm; and (c) It is instrumental in expediting the process of economic integration and competitiveness by helping to link developing economies to global supply and production chains.

Typically, the relationship between FDI and (income) poverty reduction is segmented into the relationship between FDI and (income) growth on the one hand and that between growth and poverty reduction on the other. Regarding the relationship between FDI and growth, it is generally found that inflows of FDI encourage more rapid economic growth. FDI clearly does make a *direct* contribution, for example through measurable employment and income generation, but its aggregate impact seen in these terms is very small, and it is the *indirect* contribution that is of greater consequence. The indirect benefits of FDI for a host country's economic development are transmitted through linkages (backward and forward), spillovers, demonstration effects and so on. More important, however, is the more qualitative indirect impact of FDI on a whole spectrum of human development issues, such as training, education, gender equality, housing, improved health, community development and so on.

Economic growth remains a necessary ingredient for poverty reduction. Recent studies suggest that growth tends to lift the incomes of the poor proportionately with overall growth (Dollar and Kraay 2000). FDI as a key vehicle to generate growth is thus a most important ingredient for poverty reduction. Whether the potential for domestic diffusion of best practice can be exploited depends on the absorption capacity of the host economy. Adequate levels of education and infrastructure are required to fully benefit from FDI (Borenzstein, De Gregoria and Lee 1998) as well as competition in domestic markets (Bromstrom and Kokko 1996). FDI has the potential to improve the quality of growth by: (a) reducing the volatility of capital flows and incomes, (b) improving asset and income distribution at the time of privatization, (c) helping improve social and environmental standards, and (d) helping improve social safety nets and basic services for the poor.

Social safety nets for the very poor and redistribution of assets and incomes towards them tend to require either important charitable activity or government intervention. Foreign investment can often be important for creating pre-conditions for such intervention. Foreign investors, by virtue of their productivity, can help generate the tax revenue required to fund assistance to the poor through their own tax contribution and indirectly by stimulating growth and thus broadening the tax base.

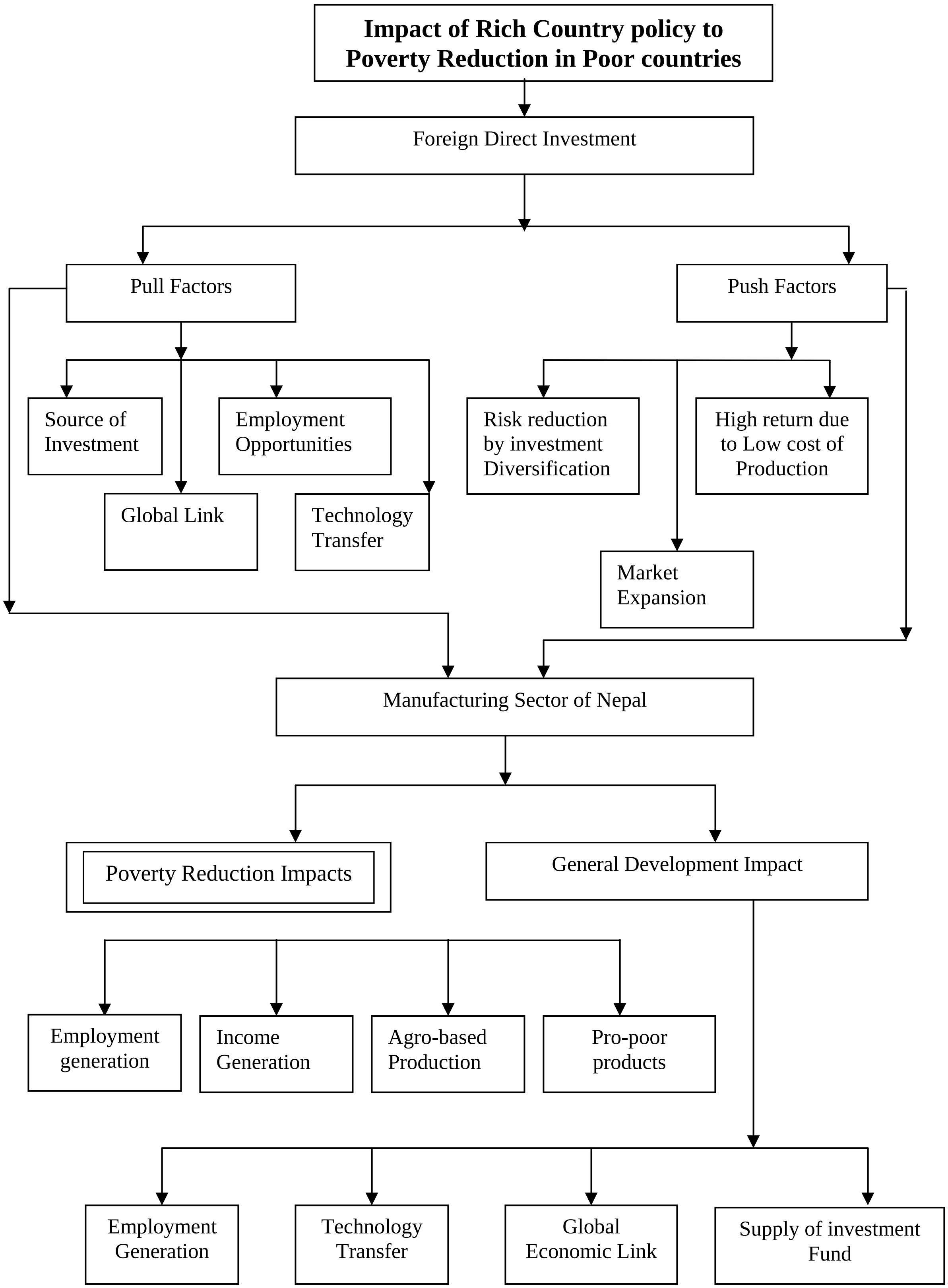
4. Methodological Framework and Data Description

4.1 Conceptual Framework

The study would approach to trace out the link of rich country to poor country with regard to policies towards poverty reduction. The study will follow the deductive approach, which will derive conclusion from general to particular. The analysis will begin with an assessment of policies initiated by rich countries in general and the sector-specific contribution of FDI in particular. FDI is advantageous for both the investor and host countries. The push factors indicate the benefits to the investors and the pull factors to the host countries. First, international flows of capital reduce the risk faced by owners of capital by allowing them to diversify their lending and investment. Second, FDI allows capital to seek out the highest rate of return. Third, FDI helps to expand market. For the host countries, it can contribute to the general development as well as to the poverty reduction objective in a variety of ways. Major benefits to host countries are as follows:

- FDI allows transfer of technology—particularly in the form of new varieties of capital inputs—that cannot be achieved through financial investments or trade in goods and services. FDI can also promote competition in the domestic input market.
- Recipients of FDI often gain employee training in the course of operating the new businesses, which contributes to human capital development in the host country.
- Profits generated by FDI contribute to corporate tax revenues in the host country. Thus, it contributes not only to the direct source of investment but also to the government revenue.
- FDI helps to integrate the host countries economy to the global economy.

The following schematic framework presents the conceptual framework:



4.2 General Methodology

This study will be based on secondary data and information. However, primary data will be employed to measure the impact of FDI on poverty reduction in manufacturing sector. For quantitative analysis, ten years' data, covering the period 1994-2003, will be used. An analytical approach will be pursued to assess the link between the policies and decisions taken by rich countries and the degrees that affect the quantity, quality and impact of investment flows. Both quantitative as well as qualitative techniques will be used in this study.

Manufacturing sector has been chosen for impact study. The reason behind the choice is that FDI and its impact on the development of manufacturing sector of Nepal is a green area of research not undertaken before. The research will focus primarily on the impact of FDI on poverty reduction through the development of manufacturing sector. The reasons for the selection of this sector are: (a) Manufacturing is the major sector attracting FDI in terms of the size of investment, (b) Manufacturing sector is generating more employment from FDI, (c) Manufacturing sector has more spillover effects, and (d) It is relatively easy to identify and quantify the impact of FDI on manufacturing sector.

During the course of research study, trends in FDI from USA, Japan, UK and Germany will be reviewed extensively from the perspectives of rich country policies. The FDI from India and China will also be considered for comparative study, because Indian join ventures constitute 35 per cent of the total projects, and also FDI from China is increasing over the years.

4.3 Tools of Analysis

Quantitative techniques will be used to find out the determinants of private investment in Nepal. For this, the explanatory variables to be used are GDP growth rate over the previous year (G), domestic credit availability as share of GDP (CRDT/Y), net foreign direct investment inflows as share of GDP (FDI/Y), terms of trade (TOT), real exchange rate (RER) and real lending rate (RLR).

Similarly to explain the growth and poverty linkages:

- Employment elasticity to growth will be calculated
- Linkage between income elasticity and poverty reduction will be determined

To estimate elasticity, variables such as level of employment, types of employment and real wages received by the worker will be employed. Moreover to analyse the impact on poverty reduction of the income received, the expenditure pattern of workers will also be examined.

4.4 Specific Objective-wise Methodology

By objectives, the methods used to achieve them are as follows:

i) Assess the link between the rich country FDI policy and poverty reduction impact

- The major policy documents of rich countries designed for poor countries will be reviewed, and also Nepal country assistance programmes of rich countries will be studied. This review and study is necessary to find out the link that exists between the policies of rich countries and the flow of FDI in poor countries. Moreover, this review will help to know how policies influence the flow of FDI in priority sector of host country.

- On the basis of secondary data/information, attempt will be made to show the impact of rich country policy on the flow of FDI, use of FDI and its performance in manufacturing sector.

- An expert opinion survey of policymakers, experts and a perception survey of stakeholders and civil society will be conducted by administering questionnaires on sample populations in order to understand the recognition of the role of FDI on poverty reduction at the level of both experts and people.

ii) <u>Analyze the FDI trend, pattern, composition and sources in the light of foreign investment policy of Nepal</u>

This analysis will be carried out by using the data for a period of ten years starting from 1994 to 2003. Interpretation of results will be made with reference to foreign investment policy of Nepal.

iii) <u>Evaluate the impact of FDI on price competitiveness, quality enhancement, human resource development, export promotion and employment generation</u>

The impact of rich country policy on Nepal's efforts towards poverty reduction will be examined by preparing case studies of sample three major joint venture industries under manufacturing sector. For this, primary data will be generated through field survey. Sample joint ventures in manufacturing sector will be selected on the basis of industrial classification comprising location, size, nature and employment status. These case studies will present a comparative picture of the status of the firm/industry before and after situation taking into consideration that are outlined under the general development impact and poverty reduction impact in Conceptual Framework.

iv) A<u>ssess economic integration and competitiveness as reflected in global supply and production chains</u>

For this, export volume of the product, diversification of the destination of exports, competitiveness of Nepalese product in terms of cost, price and quality will be judged.

v) <u>Assess direct as well as indirect impact of FDI on poverty reduction and derive policy implications for FDI from poverty reduction perspectives</u>

- Synthesizing experience of developing country by reviewing literature on FDI impact and juxtaposing the Nepalese experience of the impact of FDI on development
- Running internal and external environmental scan of the sample manufacturing industry to assess the context in which FDI has to generate impact
- Evaluation of the Impact of FDI considering ground realities of Nepal

- Documentation of lessons
- Organization of a seminar to disseminate the findings of the study among stakeholders.

5. Expected Outcomes

1. Knowledge about the linkage between the rich country policies and the development of poor countries enhanced.
2. Development impact of rich country policy influenced FDI assessed, and
3. Impact of FDI in manufacturing sector on poverty reduction measured.

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