5 Nepal

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I. Introduction

Location

Nepal is a small Asian country situated in the lap of Himalaya. It is a landlocked country located between the Tibetan region of the People's Republic of China to the north and the Republic of India to the south, east and west. It extends from 80°4' E to 88°12' E longitude and 26°22' N to 30°27' N latitudes, along the Southern slopes of the Himalayas (snow peaks) in south Asia. The elevation ranges from 60 meters above the sea level in the Southern plain to 8848 meters in the Northern part. Mt. Everest[1], the highest peak in the world with an altitude of 8848 meters, lies in Nepal. On an average, Nepal extends 885 km from east to west direction and non-uniform mean width of 193 km from north to south with total area of 147,181 square kilometers. This area is about 0.03% of the world and 0.3% of the Asia. Kathmandu is the capital of the country that is located in the central part of Nepal at an altitude of 1336 m above the sea level.

Climate

The climate in Nepal varies from sub-tropical to alpine within a short distance due to tremendous variation in topography and altitude. These factors along with direction of mountain slope have created numerous micro-environments. Alpine, cool temperate, warm temperate, subtropical and tropical climates prevail in Nepal. Subtropical and tropical climates are found in the Terai, temperate climate in the hills and alpine in the mountainous region of the country. The average rainfall of the country in the whole year is about 2000 mm; but the mean annual rainfall varies from less than 300 MM in the region near the Tibetan plateau to more than 5000 mm in the Pokhara valley and the southern slopes. About 60 to 80 percent of annual rainfall is from the monsoon season that usually starts in the month of June and ends in September. During summer the maximum temperature in the Terai is more than 40° c and it is about 28° c in the middle Hills. During winter the minimum temperature in the Terai is about 7° c, and it is about below the freezing point in the Hills.

Natural Resources

Natural resources play an important role in the economic prosperity of a country, where at the same time it equally needs the rational utilization of those resources too. The major natural resources that are available in Nepal are Water, Forest and Mineral resources, but unfortunately these resources are being heavily unused, underused or misused.

(i) Water Resources

Water resource is the most important natural resource of the country. Nepal is the second richest country in the world possessing about 2.27 percent of the world water resource. The major sources of water are: glaciers, snowmelt from Himalays, rainfall and groundwater. It is estimated that there are altogether 6,000 rivers (including rivulets and tributaries) having about 45,000 kms. length. Koshi, Gandaki and Karnali are the main river systems getting major part of their water supply.

(ii) Forest Resources

[1] Mt. Everest is commonly called "Sagarmatha" in Nepalese language.

Forest is another major natural resource for the country that provides more than fifty percent of fodder to the livestock. Several industries in the country are based on forest products for their raw materials. The benefits and the beauty that are derived from the forest and its usefulness to maintain natural and ecological balance cannot be measured in the economic term.

(iii) Mineral Resources

Studies on mineral resources indicate that iron, copper, mica, gold, lead and zinc, lime-stone, slate, mineral oil and gas, coal, nickel, sulphur, figureite, dolomite are available in Nepal. But the proper exploitations of these minerals require financial resources, technical know-how and a good system of transportation facility which Nepal does not have as per the requirement. So, Nepal has not got success to get enough benefits from these resources.

Ecological Division

Ecologically, the country has been divided into three regions, running from East to West, namely; (i) Plain (Terai) Region (ii) Hill Region, and (iii) Mountain Region.

(i) Plain Region

Plain Region, commonly known as Terai, lies on the southern part of the country with the altitude ranges from 60 meters to 610 meters above the sea level. This region is low, flat and fertile. It covers 23 percent of the total area of the country out of which 40 percent is under cultivation. It is also known as the “grain basket” of Nepal. Water resources, fertility and its flatness permits the cultivation of variety of crops in this area such as paddy, maize, wheat, sugarcane, vegetables, tobacco, jute and several others. According to the Population Census carried out by the Central Bureau of Statistics (CBS) in 2001 48.4 percent of the total populations live in this region.

(ii) Hill Region

The hill region lies between the altitudes of 610 meters to 4,877 meters above the sea level. This region accounts the largest share (42 percent) of the total land area of the country out of which only 10 percent is under cultivation. In the higher altitudes of this region the main occupation includes animal grazing, cottage industry and cultivation of high altitudes cereals whereas in the lower altitudes, cultivation of cereal and cash crops is adopted as the main occupation. This region comprises of several gorgeous mountains, high peaks, hills, basins and valleys such as Kathmandu, Pokhara, Hetauda, Dang, Surkhet and several others. These valleys, especially the Kathmandu valley, support relatively high percentage of the hill population. Share of population of this region was 44.3 percent on 2001 census. This region comprises several gorgeous mountains, high peaks, hills, valleys and lakes.

(iii) Mountain Region

This region lies on the northern part of the country covering mountainous area. The altitude ranges from 4877 meters to 8848 meters above the sea level. There are more than 250 peaks in this region with more than 6000 meters in height. In this region the snow line lies above 5000 meters and there is no human settlement above this line. This region covers 35 percent area of the country but only 2 percent of the land is suitable for cultivation. Since this region is mostly steep, rugged and cold, it is the most sparsely populated region of the country. According to the 2001 census, the region accommodates 7.3 percent of the total population. The main occupation of the people of this region is livestock raising.

Development Region and Administrative Division

In order to ensure the balanced development in the various parts of the country, Nepal has been divided into five development regions. For administrative purpose, the country has been divided into 14 Zones, and 75 Districts. Districts are further divided into number of Village Development Committees (VDC) and Municipalities. For several reasons, number and size of these local units changes from time to time. Currently there are 3,915 VDCs and 58 Municipalities including one Metropolitan and four Sub-metropolitan cities. Each VDC and municipality is further divided into wards. Total number of wards in Nepal is more than 36 thousand.

Brief History and Political Structure

The modern history of Nepal dates from the second half of the 18th century, when the King of Gorkha, Prithivi Narayan Shah[2], began to unify a group of warring Himalayan principalities conquering Kathmandu in 1768. Since that time Kathmandu has been the capital of the country. In 1846, Jung Bahadur Rana staged a coup d'etat, designated himself as the Prime Minister of the country leaving the monarchy with only nominal power. After then, Rana family ruled Nepal as hereditary prime ministers for 104 years. The Rana regime, a tightly centralized autocracy, pursued a policy of isolating Nepal from external influences. Government participation (or interference) in the economy was very strong. During Rana rule, there were very few industries other than cottage type, and they were under strict government supervision. This policy helped Nepal maintain its national independence during the colonial era, but also impeded the country's economic development. The system lasted until 1950 when the late King Tribhuvan[3] led a popular revolution which overthrew the family autocracy. Thus, Nepal entered to the new era.

Nepal introduced the annual budget system for the first time in 1952. Economic planning as an approach to development was discussed and First Five-Year Plan (1956-61) was announced in 1956. In 1959 the first general election was held and a parliamentary government set up for a short period. However, on December 15th 1960 King Mahendra declared democracy a failure and dismissed the government. In 1962 he promulgated a new constitution establishing a new political structure to consolidate direct rule. This system banned political parties and created panchayats, or councils, at the village, district and national levels that advised the king, who regained absolute power.

In 1990, the political parties organized popular Movement for the Restoration of Democracy in the country. In April 1990, the King dissolved the panchayat system, lifted the ban on political parties, thus Nepal got Democracy again. A new constitution enshrining the sovereignty of the people was adopted in that year and multi-party elections held in 1991 to elect a truly democratic government under a constitutional monarchy.

The present political structure of Nepal consists of a multi-party democracy and parliamentary system of government. The citizens of Nepal exercise rights of adult franchise. The Executive, the Legislative and the Judiciary bodies function and exercise their rights independently. For the last few years, Nepal suffered a great problem of political instability and domestic (politically motivated) war which has got some rest recently. Major political parties are now participating to build peace and prosperity in the country.

Population, Language, Religion and Cultures

According to the National Population Census of 1991 the total population of Nepal was 18.49 million which increased to 23.2 million in 2001 with an annual growth rate of 2.3 percent, despite high rates of infant mortality (59 per 1,000 live births) and a low life expectancy at birth of just 62 years. An estimation made by the Central Bureau of Statistics (Nepal) shows the population for the year 2006 to be 25.89 million with average life expectancy of 63.3 yrs. The national census (2001) shows that 14.2 percent of the total populations live in the urban areas and the rest in the rural areas. Nepal's urban population almost doubled between 1991 and 2001. The average household size was 5.4 persons in 2001. In terms of geographical distribution, 7.3% of the populations live in the mountain districts, 44.3% in the hill districts and 48.4% in the Terai, or plains, in the south. There is steady

[2] Late King Prithivi Narayan Shah is popularly known as the builder of the nation.
[3] Late king Tribhuvan Bir Bikram Shah is popularly known as the Father of the Nation.

migration from the impoverished hill and mountain areas to the Kathmandu valley and the Terai region.

Age structure of the total population shows that out of the total population, 38.5 percent belongs to age of 1-14 years, 57.4 percent belongs to 15-64 years and the rest 4.1 percent people are of the age 65 and over.

Table 1 Population by age, 2001

Age range (years)	Population (m)	% of total
0-14	8.94	38.5
15-64	13.32	57.4
65 & over	0.94	4.1
Total	23.2	100.0

Nepal is a multiethnic, multilingual country comprised of 103 distinct groups speaking 92 languages (mother tongues). All these languages are the national languages of Nepal and Nepali is the official language as well as the Lingua Franca of the people of Nepal.

Nepal is rich in cultural heritage. It is known as the country of non-stop festivals. Kathmandu city is full of golden Pagodas and Parasols. It is also the home of the Living Goddess (Kumari). Lord Buddha who is well known as the God of peace and tranquility was born in Lumbini, Nepal. According to the 2001-census, almost 80.6% of the population are Hindus, 10.7% are Buddhists, 4.2% are Islam and 4.5% others. Religious tolerance and harmony are the common features in the Nepalese way of life.

Education

The literacy rate for 15-year olds and above in the 2001 census was 48% (65% male and 42.4% female). Progress in education has been painfully slow. The government is the major education provider, and in 2003/04 (mid-July to mid-July) around 66% of a total of 6.06 million students were studying at the primary level. Nepal had 36,729 schools in 2004 – 24,746 primary, 7,436 lower secondary and 4,547 secondary schools. Nepal had 5,919 private schools in 2003/04. These schools were educating around 700,000 pupils. Males are more likely to receive an education: net female enrolment (grades 1-10) was around 56%, compared to 65% for males in 2003.

Nepal has five universities. Nepal's largest university, Tribhuvan University (TU), provides for the vast majority of undergraduates. In 2003/04 its 60 publicly funded campuses and 287 privately run affiliated campuses had a student body of 177,375 (64,647 in private colleges). Other universities are: Kathmandu University, Eastern University, Pokhara University and Nepal Sanskrit University.

Successive governments have promised to make primary education free and compulsory for all, but even today about 20% of all school-age children do not go to school. Many students never make it beyond primary level, and dropout rates are high.

Education is a priority in the current Poverty Reduction Strategy Paper (PRSP) in Nepal's tenth five-year plan (2002/03 ~ 2006/07). The *Education For All* (EFA) program 2004-09 has six major goals: expanding early childhood care, ensuring access to education, meeting the learning needs of all, reducing adult illiteracy, eliminating gender disparities and improving all aspects of educational quality.

International Affairs

As Nepal is a small land locked country surrounded by India and China, her geofigureical location has been instrumental to shape her foreign policy. Nepal seeks good relations with both neighboring countries as well as with other countries around the world. Nepal remained almost isolated from the rest of the world until the downfall of the Rana regime in 1951. Before 1951, Nepal's foreign relation was limited with 4 countries; namely – India, United

Kingdom, USA and France. After Democracy in 1951, extension of diplomatic relations with various countries of the world increased considerably. Nepal joined the United Nations in 1955 and establishes diplomatic ties with 118 countries around the world by October 2005.

On international issues, Nepal follows a non-aligned policy and often votes with the Non-Aligned Movement in the United Nations. The main features of Nepalese foreign policy are based on:

a. Principles of Pancha-sila (Five-Precept),
   i. Mutual respect for each other's territorial integrity and sovereignty
   ii. Mutual non-aggression
   iii. Mutual non-interference in each other's internal affairs
   iv. Equality and mutual benefit
   v. Peaceful co-existence
b. Adherence to the United Nations charter and to the belief that all member countries should follow the charter,
c. Principles of “Non Alignment”,
d. The peace as a basic tenet.

Nepal has played an active role in the formation of the economic development oriented *South Asian Association for Regional Cooperation (SAARC)*, which has its headquarters in Kathmandu. Nepal is also a signatory of the agreement on South Asian Free Trade Area (SAFTA), which came into force on January 1, 2006. On February 8th 2004 Nepal obtained membership of the Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Co-operation (BIMST-EC) group. BIMST-EC was set up in 1997, and Nepal had been an observer at the forum since 1998. Nepal is a member of the World Trade Organization, World Bank, International Monetary Fund, Colombo Plan, and Asian Development Bank.

II. Overview of Macroeconomic Activity and Fiscal Position

Nepal is an underdeveloped country with a per capita income of around US$300. Nepal has an agrarian market economy. Agriculture accounts for about 39 percent of the GDP and employs more than 80 percent of the workforce, even though less than one-fifth of the total land area is arable, and agricultural productivity is very low. In recent years, the country’s efforts to expand manufacturing industries and other technological sectors have achieved some progress, but still it accounts for less than 10 percent of the GDP. Major industries are woolen carpets, garments, textiles, leather products, paper and cement. Other products made in Nepal are steel utensils, cigarettes, beverages and sugar. Being situated at the crossroads of the ancient Trans-Himalayan trade route, trading is one important nature to the Nepalese people since early times. Foreign trade is characterized mainly by import of manufactured products and export of agricultural raw materials. In FY 2004/05, Nepal’s total import was NRS 58.71 billion (about US $ 0.8 billion) and total export was NRS 149.47 billion (about US $ 2.1 billion). Readymade garments and woolen carpets are Nepal's largest export, earning the country over NRS 12 billion (about US$ 0.16 billion) in the FY 2004/05. Other important exports are pashmina, jute, vegetable ghee, pulses, hides and skins, jute, zinc sheet and medicinal herbs. Because of Nepal's natural beauty, rich cultural heritage and the diversity of sight-seeing and adventure opportunities, tourism is the another most potential sector for the economy of the country. At one time, tourism used to be the biggest foreign currency earner for the country. But because of the political instability and security problem, the trend of tourism decreased to low level in last some years. As now Nepal has restored the peace and security, we can hope to achieve the same lucrative return to the national economy from the tourism sector.

Talking about the openness of the economy, before 1951[4], the economy of Nepal was of closed nature. It had its economic relations with India and very nominal with Tibet. Since 1951, Nepal adopted a policy of mixed economy, which continued until late 80s. After the re-establishment of multiparty political system in 1990, Nepal pursued liberal, open and market-oriented economy. The government has been moving forward with economic reforms that encourage foreign investment. Foreign direct investment is welcomed in almost all sectors/sub sectors of the economy, including the development, operation and management of infrastructure, like road, transport and electricity, especially hydroelectricity, of which the country has immense potentiality. But still Nepal has not got enough success in attracting FDI that indicates that she has to do a lot to achieve economic growth in the days to come. To attract more FDI, sustainable policy, stable government and the security – all are equally important and the government of Nepal should value all these preconditions. Recent development in the political system of the nation has made some optimistic to attract more FDI in the nation.

2.1 Macroeconomic Activity

2.1.1 International Environment

Trade Balance

Nepal has been facing trade deficit from history to yet, especially with India and then to the rest of the world. Whatever may be the claim of the government, the trade sector is the one of the least attended sector of the economy; however, it has a great role to increase the economic growth and to alleviate the poverty. Various measures like export exchange entitlement scheme, dual exchange rate, direct cash subsidies and frequent changes in other procedural aspects such as the licensing system and the tariff structure were made aimed much fanfare but with little impact. The trade deficit continued to grow unbridled, and is increasingly posing a serious challenge to the various economic structure of the nation.[5]

The detail picture of the Nepal's international trade for the last ten years from FY1995/96 to FY2004/05 has been presented in table 2 where we can see that the trade balance over the period was always in deficit and in increasing trend except in 1997/98 and 1998/99. Average annual growth in export during the period was 13.7 percent and that of import was 9.5 percent resulting 10.4 percent of annual growth rate in total international trade. Though annual growth rate of export was higher than that of import, the trade balance was always in deficit keeping the annual average growth of 8 percent over the period because of the heavy share of import in the international trade from the very beginning. As India is one major neighboring trade partner of Nepal, she holds the major share in Nepal's international trade. This share was 29.8 percent in 1995/96 that continuously increased keeping the record of 61.3 percent in 2004/05. Though the total volume of Nepal's international trade with those countries other than India is in fluctuating trend, this share with India is always in increasing trend. Similarly, trade deficit with India is continuously in increasing order after 1999/2000 indicating that Nepal's international trade is highly dependent upon India. In FY 1995/96, total trade deficit was NRs.54.57 billion, out of which 38 percent was with single country India and the 62 percent with other countries. In FY 2004/05, the total figure if trade deficit has increased to NRs. 90.77 billion, out of which about 55 percent is only with India. It shows the increasing trade deficit situation of Nepal with India.

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4 1951 is the year in which Nepal got freedom from a century long Rana-family regime.

5 Sharma, Shankar and Bajracharya, Pushkar, (1996). "Impact of Economic Liberalization in Nepal" IIDS, Kathmandu, Nepal

Table 2 Direction of International Trade

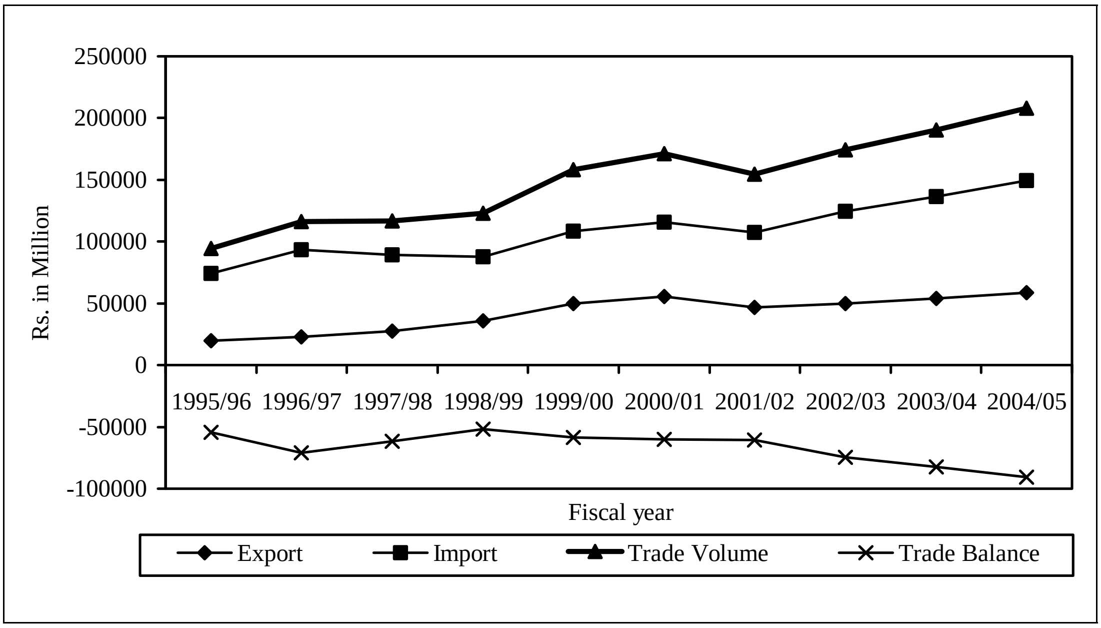
Rs. in Million

Fiscal Years[6] ⇒	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Export F.O.B.	**19881.1**	**22636.5**	**27513.5**	**35676.3**	**49822.7**	**55654.1**	**46944.8**	**49930.6**	**53910.7**	**58705.7**
India	3682.6	5226.2	8794.4	12530.7	21220.7	26030.2	27956.2	26430.0	30777.1	38916.9
Other countries	16198.5	17410.3	18719.1	23145.6	28602.0	29623.9	18988.6	23500.6	23133.6	19788.8
Import C.I.F.	**74454.5**	**93553.4**	**89002.0**	**87525.3**	**108504.9**	**115687.2**	**107389.0**	**124352.1**	**136277.1**	**149473.6**
India	24398.6	24853.3	27331.0	32119.7	39660.1	45211.0	56622.1	70924.2	78739.5	88675.5
Other countries	50055.9	68700.1	61671.0	55405.6	68844.8	70476.2	50766.9	53427.9	57537.6	60798.1
Trade Balance	**-54573.4**	**-70916.9**	**-61488.5**	**-51849.0**	**-58682.2**	**-60033.1**	**-60444.2**	**-74421.5**	**-82366.4**	**-90767.9**
India	-20716.0	-19627.1	-18536.6	-19589.0	-18439.4	-19180.8	-28665.9	-44494.2	-47962.4	-49758.6
Other countries	-33857.4	-51289.8	-42951.9	-32260.0	-40242.8	-40852.3	-31778.3	-29927.3	-34404.0	-41009.3
Total Vol. of Trade	**94335.6**	**116189.9**	**116515.5**	**123201.6**	**158327.6**	**171341.3**	**154333.8**	**174282.7**	**190187.8**	**208179.3**
India	28081.2	30079.5	36125.4	44650.4	60880.8	71241.2	84578.3	97354.2	109516.6	127592.4
Other countries	66254.4	86110.4	80390.1	78551.2	97446.8	100100.1	69755.5	76928.5	80671.2	80586.9
% Share in Total Trade	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
India	29.8	25.9	31.0	36.2	38.5	41.6	54.8	55.9	57.6	61.3
Other countries	70.2	74.1	69.0	63.8	61.5	58.4	45.2	44.1	42.4	38.7

Source: Nepal Rastra Bank

The following figure 1 shows us quite memorable picture of the Nepalese international trade with increasing volume of export, import, total trade and the trade deficit.

Figure 1 Direction of International Trade



[6] In Nepal, FY runs through Shrawan 1 (July16) to Ashadh 31 (July 15) of the following year.

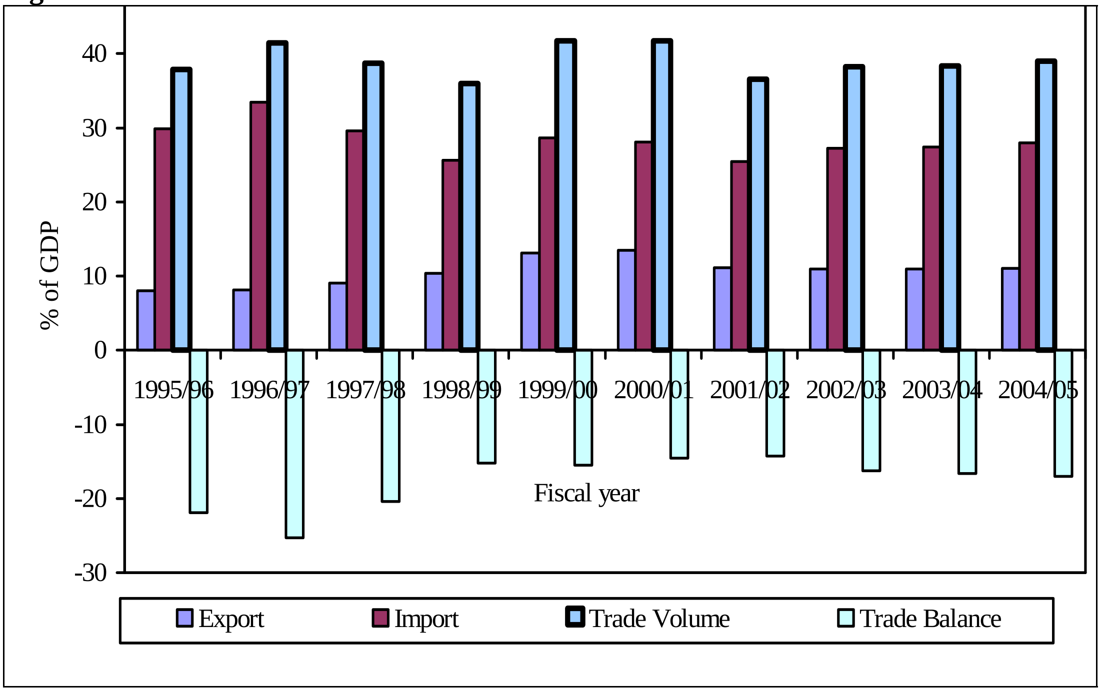
Comparing to the GDP, the average annual ratio of the total international trade to GDP over the last one decade from FY 1995/96 to FY 2004/05 was 39 percent (details in Table 3). This ratio was 10.6 percent for export and 28.3 percent for import resulting the average annual trade deficit 17.7 percent of the GDP. The figure ….on the next page shows the huge gap of the ratio of export and import to the GDP of the nation. Looking after the trend, the percent of export to GDP has been increased during the period from 8.0 percent in FY 1995/96 to 11.0 percent in FY 2004/05. Similarly, the ratio of import to GDP was 29.9 percent in FY 1995/96 that has been decreased to 28.0 percent in FY 2004/05. Thus, ratio of trade deficit to GDP has been decreased from -21.9 percent in FY 1995/96 to -17.0 percent in the FY 2004/05. Thus, decade long data shows some positive results; but comparing to ratio after FY 2001/02, the ratio of trade deficit to GDP is continuously in increasing order. It shows that the export has not been increased as much as import during the same period.

Table 3 Trade Indicators (% of GDP)

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
GDP (Producer's Price)	248913	280513	300845	342036	379488	411275	422807	456675	496745	533538
% of GDP										
Export	8.0	8.1	9.1	10.4	13.1	13.5	11.1	10.9	10.9	11.0
Import	29.9	33.4	29.6	25.6	28.6	28.1	25.4	27.2	27.4	28.0
Total Vol. of Trade	37.9	41.4	38.7	36.0	41.7	41.7	36.5	38.2	38.3	39.0
Trade Balance	-21.9	-25.3	-20.4	-15.2	-15.5	-14.6	-14.3	-16.3	-16.6	-17.0

Source: Nepal Rastra Bank

Figure 2 Trade Indicators



Looking after the nature of goods/services in Nepal's international trade, Nepal mainly imports machinery, fuel, vehicles, medicine, chemicals, and foods. Nepal's export includes readymade garment, carpet, hand-made articles, pasmina, raw materials, vegetable ghee and so on. The shares of different imported/exported goods during last 10 yrs have been presented in the table 4.

Table 4 International Trade by SITC Group

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Export (Rs in million)	**19881.1**	**22636.5**	**27513.5**	**35676.3**	**49822.7**	**55654.1**	**46944.8**	**49930.6**	**53910.7**	**58705.5**
% Composition										
Food & live Animals	9.79	11.76	11.35	10.44	8.51	8.58	10.85	12.22	11.64	9.79
Tobacco & Beverage	0.05	0.07	0.08	0.14	0.24	0.14	0.31	0.28	0.10	0.05
Crude Materials & Inedibles	3.87	2.93	1.77	1.32	1.13	1.35	1.33	1.60	1.32	3.87
Mineral Fuels & Lubricants	0.01	0.01	0.08	0.00	0.00	0.00	0.00	0.01	0.03	0.01
Animals & Vegetable Oil & Fats	1.26	1.38	7.76	10.08	6.48	7.37	15.81	8.57	6.26	1.26
Chemicals & Drugs	3.22	5.98	7.15	7.86	7.89	7.26	7.05	6.57	7.17	3.22
Classified by Materials	52.59	48.72	42.30	37.95	31.79	33.98	37.05	35.64	43.78	52.59
Machinery & Transport Equipment	0.18	0.26	0.21	0.27	0.78	0.62	0.78	0.42	1.15	0.18
Miscellaneous Manufactured Articles	29.03	28.89	29.29	31.93	43.17	40.70	26.82	34.61	28.53	29.03
Not Classified	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.09	0.01	0.00
	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Import (Rs in million)	**74454.5**	**93553.4**	**89002.0**	**87525.3**	**108494.9**	**115687.2**	**107387.5**	**124352.1**	**136277.1**	**149473.6**
% Composition										
Food & live Animals	6.43	5.77	5.54	8.71	9.99	5.18	5.90	7.54	6.28	6.57
Tobacco & Beverage	0.68	0.63	0.90	0.97	0.84	0.78	0.67	0.64	0.75	0.68
Crude Materials & Inedibles	6.54	5.87	7.84	7.14	6.46	6.53	6.27	6.82	7.74	7.50
Mineral Fuels & Lubricants	7.45	7.65	10.72	9.98	8.39	9.74	14.16	16.04	16.07	20.02
Animals & Vegetable Oil & Fats	3.80	2.49	2.28	3.80	4.10	4.83	7.34	6.23	6.34	4.02
Chemical & Drugs	11.67	9.09	12.45	14.25	13.34	11.19	11.53	11.52	12.14	12.83
Classified by Materials	37.78	47.82	36.63	29.29	31.72	35.60	30.63	28.06	26.79	24.79
Machinery & Transport Equipment	20.55	14.75	18.80	20.64	18.94	19.91	18.17	16.65	18.85	17.57
Miscellaneous Manufactured Articles	5.10	4.29	4.47	4.92	6.16	6.23	5.28	5.29	3.75	5.05
Not Classified	0.00	1.64	0.39	0.30	0.06	0.00	0.06	1.22	1.29	0.97
	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Nepal Rastra Bank

Balance of Payment

Nepal is following the 5th Balance of Payment (BOP) manual of the IMF to compile the BOP statistics. Although this manual was introduced in 1993, it was only from May 2003 that the Nepal BOP statistics was published in conformity with the mentioned format. Here, BOP data for the five years (FY 2000/01 to 2004/05) have been presented on the table 5.

Table 5 Balance of Payment Summary

Rs. in Million

	2000/01	2001/02	2002/03	2003/04	2004/05
A. Current Account	**20148.5**	**18161.1**	**11614.7**	**14598.0**	**11544.6**
Balance on Goods	**-56449.5**	**-53358.5**	**-70292.3**	**-77681.6**	**-85762.1**
Goods: exports f.o.b.	69788.5	57983.5	50760.7	55228.3	59956.1
Oil	*13837.0*	*10452.1*	*0.0*	*0.0*	*0.0*
Other	*55951.5*	*47531.4*	*50760.7*	*55228.3*	*59956.1*
Goods: imports f.o.b.	-126238.0	-111342.0	-121053.0	-132909.9	-145718.2
Oil	*-24940.7*	*-22136.5*	*-18811.6*	*-20167.3*	*-26653.6*
Other	*-101297.3*	*-89205.5*	*-102241.4*	*-112742.6*	*-119064.6*
Balance on Services	**9302.3**	**3938.4**	**7049.7**	**9074.9**	**-2034.2**
Services: credit	29821.7	23508.2	26518.9	34315.9	26001.9
Travel	*11717.0*	*8654.3*	*11747.7*	*18147.4*	*10463.8*
Government n.i.e.	*7614.2*	*8894.5*	*6624.0*	*7143.9*	*6804.9*
Other	*10490.5*	*5959.4*	*8147.2*	*9024.6*	*8733.2*
Services: debit	-20519.4	-19569.8	-19469.2	-25241.0	-28036.1
Transportation	*-9308.7*	*-8854.4*	*-8618.4*	*-9382.1*	*-10602.2*
Travel	*-5520.4*	*-5731.1*	*-6171.5*	*-10021.5*	*-9691.9*
Other	*-5690.3*	*-4984.3*	*-4679.3*	*-5837.4*	*-7742.0*
Balance on Goods and Services	**-47147.2**	**-49420.1**	**-63242.6**	**-68606.7**	**-87796.3**
Balance on Income	**1700.7**	**-604.9**	**-675.7**	**-1683.9**	**1636.5**
Income: credit	5470.5	4297.0	4487.0	3841.5	7751.6
Income: debit	-3769.8	-4901.9	-5162.7	-5525.4	-6115.1
Balance on Goods, Services and Income	**-45446.5**	**-50025.0**	**-63918.3**	**-70290.6**	**-86159.8**
Balance on Current transfers	**65595.0**	**68186.1**	**75533.0**	**84888.6**	**97704.4**
Current transfers: credit	67027.7	70157.3	77765.1	89161.8	101310.1
Grants	12046.4	12650.5	13842.2	19557.8	21071.9
Workers' remittances	47216.1	47536.3	54203.3	58587.6	65541.2
Pensions	6309.1	8269.6	7327.3	7906.2	12502.2
Other	1456.1	1700.9	2392.3	3110.2	2194.8
Current transfers: debit	-1432.7	-1971.2	-2232.1	-4273.2	-3605.7
B. Capital Account (Capital Transfer)	**6173.1**	**5694.0**	**5393.9**	**1452.2**	**1573.6**
Total Groups A + B	**26321.6**	**23855.1**	**17008.6**	**16050.2**	**13118.2**
C. Financial Account (excluding group E)	**-28522.2**	**-37333.4**	**-17198.9**	**-21540.1**	**-25536.9**
Direct investment in Nepal	-33.0	-282.3	961.4	0.0	136.0
Other investment: assets	-30191.1	-35136.9	-34629.5	-32591.2	-21863.2
Trade credits	1108.2	-1294.5	1041.0	-2247.6	-323.8
Other	-31299.3	-33842.4	-35670.5	-30343.6	-21539.4
Other investment: liabilities	1701.9	-1914.2	16469.2	11051.1	-3809.7
Trade credits	-9319.0	-5279.0	16899.3	3629.8	-4489.0
Loans	6693.4	2899.6	-52.4	3325.2	744.4
General Government	6976.5	2963.5	-432.8	3479.1	1300.4
Drawings	11715.1	8040.3	5236.0	9244.7	7253.7
Repayments	-4738.6	-5076.8	-5668.8	-5765.6	-5953.3
Other sectors	-283.1	-63.9	380.4	-153.9	-556.0
Currency and deposits	4327.5	465.2	-377.7	4096.1	-65.1
Nepal Rastra Bank	138.4	-197.4	-23.4	-77.4	46.2
Deposit money banks	4189.1	662.6	-354.3	4173.5	-111.3
Total, Groups A through C	**-2200.6**	**-13478.3**	**-190.3**	**-5489.9**	**-12418.7**
D. Net Error and Omission	**11749.5**	**10600.6**	**4176.1**	**25587.2**	**18098.1**
Total Groups A through D (BOP)	**9548.9**	**-2877.7**	**3985.8**	**20097.3**	**5679.4**
E. Reserves and Related Items	**-9548.9**	**2877.7**	**-3985.8**	**-20097.3**	**-5679.4**
Reserve assets	-9224.1	3203.4	-3685.2	-20654.0	-6464.6

Nepal Rastra Bank	-7445.1	-1712.7	-7809.9	-19503.8	-3253.7
Deposit Money Banks	-1779.0	4916.1	4124.7	-1150.2	-3210.9
Use of Fund credit and loans	-324.8	-325.7	-300.6	556.7	785.2
Change in Net Foreign Assets(-deficit)	**-5221.4**	**3342.9**	**-4363.6**	**-16001.2**	**5744.5**

Source: Nepal Rastra Bank

The BOP data shows that the performance of the Nepalese BOP was mixed during the last five years. Except for a deficit in FY 2001/02, a surplus has been recorded in the BOP in the remaining years.

The current account has been registering a surplus but in decreasing order during the last five years. Receipts from travel have been fluctuating due to the uncertain security conditions but still current account is in surplus primarily due to the growing remittance inflows. Travel receipts declined by 42.3 percent in FY 2004/05 due to the decline in the number of tourists. Political instability and other domestic incidences were detrimental for Nepalese tourism. Strong travel advisories were issued against Nepal by some of the major tourist generating countries. But the significant increase in worker's remittances by 11.9 percent was the primary factor which was attributed to the upsurge in the current account surplus in the year. During FY 2004/05, there was a surplus of NRs. 11,545 million (about US$160 million) in the current account, about 21 percent less then the previous year 2003/04. Going back to FY 2000/01, the current account was NRs 20,149 million that is about 75 percent higher than that of FY 2004/05. Thus, during the last five year, Nepal's current account has been decreased except an increase by 26 percent in 2003/04. A major component of current account, trade balance was always deficit in Nepal's history, but even net service, which used to be surplus, recorded deficit of NRs. 2,034 million in FY 2004/05. In such situation, worker's remittance which is continuously in increasing trend, has highly contributed to keep current account surplus.

Capital transfer recorded surplus, but fluctuating situation during the last five years. During the first four years it was continuously in decreasing trend; but it increased from NRs 1452 million in FY 2003/04 to NRs 1574 million, an increase by 8.4 percent during 2004/05. Financial account is highly unfavorable. This account continuously increased unfavorably during the last three year keeping NRs. -25,537 million in FY 2004/05. Based on the foregoing development, an overall surplus of NRs. 5679 million (about US$ 80 million) was recorded in the BOP in 2004/05 that's 71.7 percent less than the previous year.

Exchange Rate and Exchange System

Nepal's foreign exchange system was strictly controlled as in the case of many of other developing countries in the world until the beginning of the 1990s when the country embarked upon the liberalization era. The exchange rate so determined may not represent the market as there would be no necessary adjustments in the rate for a long time. There was no self-adjusting mechanism in such a system. After the introduction of the partial convertibility of the Nepalese rupee in March 1992 and subsequent full convertibility in February 1993, there has been substantial change in the exchange rate system of Nepal. Except for the Indian rupee, the exchange rates of convertible currencies started to be determined on the basis of demand and supply in the market. In case of Indian currency, Nepalese exchange rate policy is aimed at supporting the peg with the Indian rupee. The peg has enabled the domestic economy to benefit from its close economic ties with India. Thus, the role of the Nepal Rastra Bank (NRB), the central bank of Nepal, has changed from a rate maker to a rate taker. Though the NRB also published the exchange rates of foreign currencies for its own use, it's only indicative. Each of the commercial banks is free to determine its own buying and the selling rate for convertible currencies and other near money instruments. As the central bank of the country, the NRB cannot be indifferent in such an important matter relating to exchange rates, however. In this connection, though commercial banks are authorized to determine the buying and the selling rate of the foreign currency, the NRB has been successful to make them agree, through moral suasion, in keeping the difference between the buying and the selling rate within one percent. It means that if a commercial bank fixes the buying rate lower, accordingly its selling rate needs to be lower, too.

When banks are allowed to determine the exchange rate, the rates may be different for different banks. In such a situation, the question may arise with respect to the exchange rate being published by the NRB. Normally, the commercial banks in Nepal use similar exchange rates, though there have been some instances of different rates being used by different banks. The commercial banks have established an association called the Foreign Exchange Dealers Association (FEDAN) with a view to sharing knowledge and avoiding unhealthy competition in foreign exchange transactions. Its membership consists of all the banks of the country. One of the primary tasks of FEDAN is to work as a bridge between its members and the NRB in matters relating to foreign exchange. Each commercial bank is required to send its exchange rate to the FEDAN on a daily basis. The FEDAN collects such exchange rates and then sends to the NRB. After receiving the exchange rates of all commercial banks via the FEDAN, the NRB calculates the average exchange rate for the US dollar; and this average rate is the exchange rate for US dollar to be published for the next day. After computing the exchange rate of the US dollar, the exchange rates for other convertible currencies are calculated on the basis of their cross rates with the US dollar in the international market.

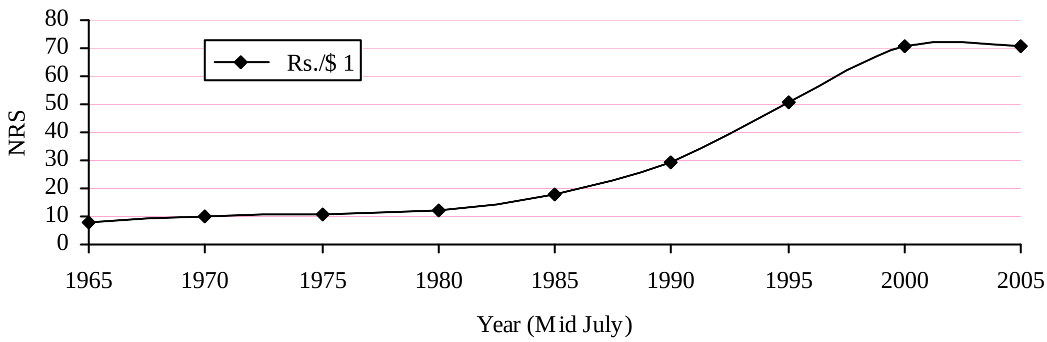
If we look after the exchange rate of Nepalese currency with American dollars over the last four decades, it's undervalued significantly which can be seen in figure 3.

Table 6 Exchange Rate of NRs. Vs. US $

Mid July =>	1965	1970	1975	1980	1985	1990	1995	2000	2005
NRs./$ 1	7.64	10.15	10.55	12.00	17.70	29.20	50.70	70.75	70.65

Source: Nepal Rastra Bank

Figure 3: Exchange Rate of NRS. Vs. US $



Foreign Direct Investment

Nepal has realized that the foreign investment and technology transfer is essential for leading the economic system towards the attainment of self-dependency and making it a robust, firm, dynamic and competitive through the maximum mobilization and highest utilization of available capital, natural and human resources in the process of industrialization of the country. So, the Government of Nepal officially welcomes foreign direct investment. The GON began carrying out policy and regulatory changes in industry, trade, finance and the Stock Exchange beginning in 1992 in order to promote foreign investment and technology transfer in the country. With a view to attracting foreign investment for the rapid economic development of the country, necessary measures have been taken to simplifying the process of granting necessary approval and providing services to the foreign investment through a single door system in line with the Foreign Investment and Technology Transfer Act.

To attract the investment of Non- Resident Nepalese who are rich and residing in foreign countries, the Government of Nepal has recently made the legal provision to provide unlimited visa and provide other trading facilities and rights similar to those for the Nepalese till they invest in Nepal.

At present, there are some 1050 operating joint ventures in Nepal. Indian-invested ventures lead the list with about 31 percent of the total number. In terms of total foreign investment, the United States is second; China, third; the British Virgin Islands, fourth; Norway, fifth; Japan, sixth; and South Korea, seventh. Multinational investors based or looking to expand in the growing Indian market are expressing an interest in investing in Nepal. Policy changes have allowed business people to operate in sectors that were previously Government monopolies. Licensing and regulations have been simplified. 100 percent foreign ownership is allowed in any industry except in some industry included in the "negative list" such as Defense sector and those which are judged to be either hazardous to general health or the environment. New banking institutions and a growing stock exchange provide alternative sources of investment capital.

In FY 2003/04, 78 industries, to be financed from foreign investment, were allowed to operate with the total project cost of 4,323.7 million rupees while 64 industries with the total project cost of 1,801.1 million rupees are found to have been allowed to operate from the foreign investment in FY 2004/05. During the first nine months period of fiscal year 2005/06, 81 industries having the fixed capital of 2,173.9 million rupees and project cost of 2,874.7 million rupees were given the permission to operate with the joint investment of private and foreign sector. In this manner, as an effort of appealing to the foreign investment by adopting the time-suitable, practical, liberal and open policy; a total of 1,063 industries are given the permission to operate under the foreign investment during first nine months of fiscal year 2005/06. The fixed capital of these industries amounted to 76,863 million rupees and the total project cost amounted to 92,809.7 million rupees. A total of 28,567.4 million rupees is found to have been invested from foreign financing in these industries. Following the operation of these industries, about 104.848 thousands Nepalese people would be additionally benefited from getting employment opportunities.

Borrowing form abroad

Developing countries such as Nepal utilize external borrowing as a technique to address the gap between the government revenue and investment as the revenue is not enough to meet the government expenditure. This kind of borrowing adds to the total resources available to the government over a given period and enables the government to incur higher expenditure than would be otherwise possible.

The stock of outstanding medium and long-term external debt (direct and indirect) of the Nepalese government in mid-July 2005 stood at NRS 219641.9 million, a decline of 5.64 percent compared to the figure of NRS 232779.3 million in mid-July 2004. This figure was NRS 223433.2 million in mid-July 2003. Going back more, the amount of foreign loan was Rs. 2.41 billion in FY1990/91 that increased to Rs. 4.3 billion and Rs. 3.8 billion in FY 1995/96 and FY 2000/01. The ratio of the outstanding foreign debt to GDP (at current producers' price), a measure that indicates the country's ability to payback its debt, was 48.9 percent, 46.9 per cent and 41.2 percent in FY2002/03, 2003/04 and 2004/05 respectively.

2.1.2 Domestic Environment

Economic Growth Rate

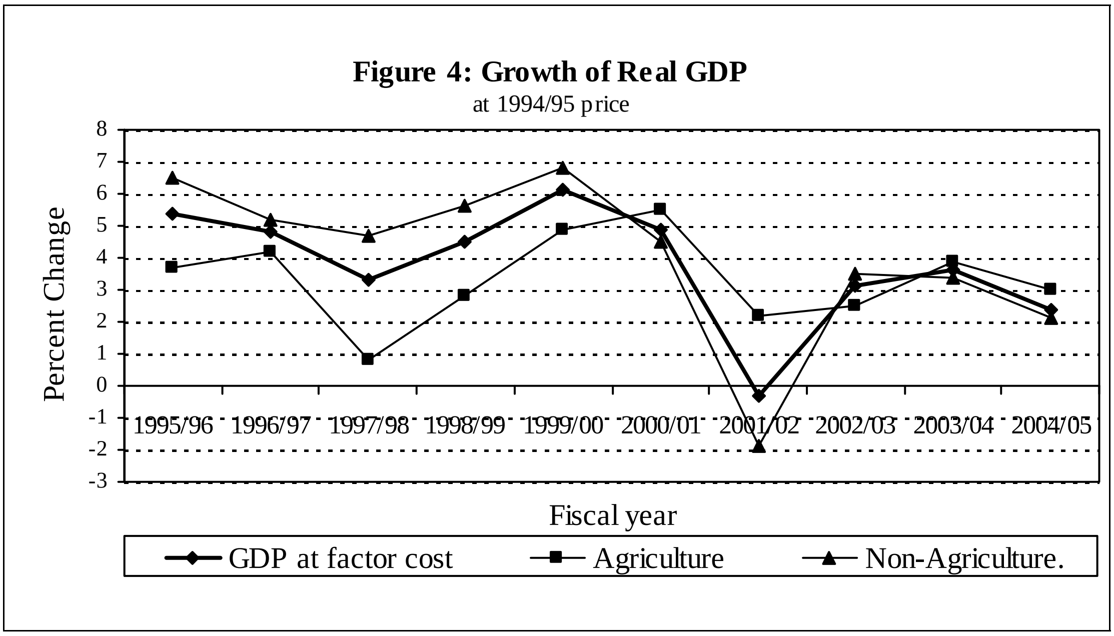
The growth of GDP at constant (1994/95) prices fluctuated over the past ten years from the peak of 6.1 percent recorded in FY 1999/2000 to the lowest level of -0.3 percent recorded in FY 2001/02. Thus, Nepal faced a negative growth rate in 2001/02 after 20 years as there were negative real GDP growths of -2.32 in FY 1979/80 and -2.98 in FY 1982/83. This growth rate was 5.4 percent in 1995/96 which decreased continuously to the following two years and dropped to 3.3 percent in 1997/98; but there after it increased to 4.5 percent in 1998/99 and 6.1 percent in 1999/2000. The high growth rate achieved in FY 1999/2000 resulted from an encouraging growth in the agriculture and non-agriculture sector of 4.9 percent and 6.8 percent respectively. But there after, Nepal couldn't get the same level of growth in the following years up to now. The GDP growth rate declined to 4.8 percent in FY 2000/01 and further dipped to -0.3 percent in the following FY 2001/02. A lower growth rate recorded in the agriculture sector due to drought and negative growth rate in non-manufacturing sectors were attributed to the negative growth in that year. The economy rebounded by 3.1 percent in FY 2002/03 and was stagnant at 3.6 percent in FY 2003/04. The overall performance of the economy in FY 2004/05 declared to 2.3 percent growth. In FY 2004/05, the agriculture and non-agriculture sectors grew by 3.0 percent and 2.1 percent respectively.

Table 7 Real GDP Growth Rate

(at 1994/95 price)

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
GDP at factor cost	**5.4**	**4.8**	**3.3**	**4.5**	**6.1**	**4.9**	**-0.3**	**3.1**	**3.6**	**2.4**
Agriculture	3.7	4.2	0.8	2.8	4.9	5.5	2.2	2.5	3.9	3.0
Non-Agriculture.	6.5	5.2	4.7	5.6	6.8	4.5	-1.9	3.5	3.4	2.1

Source: Central Bureau of Statistic, Government of Nepal



Inflation Rate

The level of ten-year average inflation from FY 1995/96 to FY 2004/05, using the National Urban Consumer Price Index (Base year 1995/96 = 100), depicted a rise of 5.8 percent. Year wise, the rise of such inflation fluctuated from 11.4 percent in FY 1998/99 to 2.4 percent in FY 2000/01. The high inflation rate in FY 1998/99 resulted from an increase in price index of Food and Beverage group by 16.1 percent which is extremely higher if we compare to other years increase rate.

Group wise, on a ten-years average basis, the index of Food and Beverage group increased by 5.4 percent whereas, the index of non-food and services group increased with a higher rate of 6.2 percent, due to the high pressure of imported inflation i.e. mainly the prices of petroleum products.

The Consumer Price Indexes and the Inflation Rate for the period from FY 1995/96 to FY 2004/05 are presented in the following table 8.

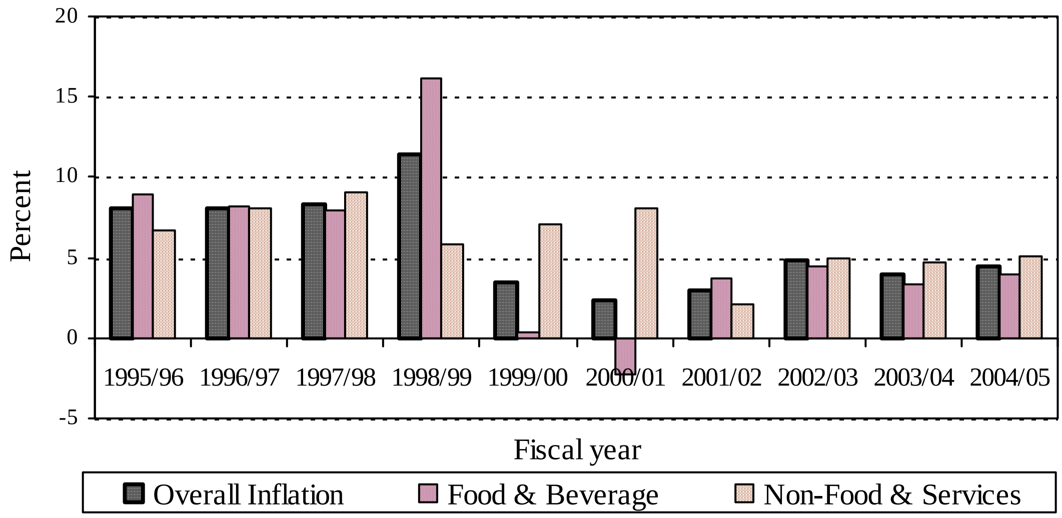
Table 8: National Urban Consumer Price Index

Base Year 1995/96 = 100)

Groups & Sub-groups	Wt. %	Fiscal Year									
		1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Overall Index	100	100	108.1	117.1	130.4	134.9	138.1	142.1	148.9	154.8	161.8
Food & beverages	53.2	100	108.2	116.7	135.5	136.1	133	137.9	144	148.8	154.7
Non-food & Service	46.8	100	108.0	117.8	124.6	133.4	144.2	147.2	154.6	161.8	170.1
Inflation Rate	100	8.1	8.1	8.3	11.4	3.5	2.4	2.9	4.8	4.0	4.5
Food & beverages	53.2	8.9	8.2	7.9	16.1	0.4	-2.3	3.7	4.4	3.3	4.0
Non-food & Service	46.8	6.7	8.0	9.1	5.8	7.1	8.1	2.1	5.0	4.7	5.1

Source: Nepal Rastra Bank

Figure 5: Annual Inflation Rate



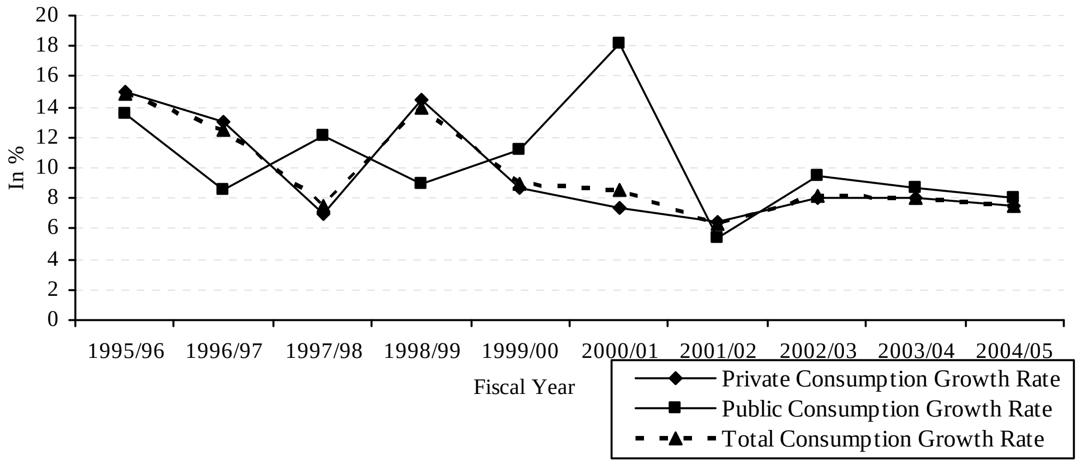
Consumption

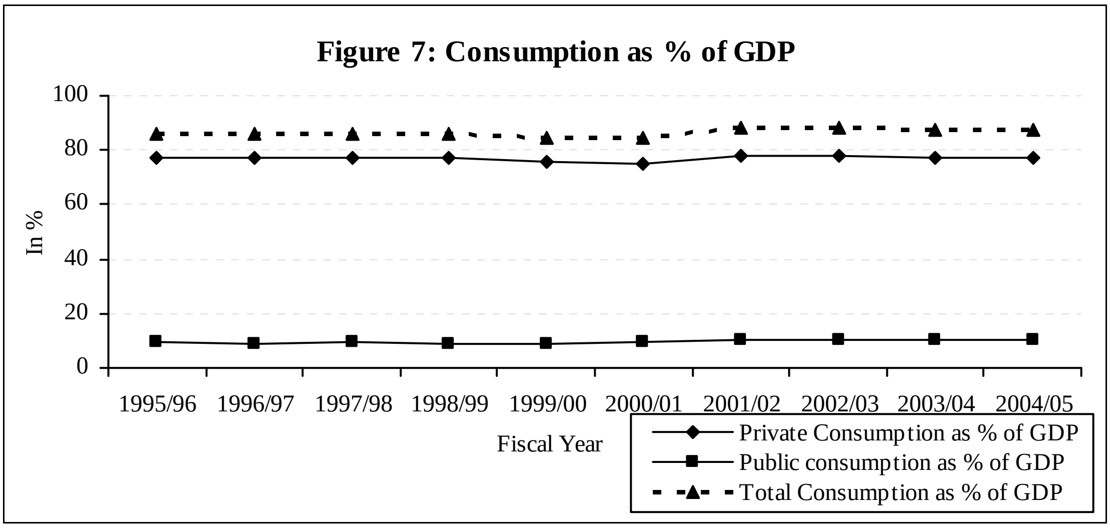
In the Nepalese economy, the average annual growth of the total consumption in current price over the last 10 yrs from FY 1995/96 to FY 2004/5 stood at 9.6 percent, ranging form 6.38 percent in FY 2001/02 to 14.88 percent in FY 1995/96. In FY2004/05, consumption in current price increased by 7.56 percent. Its relative share in GDP has also shown a small increase. Total consumption in current price was 87.57 percent of GDP in FY2004/05. Of the total consumption, private consumption grew by 7.50 percent in FY2004/05. Likewise, public consumption has shown a growth rate of 8.03 percent in FY2004/05. The shares of private and public consumption in total consumption for FY2004/05 were estimated at 88.35 and 11.65 percent respectively. Increasing urbanization, less attraction to savings, and increase in remittances are supposed to be the key factors to increase the consumption in this trend.

Table 9 Trend of Consumption

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Private Consumption Growth Rate	15.04	13.00	6.95	14.50	8.68	7.35	6.50	8.00	8.00	7.50
Public Consumption Growth Rate	13.57	8.55	12.12	8.97	11.25	18.21	5.42	9.53	8.67	8.03
Total Consumption Growth Rate	14.88	12.52	7.48	13.90	8.95	8.49	6.38	8.17	8.08	7.56
Pvt. Consumption as % of Total Consumption	89.27	89.65	89.20	89.67	89.45	88.50	88.61	88.46	88.40	88.35
Pbl. Consumption as % of Total Consumption	10.73	10.35	10.80	10.33	10.55	11.50	11.39	11.54	11.60	11.65
Private Consumption as % of GDP	76.92	77.13	76.91	77.46	75.88	75.16	77.86	77.85	77.30	77.37
Public consumption as % of GDP	9.25	8.91	9.31	8.93	8.95	9.76	10.01	10.15	10.14	10.20
Total Consumption as % of GDP	86.17	86.04	86.23	86.39	84.83	84.92	87.87	88.01	87.44	87.57

Figure 6: Trend of Consumption Growth





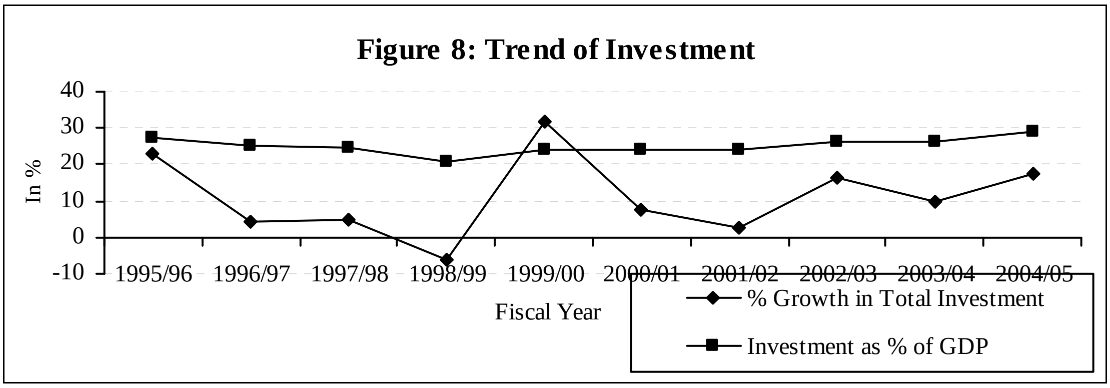
Investment

Average Growth of Gross investment in current price over the last decade in Nepal stood at 11.3 percent. This ratio was 10 percent in FY 2003/04 which increased by 17.7 percent in FY 2004/05, but preliminary study shows that this growth is only 14.5 percent in FY 2005/06. Increase in consumption and consequent decline in GDS is likely to bring down the investment growth. Similarly, the average proportion of gross investment to GDP over the last decade recorded 25.5 percent. This proportion is continuously in increasing order as 24.1 percent, 24.2 percent, 26.1 percent, 26.4 percent and 28.9 percent from FY 2000/01 to FY 2004/05 respectively, and preliminary study shows that this ratio was 30.3 percent in FY 2005/06. The detail data, presented in table 10 about the investment has been plotted in figure 8 that helps us to understand more clearly the trend of investment in Nepal.

Table 10 Trend of Investment

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
% Growth in Total Investment	23.2	4.5	5.1	-6.2	31.7	7.6	2.9	16.5	10.0	17.7
Investment as % of GDP	27.3	25.3	24.8	20.5	24.3	24.1	24.2	26.1	26.4	28.9

Source: Economis Survey, Ministry of Finance, Governement of Nepal



Stock Market

The history of securities market in Nepal began with the floatation of shares by Biratnagar Jute Mills Ltd. and Nepal Bank Ltd. in 1937. Introduction of the Company Act in 1964, the first issuance of Government Bond in 1964 and the establishment of Securities Exchange

Center Ltd. in 1976 were other significant development relating to capital markets. Securities Exchange Center was established with an objective of facilitating and promoting the growth of capital markets. Before conversion into stock exchange it was the only capital markets institution undertaking the job of brokering, underwriting, managing public issue, market making for government bonds and other financial services. Government, under a programme initiated to reform capital markets, converted Securities Exchange Center into Nepal Stock Exchange (NEPSE) in 1993 under Securities Exchange Act, 1983. The basic objective of NEPSE is to impart free marketability and liquidity to the government and corporate securities by facilitating transactions in its trading floor through member, market intermediaries, such as broker, market makers etc. NEPSE opened its trading floor for licensed members on 13th January 1994.

After then, Nepali stock market has made a good progress. The number of total corporate entities listed in the NEPSE reached to 128 on mid-April, 2006. However, the frustrating point is that all the sectors have not been performing well. Since beginning of 'Open Out-Cry' system, commercial bank sector has dominated the stock market. There is a genuine cause behind this. Majority of the manufacturing and processing companies and trading firms have become unable to fulfill the general investors' expectations. Neither they have become able to give returns to the investors nor to disseminate information in time.

Trend of primary market in Nepal for the last one decade has been presented in table 11. Data shows that the permission for capital mobilization during FY 1996/97 was NRs.332.2 million that reached to NRs. 1270.3 million in FY 2004/05 with fluctuating trend over the period. The amount for FY 2004/05 is lower than the previous year by 18 percent where as there was a growth by 81.3 percent during FY2003/04 in comparison to FY2002/03. Number of companies making public issues was only 12 during FY 2004/05 comparing to 16, 17, and 16 during previous FY 2001/02, 2002/03 and 2003/04 respectively. It might be because of the unfavorable political crisis and security problem in the market.

Table 11 Trend of Primary Market

Rs in Million

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Permission for Capital Mobilization	332.2	462.4	258.0	630.3	634.3	1555.1	853.8	1547.8	1270.3
(a) Ordinary Shares	57.0	119.4	148.0	412.5	268.5	528.7	551.5	755.0	300.9
(b) Right Shares	275.2	250.0	30.0	124.6	365.8	387.9	162.2	429.9	669.4
(c) Preferential Share	-	-	80.0	-	-	140.0	-		-
(d) Debenture	-	93.0	-	-	-	360.0	-	300.0	300.0
(e) Mutual Fund	-	-	-				100		-
(f) Units	-	-	-	93.2	82.9	138.5	40.1	62.9	45.5
Number of Companies making Public Issues	5	12	5	9	9	16	17	16	12

Source: Economic Survey, Ministry of Finance
Nepal Stock Exchange Market Ltd.

Total number of entities listed in Nepal Stock Exchange was 95 at the end of FY1996/97 that increased to 125 by the end of FY2004/05. During the period, 25 companies were removed form the list during FY2001/02. Out of 125 listed entities, 102 entities' shares were transacted in the secondary share market during FY 2004/05 with total value of traded shares equal to 4507.7 million. It is quite higher than the previous FY 2003/04 by 110.22 percent. But, the value of share traded in the secondary market over last ten years is quite fluctuating in nature. During FY 2004/05, total market capitalization was NRs.61365.9 million that is 48.14 percent higher than the previous year. This figure of the market capitalization in FY 2004/05 is 12.17 percent of the GDP for the same year which was 8.77 percent in the previous year. Similarly, NEPSE index for FY 2004/05 was 286.67 point comparing to 204.86 and 222.04 for FY 2002/03 and 2003/04 respectively. The details about the secondary market data has been presented in the following table 12.

Table 12 Trend of Secondary Market

Rs in Million

	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Value of Shares Traded	215.6	416.2	202.6	1500.0	1155.0	2344.2	1540.6	575.8	2144.3	4507.7
No. of Shares Transacted 000	2954	9443	1195	4857	7674	4989	6005	2428	6468	18434
No. of Transactions	18482	12428	16104	15814	29136	46095	42028	69163	85533	106264
Market Capitalization	12295.0	12698.0	14289.0	23508.0	43123.3	46349.4	34703.8	35240.4	41424.8	61365.9
Traded value as a percent of market capitalization	1.75	3.28	1.42	6.38	2.68	5.06	4.44	1.63	5.18	7.34
Market Capitalization as a % of GDP	4.94	4.70	4.90	7.1	11.77	11.78	8.56	8.09	8.77	12.17
Paid-up value of listed stocks	3358.5	4476.5	4959.8	6487.4	7347.4	8165.2	9685.0	12560.0	13404.9	16771.9
No. of listed entities	-	95	101	107	110	115	96*	108	114	125
No. of Transacted companies	59	67	68	69	69	67	69	81	92	102
NEPSE Index (point)**	185.61	176.3	163.3	216.9	360.70	348.40	227.50	204.86	222.04	286.67

* 25 Companies delisted
**Base Feb.1994=100
Source: Economic Survey, Ministry of Finance and Nepal Stock Exchange Market Ltd.

Money Supply

Money supply reported a fluctuating trend over the past few years. The growth of broad money (M_2) was 14.4 percent during FY 1995/96 that decelerated to 11.9 percent in the consequent year, but accelerated rapidly with the growth rate of 21.9, 20.8 and 21.8 percent in FY 1997/98, 1998/99 and 1999/00 respectively. Again, M_2 decelerated to 15.2 and 4.4 percent growth during FY 2000/01 and 2001/02, but after then, accelerated with higher growth rate of 9.8 and 12.8 percent in FY 2002/03 and FY 2003/04 respectively. The growth of M_2, however, decelerated to 8.3 percent in FY 2004/05 due mainly to negative growth of net foreign assets (NFA) that was increased by 17.5 percent in FY 2003/04.

The share of Net Foreign Assets (NFA) and Net Domestic Assets (NDA) in M_2 has also been fluctuating over the last decades. From FY 1995/96 to FY 2004/05, average share of NFA was 40.19 percent and that of NDA was 59.81 percent. In FY 2004/05, share of NFA was 35.86, a decrease from 39.24 percent in the previous year. The ratio of time deposits, a component of M_2, to M_2 has been increasing because of growing remittance inflows, implying the availability of long-term loanable fund in the banking system.

Like $M_{2,}$ the narrow money (M_1) also reported quite fluctuating trend during the last decade. During FY 1995/96, M_1 increased by 10.6 percent but it decelerated to 5.4 percent in the subsequent year. That recorded higher growth for next some years. In FY 2004/05, the growth rate on M_1 decelerated to 6.6 percent from 12.2 percent in the previous year. Over the 10 years period, average annual growth of M_1 stood at 11.83 percent. The detail data about the monetary survey in Nepal over last 10 years has been reported in the table 13.

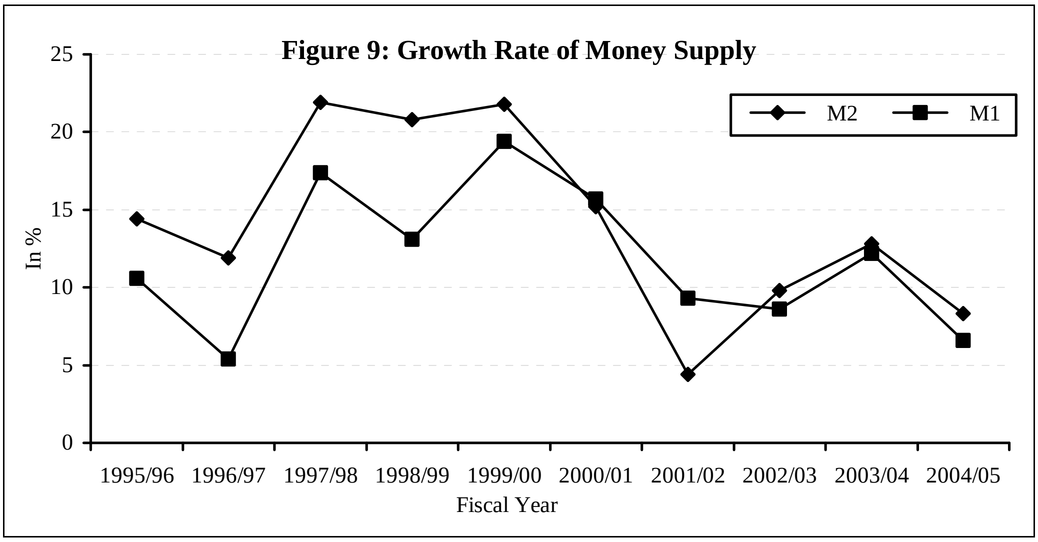
Table 13 Monetary Survey

Rs in Million

Mid July=>	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
1. Net Foreign Assets	37703.6	40191.1	55572.8	65027.6	80467.5	87798.0	88419.1	91407.0	108804.7	107742.1
2. Net Domestic Assets	54948.6	63529.5	70889.9	87772.6	105653.3	126656.1	135569.2	154504.2	168501.3	192697.9
3. Domestic Credit (4+5+6)	89265.7	100916.7	115812.1	134832.7	158001.1	187855.4	207323.0	228443.8	251089.0	285157.5
4. Net Claims on Government	27531.7	29229.4	31753.1	34918.2	38242.6	49191.1	59576.6	62825.0	62313.7	68811.6
5. Claims on Govt. Enterprises	6209.3	7028.6	7228.9	9114.0	10310.9	11906.4	14431.1	14661.9	16258.8	19329.0
(a) Financial	4251.0	5431.6	6170.4	7547.3	8502.8	9683.4	11355.1	11828.7	13343.9	12762.8
(b) Non-Financial	1958.3	1597	1058.5	1566.7	1808.1	2223.0	3076.0	2833.2	2914.9	6566.2
6. Claims on Private Sector	55524.7	64658.7	76830.1	90800.5	109447.6	126757.9	133315.3	150956.9	172516.5	197016.9

7. Net Capital & Other Items	34317.1	37387.2	44922.2	47060.1	52347.8	61199.3	71753.8	73939.6	82587.7	92459.6
8. Money Supply, M2	**92652.2**	**103720.6**	**126462.6**	**152800.1**	**186120.9**	**214454.1**	**223988.3**	**245911.3**	**277306.0**	**300439.9**
9. Money Supply, M1	**36498.0**	**38460.3**	**45163.8**	**51062.4**	**60979.8**	**70576.9**	**77156.2**	**83754.1**	**93969.6**	**100205.7**
(a) Currency	25046.4	27333.7	30893.2	34984.3	42143.0	48295.1	55658.3	56885.2	63218.9	68784.1
(b) Demand Deposits	11451.6	11126.6	14270.6	16078.1	18836.8	22281.8	21497.9	26868.9	30750.7	31421.6
10. Fixed & Savings Deposits	56154.2	65260.3	81298.8	101737.7	125141.1	143877.2	146832.1	162157.2	183336.4	200234.2
% Change in Money Supply										
M2	14.4	11.9	21.9	20.8	21.8	15.2	4.4	9.8	12.8	8.3
M1	10.6	5.4	17.4	13.1	19.4	15.7	9.3	8.6	12.2	6.6

Source: Nepal Rastra Bank



Agriculture

Nepal is an agricultural country. It is the backbone of national economy, means of livelihood for majority of population, main source of GDP, income and employment opportunities. It accounts for about 39 percent of the GDP and provides part and full time employment opportunities to 80 percent of the total population. As the most part of Nepal is hilly, only about one-fifth of the total area is cultivable. The Terai (plain) region produced an agricultural surplus, part of which is supplied to the food-deficient hill areas.

Rice is the stable diet in Nepal and around four million tons are produced annually. Other major food crops are maize, pulses, wheat, millet, barley and potato. Besides food grains, cash crops like sugarcane, oil seeds, tobacco, jute, lintels, medicinal herbs, cardamom, ginger, coffee and tea are also grown. Large quantities of medical herbs, grown on the Himalayan slopes, are sold worldwide. Livestock raising is second to farming in Nepal’s economy. Cow, Buffaloes, Goat, Sheep, Pigs and Poultry are the main livestock. Fish culture is gaining popularity mainly in Terai region by recently.

Most of those people involved in agriculture are following agriculture only for their household purpose rather than commercial purpose. That’s why, agriculture in Nepal is not developed; it lacks competitiveness. There are lacks of sufficient information and new agricultural technologies to the farmer. There is shortage of initiated advisors and technicians of related fields to develop the agricultural sector. Moreover, high level research work as well as prioritize studies on various fields of agriculture sector, are not carried out well. Due to low investment capacity and lack of infrastructure and market opportunities, majority of farmers are adopting traditional technology in their production system. Irrigation is not enough and so agriculture is highly dependent on weather, or we can say that the weather is dominant factor in determining the success or failure of agricultural products. Thus, the annual monsoon rain, or lack of it, strongly influences economic growth in Nepal. Due to continuous fragmentation of land, the land holding/family across Nepal is found to be less than a hectare at present. Because of fragmentation of land and unavailability of the other employment opportunities in the country, majority of farmers in the country are compelled to adopt subsistence agriculture. National Agriculture Policy 2004 states its long term vision as to develop the agricultural sector into more commercialize and competitive with a goal of achieving improvement in living standard from sustainable development of agriculture.

Employment

A separate provision for survey, projection and estimation of employment has not yet been established in Nepal and so it has been realized difficult to estimate the employment in the absence of credible survey system. According to the Tenth Five Year Plan (July16, 2002~July 15, 2007), produced by the National Planning Commission, 10.48 million out of Nepal's 23.2 million population were economically active at the beginning of the period. Out of this 9.959 million people were employed keeping 5 percent of the population fully unemployed; but out of those employed, 32.3 percent of populations were underemployed. Converting that underemployment into total unemployment, it would be equivalent to 12.4 percent – making the total estimated unemployed population at around 17.4 percent. If we take this in general, the situation is quite alarming.

As mentioned in the Tenth Five Year Plan, a total of 11.580 million populations would reach the economically active level by the end of the plan period (July 2007). During the period, additional 1.053 million employments (Job opportunities) will be created. Productivity increases in different sectors of the economy and their inter-sectoral linkages are thought to generate new employment opportunities. So the composite inter linkages of the sectors are estimated to generate a total of 11.012 million jobs. Thus, out of total economically active population, fully unemployed population would be only 4.1 percent. The situation of underemployment is estimated to go down to 22.3 percent by the end of the Plan period.

Foreign Employments: As there is not enough employment opportunity in the country, the number of people visiting abroad for foreign employment has been increasing annually in Nepal. The number of persons granted official permission for foreign employment was 453,722 by the end of FY 2003/04 that reached to 591400 at the end of FY 2004/05. The date from the Department of Labor and Employment Promotion shows the number of such people to be 714,679 by the mid-march 2006. Country-wise data shows that Malaysia (39.32 percent) is the major destination for foreign employment followed by Qatar (26.24 percent), Saudi Arabia (19.95 percent) and UAE (11.0 percent).[7]

2.2 Fiscal Position

2.2.1 Government Revenue and Expenditure

In the last 10-year period from 1995 to 2005, government revenue in current price reported an average annual growth rate of 11.1 percent ranging from 3.2 percent in FY 2001/02 to 15.1 percent in FY 1999/2000. In most of the review years, revenue recorded a double-digit growth rate- e.g. revenue has increased by 11.5 percent, 10.9 percent and 12.5 percent respectively during the last three fiscal years 2002/03, 2003/04 and 2004/05 respectively. However, the snail-pace growth of the economy and the deceleration especially in the customs duty are major reasons for low growth of the revenue.

[7] India is the neighboring country of Nepal, where Nepalese don't need any visa or other permission to go and get employed. So, there is no relevant data about such Nepalese employed there.

Looking after Tax Revenue, the average annual growth rate stood at 10.7 percent, a growth of only 1.2 percent in FY 2001/02 to 17.2 percent in the previous FY 2000/01. Comparatively, non-tax revenue reported a higher but more fluctuating annual growth rate of 12.8 percent in average ranging from 25.9 percent in FY 1995/96 to -4.4 percent in FY 1996/97. Relating to GDP at producer's price, government revenue is very stable. This ratio was 11.7 percent in average ranging from 10.8 percent in FY 1996/97 to 13.1 percent in FY 2004/05.

Composition of Government Revenue

In Nepal the major source of government revenue is the tax revenue, as it contributes around 77 percent (FY 2004/05 figure) of the total revenue mobilization. The remaining 23 percent is mobilized from non-tax revenue sources such as fees, fines, royalties, dividends, principal repayments and others. On the tax revenue, almost 76 percent comes from the sources of indirect tax (VAT: 35 percent, Customs: 29 percent and Excise: 12 percent) and the remaining 24 percent from direct tax sources. The components of direct tax include personal income tax, corporate income tax, house and land registration tax and property tax. Income tax contributed about 20 percent of the total tax revenue.

Before FY 2004/05, the customs revenue used to be the highest contributor of the total tax revenue, but in this year the share of VAT revenue on the tax revenue exceeded the share of customs revenue by around 6 percent due mainly to the deduction in the customs rate to make the Nepalese system compatible with the WTO valuation system and increase in VAT rate from 10 percent to 13 percent from mid-January, 2005. The overall picture of the government revenue can be seen on the following table 14 and 15.

Table 14 Tax Revenue

Rs. in Million

Heading	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Customs	**7327.4**	**8309.1**	**8502.2**	**9517.7**	**10813.3**	**12552.1**	**12658.8**	**14236.4**	**15554.8**	**15701.6**
Imports	6246.5	7093.2	7019.4	7698.3	8959.9	10391.9	9678.4	10567.7	10666.9	12299.1
Exports	149.9	167.8	217.1	378.0	432.5	492.6	917.4	855.6	527.1	697.9
Indian Excise Refund	899.9	1009.1	1102.0	1206.0	1331.7	1456.2	1700.9	2370.6	3882.7	2188.3
Others	31.1	39.0	163.7	235.4	89.2	211.4	362.1	442.5	478.1	516.3
Tax on Consumption and Product of Goods & Service	**9684.7**	**10775.2**	**11249.7**	**11719.1**	**13387.3**	**16153.6**	**16074.3**	**18244.8**	**20705.6**	**25331.3**
Excise	1944.3	2298.1	2885.8	2953.2	3127.6	3771.2	3807.0	4785.1	6226.7	6445.9
Sales Tax/VAT	7740.4	8477.1	8363.9	8765.9	10259.7	12382.4	12267.3	13459.7	14478.9	18885.4
Land Revenue & Registration	**1066.6**	**1015.4**	**1004.2**	**1003.2**	**1015.9**	**612.9**	**1131.8**	**1414.3**	**1697.5**	**1799.2**
Land Revenue	18.2	5.9	3.6	1.4	4.6	5.1	0.8	0.0	0.0	0.0
House & Land Registration	1048.4	1009.5	1000.6	1001.8	1011.3	607.8	1131.0	1414.3	1697.5	1799.2
Tax on Property, Profit & Income	**3589.3**	**4324.6**	**5183.7**	**6512.9**	**7935.6**	**9546.5**	**9465.7**	**8691.5**	**10215.1**	**11272.6**
Income Tax from Public Ent.	1144.5	1231.1	1317.8	1526.5	2198.8	2928.0	1769.3	1251.0	2056.6	1332.4
Income Tax from Private Corp.	563.9	858.4	925.1	1155.0	1339.5	1924.3	1412.0	1236.3	1531.3	2467.8
Income Tax from Individuals	1470.1	1711.4	2120.8	2772.7	3016.4	3200.5	4419.1	3362.3	3533.4	3926.3
Income Tax from Remuneration	133.1	168.1	322.2	396.5	451.5	597.3	835.6	1252.6	1391.2	1675.9
Urban House and Land Tax	87.2	95.0	110.7	123.3	118.5	2.9	2.3	0.0	0.0	0.0
Vehicle Tax	70.7	106.2	174.9	219.4	396.5	429.6	559.7	559.5	700.6	806.5
Tax on Interest	119.8	154.4	212.2	319.5	414.4	463.9	467.7	864.0	733.4	757.0
Other Taxes	-	-	-	-	0.0	0.0	0.0	165.8	268.6	306.7
Total Tax Revenue	**21668.0**	**24424.3**	**25939.8**	**28752.9**	**33152.1**	**38865.1**	**39330.6**	**42587.0**	**48173.0**	**54104.7**
Tax Revenue Growth Rate	10.2	12.7	6.2	10.8	15.3	17.2	1.2	8.3	13.1	12.3
Tax Rev as % of GDP	8.7	8.7	8.6	8.4	8.7	9.4	9.3	9.3	9.7	10.1

Source: Economic Survey, MoF, Government of Nepal

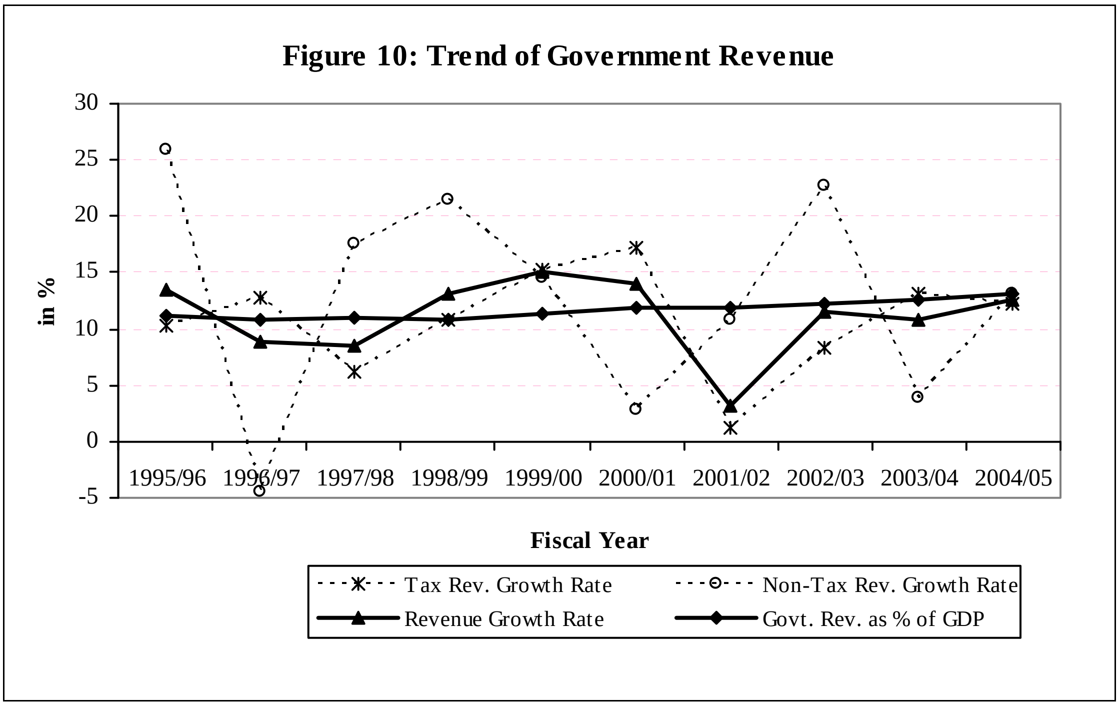
Table 15 Non-tax Revenue

Rs. in Million

Heading	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Charges, Fees, Fines and Forteiture	**286.1**	**270.8**	**329.6**	**336.1**	**386.3**	**386.7**	**518.8**	**579.6**	**1202.5**	**1359.9**
Firm Registration	39.2	47.4	50.9	53.8	65.8	60.0	71.9	78.7	85.1	119.6
Arms Registration	2.5	2.0	2.8	2.4	2.4	1.5	1.4	1.6	2.4	3.7
Vehicle Licence	57.2	52.9	68.2	94.7	106.0	95.0	111.1	119.5	635.4	635.9
Judiciary	114.8	78.3	89.1	97.3	95.8	106.8	192.2	104.3	102.1	119.1
Administration, Penalty & Forfeiture	72.4	90.2	118.6	87.9	116.3	123.4	142.2	275.5	377.5	481.6
Receipts from sales of Commodities & Services	**1673.3**	**1799.6**	**2255.5**	**2146.6**	**2428.9**	**2728.0**	**2611.1**	**3063.0**	**3497.0**	**3849.9**
Drinking Water	19.2	19.1	21.1	21.4	14.1	9.1	6.5	5.6	5.3	5.0
Irrigation	1.7	1.7	1.6	1.3	1.5	1.1	1.3	1.4	0.6	1.1
Electricity	2.5	2.0	212.3	2.4	0.3	0.0	0.0	0.0	0.0	0.0
Postal Service	157.6	165.7	198.8	201.7	226.6	229.6	230.3	219.9	247.0	245.7
Food and Agriculture	21.0	30.7	28.7	34.1	43.4	50.6	45.9	42.3	42.8	48.6
Education	22.7	37.2	58.5	50.5	83.5	94.0	128.0	112.3	128.7	141.2
Forest	442.1	369.7	390.5	374.6	525.2	602.6	546.2	683.6	674.1	553.7
Transport	263.1	270.3	311.5	235.9	86.0	86.3	99.9	93.5	131.6	133.7
Others	743.4	903.2	1032.5	1224.7	1448.3	1654.7	1553.0	1904.4	2266.9	2720.9
Dividend	**1363.0**	**1134.4**	**1311.0**	**1782.8**	**2507.5**	**2336.5**	**2512.9**	**2497.6**	**2661.1**	**4589.9**
Financial Institutions	1281.3	1120.7	1276.7	1455.2	2135.5	2076.3	2281.8	1904.3	1103.1	1242.5
Trading Concerns	47.2		31.0	124.0	9.7	13.4	8.8	11.0	9.1	3.1
Industrial Undertakings	2.0	0.1	2.8		103.2	0.0	0.0	6.1	3.0	40.8
Services Sector	32.5	13.6	0.5	203.6	138.0	226.6	161.8	576.2	1510.3	3303.5
Extra					121.1	20.2	60.5	0.0	35.6	0.0
Royalty and Sale of Fixed Assets	**67.8**	**447.9**	**565.2**	**202.3**	**563.3**	**949.6**	**723.9**	**1945.4**	**1465.0**	**1931.4**
Royalty from Mining	2.2	3.0	3.9	11.1	11.7	5.4	15.3	11.9	9.8	34.0
Other Royalties	25.5	394.1	440.7	94.8	370.9	483.1	637.2	1142.1	1002.2	1333.1
Others	40.1	50.8	120.6	96.4	180.7	461.1	71.4	791.4	453.0	564.3
Principal and Interest Payment	**2818.8**	**2220.7**	**2461.1**	**3927.5**	**3751.0**	**3497.2**	**3109.5**	**2464.3**	**3507.1**	**2714.3**
Loan Corporations	1089.8	862.8	1244.9	2235.2	2176.0	2050.6	1880.7	1516.7	1826.7	1238.4
Interest from Loan to Corporation	1724.2	1357.1	1212.4	1682.7	1565.1	1437.1	1206.8	911.2	1654.0	1453.0
Others	4.8	0.8	3.8	9.6	9.9	9.5	22.0	36.4	26.4	22.9
Miscellaneous Items	**16.1**	**75.8**	**75.7**	**102.8**	**104.6**	**130.8**	**1638.8**	**3092.8**	**1825.3**	**1572.6**
Miscellaneous	16.1	75.8	75.7	102.8	104.6	130.8	1638.8	3092.8	1825.3	1572.6
Total Non-tax Revenue	**6225.1**	**5949.2**	**6998.1**	**8498.1**	**9741.6**	**10028.8**	**11115.0**	**13642.7**	**14158.0**	**16018.0**
Non-tax Rev. Growth rate	25.9	-4.4	17.6	21.4	14.6	2.9	10.8	22.7	3.8	13.1
Non-tax Rev as % of GDP	2.5	2.1	2.3	2.5	2.6	2.4	2.6	3.0	2.9	3.0

Total Govt. Revenue	27893	30374	32938	37251	42894	48894	50446	56230	62331	70123
Revenue Growth Rate %	13.4	8.9	8.4	13.1	15.1	14.0	3.2	11.5	10.9	12.5
GDP at Producers' Price	248913	280513	300845	342036	379488	411275	422807	456675	496745	533538
Govt. Rev. as % of GDP	11.2	10.8	10.9	10.9	11.3	11.9	11.9	12.3	12.5	13.1

Source: Economic Survey, MoF, Government of Nepal



The annual figure of the government expenditure of Nepal is in increasing trend. During the last 10 years from 1995 to 2005, this rate recorded an annual average growth of 10.3 percent. In FY 2004/05, this growth was 14.7 percent from 6.5 percent in FY 2003/04. Actually, the growth in expenditure has remained relatively at the lower level or in other words, Nepal is not being able to spend even the entire budgeted figure for the last couple of years mainly due to increased insecurity and politically instability in the country that has adversely hit the development efforts of the government. Nepal's actual expenditure in FY 2004/05 was only 91.8 percent of the total annual budgeted amount, consisting 91.2 percent progress in recurrent expenditure and 86.6 percent progress in the capital expenditure. This ratio was only 87.3, 87.5 and 78.8 percent respectively in FY 2003/04.

Composition of Government Expenditure:

Prior to FY 2004/05, government expenditure used to include two types of expenditure, namely- Regular and Development. However, FY 2004/05 onwards, the Nepalese government started following international practice of expenditure classification and reclassified the government expenditure into Recurrent Expenditure, Capital Expenditure and Principal Repayment. Before the introduction of new classification, principal repayment used to be a part of regular expenditure. The trend analysis of composition of expenditure in the last ten years reveals that there has been an overturn in the proportion of regular and capital expenditure. In FY 1995/96, the share of regular expenditure on total expenditure was 46.3 percent and that of development expenditure was 53.7 percent. In FY 2004/05 the share of recurrent expenditure (including the principal payments) in the total expenditure increased to 73.3 percent, while the share of capital (development0 expenditure reduced to just 26.7 percent. One major reason for the heavy increase in the share of regular expenditure is the significant increase in security expenses as well as increase in salary and allowances, followed by a heavy decrease in capital expenditure, because of internal conflict in the country.

Table 16 Government Expenditure and Sources of Financing

Rs. in Million

Heading	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Expenditure	**46542.4**	**50723.7**	**56118.3**	**59579.0**	**66272.5**	**79835.1**	**80072.2**	**84006.1**	**89442.6**	**102560.4**
Annual Growth Rate	*19.2*	*9.0*	*10.6*	*6.2*	*11.2*	*20.5*	*0.3*	*4.9*	*6.5*	*14.7*
Regular	21561.9	24181.1	27174.4							
% of total expenditure	*46.3*	*47.7*	*48.4*							
Development	24980.5	26542.6	28943.9							
% of total expenditure	*53.7*	*52.3*	*51.6*							
Recurrent Expenditure				31944.2	35579.1	45837.3	48863.9	52090.5	55552.1	61686.4
% of total expenditure				*53.6*	*53.7*	*57.4*	*61.0*	*62.0*	*62.1*	*60.1*
Capital Expenditure				22992.1	25480.7	28307.2	24773.4	22356.1	23095.6	27340.7
% of total expenditure				*38.6*	*38.4*	*35.5*	*30.9*	*26.6*	*25.8*	*26.7*
Principal Repayment				4642.7	5212.7	5690.6	6434.9	9559.5	10794.9	13533.3
% of total expenditure				*7.8*	*7.9*	*7.1*	*8.0*	*11.4*	*12.1*	*13.2*
Receipts	**32718.2**	**36361.8**	**38340.5**	**41587.6**	**48605.5**	**55647.0**	**57131.6**	**67568.9**	**73614.4**	**84513.9**
% of total expenditure	***70.3***	***71.7***	***68.3***	***69.8***	***73.3***	***69.7***	***71.4***	***80.4***	***82.3***	***82.4***
Revenue	27893.1	30373.5	32937.9	37251.0	42893.8	48893.6	50445.5	56229.8	62331.0	70122.7
% of total expenditure	*59.9*	*59.9*	*58.7*	*62.5*	*64.7*	*61.2*	*63.0*	*66.9*	*69.7*	*68.4*
Foreign Grants	4825.1	5988.3	5402.6	4336.6	5711.7	6753.4	6686.1	11339.1	11283.4	14391.2
% of total expenditure	*10.4*	*11.8*	*9.6*	*7.3*	*8.6*	*8.5*	*8.4*	*13.5*	*12.6*	*14.0*
Overall Surplus (+) /Deficit (-)	**-13824.2**	**-14361.9**	**-17777.8**	**-17991.4**	**-17667.0**	**-24188.1**	**-22940.6**	**-16437.2**	**-15828.2**	**-18046.5**
% of total expenditure	*-29.7*	*-28.3*	*-31.7*	*-30.2*	*-26.7*	*-30.3*	*-28.6*	*-19.6*	*-17.7*	*-17.6*
Sources of Financing Deficits										
Foreign Loan	9463.9	9043.6	11054.5	11852.4	11812.2	12044.0	7698.7	4546.4	7629.0	9266.1
% of total expenditure	*20.3*	*17.8*	*19.7*	*19.9*	*17.8*	*15.1*	*9.6*	*5.4*	*8.5*	*9.0*
Internal Loan	2200.0	3000.0	3400.0	4710.0	5500.0	7000.0	8000.0	8880.0	5607.8	8938.1
% of total expenditure	*4.7*	*5.9*	*6.1*	*7.9*	*8.3*	*8.8*	*10.0*	*10.6*	*6.3*	*8.7*
a. Banking System	*750.0*	*1500.0*	*1600.0*	*2850.0*	*3300.0*	-	-	-	-	-
b. Non-Banking System	*1450.0*	*1500.0*	*1800.0*	*1860.0*	*2200.0*	-	-	-	-	-
Cash Balance Surplus (+)/Deficit (-)	-2160.3	-2318.3	-3323.3	-1429.0	-354.8	-5144.1	-7241.9	-3010.8	-2591.4	157.7
% of total expenditure	*-4.6*	*-4.6*	*-5.9*	*-2.4*	*-0.5*	*-6.4*	*-9.0*	*-3.6*	*-2.9*	*0.2*

Note: The expenditure heads till FY 2003/04 were classified as regular and development. Since FY 2004/05, such expenditure has been classified as recurrent, capital and principal repayment. Expenditure of the previous FY up to 1998/99, which was reclassified and published according to new heading, has been presented in new format.

Source: Economic Survey, MoF, Government of Nepal

2.2.2 Public Borrowing

By the end of FY 1995/96, the total outstanding public debt of the Government of Nepal was NRS 162286.3 million, a growth of 11.9 percent comparing to the previous year. This amount increased to NRS. 307206.1 million by the end of FY 2004/05. During the period, the average annual growth rate was 8 percent with a negative growth in FY 2004/05 by 3.7 percent. Similarly, total debt was 57.6% of the GDP in FY 2004/05, which was 67.5 and 64.2 percent in FY 2002/03 and FY 2003/04 respectively.

Fractionally, foreign debt has held the major part of the total public borrowing. By the end of FY 2004/05, the ratio of foreign debt to domestic debt was 2.5.

Table 17 Trend of Public Borrowing

F.Y. =>	95/96	96/97	97/98	98/99	99/00	2000/01	01/02	02/03	03/04	04/05
Domestic Debt Growth	6.8	4.8	1.3	36.7	9.4	10.5	22.6	15.0	1.8	1.7
Foreign Debt Growth	13.3	3.2	22.0	5.1	12.5	5.1	9.8	1.5	4.2	-5.6
Total Debt Growth	11.9	3.5	17.6	10.9	11.8	6.3	12.8	4.9	3.5	-3.7
Domestic Debt as % of GDP	13.8	12.8	12.1	14.5	14.3	14.6	17.4	18.5	17.3	16.4
Foreign Debt as % of GDP	51.4	47.1	53.6	49.5	50.2	48.7	52.1	48.9	46.9	41.2
Total Debt as % of GDP	65.2	59.9	65.7	64.1	64.6	63.3	69.5	67.5	64.2	57.6

Figure 11: Trend of Public Borrowing

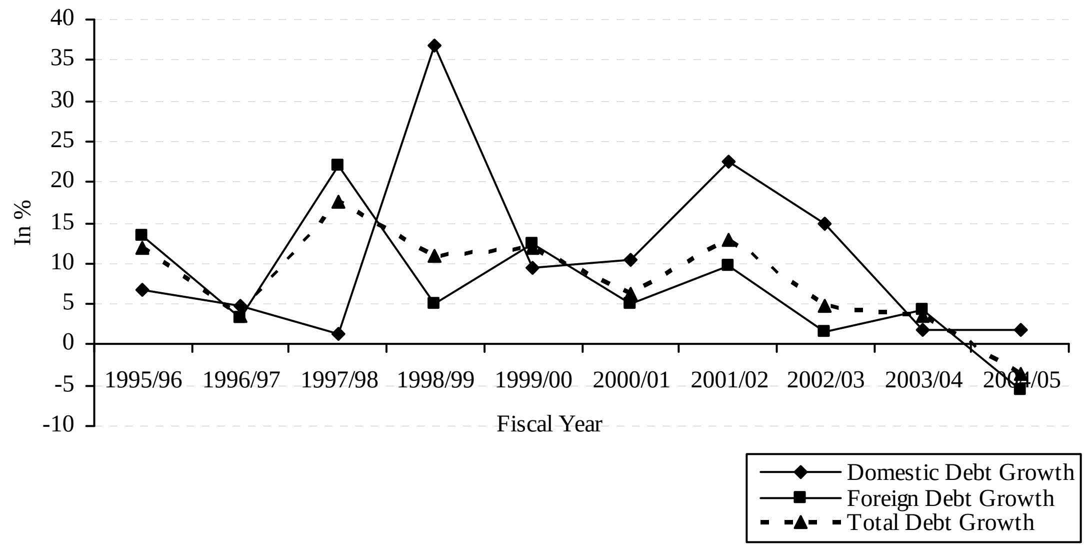
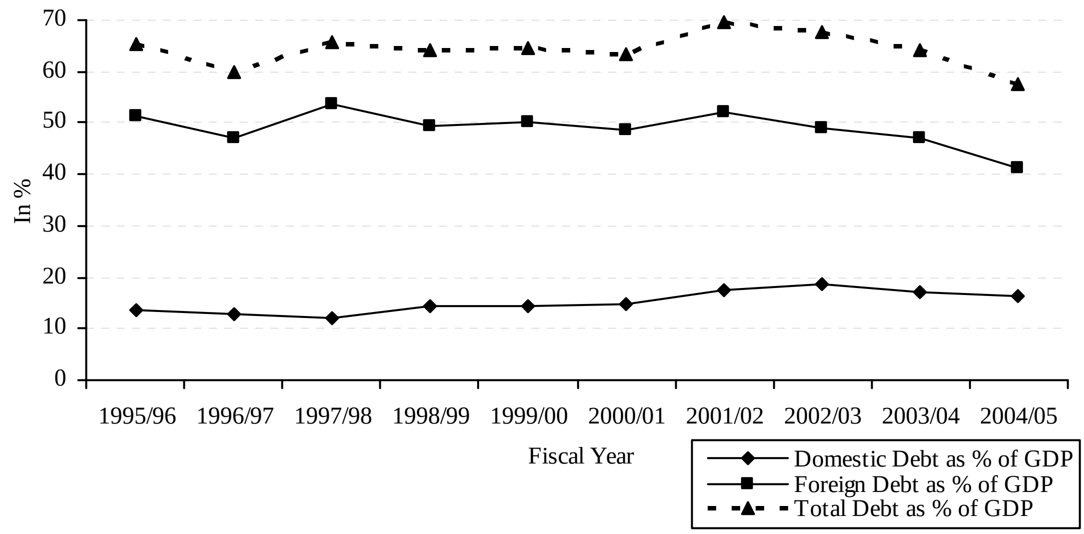


Figure 12: Public Borrowing as Percentage of GDP



2.2.3 Deficit Budget Picture

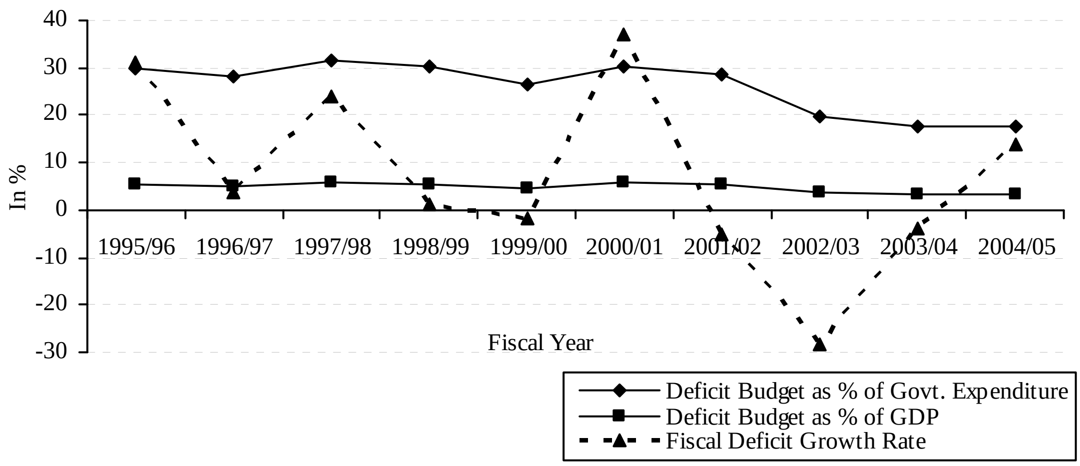
Nepal has always experienced deficit budget. Looking back to last ten years from FY 1995/96 to FY 2004/05, the growth of the budget deficit varied from 36.9 percent in FY 2000/01 to negative growth of 28.3 percent during FY 2002/03 keeping the average annual growth over the observed period at 7.2 percent. In FY 2004/05, this growth was 14 percent. The fiscal deficit in FY 2004/05 was 17.6 percent of the total government expenditure and 3.4 percent of the GDP.

Table 18 Deficit Budget Picture

Heading	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Deficit Budget as % of Govt. Expenditure	29.7	28.3	31.7	30.2	26.7	30.3	28.6	19.6	17.7	17.6
Deficit Budget as % of GDP	5.6	5.1	5.9	5.3	4.7	5.9	5.4	3.6	3.2	3.4
Fiscal Deficit Growth Rate	31.1	3.9	23.8	1.2	-1.8	36.9	-5.2	-28.3	-3.7	14.0

Source: Economic Survey, MoF, Government of Nepal

Figure 13: Trend of Fiscal Deficit



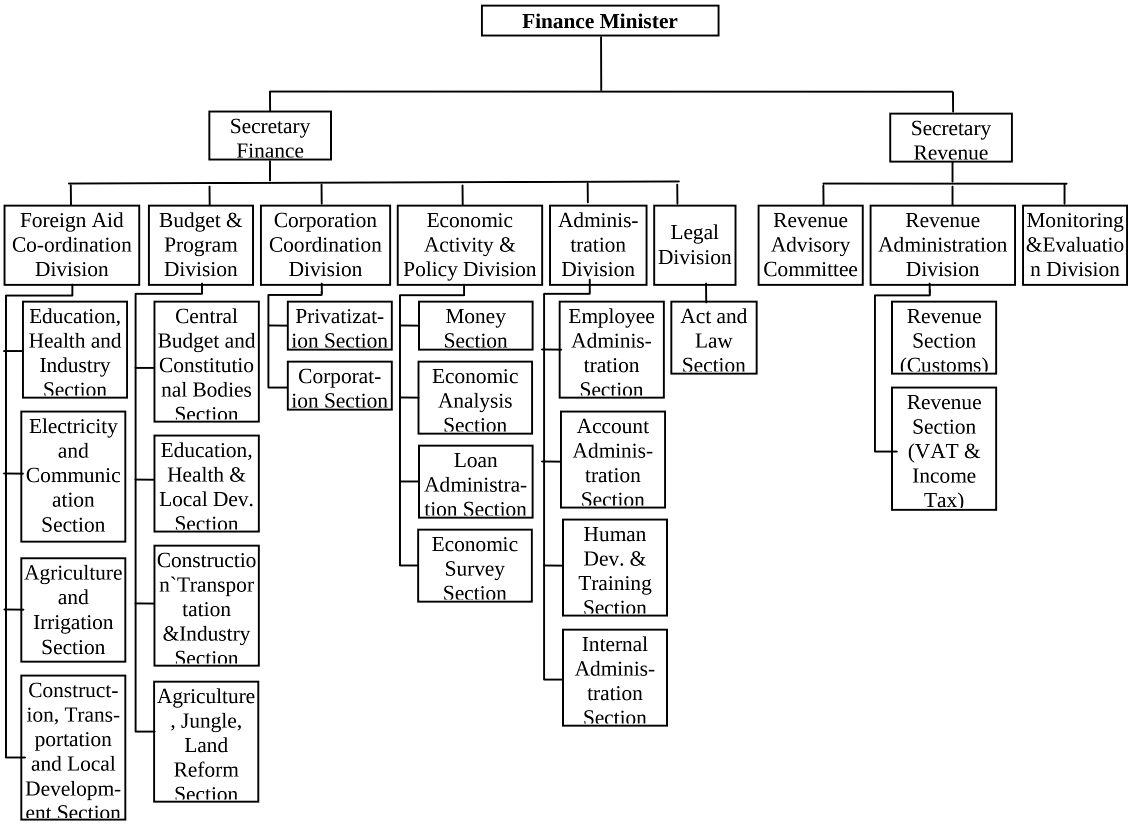
III. Tax Structure: Institutions and the Reality

3.1 Overview of Nepalese Tax Administration

3.1.1 Organizational Structure

The Ministry of Finance (MoF) is the apex body concerning tax administration in Nepal. It has been divided into 9 divisions as shown in the Figure 14. The Revenue Division of the MoF is responsible for overall formulation of tax policy and for evolving appropriate tax administration to implement the taxation policy in the country. It coordinates and supervises the functioning of the different revenue departments. It also monitors the status of both tax and non-tax revenue collection. The revenue Consultation Committee reviews the implementation of taxation policy and recommends measures concerning reform in the taxation system and tax administration.

Figure 14: Organization Chart of Ministry of Finance



There are three branches of the tax administration under the Ministry of Finance, namely: Inland Revenue Administration, Customs Administration and Revenue Investigation Administration. There is also a Revenue Administration Training Center.

Inland Revenue Administration

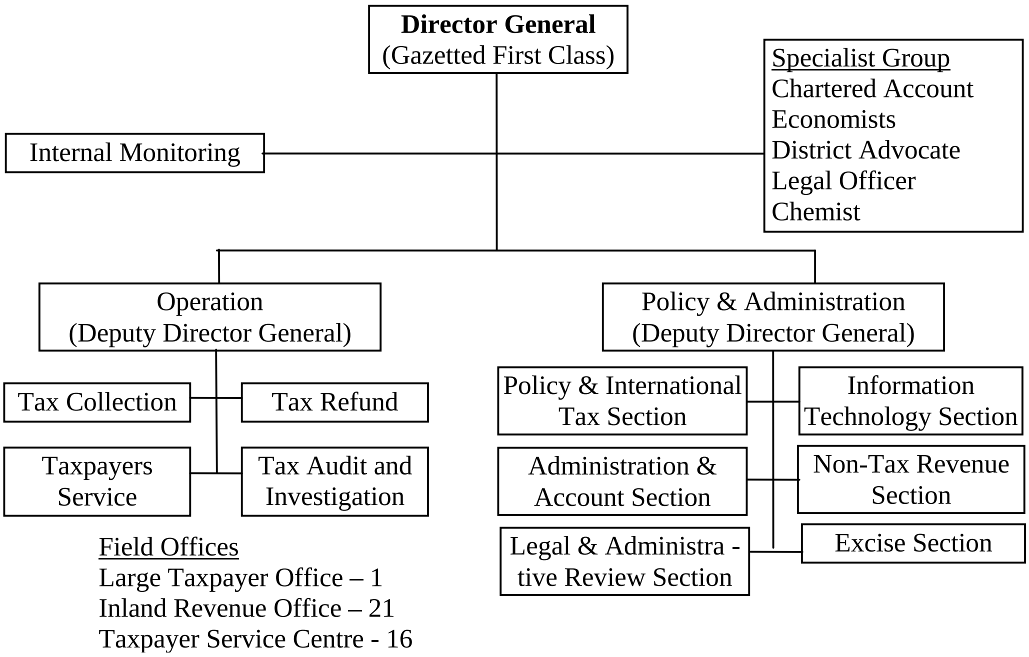
The Inland Revenue Administration is responsible for the administration of VAT, Income Tax, Excise Duties and Vehicle Tax. This administration also administers the tourism development fee and motion picture development fee on behalf of the Nepal Tourism Development Board and Motion Picture Development Board respectively.

The Inland Revenue Administration consists of the Inland Revenue Department (IRD), 1 Large Taxpayer Office (LTO), 21 Inland Revenue Offices (IROs), and 16 window offices under some IROs all over the country. The Inland Revenue Department was established in mid-July 2001 by merging then two separate departments – Tax Department and Value Added Tax Department. Along with the merger of central level departments, 21 filed offices were established merging different tax and VAT offices. Large Taxpayer Office was established in mid-January, 2004.

The IRD is structured along functional lines, which mean there are different sections and sub-sections according to the major functions of the department. Similarly, Inland Revenue Offices are organized on the basis of the major tax functions. Different sections such as taxpayer service/registration, audit, investigation, refund, collection, information technology, legal issues, and administration have been. Different officers will be made responsible for different functions under this organizational structure. The organizational structure of the IRD is given in figure 15. The Director-General, who is a Class I gazetted officer, heads the IRD.

The total strength of different personnel in the Inland Revenue Administration was 925 in 2003/04, out of which 112 were in central level department and 813 in field offices.

Figure 15: Organization Chart of Inland Revenue Department

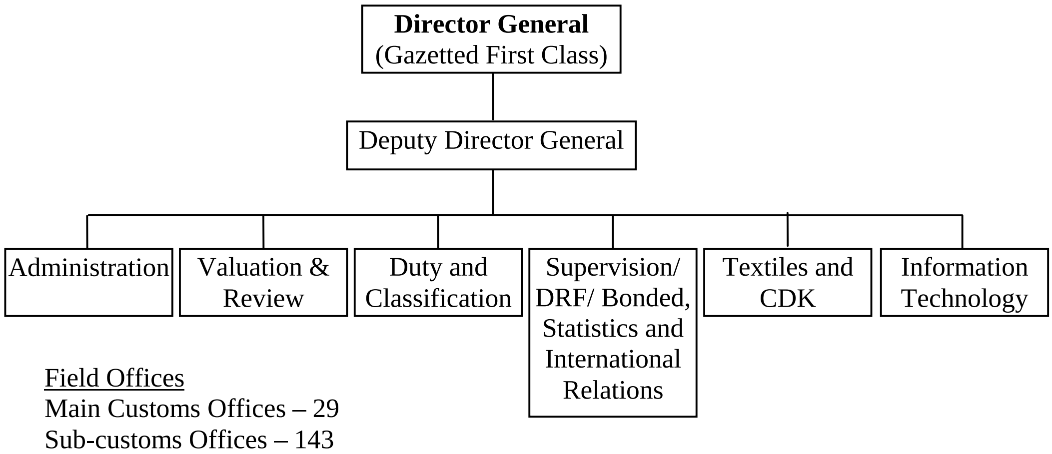


Customs Administration

The customs administration is mainly responsible for assessing and collecting customs duties, preventing fraud and smuggling and controlling carriers, persons and articles entering into and leaving the country. This is also involved in collecting VAT, excise duties and advance income tax, in any, on imports. They also collect special duty on imports and the local development fee, a tax levied on the imports of goods on behalf of the municipalities.

The Customs Administration consists of the Customs Department, 29 main customs offices and 143 sub-customs offices under these main customs offices. The organizational structure of the customs administration does not strictly follow a particular line. While the organizational structure of the Customs Department looks like a functional one, the organizational structure of customs offices does not follow the functional line. The Organizational structure of Customs Department is given in figure 16. The Director-General, who is a Class I gazetted officer, heads the Customs Department. The total strength of personnel of the Customs Department and the field offices under this department were 90 and 1622 respectively totaling 1712 all together in 2003/04.

Figure 16: Organization Chart of Customs Department



Revenue Investigation Administration

The Revenue Investing Administration, headed by the Director-General, a gazetted I Class officer, is involved in investigation of cases of fraud and issues where revenue leakage was involved, with or without collusion between taxpayers and tax collectors. It reviews suspect tax assessments and investigates possible cased of collusion between taxpayers and tax officials. It does sudden visit to the taxpayers' premises/business place or the transportation of goods (import or internal supply) and investigates the legality of the goods stored there and about the business transaction of the taxpayers. So, it needs a close cooperation with both Inland Revenue Administration and Customs Administration. To perform such investigation of fraud cases regarding the tax issues, Revenue Investigation Department along with 4 unit offices and one sub-unit office under the department in different geofigureical location are in operation. The total strength of personnel in the Revenue Investigation Department and the field offices under this department, including mobile squad, is 125.

Revenue Administration Training Center

The Revenue Administration Training Center is involved in imparting training, workshops, and seminars for revenue and accounts officials. It organizes various short-term training such as introductory, refresher and crash courses last up to 2 weeks, and medium-term program generally last up to 5 weeks. This center is headed by the Training Chief, who is a gazetted I Class officer. The total strength of staff of the training center is 40 including assistant staff. There is, however, a lack of qualified, trained and motivated instructors at the center. So, a substantial effort is needed to develop professional staff for the center.

3.1.2 Human Resources

In Nepal, tax administration is a part of the civil service with specialized revenue group within the Nepal Administrative Service. Thus, the process of hiring, transferring and promoting of staff is similar to other fields of public service administration. The Public Service Commission is responsible for recruiting civil servants for tax administration. Candidates having a minimum level of education specified for a particular position are eligible to apply for the test, which is conducted by the Commission.

Staff Position in Revenue Administration

Before creating any position in revenue administration, as a general rule, an assessment of the workload is made considering the number of taxpayers, tax coverage, revenue potential, number of audits to be carried out, taxpayers who must be attended, data entry to be done and so on even though it's not out of the criticism of being wrongly assessed and estimated. The total number of positions created in the Ministry of Finance and the various departments and field offices under it to administer the revenue of Nepal is given in table …

Table 19 : Staff Position in Revenue Administration*

Organizations	Gazetted Officers	Non-Gazetted Assistances	Total
Ministry of Finance	71	141	212
Inland Revenue Administration	261	664	925
Customs Administration	82	1630	1712
Revenue Investigation Administration	18	107	125
Revenue Administration Training Center	15	25	40
Total	447	2567	3014

Source: Ministry of Finance and respective departments

** This data doesn't cover the staff of Land Revenue Administration as it belongs to different ministry.*

The above mentioned figure is the total staff position out of which a number of positions are already vacant, but not recruited on time. Having low number of revenue officials, it's a big challenge for revenue administration to mobilize enough and potential revenue in the country. Besides, a large percentage of staffs are in assistant level including helpers and drivers. Several low-level positions demand only a very low level of education. Persons occupying such low positions cannot face the challenges of the modern tax administration. So, recruitment of enough and qualified officials based on the actual need of the administration on time is much important. Besides, abolishing lower level positions except very needed, and making the tax administration more officer oriented with enough responsibility on them is quite needed in Nepalese tax administration.

<u>Training:</u>

While the importance of training for tax officials has been reinforced time and again, no serious efforts have been made to develop a trained cadre in the tax administration. The Revenue Administration Training Center was established in 1981 and is concerned with training tax officials. However, the importance of this centre and training has been undermined over the years. The center lacks qualified and motivated staffs and trainers.

It is not mandatory to organize pre-service training for new civil servants, which means they are directly posted to field offices without being given any basic training for their responsibilities. Sometimes, tax officials are provided short-term on-the-job training by the training centers or concerned departments, and sent to foreign countries for short-term training and long-term academic courses too. But the quality of the internal training and the fairness while sending on abroad training or academic courses is always a controversial issue in the Nepalese tax administration. The number of resource persons is limited. There is also a lack of standard training materials. This can impact the quality of training and resource persons. So Nepal's tax administration is always facing the lack of qualified human resource.

<u>Transfer:</u>

The creation of a separate revenue group (but not to Secretary and Gazetted Class I Level) has ruled out transferring staff in from (or out to) other groups. However, tax officials can be transferred from one agency to another within the revenue administration. For example, anyone can be transferred from or to the Inland Revenue Administration to or from other agencies like Customs Administration, Revenue Investigation Administration, the Revenue Administration Training Center or the Ministry of Finance. Normally, tax officials are supposed to be transferred from one office to another in two years; but there is no transparent transfer policy, and tax officials try to wangle transfers to the posts most likely to result in the personal gain. Moreover, staffs are transferred frequently from one section to another within an office. Such a system is undesirable and does not develop professionalism, because it takes years to develop specialist in each field of tax administration. For example, it takes a long time in order to develop good tax auditors, so the practice of frequently rotating staff in different sections within an office is also not considered desirable.

Salary:

The salary structure for tax officials is very rigid like that of civil servants in other services and groups. Salaries are fixed by position and are not tied to performance. Personnel at any given level get the same salary, except for the grade, which is added each year.

Since tax officials are paid a very low salary, they cannot be expected to meet even the minimum demands of livelihood, which can affect their work. It's one main reason to initiate personals to participate in corruption. Traditionally speaking, the civil service (including, of course, the tax administration) was considered as the most attractive and prestigious place to work. However, this perception is undergoing titanic changes due to the low salaries. Competent and promising people do not want to join the civil service anymore. A modern tax administration demands professionals who are highly qualified in the tax system and equally familiar with modern accounting and auditing systems, and who possess a basic education in commerce, economics and law. A modern tax administration also demands knowledge of information technology, frequently to a very high degree. It is necessary to create an appropriate working environment that should include, among other things, higher salaries, so that competent professionals can be attracted and retained.

3.1.3 Information Technology

The use of the computer system was introduced for the first time in the tax administration of Nepal with the establishment of then Value Added Department in 1997. This was done with the financial assistance extended by the VAT Project, operated by the Harvard Institute for International Development of Harvard University under USAID funding. Later on, the computerization of VAT was assisted by the DANIDA funded VAT Project since the second half of 1997, when the USAID assistance for the project expired.

At the first stage, a local area network was established in the VAT department. Data entry and processing was done in the computer section of the department. The computerization of the central level office was followed by computerization of the field offices in several phases, beginning on an experimental basis in September 1998, and was completed by March 1999. The computer system at the beginning was developed using the FoxPro database platform which switched over to the Oracle database platform fully by April 2001. Similarly, the computerization of the income tax was initiated in 1998 with the development of the registration module at first. Later on, the Inland Revenue Administration was created in 2001 following the merger of VAT and Income Tax Administrations. The nascent agency administered VAT, Income Tax and Excise duties with fully computerized VAT administration and there was a common registration module for VAT and income tax. The income tax collection module was implemented in 2003, and the income tax assessment module came into force in 2004. At present, field offices (Inland Revenue Offices) entered data related to the Income and VAT and transmitted them to the department, which in turn validated the batches transmitted by the field offices, posted the data into the taxpayers' accounts, and transmitted the outputs back to the field offices. Recently, Inland Revenue Department has introduced e-TDS , an internet based system, that allows access to any withholders, withholdees and tax officers from anywhere. Excise duties, however, are still being administered manually in the traditionally manner.

Computerization in the Customs administration has been introduced with the Automated System for Customs Data (ASYCUDA) going into implementation in phased manner. This system was implemented on an experimental basis at Tribhuvan International Airport (TIA) customs office in May 1998. It is the only customs office dealing with international air transport. Subsequently, ASYCUDA was extended to other 4 major customs offices – Birgunj, Bhairahawa, Biratnagar and Kakarvitta in 2000. It is planned to extend coverage to other major customs offices – Krishnanagar and Tatopani, at which point ASYCUDA will cover more than 95 percent of the total volume of international trade.

3.2 Types of Taxes and Tax Legislation

Under the current tax system, there are 6 types of taxes that, according to their nature and function, can be divided into the following two categories as Direct and Indirect taxes.

Direct Taxes

1. Income Tax
2. Vehicle Tax
3. House and Land Registration Tax

Indirect Taxes

1. Customs Duties
2. Value Added Tax
3. Excise Duties

Here, the broadly defined income tax has been sub-divided as following:

- I. Tax on Business Income (Corporate Income Tax)
- II. Tax on Remuneration Income
- III. Tax on Investment Income
  - i. Lease or Rent
  - ii. Interest Tax
  - iii. Capital Gains
  - iv. Dividend Tax
  - v. Other income from investment
- IV. Tax on Windfall Gain
- V. Others

These taxes have been described in detail in their respective headings later on.

In Nepal, there is a constitutional provision that none of the tax could be levied without legal provision. So, there are several legal provisions/acts/rules to levy tax. Every year Government of Nepal tables the Finance Bill in the parliament to impose tax. Tax rates are fixed by the Finance Bill. The Finance Bill is published in the Nepal Gazette.

Taxes are imposed at two levels in Nepal. Government of Nepal (Central Government) levies taxes nationwide whereas the local governments levy locally in different forms.

The following tax-related Acts and Rules are effective in Nepal:

Income Tax Act, 2002 and Income Tax Rules, 2002
Value Added Tax Act, 1996 and Value Added Tax Rules, 1996
Excise Act, 2001 and Excise Rules, 2001
Customs Act, 1962 and Customs Rules, 1962
Vehicle Tax Act, 1974
Tax Arrears Clearance Commission Act, 1976
Revenue Tribunal Act, 1974

3.3 Income Tax

3.3.1. Introduction

The idea of introducing income tax in Nepal originated in the early 1950s when a multi-party democratic political system was introduced, but it couldn’t be implemented until 1958 due mainly to political instability. The first elected government finally introduced Income Tax in Nepal for the first time in Nepal by the Finance Act, 1959. The underlying reasons for the introduction of income tax were to generate more revenue in order to finance development activities and to help establish social justice through income redistribution.

In 1959, income tax was levied only on business profits and salaries. After about three years experience in 1962, the coverage of income tax was extended to income derived from different sources. In 1974, income sources were re-enumerated into five groups viz. (a) Agriculture, (b) Industry, trade, profession or occupation, (c) Remuneration, (d) House and Compound Rents, and (e) Other sources. However, agricultural income had been kept outside the tax net except a few years through the Finance Acts. In 2002, Nepal introduced new Income Tax Act, 2002 which is supposed to be very advanced and wide area covering act. The Income Tax Act, 2002 has brought all sources of income, including capital gains, into the tax net and encourages current year self-assessment system. Unlike in some other countries, Nepal has the single act for both Corporate Tax and Individual Tax though tax rate is applied in different rate. This Act divides all sources of income into three groups as followings:

(a) Income from Business Activities
(b) Income form Investment Activities
(c) Income form Employment

These headings are so enough to cover every source of income. Subject to this Act, the following income of a person for an income-year from any employment, business, or investment shall be recognized as the assessable income.

(a) Income of a resident person during the year from employment, business, or investment irrespective of the location of the source of income, and
(b) Income of a non-resident person during the year from employment, business, or investment but only to the extent the income source is in Nepal.

As on November 30 2006, the total number of registered taxpayers is 231143 out of which 190043 taxpayers are individual taxpayers.

3.3.2 Basic Provisions on Income Tax

Income Headings

Income Tax Act has made broad classification of income encompassing almost all income-earning activities. They are:

(a) Business (profits and gains of a person from conducting a business for an income year)
(b) Employment (an individual’s remuneration income from an employment for an income year); and
(c) Investment (profits and gains of a person from conducting an investment for an income year)

Income and gains are ascertained only after deducting the corresponding expenses. The income from each business and investment needs to be calculated separately.

Tax Base

As mentioned on the Income Tax Act 2002, income tax is imposed on and realized from each of the following persons for each income-year:

(a) A person who has a taxable income in an income-year;
(b) A foreign permanent establishment situated in Nepal of a non-resident person that has repatriated income in an income-year; and
(c) A person who receives the final withholding payment during the income-year.

Here, a person can be a natural person, who is an individual or a couple but includes also a proprietorship, or it can be an artificial person, i.e. an entity. An entity means a partnership, trust, company, and foreign permanent establishment or government body.

The act has distinguished between resident and non-resident persons. A resident person is an individual whose normal place of abode is in Nepal and who is present at any time of the year, or who is present in Nepal for 183 days or more, or who is an employee of the Government of Nepal posted abroad at any time during the year.

A trust is a resident person if it is established in Nepal, or has a resident person as a trustee, or is controlled by a resident person. A Company residing in Nepal and if it is incorporated under the laws of Nepal or has its effective management in Nepal is resident of Nepal for the tax purpose. Partnerships are always resident persons. Permanent establishments are places where a person carries on a business and are subject to tax if they belong to a non-resident person and are situated in Nepal.

Income Year

For every person the tax is imposed and calculated for an income year. The income year corresponds with Government's Fiscal Year, i.e. the period from the start of Shrawan of a year to the end of Ashad of the following year (mid-July to mid-July).

Calculation of Income from Business:

(1) A person's income from a business for an income-year is the person's profit and gains from operating the business in that year.
(2) In calculating a person's profits and gains from operating a business for an income-year, the following amounts derived by the person during the year should be included:
    (a) Service fees,
    (b) Amounts derived from the disposal of trading stock,
    (c) Net gains from the disposal of a person's business assets or liabilities of the business (calculated as per chapter 8)
    (d) Amounts considered as derived as per clause 4(2)(a) of Schedule – 2, from the disposal of a person's depreciable assets of the business;
    (e) Gifts received by the person in relation to the business;
    (f) Amounts received as consideration for accepting a restriction with regard to the business;
    (g) Amounts derived directly in connection with the business although the nature of it is such that would otherwise be included in calculating the person's income from an investment; and
    (h) Other amounts required to be included as per Chapter 6 or 7 or Clauses 56 or 60.

Calculation of Income from an Employment:

(1) An individual's income from an employment for an income-year should be taken as the individual's remuneration from employment and calculated on that basis.
(2) In calculating an individual's remuneration from an employment for an income-year the following payments made to the individual by the employer during the year should be included:
    (a) Payments in terms of wages, salary, pay in lieu of leave, overtime pay, fees, commissions, prizes, gifts, bonuses, and other facilities;
    (b) Payments including cost of living adjustment, subsistence, rent, entertainment, and transportation allowance and any other personal allowance;
    (c) Payments recovered or reimbursed of expenditure incurred for personal purpose by the individual or an associate of the individual,
    (d) Payments on behalf of an individual's agreement to any conditions of employment;
    (e) Payments for redundancy or loss or compulsory termination of an employment;
    (f) Retirement contributions including the retirement contribution paid by the employer to a retirement fund in respect of the employee,
    (g) Other payments made with regard to employment.

Calculation of Income from Investment:

(1) A person's income from an investment for an income-year should be taken as the person's profits and gains from making an investment calculated on that basis.
(2) In calculating a person's profits and gains from an investment for an income-year the following amounts derived by the person during the year should be included:
  (a) Any dividend, interest, payment towards natural resources, rent, royalty, gains from investment insurance, gains from an unapproved retirement fund interest, or retirement payment made by an approved retirement fund referred to in Clause 63(1) derived from the investment;
  (b) Net gains from the disposal of the person's non-business taxable assets of the investment as calculated under Chapter-8;
  (c) The excess amount of incomings over the depreciation cost including outgoings on the disposal of depreciable assets of the investment of the person as per Clause 4(2)(a) of Schedule – 2;
  (d) Gifts received by the person in connection to the investment;
  (e) Retirement contributions, including those paid to a retirement fund on behalf of the person and retirement payments with regard to the investment;
  (f) Amounts received as consideration of accepting a restriction in connection to the investment;

<u>Exemptions</u>

The following amounts are exempt from tax:

1. Amounts derived by a person entitled to privileges under a bilateral or a multilateral treaty concluded between the Government of Nepal and a foreign country or an international organization;
2. Amounts derived by an individual from employment in the public service of the government of a foreign country, provided that, the individual is a resident person solely by reason of performing the employment or is a non-resident person; and the amounts are payable from the public funds of the country;
3. Amounts derived from public fund of the foreign country by an individual who is not a citizen of Nepal or by a member of the immediate family of the individual.
4. Amounts derived by a non-Nepalese individual who is employed by the government of Nepal on the terms of a tax exemption;
5. Allowances paid by the government of Nepal to widows, elder citizens, or disabled individuals;
6. Amounts derived by way of gift, bequest, inheritance, or scholarship, except as required to be included in calculating income under this Act
7. Amounts derived by an exempt organization by way of gift; or other contributions that directly relate to the organization's function, whether or not the contribution is made in return for consideration provided by the organization, and
8. Pension received by a Nepali citizen retired from the army or police service of a foreign country provided the amounts are payable from the public fund of that country.

<u>Deductions</u>

While calculating a person's taxable income for an income year from any business or investment, the following costs incurred in the transaction can be deducted, subject to the Income Tax Act 2002, from the income calculated as explained above.

  (a) incurred during the income year;
  (b) incurred by the concerned person; and
  (c) incurred in income generation from the business or investment.

These deductions include cost of trading stock, interest paid, repair and improvement costs (not more than 7% of the depreciation basis of the depreciable assets in a particular pool at the end of the income year), pollution control costs (not exceed to 50% of the person's taxable income calculated without a deduction for pollution control costs), research and development cost (not exceed to 50% of the person's taxable income calculated without a deduction for research and development costs). Any excess cost, or part thereof, relating to repair and improvement, pollution control, and research and development for which a deduction is not allowed as a result of these limitations shall be added to the depreciation basis of asset pool to which it relates (i.e. capitalization of those uncovered expenses to the respective depreciable asset pools) and may be depreciated in the future income years. Depreciation allowance in respect of depreciable assets owned and used by the person during the year to generate income from business or investment activities, unrelieved losses and bad debt written-off are also deductible. Similarly, while calculating taxable income, gifts granted to tax exempted organizations such as social, religious, educational or charitable organizations of public character registered without a profit-motive are also deductible up to NRS. 100,000 or five percent of the taxable income for the year calculated without a deduction for such gifts, whichever is lower.

However, while calculating taxable income, taxpayers are not allowed to deduct any expenses of capital nature such as expenses (a) incurred in respect of natural resource prospecting, exploration, and development; (b) in the acquisition of an asset with a useful life exceeding 12 months; or (c) incurred on the disposal of a liability. Similarly, no deduction is allowed for domestic or personal expenses; expenses related to the exempted income; income tax payable under the income tax act; and fines and similar penalties paid to a government or a local entity of any country for violation of any law or regulations. Furthermore, a person having annual turnover for an income-year exceeds NRs. 2 million is not allowed a deduction for a cash payment in excess of NRs. 50,000 at one time other than in the specified circumstances.

Tax Accounting

For tax purposes, an individual is required to maintain his accounts on a cash basis in calculating the individual's income from an employment or investment and a company is required to maintain its accounts on an accrual basis within the basic framework of generally accepted accounting principle.

Bad debts are allowed to be written off if a debt claim of a bank or financial institution has become bad debt as determined in accordance with the prescribed standards.

Inclusions and deductions under a long-term contract are calculated according to the percentage of the contract completed during the year.

Carry forward of Losses from Business or Investment

In case of any losses from business or investment activities, taxpayer may claim to reduce such losses while calculating the taxable income of the consequent four income years. This provision is exceeded to seven years in case of projects to build public infrastructure, operate and transfer to the government of Nepal and the electricity projects that are involving in building power station, generating and transmitting electricity.

Tax on Dividend

In Nepal, dividends were kept out of the tax net in some years while they were taxed either fully or at least partially in other years. But after the introduction of Income tax act, 2002 that contains detailed provisions regarding the taxation of dividend, it's fully taxable. According to this act, distributions of profits made by the entity to any of its beneficiaries in any capacity or any capitalization of profits shall be treated as the distributed dividend of the entity for tax purpose. This means that bonus share, loans and advances to directors and shareholders, distribution made on liquidation etc. also will be brought under the tax net in order to plug loopholes for tax avoidance. As a rule, repayment of capital by a company is tax-free. Dividend distributed by a resident company[8] to its shareholder shall be taxed in the form of a final withholding tax. This withholding rate will be 5 percent. The distribution by other entities (other than company) shall be exempt from tax. On the other hand, dividends distributed by a non-resident entity to a resident beneficiary shall be taxed by including the amount in calculating the income of the beneficiary and will be subject to normal income tax.

Tax on Capital Gain

In Nepal, there was no specific provision about capital gain tax before 2002. With the introduction of new income tax act in April 2002, capital gains have been subjected to be taxed. Since it is not possible to draw a line between the capital gains and other income satisfactorily, gains on the disposition of business property (business assets, depreciable assets, or trading assets) will be taxed as an ordinary business income. In case of non-business capital gains, only the gains from the capital sales of real property (land and buildings) and securities are subject to capital gains tax at a flat rate of 10 percent. However, following assets will be exempted from the capital gains tax:

- A private residence of an individual that has been owned continuously for three years or more and lived in by the individual continuously or intermittently for a total of three years or more;
- Land and a private residence of an individual that is disposed of for less than NRs.10 million;
- An asset of an individual that is disposed of by way of any type of transfer other than sales and purchase made within three generations.

International Taxation

For taxation purposes, all payments and gains need to be considered on the basis of the source country of the payment. Details of the circumstances under which the source rules are defined are given in the Act.

Tax is imposed on the repatriated income of a foreign permanent establishment of a nonresident person situated in Nepal. A non-resident person carrying on a business of charterer or air transport operator are taxed at a flat rate on their amounts derived from carriage of passengers, mail or goods which embark in Nepal. The provision is also applied to nonresident persons who transmit messages by any technical means if the apparatus is established in Nepal.

A tax credit may be claimed for any foreign income tax paid with respect to foreign source income. The tax credits are calculated separately for assessable foreign income source in each country and will not exceed the average rate of Nepal income tax applied to the assessable foreign income.

Tax Return and Tax assessment System

In general, every taxpayer should file a signed return of income not later than 3 months after the end of each income year; but in case of those taxpayers who have no tax liability for the year or are resident individuals who have income exclusively from an employment having a source in Nepal, who have only one resident employer at a time during the year and who do not claim a deduction of their taxable income by gifts to exempt organizations, there is no need to file the tax returns.

[8] For income tax purpose, company includes a company established under company law, any corporate body incorporated under any other law, any incorporated association, committee, institution, trust, a partnership firm having twenty or more partners, a retirement fund, a co-operative society, a unit trust or a joint venture, a foreign company or any foreign institutions prescribed by the Director General.

Traditionally, income tax was assessed under the official assessment system, where taxpayers were required to file their tax returns to the tax offices and tax officials were required to make an assessment of taxable income for all the taxpayers. In past, income tax law also makes provision for the assessment by a committee representing various organizations, including tax office and local chamber or commerce and industry with respect to the small taxpayers having an annual income below certain level.

Income tax law in Nepal made provision for the self-assessment since the early 1990s. In FY 1991/92 public limited companies and firms were required to self-assess their tax liabilities. Similarly, industrial, trade, occupational, and professional firm, which had their accounts audited by recognized auditors, were also required to make self-assessment.

The income tax act, 2002 focuses on the self-assessment system. Under this law, every taxpayer is required to self-assess his tax liability, file the tax return and pay the tax liability. Unless the tax return is audited and re-assessed (if needed) by the tax officer, the file submitted by the taxpayer is supposed to be correctly assessed. Looking after the past few years experience, only about 3 to 4 percent of the total taxpayers will be audited by the tax officials. Thus we can see that the tax administration is highly dependent on the self-assessment system and at the same time tax officials are empowered to make amended assessments to adjust the tax liability of any taxpayers if needed. The tax department may amend an assessment within 4 years in order to adjust the assessed person’s tax liability; but in case of fraud, an assessment may be amended at any time. While amending an assessment, the tax payers shall be granted an opportunity in writing to produce proof, if any, in own favor with respect of the assessment, specifying the basis that led to the amendment and giving a time limit of 15 days.

The income tax act has also the provision for the jeopardy assessment under some special circumstances such as when the taxpayer becomes bankrupt, is wound-up, or goes into liquidation; or he/she is about to leave Nepal indefinitely or cease activity in Nepal; or the tax department otherwise considers it appropriate.

Where the tax department makes an assessment, the department shall be needed to serve a written notice of the assessment to the taxpayers stating the tax to be paid on the assessment for the income-year or period to which the assessment relates; the manner in which the assessment is calculated; the reasons why the tax department has made the assessment; the date on which the tax is payable; and the time, place, and manner of objecting to the assessment.

Review and Appeal

A taxpayer who is not satisfied by a reviewable decision may file an application against the decision to the department for administrative review within 30 days from the date of receipt of notice of decision. The Department may extend this period for another 30 days upon request. The Department may stay or amend or do necessary corrections with regard to these reviewable decisions. If the Department fails to serve a taxpayer with a notice of an objection decision within 90 days, the taxpayer may elect to treat the Department as having refused his objection and appeal to the Revenue Tribunal. Similarly, if a taxpayer is not satisfied with the decision after administrative review, he may appeal to the Revenue Tribunal against the decision.

Withholding Taxes

The withholding tax system has been practiced in Nepal since the inception of income tax in 1959. Since that time, employers withhold tax on income at source when the remuneration of employee is distributed. Withholding tax was extended to interest and dividends in 1975 and to commission, bonus, and other similar incomes in 1980. Thus the scope of withholding has been expanded over the years. Where the income tax act requires tax to be withheld, a withholding agent (withholder), who makes a certain payment as described as withholding payment in the income tax act to another person, has to calculate the income tax for this specific payment, deduct it from the payment to the other person and transfer the income tax to the tax authorities within 15 days after each month. Every withholding agent shall prepare and serve on each payee a withholding certificate in the form as prescribed by the IRD. The withholding tax can be of final or not final in nature. The detail about withholding system can be seen in the following table 20.

Table 20: Withholding Tax in Nepal

Withholding Agent	Withholding Payments	W/H Rate
	Not Final Withholding	
Employers	Income from employment	Normal rate for individual
Resident person	Natural resource payments; royalties; service fees	15%
Resident Banks or financial institutions	Interest in general, but not if paid to a resident bank or other financial institution	15%
Resident person	Rent in general	15%
Resident persons	Insurance premium paid for general insurance; and contract payments exceeding Rs 50,000 not covered above	1.5%
Any Payer	Payment made against the VAT Invoice for any services	1.5 %
	Final Withholding	
Resident company	dividends	5%
Resident Banks or financial institutions	Interest paid to an individual not related with business	6%
Resident person	Rent for the lease of land or a building and associated fittings and fixtures and the rent is received by an individual other than in relation with business	15%
Approved retirement funds, Gov. of Nepal	Gain from lump sump retirement payments	6%
Unapproved retirement funds; investment insurances	Gains from investment insurance and unapproved retirement interests	10%
Any of the above mentioned W/H agent	Any of the above mentioned cases, but payments are made to a non-resident person	any rate like above

- If the payment is made against the VAT invoice, then withholding rate shall be only 1.5%. (FY 2005.06)

Tax Rates

For resident individual (Single)

Income Level (F.Y.2006/07)	Tax Liability
Taxable Income <100000 100000 < Taxable Income < 175000 175000< Taxable Income	Nil (Taxable Income – 100000) x 15 % (Taxable Income – 175000) x 25 % + 11250

For resident Couple

Income Level (F.Y.2006/07)	Tax Liability
Taxable Income <125000 100000 < Taxable Income < 200000 175000< Taxable Income	Nil (Taxable Income – 125000) x 15 (Taxable Income – 200000) x 25 % + 11250

Presumptive Tax for Individuals operating business

(FY 2006.07: if taxable income ≤ 125000 and business turnover ≤ 1200000)

Business Location	Annual Tax Liability

Metropolitan or Sub-metropolitan Cities Municipalities Anywhere else in Nepal	NRs. 2000 NRs. 1500 NRs. 1000

Tax on the motor vehicles used for renting (FY 2006/07)

Types of Vehicle	Annual Tax per Vehicle
Mini-bus, mini-truck, truck, and bus	NRs. 1500
Car, Jeep, Van, and microbus	NRs. 1200
Three wheeler, auto rickshaw, tempo	NRs. 850
Tractor, power tiller	NRs. 750

Tax rate for the Entities

Business Type	Tax Rate
Bank, Financial Institution, General Insurance Business, Entities engaged in Petroleum related Business	30%
- Special Manufacturing Industry; - An entity that has operated any road, bridge, tunnel, rope-way, or overhead bridge after construction by the entity, or operated any trolley bus or tram; - An entity engaged in BOOT of public infrastructure, in power generation, transmission, or distribution	20%
Other entity	25%

3.3.3 Relative Importance of Income Tax in Nepal

The share of income tax to the total tax revenue was about four percent in the mid-1960s and 10 percent in the mid-1970s and 1980s. This share increased considerably in the 1990s which was about 16 percent in 1995/96 and reached to 23.45 percent in 2000/01. Similarly, the contribution of income tax to the total revenue was about 3 percent in the mid-1960s which increased to 18.64 percent in 2000/01. But, after 2000, the contribution of income tax in total tax revenue as well as in total revenue is in decreasing trend except in 2003/04 by marginal increase. Looking after the ratio of income tax to the GDP at producer's price, it was very low in the first phases, in increasing trend up to 2000/01 that reached to 2.22 percent, but continuously in decreasing trend after then except in 2003/04 by marginal increase. This ratio was only 1.96 percent in FY 2004/05. The detail picture can be seen in the table 21.

Table 21 Relative Importance of Income Tax Revenue in Nepal

Fiscal Year	Income Tax Revenue (Rs. in Million)	Income Tax Revenue as percent of		
		Total Tax Revenue	Total Revenue	GDP
1965/66	7	3.98	3.24	
1970/71	21	5.33	4.57	
1975/76	89	9.77	7.97	0.51
1980/81	145	7.12	5.99	0.53
1985/86	364	9.95	7.83	0.65
1990/91	746	9.12	6.95	0.62
1995/96	3431	15.83	12.3	1.38
2000/01	9113	23.45	18.64	2.22
2001/02	8656	22.01	17.16	2.05
2002/03	8132	19.10	14.46	1.78
2003/04	9514	19.75	15.26	1.92
2004/05	10466	19.34	14.93	1.96

Source: Income Taxation in Nepal, Retrospect and Prospect, 2001, Dr. RupKhadka
Budget Speeches of Various Fiscal Years.

Looking after the composition of different taxes under income tax group, the highest pie goes to the corporate tax (tax on business income) that contributed 70.12 percent of the total income tax in FY 2004/05. The contribution of tax on remuneration income and investment income to total income tax was 16.04 percent and 13.62 percent respectively on the same year. Analyzing the trend of this composition, the share of corporate tax to total income tax was 85.49 percent in 2000/01 that stood at 84.94 percent in 2001/02 but dropped to 68.25 percent in 2002/03. This pie increased to 71.65 percent in 2003/04, but again decreased to 70.12 percent in the next year.

Table 22 Composition and Trend of Income Tax Revenue

Rs. in Million

Headings	*2000/01*	*2001/02*	*2002/03*	*2003/04*	*2004/05*
Tax on Business Income (Corporate Tax)	7791	7352	5550	6817	7345
Tax on Remuneration Income	597	836	1253	1391	1676
Tax on Investment Income	725	468	1322	1292	1425
Tax on Windfall Gain / Others			7	14	21
Total	**9113**	**8656**	**8132**	**9514**	**10466**
Annual Increase (Decrease) Rate %		-5.01	-6.05	16.99	10.01

Source: Budget Speeches of Various Fiscal Years.

The trend of total income tax in Nepal is quite volatile. It continuously decreased by 5.01 and 6.05 percent in 2001/02 and 2002/03 respectively comparing to the previous years, but in 2003/04, it increased by almost 17 percent. The total income tax in 2004/05 could keep the same direction by increasing the amount by about 10 percent.

3.4 Value Added Tax

3.4.1 Introduction

Value Added Tax (VAT) is an indirect tax on consumption that is assessed on the increased value of goods at each point in the chain of production and distribution, from the raw material stage to final consumption. It is levied on the difference between the sale prices of the goods or services (outputs) to which the tax is applied and the cost of goods and services (inputs) bought in for use in its production.

VAT was introduced in Nepal in November 16, 1997 in replacement of four then taxes: Sales Tax, Entertainment Tax, Hotel Tax and Contract Tax. For the first time, Eighth Plan (1992/93-1996/97) announced a policy of adopting VAT. Prior to this, the idea of a VAT appeared in a few articles and in the IMF mission reports in the 1980s. Ultimately, although it took a little bit longer time than mentioned in the Eighth Plan to make enough study and discussion before implementing it, VAT was successfully implemented in 1997.

To implement VAT, there are separate act and rule: Value Added Tax Act, 1996 and Value Added Tax Rules, 1997. Although there will be some changes in this act and rules every year by Annual Financial Act, the basic principles and provisions are the same from the very beginning.

At the beginning, then Sales Department was changed to VAT Department to implement VAT in Nepal. But later, in 2001, Income Tax Department and VAT Department were merged to a single one named Inland Revenue Department. Now, under this department, there are 22 field offices to administer VAT along with income tax and excise duty.

3.4.2 Basic Provisions on VAT

Registration

According to the Nepalese VAT Act and Rules, any individual, partnership, company or whatever who wishing to engage into a taxable (VAT-able) transaction shall apply to a tax officer in the prescribed form for registration before beginning to engage in such transactions and tax officer shall register those individual under VAT system. After registering, taxpayer will be assigned a Permanent Account Number (PAN) or commonly known as Tax Payer's Identification Number that consists of 9 digit numerals throughout the country.

There are two types of registration under VAT system:

(1) Compulsory Registration; and

(2) Voluntary Registration.

Anyone having annual business transaction of taxable goods and services more than or equal to the threshold level (NRs. 2 million) are subject to compulsory registration. If the annual turnover of taxable goods and services is less than the threshold level, the person does not need to register under the VAT system, but still they can register their business under voluntary registration system. However, any business who import more than NRs.10 thousands at a time must register. As on November 30 2006, total number of taxpayers registered under VAT is 48,146 out of which 17547 taxpayers are individual taxpayers.

After registering under VAT, those taxpayers should issue Tax Invoice in prescribed format for their each sales transaction. They should keep their purchase and sales record in the certified Purchase Book and Sales Book. These invoices and books are the basis for VAT.

Scope of VAT

VAT is based on the destination principle. It is levied on the goods and services where the place of supply is in Nepal and importation of goods and services into Nepal. Exports of goods and services are zero-rated. This means that the tax base is domestic consumption.

VAT is broad-based tax, which applies to all business turnovers through to the retail stages, with a few exceptions. It is levied on a large number of goods and services other than those specifically exempt by law, particularly on administrative and social grounds. Exempted goods and services are mentioned by VAT act, which can be changed by the government by Financial Act and does not require parliamentary approval.

Under exempted category, there are such a commodities comprising of natural and unprocessed products in unorganized sector, basic agricultural products, goods of basic needs, live animals and animal products, medicines, medical and health services, educational services, books, newspapers, artistic and cultural goods and services, transportation services etc.

How is it charged?

The VAT due on any sale is a percentage of the sale price but from this the taxable person is entitled to deduct all the tax already paid at the preceding stage. Therefore, double taxation is avoided and tax is paid only on the value added at each stage of production and distribution. In this way, as the final price of the product is equal to the sum of the values added at each preceding stage, the final VAT paid is made up of the sum of the VAT paid at each stage.

Registered VAT traders who are given a number called PAN (Permanent Account Number) have to show this number to charge VAT from the customers. The customer, if he is a registered trader, knows how much he can deduct in turn and the consumer knows how much tax he has paid on the final product. In this way the correct VAT is paid in stages and to a degree the system is self-policing.

Input Tax Credit System

All the registered taxpayers are allowed to claim credit of input tax that is paid on the purchase of inputs/supplies from registered suppliers irrespective of when these will be utilized/sold/exported. Input tax paid on purchase of capital goods will also be available to claim credit by the taxpayers. So, taxpayers can adjust such input tax paid on trading or capital goods with the tax collection on sales. If the tax credit exceeds the tax payable on sales in a month, the excess credit can be carried over for the next month. If there is any excess unadjusted input tax credit for more than 6 months, then the same will be eligible for refund to the taxpayers.

Treatment of Exports and Imports

For the purpose of exports, no VAT is charged on the transaction and the VAT already paid on the inputs of the goods used for export is deducted - this is an exemption with the right to deduct the input VAT, sometimes called ‘zero-rating’. There is thus no residual VAT contained in the export price. However, as far as imports are concerned, VAT must be paid at the moment the goods are imported. Taxable people registered for VAT will be allowed to deduct this VAT in their next VAT return.

Tax invoice and other records are fundamental to obtain credit

This entire design of VAT with input tax credit is crucially based on documentation of tax invoice, cash memo or bill. Every registered dealer, having turnover of sales above an amount specified, shall issue to the purchaser serially numbered tax invoice with the prescribed particulars. This tax invoice will be signed and dated by the dealer or his regular employee, showing the required particulars. The dealer shall keep a counterfoil or duplicate of such tax invoice duly signed and dated. Failure to comply with the above will attract penalty.

VAT Rate

For the first couples of years, the basic VAT rate was 10 percent, but in mid-January, 2005, the government increased this rate to 13 percent. At present, there is one basic VAT rate of 13 plus a special VAT rate of zero-percent applicable for export, and imports of goods and services by accredited diplomats.

Tax Refund

Under the Nepalese VAT system there is a provision for the refund of VAT. Such a situation will generally arise in the case of zero-rated goods, i.e. exports, where there will be an excess of input tax (the tax on purchases and inputs into the business) over output tax (the tax on sales). The possibility of a tax refund will also arise in the case of domestic sales if the excess of input tax over output tax is reported in each of six consecutive months.

Tax Assessment System

VAT is based on the self-assessment system. Each taxpayer assess his/her tax liability before submitting tax return based on the total input tax paid in purchase and total output tax collected on sales that are recorded in purchase and sale book respectively. Under VAT, simplified form of return and other procedures have been notified that are simple and similar irrespective of nature of business or tax office. Tax returns are to be filed monthly/bimonthly/ quarterly as specified in the Acts/Rules. Every returns furnished by taxpayers are scrutinized expeditiously within prescribed time limit from the date of filing the return. If any technical mistake is detected on scrutiny, the taxpayer will be required to pay the deficit appropriately.

There is no longer compulsory assessment at the end of each year. If no specific notice is issued proposing departmental audit of the books of accounts of the taxpayer within the time limit specified in the Act (4 years from the return filed date), the taxpayer will be deemed to have been self-assessed on the basis of returns submitted by him.

A certain percentage of the taxpayers are taken up for audit every year on a scientific basis, specially based on the certain data provided that are assumed to be risky area from revenue prospective. If the file is selected for audit, then VAT audit as well as Income Tax audit will be done simultaneously. The audit team will conduct its work in a time bound manner and audit will be completed, except some critical cases, within three months. The audit report will be transparently sent to the taxpayer also.

3.4.3 Relative Importance of VAT in Nepal

Value Added Tax (VAT) is one of the largest sources of government revenue in Nepal. Form the very beginning of VAT, its contribution to total revenue was quite remarkable and it got the first position sending back to Customs revenue in second position in ratio of contribution to total revenue during the FY 2004/05. During the first year, i.e. FY 1997/98, of VAT implementation, total VAT revenue was NRs. 7123 million, holding the contribution on total indirect tax, total tax and total revenue as 35.57 percent, 27.46 percent and 21.63 percent respectively. It was 2.37 percent of total GDP. During the period after 1997/98, the contribution of VAT is quite mixed in nature with upward and downward movements in different years. Total amount of VAT revenue kept its upward direction except marginal decrease (-0.7 percent) during FY 2001/02. During FY 1999/2000, there was a great up in total VAT revenue by 25.03 percent with an increase of contribution in total tax revenue form 27.41 percent to 29.73 percent. This direction was almost same in the FY 2000/01 too, but during 2001/02, the contribution of VAT decreased. The FY 2004/05 data shows a great increase in the contribution of VAT in Nepal's revenue. During the year, VAT revenue increased by 30.43 percent, to sum up NRs. 18885 million that is even higher than the customs revenue for the same year (NRs 15702). Before then, Customs was always in the leading position in total revenue. The figure is 45.14 percent of total indirect tax, 34.9 percent of total tax, 26.93 percent of total revenue and 3.54 percent of GDP for the year. As the government of Nepal is following the policy of decreasing the customs tariff rate in recent years and have already been the member of WTO, in this circumstances it's certain that the contribution of customs will be decreased in the days to come and so as VAT is the best and most reliable source of government revenue in Nepal. The following table 23 shows the details about the situation of VAT in Nepal.

Table 23 Trend and Relative Importance of Value Added Tax in Nepal

Fiscal Year	VAT (Rs. in Million)	% Change in VAT	VAT as Percent of			
			Total Indirect Tax	Total Tax Revenue	Total Revenue	GDP
1997/98	7123	-	35.75	27.46	21.63	2.37
1998/99	7882	10.66	36.74	27.41	21.16	2.30
1999/00	9855	25.03	40.07	29.73	22.98	2.60
2000/01	12048	22.25	41.35	31.00	24.64	2.93
2001/02	11964	-0.70	40.84	30.42	23.72	2.83
2002/03	13460	12.50	40.74	31.61	23.94	2.95
2003/04	14479	7.57	39.17	30.06	23.23	2.91
2004/05	18885	30.43	45.14	34.90	26.93	3.54

Source: Budget Speeches of Various Fiscal Years.

Looking after the relative importance of VAT collection on domestic transaction vs. import, VAT on import holds quite higher contribution from the very beginning. Of course, it's easy for the government to collect VAT on import rather than on domestic transaction, but here one important aspect is that VAT paid in customs is claimed as credit in domestic collection, but there is no credit to be claimed while paying VAT in customs point. Anyway, there is no doubt that relative share of VAT from domestic transaction shows the relative competitiveness and effectiveness of the VAT administration. The ratio of VAT from domestic transaction to import was 29:69 on the first year of VAT implementation (FY

1997/98) in Nepal. After the year, the share of domestic VAT increased continuously for the next four years with a ratio of 39:61 in FY 2001/02; but during FY 2002/03, this share dropped to 36:64. In FY 2003:04, the ratio again got the same position as before (39:61); but during FY 2004/05, the contribution of domestic VAT decreased to 35 percent vs. 65 percent of imports on total VAT revenue. Thus the data shows that the VAT revenue of Nepal highly depends upon the imports. We can see the composition of VAT revenue in the table 24.

Table 24 Composition of VAT Revenue

Fiscal Year	VAT Collection		
	Domestic	Import	Ratio
1997/98	2101	5022	29:69
1998/99	2813	5069	36:64
1999/00	3726	6129	38:62
2000/01	4745	7303	39:61
2001/02	4609	7355	39:61
2002/03	4831	8629	36:64
2003/04	5604	8875	39:61
2004/05	6615	12270	35:65

Source: Annual Report 2004/05, Inland Revenue Department

3.5 Excise

3.5.1 Introduction

Excise is an indirect tax imposed on the production, sale, or consumption of the selected commodities such as alcoholic beverages and tobacco products within a country. This traditional definition of the excise duty has been widened in scope in recent years. It is also applied on service sector and the import of selected goods and commodities.

Looking after the history of excise duty in Nepal, it's one of the oldest existing revenue sources. For the first time, the civil code 1854 gave legal basis for imposing this duty on liquor, mining of iron, animal bones, hashish, cannabis, timber wood etc. It is believed that the duty was raised to cover the expenditure on war with Tibet. Before 1951, during the Rana regime, the excise duty was collected on a contract basis. After 1951, the contract system to raise excise duty from hashish and cannabis was terminated and the license system was introduced, however the contract system on other products was continued. The contract system on low grade production and distribution of liquor was particularly significant. The Excise Act 1959 authorized the government to impose excise duty on domestic industrial products like matches, sugar, liquor etc. The administration of customs and excise was merged in 1962 (or 1959) with the establishment of Department of Customs and Excise. In 1966, as the scope of both customs duties and excises expanded, the Customs and Excise Department was split into two separate departments: the Customs department and the Excise Department. The purpose was to make the both tax administration more effective and efficient in order to raise revenue. The Excise Department established field offices in various parts of the country. Later on, the Liquor Act 1975 was promulgated, which gave legal basis to introduce distillery system in the production and distribution of liquor. In 1993, the Excise Department and the Sales Tax Departments were merged together to form the Sales Tax and Excise Department. Later on, with the introduction of VAT replacing then Sales Tax, the Excise administration merged with VAT administration on July 16, 1996. In 2001, another change occurred in the tax administration with the merger of VAT, Excise and Income Tax together by establishing Inland Revenue Department and the field offices under this department. Currently, one director in the Inland Revenue Department is given specific responsibility on the excise administration and similar responsibility has been assigned to tax officer in all field offices. The excise act was revised in January 2002 expanding the scope of excisable products. The Excise Act 2002 authorized the government to impose excise on domestic goods and services as well as on the import of goods on a selective basis.

Objectives of Levying Excise Duty

There are multiple objectives of levying excise duty on selected goods and services by the government of Nepal. The Government's main objective of levying excise duty is the revenue generation. The social objective is to discourage the consumption of health hazard products. Therefore, the Excise duty is imposed on the manufacturing of the products like beer, liquor, tobacco and cigarettes. The countervailing duty was imposed on imported products to protect the domestic industries from unfair competition but, as a member of WTO, the provisions of WTO discourage to discriminate against the domestic and foreign products; hence this objective of protection of the domestic industries by the imposition of countervailing duty has lost its significance in recent days. The excise duty applied for the domestic manufacturing industry is also applied without discrimination to the identical or similar products imported from the foreign countries. The excise duty is also applied with the objective of protecting the environment .The example is excise duty on plastic paper bags, the production of bricks and the import of vehicles.

3.5.2 Basic Provisions on Excise Duty

License Required

No one is allowed to manufacture, import, sell and store excisable goods without taking license. Likewise, the Act prohibits importing excisable services without having license. Person, firm or institutions who need such license may submit a prescribed application form before excise officer at concerned IROs.

Controlling Excise

As provisioned in the law, the excise commodities are closely controlled and supervised by the Government from their production to selling stage. Excisable commodities are realized for sale with an excise stamp to assure the sales of taxed commodities. Among the excise commodities, special provision is made for alcoholic beverages and tobacco because of high sensitivity with respect to the revenue as well as negative externalities. They are controlled and supervised physically from their starting stage of manufacturing to last selling stage. The excise personnel are stationed in the factory to maintain controls of production and sales. The deployed persons have been responsible to control, supervise and monitoring the products. In respect of less sensible goods such as cement, soft drink and some plastic products they have been regulated by self-removal system.

Credit Claim

Liquor/Beer producers are allowed to claim input tax credit for excise duty paid on raw materials used for providing excisable goods/services. Provision is made for an Administrative Review at IRD if the decision made by excise officer is not acceptable to the taxpayer. In such case, taxpayer has to submit and appeal within 35 days from the date of receipt of the decision made by excise officer. Taxpayer can approach to Revenue Tribunal if he is not satisfied with the Department's decision.

Excisable Goods and Services

It is reported that the number of selected excisable products which attracted excise duty was 14 in 1964[9]. The number increased to more than hundred during the period 1964 to 1990.

[9] Economic Policy Network, Policy Paper 18, Study on Excise Duty, M. P. Ghimire, September 2006

The reform in the excisable products started in 1990s.In order to impose excise duty in a few sensitive products; most of the duty of excise was adjusted in customs tariff and sales tax. The major contributor in the excise duty such as liquor, beer and the cigarette remained under the excisable duty. In 1997, the number of excisable products was 13 which increased to 21 in 1998. The number was 26 in 2005 (July) that increased to 30 in 2006(January) and further increased to 43 in 2006 (July). At present, excise duty is levied on cigarette, liquor, beer, cement, iron rod, marble, tiles, plastic, beverages and spirits, sugar; vehicles and parts and accessories there of; motorcycle, all kind of packed readymade juice, color television and accessories there of, and so on. The reason for the increase in the number of excisable goods seems to be to generate the government revenue to cover the increasing public expenditure in the recent years.

<u>Export is exempt from Excise duty</u>

There is no excise duty on export of any goods that would be taxable if in domestic market. If any excise duty was paid while producing such exported goods, credit could be claimed by the exporter.

3.5.3 Relative Importance of Excise Duty in Nepal

Historically, excise duties had constituted one of the largest sources of the tax revenue in Nepal. It had covered a wide range of domestic products accounting for 14.49 percent of total tax revenue during FY 1975/76. This contribution dropped in 1980/81 to 11.89 percent, but got almost the same position during FY 1990/91 holding 14.68 percent in total tax revenue. But, it dropped in recent years as follows the almost universally accepted norms, excise duties are restricted to a narrow range of domestic products. The contribution of excise duty in total tax revenue was 12.93 percent in FY 2003/04 that dropped to 11.91 percent during FY 2004/05. If we look the total revenue from excise duty, it has consistently increased each year since 1975/56. The total duty was NRs.132 in 1975, which more than tripled in ten years in 1985/86 (NRs.559 million). The 1985/86 duty further doubled in five years in 1990/91 (NRs.1200 m). This figure more than tripled in ten years in 2000/01 (NRs. 3771 m). During the last five years, it kept its same speed. During FY 2004/05, the total figure was NRs 6446 million which is 3.52 percent higher than the previous year comparing to 30.14 percent increased in the previous year. If we check the ratio of excise to GDP, the ratio was 1.25 percent in 2003/04 and 1.21 percent in 2004/05. The detail figure about the excise duty in Nepal can be seen in table 25.

Table 25 Trend and Relative Importance of Excise Duty in Nepal

Fiscal Year	Excise (Rs. in Million)	Excise as Percent of			
		Total Indirect Tax	Total Tax Revenue	Total Revenue	GDP
1975/76	132	19.50	14.49	11.83	0.76
1980/81	242	14.37	11.89	10.00	0.89
1985/86	559	18.53	15.28	12.03	1.00
1990/91	1200	17.56	14.68	11.18	1.00
1995/96	1944	11.38	8.97	6.97	0.78
2000/01	3771	12.94	9.70	7.71	0.92
2001/02	3807	13.00	9.68	7.55	0.90
2002/03	4785	14.48	11.24	8.51	1.05
2003/04	6227	16.85	12.93	9.99	1.25
2004/05	6446	15.41	11.91	9.19	1.21

Source: Budget Speeches of Various Fiscal Years.

Excise duty is the single forth largest source of government revenue in Nepal. As the customs tariff rate has shown declining trend in the last few years, it is necessary for the government to explore alternative means to compensate for the loss of revenue and mobilize additional revenue to meet the growing administrative expenses. Excise duty is the potential area which is expected to contribute substantially in the future. This study is therefore an attempt to explore the potential, examine the status and the constraints and suggest recommendations for resource mobilization.

Trend and Composition

The composition of excise duty reveals the importance of revenue generated from three major excisable items – cigarette, liquor and beer – in total excise revenue. The levies on tobacco products and alcoholic beverages have contributed more than ninety percent of the total excise duty receipts. The excise duty from the cigarettes is the single largest contributor of the total excise duty which was 46.6 percent during the FY 2000/01 and 47.6 percent in FY 2001/02. After then, though in decreasing trend, it's still holding the highest share of 42.9 percent in 2002/03 and 38.4 percent in FY2003/04 and FY2004/05. The second largest share belongs to liquor followed by beer at the third position. Given the relative inelasticity of demand for these commodities, the duties have contributed to generate substantial revenues with frequent increase in tax rate over the years. In the last three years, the excise duty on import of vehicles and motorcycles is contributing significantly which is 16.8 percent of the total excise duty during FY 2004/05, compared to 4 percent in FY 2002/03. The detail pictures can be seen on the table 26.

Table 26 Trend and Composition of Excise Duty

Rs. in Million

Headings	*2000/01*		*2001/02*		*2002/03*		*2003/04*		*2004/05*	
	Amt.	Ratio	Amt.	Ratio	Amt.	Ratio	Amt.	Ratio	Amt.	Ratio
Cigarettes	1758.0	46.6	1813.2	47.6	2052.5	42.9	2393.1	38.4	2472.9	38.4
Bidi	5.4	0.1	4.2	0.1	4.7	0.1	3.3	0.1	3.4	0.1
Liquor	1033.4	27.4	930.1	24.4	1180.0	24.7	1266.7	20.3	1395.9	21.7
Beer	843.6	22.4	807.1	21.2	1032.5	21.6	982.5	15.8	1164.4	18.1
Other Ind. Production	130.8	3.5	252.4	6.6	324.6	6.8	296.2	4.8	325.2	5.0
Excise on Import	-	-	-	-	190.8	4.0	1085.0	17.4	1084.1	16.8
Total	3771.2	100	3807.0	100	4785.1	100	6226.7	100	6444.9	100
Annual Increase %	-		0.95		25.69		30.13		3.50	

Source: Budget Speeches of Various Fiscal Years, MoF, GoN

3.6 Customs Duty

3.6.1 Introduction

The trade relation of Nepal was very limited with India and Tibet before 1951. At that time, the customs revenue collection system was given to the private sector on contract since the institutional base was weak and fragmented. The customs commissioner's office at central level was first established in 1957. It was replaced by Department of Customs and Excise in 1962. As the volume of trade and trading partners grew, the role and scope of customs was expanded with new challenges. Therefore, customs was separated from Excise in 1966 and established as a separate department under the Ministry of Finance. From that day, it is working as a distinct department mainly to collect revenue. At present, customs administration is responsible for enforcing customs duties, VAT and excise duty on imports. It also collects the local development fee (a tax levied on the imports of goods on behalf of the municipalities) and special duties (if any) in import value. Besides revenue collection to the government, customs administration has been playing great role in regulating international trade, providing trade facilitation, controlling illegal activities in the border and so on.

Customs Duties

Following are two types of Customs duties:

a. Import Duty: - Customs duty is imposed on goods imported to Nepal from any foreign countries. Now the prevailing duty rates are 5, 10, 15, 25 and 40 in percentage term. Some exemptions are provided by special provision to promote certain crucial sector of the economy. Import duty rates are gradually declining as per the world tendency under WTO regime.
b. Export Duty: - There are very few commodities that subject to export duty. The objective of levying the export duty is either to protect natural resources or to collect government revenue. However, the government is going to lowering the export duty to reach to zero in the near future.

Note: - Besides these duties, other taxes viz. VAT (13%), Excise, advance income tax (if any), special duties (if any) and Local Development Tax on import are also collected at the Customs Points.

3.6.2 Valuation System

Valuation is one important issue in customs administration. Traditionally, there was a system that the values of the imported/exported goods were used to be valued by the customs administration and the duties were charged based on such values as a result of which, there were great possibility of the base values different than the actual transaction values. It would harm both – fair business and government revenue. In recent years, like other developing countries, Nepal has followed the transaction value as the base value for the duty collection purpose. In 1997, Nepal introduced such new valuation system. In 2003, Nepal made its policy more clear including WTO valuation agreement in a more transparent way that the basis of the valuation of any imported goods would be the transaction value. It also explicitly mentioned that the WTO valuation principle should be applied in determining customs value.

Basic Policy of valuation that Nepal has followed can be summarized as followings:- Customs duty of any importing goods shall be determined on the basis of transaction value of the goods concerned. Here, transaction value means the total declared amount by the importer which is actually paid or payable by the buyer to the seller to import goods. It also includes the amount incurred or likely to be incurred for freight, insurance and all other expenses up to the border of Nepal. The owner of the goods has to submit to the customs office the invoice or bill indicating the value of the goods and other documents demanded by customs officer to prove the transaction value of the goods. If the documents of the freight, insurance and all other expenses are not submitted, the Customs Officer shall determine the transaction value on the basis of the presumptive expenses. The Director General of the Department of Customs may fix the norms for expenses incurred or likely to be incurred for the purpose of determining the transaction value. Customs officer shall have to follow the fundamental principles of the World Trade Organization (WTO) in regard to the determination of value, whether or not the buyer and seller are related.

3.6.3 Relative Importance of Customs Duty in Nepal

Customs duty has some good contributions in the government revenue of Nepal. Going back to FY 1975/76, the share of customs duty in total tax revenue was 39.03 percent which was 32.08 percent of the total revenue of the Nepalese government for that year. In 1980/81, these ratios increased to 40.08 and 33.73 percent respectively. From 1985/86 to 2003/04, the contributions of customs to total tax revenue and total revenue of the government were almost in consistent figures occupying the leading role / the highest contribution. But, in 2004/05, VAT overcame to customs keeping customs in the second position. Thus, customs is the second largest source of total revenue in Nepal. Its contribution to total tax revenue and total revenue were 29.02 and 22.39 percent respectively in 2004/05. Looking after the ratio of customs to GDP, the ratio was 2.06 percent in 1975/76 that increased to almost 3 percent in

1980/81, but lowered to 2.21 percent in 1985/86, and increased to 2.53 percent in 1990/91. From 1995/96 to 2004/05, this ratio is close to 3 percent every year. We can see the detail pictures in table 27.

Table 27 Trend and Relative Importance of Customs Duties in Nepal

Fiscal Year	Customs Duties (Rs. in Million)	Customs Duties as Percent of			
		Total Indirect Tax	Total Tax Revenue	Total Revenue	GDP
1975/76	358	52.88	39.30	32.08	2.06
1980/81	816	48.46	40.08	33.73	2.99
1985/86	1231	40.82	33.64	26.50	2.21
1990/91	3044	44.56	37.23	28.37	2.53
1995/96	7327	42.89	33.81	26.27	2.94
2000/01	12552	43.08	32.30	25.67	3.05
2001/02	12659	43.22	32.19	25.09	2.99
2002/03	14236	43.09	33.43	25.32	3.12
2003/04	15555	42.08	32.29	24.96	3.13
2004/05	15702	37.53	29.02	22.39	2.94

Source: Budget Speeches of Various Fiscal Years, MoF

3.7 Nepalese Tax Reform

Nepal's economy went through a difficult time in the early 1980s. Real GDP growth rates during the period fluctuated erratically. Development expenditure raised so much relative to revenues that the share of such expenditures financed by revenue surpluses (total revenue less regular expenditure) dropped to below 17 per cent. Borrowing from the banking system largely financed the enlarged budget deficit. The pace of expansion of domestic credit persisted due mainly to increased banking sector credit to the government.

To counter various disturbing trends in the macro economic scenario the government initiated a reform program including currency devaluation, financial deregulation, trade liberalization, reduction in budget deficits and policy reforms, removing input subsidies and input taxes. The gradual removal of subsidies from power, agriculture, and industry also forms part of the reform programs launched in the country. So, we can say that the modern reform program in Nepalese Tax Policy started from the same time.

On the revenue front, taxes were rationalized both on levels and slabs. Tax rates were drastically slashed and tax brackets were also reduced. The objective of doing so was to enlarge the tax base and thereby increase the tax collection. As Nepal is a least developed country, revenue collection from direct taxes is less compared with the indirect taxes. So, in view of indirect taxes occupying important place in total revenue, reforms were focused on indirect taxation.

After the reestablishment of democracy in 1991, various reforms have been initiated to improve the quality of services in tax administration, make the administration taxpayer friendly and increase the revenue yields required for meeting expenses of various development activities. Sweeping changes have occurred in the tax policy in recent years, as it changed from the regime of high tax incentives for directing private sector investment in predefined priority areas to the regime of equal treatments to all sectors. In early stage of private sector development, tax incentives were taken as the instruments for attracting private investments whereas in recent years maintaining neutrality and rationalizing tax rates have been the main agenda of tax reformers in the country. Tax rates were drastically slashed and tax brackets were also reduced. The objective of doing so was to enlarge the tax base and thereby increase the tax collection. Despite significant reforms, there still persists the problem of inefficiency, narrow base and procedural rigidity and non-clarity in the tax system, which requires further reforms in policy, legislation and procedures. In addition, creation of a taxpayer friendly environment as well as competent and professional tax administration capable of functioning efficiently in the changed context of global economic integration has become the need of the time.

Government of Nepal introduced value Added tax (VAT) in 1997 in the process of taxation reform. The performance of the VAT regime at the beginning although was not satisfactory however, now VAT is the main source of Nepal’s revenue. In 2001, the government reorganized the tax administration creating a new Inland Revenue Department merging then Value Added Tax Department and Income Tax Department. In 2002, the government introduced new Income Tax Act that is supposed to be very advance and practical. These steps have brought positive impact in creating investment and taxpayers-friendly environment.

On the phase of Tax Reform, current year budget was proposed to establish a separate Excise Department to make excise administration more effective. For this, there has been already a feasibility study and administratively, it’s already decided to create such separate Excise Department, but because of the political instability in the recent years, it has not got the concrete form. But, we can hope it very soon. Similarly, a preliminary study was conducted to change current Inland Revenue Department into an autonomous body, namely, Revenue Authority Board.

We can point out the recent reforms as well as the programs in Nepalese Tax environment as followings:

1. Improve the buoyancy and elasticity of the tax system by widening the tax base of value added tax (VAT), income tax, and excise duty;
2. Streamlining the tax rates and tax slabs in income tax, VAT, and excise duty;
3. Minimize exemption list in VAT;
4. Control the tendency to provide tax rebate and exemption by reforming other sectoral laws, and cabinet decisions;
5. Grooming tax personnel towards developing taxpayer-friendly behavior;
6. Formation of a separate revenue group within Nepalese civil service to make employees professional and competent;
7. Introduction of self-assessment system in income tax and VAT to increase taxpayers' compliance.
8. Introduction of VAT in 1997 covering a wide range of business keeping threshold at NRs.2 millions;
9. Introduction of a new income tax law in 2002 covering worldwide income into the tax net;
10. Introduction of a new excise law in 2002 covering domestically manufactured and imported excisable goods and services;
11. Amendment in customs act to introduce the General Agreement on Tariffs and Trade valuation system.
12. VAT Department and Income Tax Department were merged into Inland Revenue Department so that there would be consistency and effectiveness while dealing with taxpayers in regard of tax related issues. Now, there are 22 district level frontline offices to administer the VAT, income tax, and excise duty.
13. A Large Taxpayer Office has been established in 2005 to administer the state-owned public enterprises, banks, finance company, and big houses whose annual turnover exceeds 150 millions; now this turnover has been changed to 250 millions.
14. VAT system was computerized and income tax system is under way to be computerized;
15. Process and procedure are being rationalized; manuals, returns, formats, and enclosures are being simplified;

16. Taxpayer education program is highly focused by the government through different interaction programs, public notice in National Daily, website and home page design, consumer awareness programs through Lottery provision in VAT billing.
17. Taxpayers' Charter and grievance handling system in tax administration has already been introduced, but still to be publicized more effectively among the taxpayers.
18. The provision of VAT refund at the airport to tourists has been implemented.

3.8 Taxpayer’s Rights in Nepal

Taxpayer’s right is one important aspect in the modern tax administration. We can see tax administrations from different countries having publicized taxpayer rights. In Nepal also, it was thought necessary to draw up taxpayer rights in the second half of the 1990s. The then Tax Department and the VAT Department had announced taxpayers’ rights independently. Later on, Income Tax Act, 2002 specifically quoted the taxpayers right. After the merger of income tax and VAT administration, current Inland Revenue Department has also publicized taxpayer's’ rights; but one important point is that it is necessary to consolidate taxpayers rights developed independently on various occasions and publicized it.

Income tax act has mentioned the following points as the rights of the taxpayers:[10]

A taxpayer with respect of paying tax under this Act shall have the following rights:-

a. right to get respectful behavior;
b. right to receive tax related information as per the prevailing laws;
c. right to get the opportunity of submitting proof in own favor in respect of tax matters;
d. right to appoint lawyers or auditors for defense;
e. right to secrecy in respect of tax matters and keep it inviolable

Taxpayers Rights and Assurances[11]

a. In addition to the specific rights and assurances provided in the concerned Acts, taxpayers in general are assured of the following rights. These assurances will be strictly adhered to. The Taxpayers rights, among others, include:
b. Each taxpayer is treated with due respect and honor.
c. Each taxpayer will get an immediate receipt of return submission whilst a receipt of other correspondences is to be provided in ONE hour.
d. Each taxpayer willing to seek an advance ruling may apply either in the Department or through concerned Inland Revenue Office. There is a legal provision that a decision should be made within 45 days after the request is made.
e. Each taxpayer can represent or make any correspondence by an authorized person including legal assistants and the accounts specialist or auditors just in case if he/she is unable to represent or make any correspondence.
f. Each taxpayer is to get copies of the documents related with him/her or submitted to the IRO or documents or decisions affecting her/him generally in TWENTY FOUR hours of his/her request in the concerned IRO.
g. Each taxpayer is to get refund of his excess input tax (VAT) and other taxes. The exporter will get refund generally within 15 days in IROs and 30 days in IRD upon receiving application for refund.
h. Each taxpayer is to get certificate/renewal of Excise/Liquor business generally within TWENTY FOUR hour after the request is made.
i. Each taxpayer is to get sales and purchase books certified by the Tax Officer generally within TWENTY FOUR hours after the request is made.
j. Each taxpayer is to get initials of the Tax Officer on stock transfer or sales to the non-registrants generally within TWENTY FOUR hours after the request is made.

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[10] Income Tax Act 2002, Section 74

[11] Published in the official website of Inland Revenue Department (www.ird.gov.np)

k. Each taxpayer is to get Permanent Accounts Number (PAN) or the Certificate generally within 3 days after the request is made, and
l. Each taxpayer is to get Tax Clearance Certificate generally within TWENTY FOUR hours after the request is made.

Other Rights in Existing Acts/Rules:

- Taxpayers have a right to examine their own tax records, audit files, and collection files.
- Taxpayers have a right to request copies of their own tax returns and return information, if available, subject to copying fees.
- Taxpayers have a right to obtain explanations regarding billings and assessments.
- Taxpayers have a right to be free from harassment and inappropriate contact by Tax Department personnel in matters relating to the collection of delinquent taxes and during the course of audits.
- Taxpayers have a right to be assured that their dealings with the Tax Department will be kept confidential.
- Taxpayers have a right to be assured that their tax returns and tax return information will not be disclosed, except as provided by law.
- Taxpayers are entitled to seek a refund if they have overpaid their taxes. A claim for refund must be filed within the applicable statute of limitations.
- Audit and Assessment: Taxpayers have a right to get a Proposed Notice of Assessment. A Proposed Notice of Assessment is mailed to the taxpayer's that: (1) explains the basis for the assessment of taxes, penalties, and interest; (2) informs taxpayers of their right to request clarification or to object to the tax assessment within 15 days from the date the Proposed Notice of Assessment was mailed; and (3) informs taxpayers that, if there is no response or not substantial reason to change the tax amount, the proposed tax assessment will become final after the expiration of 15 days from the mailing of the Proposed Notice of Assessment. Taxpayers have a right to request a meeting with the auditor or collector, their supervisor, or senior management to discuss a Proposed Notice of Assessment if they do not agree with the tax assessment. Taxpayers have a right to a Final Notice of Assessment, issued after the expiration of 15 days from the mailing of the Proposed Notice of Assessment that provides the basis for the tax assessment, and informs the taxpayer of the procedures for appealing the assessment.
- Tax Appeals: Taxpayers have a right to ask the information regarding procedures for appealing a tax assessment. They have a right to appeal an assessment, either to the Administrative Review or to the Tax Tribunal. The appeal must be filed within 30 days from the date the Final Notice of Assessment was mailed. If the appeal is filed in the Administrative Review, the decision will be within 60 days. In addition, if the taxpayers do not agree with the decision of Administrative Review, they can go to the Tax Tribunal. And, even they can go to the Supreme Court if not agree with the decision of Tax Tribunal.
- Representation: Taxpayers have a right to represent themselves or have another person accompany or represent them (with proper written authorization) when dealing with the Tax Authority on any tax matter, including audits, collections, and appeals.

3.9 Tax Treaties

Income tax can be levied on the basis of the source or the worldwide principle. Here, in such case, international double taxation may arise because of the selection of different tax bases by different countries. Some countries levy tax on income originated within its boundaries (source principle) while some countries levy tax on the worldwide income of their residents.

Generally, developing countries levy tax on the basis of source principle. They want to tax income generated within their territory even by the foreign investors to generate some revenue. They do not tax foreign source income of their residents for administrative reasons. On the other hand, developed countries emphasize on the residence principle, which advocates taxation on the total income, to the resident, irrespective of its origin (worldwide principle). Non-residents, however, are taxed on their domestic source income only under this principle also. As a result, income of resident earned outside the country is taxed twice, once by the country of source and once by the country of residence. To address this issue, there is a great role of tax treaties between two countries.

The importance of bilateral tax treaties to avoid international double taxation has been realized in Nepal since the enactment of the Income Tax Act 1962, but Nepal signed its first tax treaty with India only on January 18, 1978. After then, it took a long time to move to same direction. After the establishment of democracy in 1990, then elected government adopted the liberal economy, as a result of which, the foreign investment has started to increase and it is extremely necessary to avoid double taxation on income from such foreign investment or foreign trade to encourage such investment. So, Nepal has adopted a plan to gradually remove the double taxation on income and capital and to promote cross boarder investment and trade by concluding agreements for avoidance of double taxation and fiscal evasion with the countries of our economic interest. After adopting such policy, Nepal signed its second treaty with Norway on May 13, 1996. Up to now, Nepal has signed 9 such bilateral tax treaties and negotiations for the bilateral agreement with some other countries are under considerations. While doing such agreement, Nepal normally follow UN model. The countries having tax treaty with Nepal are as followings:

Country	Agreement Date
India	18 Jan 1987
Norway	13 May 1996
Thailand	02 Feb 1998
Sri Lanka	06 July 1999
Mauritius	03 Aug 1999
Austria	15 Dec 2000
Pakistan	25 Jan 2001
China	14 May 2001
Korea	05 Oct 2001

It is expected that such type of agreement will prevent from diminishing the volume of investment and trade due to probable unhealthy competition among the countries having taxing rights.

IV. Country-Specific Fiscal Issues

A. Fiscal situation:

The fiscal position of Nepal is very critical. The share of government expenditure in its regular and development activities play a vital role in the overall economy of the nation. Since the early 1990s, there has been a quite drastic change in the composition of regular and development expenditure[12]. In the early 1990s, the regular expenditure used to be about one-third of the total expenditure while development expenditure accounted about two-third. Regular expenditure increased rapidly and exceeded the development expenditure during FY 1998/99. Not only has the share of development expenditure in total expenditure gone down, but also the volume of development expenditure decreased in real terms in FY 2001/02 and

[12] Since FY 2003/04, the government expenditures have been changed from two headings (Regular and Development) to three headings as Recurrent, Capital and Principal Repayment

2002/03. This is not a desirable situation in a developing country like Nepal, where there is a need to enhance development expenditure in order to create the infrastructure required for economic development and the execution of many projects to improve social conditions such as health and education.

Regular expenditure has been increased at a high rate due mainly to increasing defense expenditure, debt-repayments and employment pension. As Nepal suffered a decade long internal politically motivated Maoist insurgency, government expenditure demanded high defense expenditure. The situation has now got some rest with a hope to solve the problem forever and we can expect reduced defense expenditure in the days to come, but still the total regular expenditures are likely to increase even more rapidly in the future. For example, since many foreign loan agreements are nearing their maturity date, there will be a need to pay a huge amount of principal and interest to many bilateral and multilateral donors. Depreciation of the value of Nepalese currency has aggravated the problem more serious. Pension provision to the large number of schoolteachers and others is likely to incur huge costs as well.

Total revenue has not been able to keep pace with total expenditure. Tax revenue contributes about three-quarters of the total revenue and one-quarter comes from non-tax revenue. While there is some scope for generating more revenue through the rationalization of non-tax sources, particularly improvement in pricing policies and operational performances, these sources cannot be used effectively as revenue raisers since most of these sources are levied for purposes other than revenue generation. So, it's quite necessary to make every effort to generate more revenue through taxes that are levied on income, commodities and properties.

The fiscal deficit is another characteristic of Nepal's public finance. As public revenue has not been able to keep pace with public expenditure, there is a large deficit in the fiscal system and it is increasing year by year. The fiscal deficit has been financed both by foreign and internal loans. Foreign loans are inflationary. Furthermore, the heavy reliance on external loans indicates a danger of debt trap since Nepal will have to pay a higher amount of principal and interest with the depreciation in the value of the Nepalese currency. Like external loans, the internal loans also cause inflationary pressure, particularly because the banking system provides the bulk of these loans and this leads to an increase in the money supply which is not desirable.

To solve the problem, attempts must be made to mobilize more tax revenue through the reform of the tax system. Besides, regular expenditure should be reduced and development expenditure should be increased to solve the real demand of a developing country. Before accepting any foreign loan, there should be proper evaluation about either it is really needed or not and how it would be used.

B. Narrow Tax Base

Despite recent efforts and measures, the tax base has remained narrow, due mainly to poor enforcement of the tax laws. Though the total amount to tax revenue has been in increasing order, the level of total tax revenue is still very low. The tax revenue to GDP ratio was always below 10 percent that got new record of 10.14 percent in FY 2004/05; but still much lower than that of many developing countries. The number of taxpayers is limited. For example, the total number of income tax registrants is about 231,000 out of which, the number of registered individual taxpayers is about 190,000 that is less than 0.8 percent of the total population. Similarly, out of total taxpayer, about 48000 are also registered under VAT. The bulk of tax revenue is generated from a few taxpayers in the formal sector, who have to compete with a large number of other businessmen who do not pay any tax. It will be difficult for genuine taxpayers to survive if they have to face unfair competition for a long time. They will be forced to evade tax in order to survive. The base of the VAT has been limited due to large exemptions. To solve the problem, there should be strong initiation to enforce the tax laws more efficiently; and the unnecessary long list of tax-exempted goods/services should be reduced to only basic needs.

C. International Trade has been concentrated with single country

Sometimes people use to say that as a land locked country with the Himalayas in the north, Nepal is virtually India-locked. Nepal's international trade is concentrated with a single country, India, more and more. During FY 1995/96, the share of Nepal's international trade with India out of total was 29.8 percent that has been more than doubled within 10 years making the share 61.3 percent during FY 2004/05. In FY 1995/96, Nepal's total export to India was only 18.5 sending rest to the other world, but in FY 2004/05, this share has been just reversed as 66.3 percent with India and rest with other countries. After FY 2000/01, not only the share, but also the total volume of export with third world has been reduced. Here, increased trade with India itself is not a problem; the issue is that Nepal's economy is becoming highly dependent upon India. It has two issues: first, Nepal is loosing its potential higher return from western market and second is that in case of any disrupt from Indian government or any problem in Indian economy, Nepal will suffered a lot. There are already some such examples in past where the trade was related to the political system in the country and Nepal had to face the problem. So, market diversification is highly important in current situation to prevent the future possible problem from the above mentioned risk matter.

D. Trade Deficit

Nepal has been facing trade deficit from history to yet and it's in increasing trend. During FY 2004/05, total export was only 11 percent of GDP while import was 28 percent making 17 of GDP as trade deficit. Though there is favorable balance of payment, it is because of enough surplus current accounts to cover such trade deficit. The significant increase in worker's remittances is the primary factor which has attributed to the upsurge in the current account surplus. But, Nepal should focus to reduce the trade deficit. Product diversifications as well as market diversifications are highly important to Nepal. Export promoting policies and commitments are much needed.

E. Investment Environment

Foreign investment and technology transfer is quite essential for leading the economic system towards the attainment of self-dependency and making it a robust, firm, dynamic and competitive through the maximum mobilization and highest utilization of available capital, natural and human resources in the process of industrialization of the country. Realizing the above facts, Nepal adopted different favorable policies in industry, trade, finance and the stock exchange to attract more FDI from early 1990s; but still Nepal couldn't attract enough FDI comparing to other similar developing countries despite the wide availability of extremely cheap skilled labor. Of course, one main reason is the political instability and the security problem during the last few years that has got rest recently and we can hope positive impact on FDI; but at the same time, the policy adopted towards FDI also has to be re-examined and compare with other neighboring countries' policy. There should be enough adjustment in the policy to attract more FDI to fulfill the lack of domestic capital. Besides, there should be enough advertisement in the international financial market about the liberal policies related to FDI in Nepal. At the same time, government should ensure the security of those investments.

F. State-owned enterprises- a burden to the government

Most of the state-owned enterprises are very inefficient and running in losses for years and years increasing the government liability to compensate their even regular expenditure. During 1990s, Nepal privatized some such enterprises, but for the last couple of years, there is no such step towards privatization. This will create long-term negative impact on the overall economy of the country. So, government should privatize all those enterprises and make the market more competitive. There should be detailed plan, fair evaluation and political commitment to privatize these public enterprises and make the market more and more competitive.

V. Conclusion: Where we stand and where we go?

Nepal, a developing country with per capita income of only about US$300, is suffering from rapid population growth, growing budget deficit, heavy trade deficit, low productivity, and lower GDP growth rate. Similarly, there is higher inflation basically due to increased oil prices and the prices of other basic commodities. To support the development activities particularly building basic infrastructures, public expenditure is increasing year by year. Besides, regular government expenditure has been increased during last some years due to increased security expenditures. In such case, revenue collection is not enough to cover the government expenditure. To cover deficit budget, domestic as well as foreign loan is the alternative source, but the amount of foreign loan is already quite higher and it’s going up because of the depreciation on the value of Nepalese currency as well. High poverty, low literacy rate, and unemployment are other existing problems in the country. Nepal has already got the membership of WTO, but still has to do a lot to fulfill the commitment made there. In this situation it’s quite complicated, though not impossible, to come out of these problems.

Being located in between the two big emerging Asian countries, India and China, Nepal has equally good opportunities as well as challenges in the days to come. Being an underdeveloped small country, there is a risk that the industrial environment of the nation will be highly dominated by the neighboring big industrial markets. There may be abundant supply of industrial product from neighboring countries making the small domestic industrial sectors out of competition; but at the same time, there is a high possibility of gaining from the transactions between the two big nations. The reality is also the same that Nepal can’t avoid the impact from the neighboring economy in this globalization era and so, opportunities should be searched from those challenges to maximize the national interest. There is a high possibility of making Nepal as a transit between two big economies and it is really needed. Besides, to maximize the use of cheaper and skilled domestic labor and natural resources, Nepal should try to import foreign capital and advanced technologies that will help to establish her industrial market more competitive. After getting the membership of WTO, the door to the world market has been opened more. In this stage, there is a high threat from the low-cost products to the domestic industries, but it’s the reality of the time and Nepal cannot go back out of the reality. So, institutional compatibility is really needed in the industrial market of the nation.

Nepal has enormous hydropower potential. Study has shown that the hydropower potential of Nepal's rivers, based on average flows, is about 83,000 MW out of which about 50 percent is economically feasible. This is one of the largest potentialities in the World. Despite of enormous hydropower potential, by the end of FY2004/05, hydropower generation reached only 556.8 MW in the country, which is 0.67% of its potential. The demand for power is growing at about 10 percent annually. At present, electric power supply is available to only 42 percent of the total population. It is estimated that power demand of the country will grow to 1.64 million kilowatts by the year 2015. Nepal has adopted liberal policy to attract private investment for the development of hydropower projects; but still there is not enough investment in this sector. Out of this, one obvious reason is the political instability, conflict and security problem in the country that has recently got some rest. Now, it’s a time to welcome foreign investment in this sector as much as possible. With the production of hydropower electricity, there is a high possibility to export electricity to the neighboring countries gaining foreign currencies. Besides, as there is no oil resources explored yet, Nepal has to import very big volume of petroleum products annually from other countries that had pressed Nepal's international trade to highly deficit balance. With the production of hydropower, Nepal could reduce its current import of petroleum products that will help to reduce the trade deficit. Not only this, the development of hydropower will help to achieve the millennium development goals with protecting environment, increasing literacy, improving health of children and women with better energy. Growing environmental degradation adds a sense of urgency.

Although a small countries, Nepal possesses a lot of natural beauties: mountains, hills, lacks, falls, rivers, diversified climates and environment, birds, flowers and so on which are the attractions of the tourism. There is no doubt that Nepal possesses a high degree of natural beauty, but the problem is the lack of enough advertisement in the world-tourism market, lack of enough infrastructures to access/reach and enjoy such beauties. Because of almost a decade long political movement, Nepal suffered a big loss in its tourism industry. Now, there is a green signal of political solution and peace process. Nepal should highly use this opportunity to expand her tourism industry.

Being an underdeveloped country, government has to invest a lot in its infrastructure development to support rapid economic growth. In the lack of enough infrastructures, other sectors couldn't be expected to grow rapidly. So, there is no doubt that the public expenditure will be increased more rapidly in the days to come. But to minimize its growing budget deficit, there should be proper evaluation of the projects before making investments. Since the FY 1998/99, regular expenditure has increased rapidly and exceeded the development expenditure which is really against the need of a developing country. So, there should be structural changes in the government expenditures; regular expenditures should be controlled to increase development related activities.

Despite several reforms in tax structure and the tax administration, tax collection is still very low comparing to other developing countries. Of course, we cannot ignore the positive impacts resulted from the tax reform during last one decade; but there are a lot of things remaining to do. The tax administration is still running by traditional system. Tax compliance is low and corruption is being a big problem in the bureaucracy. To come out of these problems, there should be fundamental changes in the tax-administration. Modernization of tax administration with computerization of the tax related information, analysis of such data to combat against tax evasions, upgrading the analytical skills to the tax officials, tax education, taxpayers friendly services, and political commitment to keep the tax administration out of the political influence are necessary measures to achieve high growth in the tax revenue to cover the increasing public expenditures.

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