4. Nepal

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I. Introduction

Nepal is a developing country located in south Asia. Nepal is the homeland of Mount Everest- highest peak of the world, birthplace of Lord Buddha, habitat of thousands of flora and fauna, and residence of hospitable Nepalese people. Nepal is blessed with highest mountain ranges, ample natural resources, and huge manpower; however despite unlimited potential, the nation has still long way to go to achieve the goal of poverty alleviation.

Geography and climate

For a small territory, the Nepali landscape is uncommonly diverse, ranging from the humid Terai (plain region) in the south to the lofty Himalayas in the north. It covers an area of 147181 sq km. Nepal in area is 65 times smaller than China, 22 times smaller than India and 2.5 times smaller than Japan. It stretches from 80º 4' E to 88º 12' E longitudes and 26º 22' N to 30º 27' N latitudes. Nepal shares her border with People's Republic of China to the north and Republic of India in all rest of the sides- south, east and west. The elevation ranges from 60 meters above the sea level in the southern plain to 8848 meters in the northern part. Eight out of top ten highest peaks of the world including Mt. Everest (8848 meter high) lie in Nepal. Roughly rectangular in shape, Nepal extends 885 km long from east to west direction and average 193 km width from north to south.

On the basis of physical setting, the country has been broadly divided into three ecological regions: the mountain, the hills and the plain. The mountain region includes the highlands and trans-Himalayan valleys. Similarly, the hill region lies just below the mountain region and covers the hills and the valleys. The plain region contains the low tropical plains along with the southern part of the country. Topographic extremities govern the climatic condition of Nepal.

Due to the tremendous variation is topography and altitude, the climate ranges from tropical to alpine climate. Moreover, landscape and slope of mountains and hills have created numerous micro climatic environments. Alpine, cool temperate, warm temperate, subtropical and tropical climates are the varieties of climate in Nepal. Generally, subtropical and tropical climate covers the southern plain region, temperate in mid hill region and alpine in Himalayan region.

Generally, there are four seasons: (a) Spring: March-May (b) Summer: June-August (c) Autumn: September- November (d) Winter: December-February.

The monsoon starts approximately from the end of June to the mid of September. About 80% of the rain falls during that period, so the rest of the year is almost dry. Spring and autumn are the most pleasant seasons; winter temperatures drop to freezing level with high snowfall in the mountains. Summer temperatures range from 28ºC in the hill regions to around 40ºC in the Terai (plain region). In winter, average maximum and minimum temperatures in the Terai range from a 7ºC to a mild 23ºC. The hilly valleys experience a minimum temperature often falling bellow freezing point around 12ºC (54ºF) maximum. Much colder temperatures prevail at higher elevations. The Kathmandu Valley, at an altitude of 1310m, has a pleasant climate, ranging from 19-27ºC (67-81ºF) in summer and 2-20 º C in winter.

Natural Resources

Plenty of water resources and lofty mountains are the major natural resources of Nepal. Nepal is second largest country in the world after Brazil in water resources possessing 2.27 percent of the world water resources. The major sources of water are snowmelt from Himalayas, glaciers, rain fall and ground water. There are roughly 6000 rivers (including rivulets and tributaries) flowing in a high speed from north to south with a high potential of hydroelectricity generating.

Forest resource also accounts a major natural resource of the country and it provides fodder to the livestock. Some industries also depend on forest resources as raw materials.

Other than water resources and forest resources, Nepal contains mineral resources as well though they are not excavated substantially. Studies indicate that iron, copper, gold, lead, zinc, limestone, slate, oil and gas, coal, sulphur etc are available.

Utilization of naturalization of natural resources and environmental impact are considered, nowadays, simultaneously as a base of sustainable development.

Brief History and Political Structure

Neolithic tools found in the Kathmandu Valley indicate that people have been living in the Himalayan region for at least nine thousand years. It appears that people who were probably of Tibeto-Burman ethnicity lived in Nepal two and half thousand years ago[1]. Various dynasties namely Gupta (4th Century), Lichhavis (5th Century), and Malla (13th Century ruled over the long period of history respectively. However, Nepal has its long ancient and medieval history, the modern history dates back from the second half of the 18th century. Prithivi Narayan Shah[2], king of Gorkha State, resumed unification movement to consolidate a strong nation by merging the warring Himalayan principalities and finally conquering Kathmandu in 1768. Since that time Kathmandu has been the capital of the country. Jung Bahadur Rana, a fast rising military leader, designed Kot Massacre 1846 and declared himself prime minister of the country leaving monarchy with only nominal power. Rana family ruled the country for 104 years. Rana regime pursued a policy of isolating country from external influences. This policy helped the country maintain national independence during the colonial era but impeded the country's economy. Popular movement of 1950 overthrew the Rana family autocracy and the country entered into an open political environment.

In 1959 General election was held for parliament and a democratic government formed as per the mandate of people, however, it lasted for short period. In 1960 King Mahendra democracy a failure and dismissed the elected government. Later, new constitution by the same king banned on running political parties and started party less 'Panchayat System'.

People's movement of 1990 restored democracy in the country and consequently King had to dissolve the Panchayat system and to open the barrier imposed on political parties. New constitution ensured the provision of the sovereignty of the Nepalese people, multi-party democracy, and constitutional monarchy.

In June 2001 Crown Prince Dipendra went on a shooting-spree assassinating 11 members of the royal family including King Birendra and Queen Aishwarya before shooting himself. Consequently, Prince Gyanendra (Birendra's brother) inherited the throne and he is the King at present.

As the Maoist insurgence escalated, in October 2002 the king temporarily deposed the government and took complete control of it. In February 2005 Gyanendra dismissed the entire government and assumed full executive powers, declaring a "state of emergency" to quash the Maoist movement.

Again people's movement in April 2006, in Kathmandu and other cities forced the king to reinstate the parliament. A seven-party alliance regained control of the government and stripped the king of most of his powers. At present, interim parliament has declared Nepal as people's republic to be ratified by the new Constitution Assembly. Now, Nepal is governed by an interim government under an interim constitution until the new constitution will be made through a long process of the election of constitutional assembly.

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[1] http://en.wikipedia.org/wiki/Nepal#_note-Library_of_Congress. 2007.06.02.

[2] Late kind Prithivi Narayan Shah is known as the builder of Nation.

Demography

Nepal stands in the 40th position based on the population as estimated by United Nations. According to the census 2001, the population of Nepal stands at 23.2 million which comprises 50.8 percent male and 49.2 percent female. Annual population growth rate was 2.27 in the 1990s whereas it was 2.1 in the 1980s. This growth rate is considerably high compared to other developing countries. First census was held in 1911 and the population was 5.6 million and within a period of less than a century the population has quadrupled; the projected population for 2006 is 25.89 million.

Life expectancy is projected 63.3 years at birth which was 60.4 in 2001. As of 2001, crude birth rate per 1000 is 33, crude death rate is 9.6. Total fertility rate per woman is 3.1. Only 13.9 percent people live in urban area and rest of 83.1 percent people live in rural area.

Table 1: Population Changes During The 90-Years Period, 1911-2001

Census Year	Population	Inter-Censual change in Population		Exponential Growth Rate	Persons per sq. km
		Number	Percent		
1911	5638749	…..	….	-	38.31
1920	5573788	-64961	-1.15	-0.13	37.87
1930	5532574	-41214	-0.74	-0.07	37.59
1941	6283649	751075	13.58	1.16	42.69
1952/1954	8256625	1972976	31.4	2.27	56.1
1961	9412996	1156371	14.01	1.64	63.96
1971	11555983	2142987	22.77	2.05	78.52
1981	15022839	3466856	30	2.62	102.07
1991	18491097	3468258	23.09	2.08	125.64
2001	23151423	4660326	25.2	2.25	157.3

Source: Central Bureau of Statistics, Government of Nepal

The above table 1 shows that population sized is continuously increasing in every series of census, except the second census in 1920. The central bureau of statistics predicts that it may be because of some epidemic on that time and the casualty of Nepalese Army in World War I.
Population by age group:

Table 2: Population by Age Group

Age Groups	Percent
0-14	39.4
15-59	54.1
60 and over	6.5

Source: Nepal at a glance 2006, Central Bureau of Statistics, Nepal

Literacy rate in 2001 is 54 percent where male 65.5 percent and female 42.8 percent. Women are back in education but the ratio of girls to boys in primary education in 2005 is 0.9. This ratio indicates that biasness to impart education for girl is decreasing.

Nepal is rich in cultural heritage. Kathmandu city is well known as a city of temple. Lord Buddha, god of peace and tranquility was born in Lumbini, Nepal. According to the 2001 census, 80.6 percent of the population is Hindus, 10.74 percent is Buddhist, and 4.2 percent is Islam, 0.45 percent Christians and 3.99 others. Religious harmony is the common feature in the Nepalese way of living.

II. Overview of Macroeconomic Activity and Fiscal Position

Nepal is a developing country with per capita income of around US$300. Economy is mainly based on agriculture. Agriculture accounts 39 percent of GDP and, it consumes 80 percent of workforce. It is noted that only by the improvement in agriculture sector, we cannot achieve notable increase in per capita income. Nepal is landlocked country and cost of production is high because of the transportation cost from sea to the place of production. So, manufacturing industry and other technological sector is sharing less than 10 percent of GDP. Tourism is the most potential sector for Nepal but its development has been stagnated due to the poor security situation last decade.

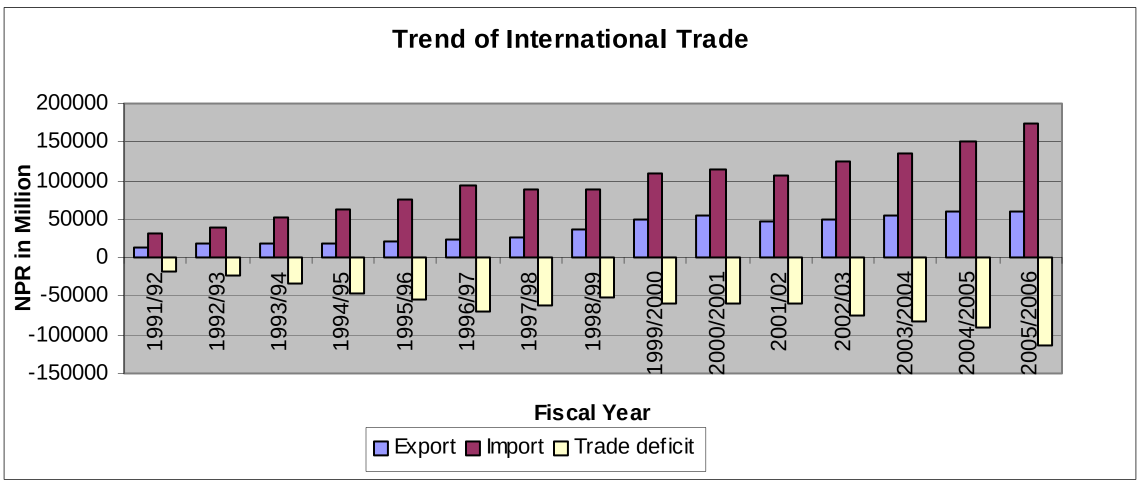
II.1 Macroeconomic Activity

II.1.1 International Environment

a. Trade Balance

Nepal has been facing trade deficit from history to the present time. The country-wise and product-wise area of export trade of Nepal seems narrow. On the product-wise basis, export of other products than readymade garments, Pasmina and Woolen Carpets to the third country export basket is nominal. The export trade of low volume, high value products like herbs, ornaments, and precious stones has been shrinking day by day.

Figure 1: Trend of International Trade

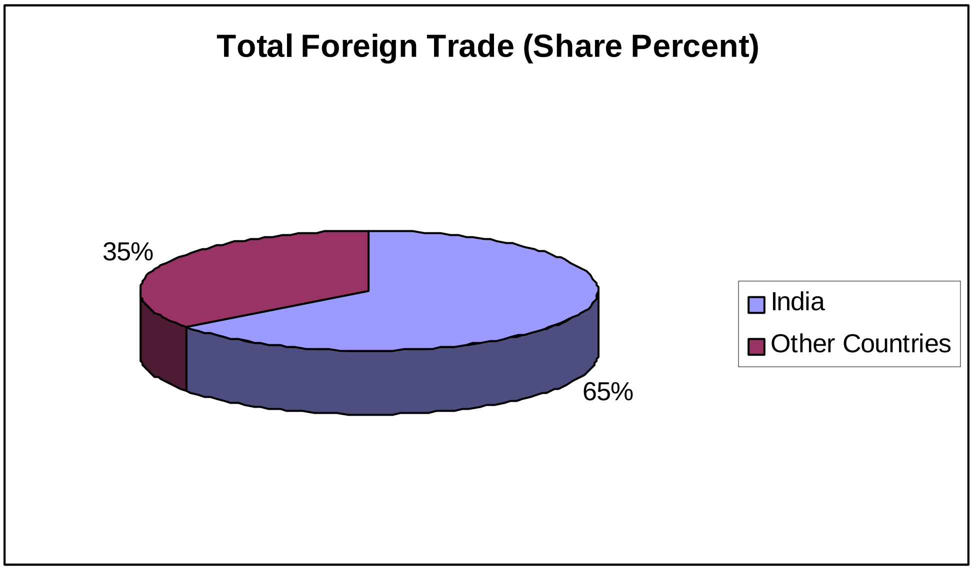


Source: Economic Survey, Government of Nepal, Ministry of Finance, July 2007.

The chart above shows that trade deficit is one of the facts of Nepalese economy. The knowledge and research based trade system has not been developed estimating the changes in the demand of the market, to provide goods and services accordingly.

On the country-wise basis, the main markets are India, USA, and Germany. Even then, major share of trade is with India. Almost 65 percent of the international trade is with India and rest 35 percent is with rest of the world.

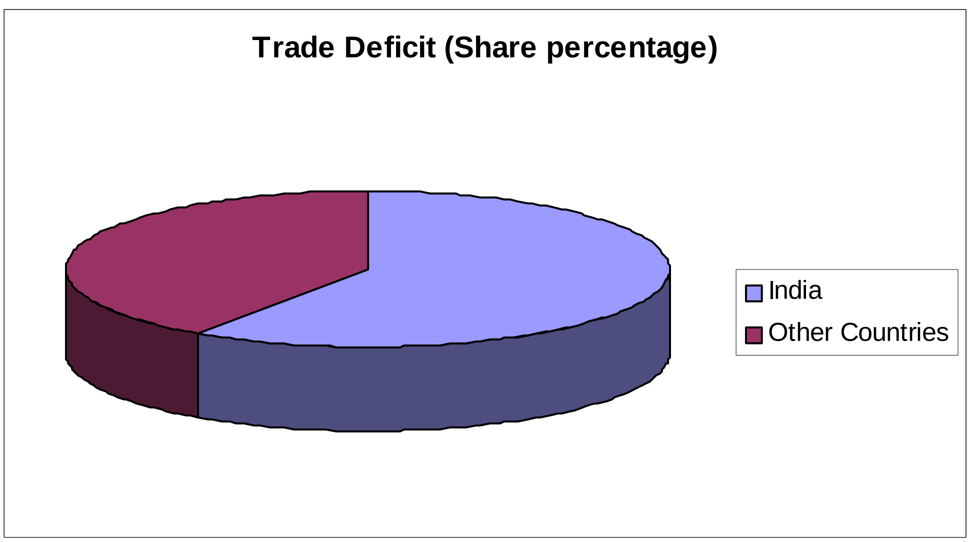
Figure 2: Share of Foreign Trade



Source: Economic Survey, Government of Nepal, Ministry of Finance, July 2007.

Similarly, the share of trade deficit with India holds major part. It is almost 60 percent of total trade deficit whereas; it is 40 percent with rest of the world.

Figure 3: Trade Deficit Share



Source: Economic Survey, Government of Nepal, Ministry of Finance, July 2007.

In international trade, quality control is inevitable for competition. Only few industries have got ISO 9000 certification in Nepal. This may obstruct the access in the markets of developed countries like European Union, USA and Japan. Therefore, it is necessary to evaluate the quality of goods and services, which will be exported to the international market and design the program to support it.

b. Balance of Payment

The balance of Payment data shows that the performance of the Nepalese Balance of payment has mixed status during the last five years. Receipts from tours and travels have been reduced significantly due to the vulnerable security condition. Current account is now largely supported by remittance inflows. The remittances are functioning as safety valve in the Nepalese economy. Remittance has become the main source of earning foreign currency in the country. So, it is essential to estimate correctly and build the flow maximum portion of remittance in the country through institutional channel.

A major component of current account, trade balance was always in deficit in Nepal's history. Even net service has been recorded deficit in FY 2004/05. In such a situation, worker's remittance inflow, which is continuously in increasing trend, has highly contributed to keep current account surplus.

c. Exchange Rate and Exchange System

The pace of reform in foreign exchange management system has been expedited along with the adoption of the economic liberalization policy, initiated since mid-1980s. Convertibility of the rupee in current account; introduction of open general license system for imports; freedom to determine the exchange rate of the foreign currencies, except the Indian rupee, to the market; relaxations of rules and regulations for providing foreign exchange facilities; opening foreign currency account in local banks, amendment in foreign exchange management laws, permission to import selected goods from India in convertible currencies etc. are some of the important reform measures adopted over the period. Despite these reforms, there still remain some restrictions in current account transactions. In this context, it is pertinent to direct the foreign exchange management system towards more liberal, efficient and dynamic one. [3]

Nepal Rastra Bank publishes the exchange rates of foreign currencies for its own use; it's only indicative. Commercial banks are free to determine their own exchange rates for convertible currencies and other near money instruments.

Generally, 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 Foreign Exchange Dealers Association (FEDAN) with a view to sharing information and avoiding unhealthy competition in foreign exchange transactions. FEDAN works as a bridge between all member banks and Central Bank. All the commercial banks are the member of the FEDAN. FEDAN collects the daily exchange rates from its members and sends to Central bank. Central bank uses this information of exchange rate to determine the exchange rate for US dollar 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 the cross rates with the US dollar in the international market.

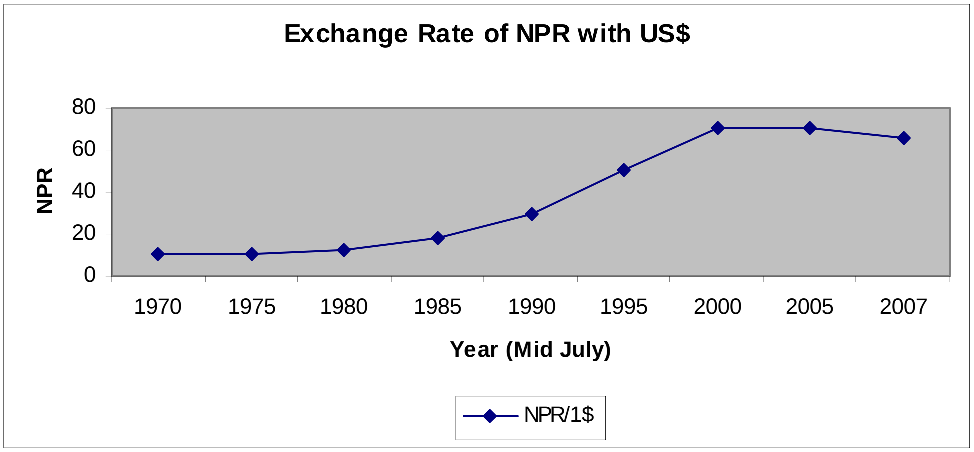
Table 3: Exchange Rate of NPR to US$

Year Mid July	1970	1975	1980	1985	1990	1995	2000	2005	2007
NPR/1$	10.15	10.55	12.00	17.70	29.20	50.70	70.75	70.65	65.44

Source: Nepal Rastra Bank

[3] Nepal Rastra Bank, Strategic Plan 2006-2010

Figure 4: Exchange Rates



Source: Nepal Rastra Bank

d. Foreign Direct Investment

Nepal has opened her door for foreign investment after adopting liberal economic policies. It is believed that foreign direct investment is a supplement to the domestic private investment through foreign capital inflow, transfer of technology, enhancement of managerial skills, productivity and to get into the global market. Government of Nepal has begun 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. Single door policy has been carried out to simplify the process of granting necessary approval and providing services to the foreign investment through a single place.

To attract the investment of Non-resident Nepalese (NRN), who is residing in foreign countries, the Government of Nepal has made the legal provision to provide visa for unlimited time and provide other trading facilities and rights similar to those for the Nepalese until they invest in Nepal. This policy is effective because NRN may invest in Nepal with their sentiments and those who want to come back to native land can come with investment and contribute for the economic development of the country. In the budget speech of FY 2007/08 the government has reiterated its commitments to remove the obstacles seen in course of insuring NRN`s participation in the development of the country by utilizing their knowledge, skills, capital, and technology.

The law of Nepal also assures the security of investments against nationalization. Besides this, Nepal being a member of Multilateral Investment Guarantee Agency (MIGA) assures the foreign investors against non-commercial risks like currency transfer, breach of contract, war and civil disturbances in the country. As of July 2004, according to the statistics of foreign investment division of Department of Industry, there are about 905 foreign direct investment projects in Nepal that worth approximately US$ 1.65 billion. These projects in the sectors like Agriculture/Forestry; Manufacturing; Energy; Construction; Mineral; Tourism and other service related industries have generated employment opportunities to almost 95,000 people in Nepal. India, USA, China, UK, Norway, Japan, South Korea and Germany are the leading countries with highest number of projects in Nepal.

e. Borrowing from Abroad

It is the compulsion of Nepal to borrow from abroad to close the gap between the internal revenue and finance the government expenditures. In the FY 2004/05, outstanding foreign loan totaled NPR 219 billion 641.9 million. In the following year, it increased by 6.5 percent and amounted to NPR 233 billion 968.6 million.

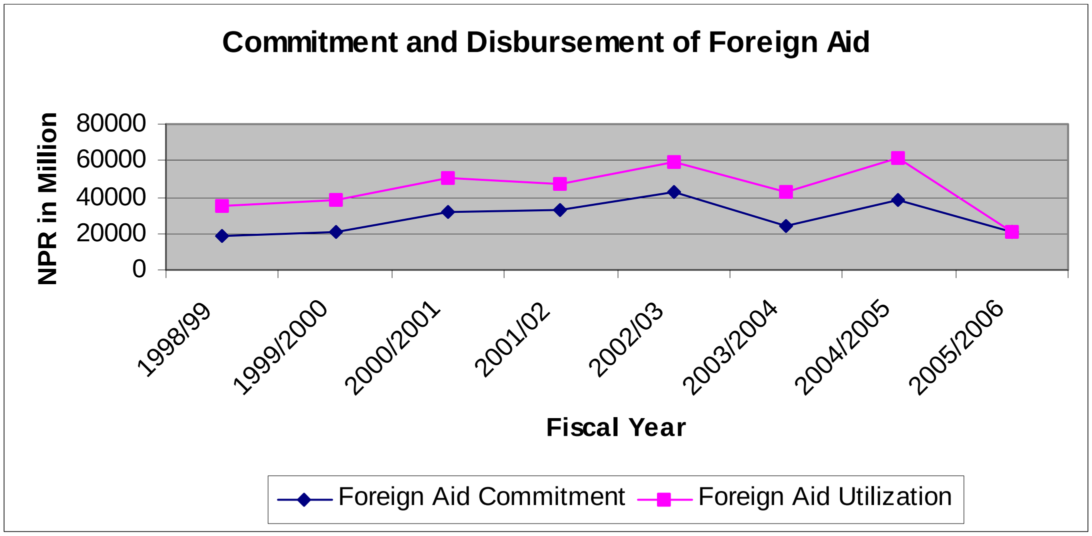
Ratio of outstanding foreign loan to GDP (at current producer price) in FY 2003/04 was 43.4 percent. In the following year, it declined to 37.3 percent and further declined to 36.2 percent in FY 2005/06.

f. Foreign Aid

Foreign Aid is also a very important source of deficit financing in Nepal. Commitment for the foreign aid has largely depended on the nature and behavior of the government. In FY 2005/06, committed amount was NPR 20 billion including both grant and loan. Compared to the previous FY, in FY 2005/06, commitment in the form of foreign grant, and commitment in the form of loan, decreased by 28.07 percent and 79.16 percent respectively.

During the first eight-month period of the current FY 2006/07, foreign aid commitment was raised up 40.19 percent as bilateral grant and 59.81 percent as multilateral grant.

Figure 5: Commitment and Disbursement of Foreign Aid



Source: Economic Survey, Government of Nepal, Ministry of Finance, July 2007.

The above chart shows continuous growth of commitment of foreign aid up to FY 2002/03. In the following years commitment for the foreign aid seems decreasing.

II.1.2 Domestic Environment

a. Economic Growth Rate

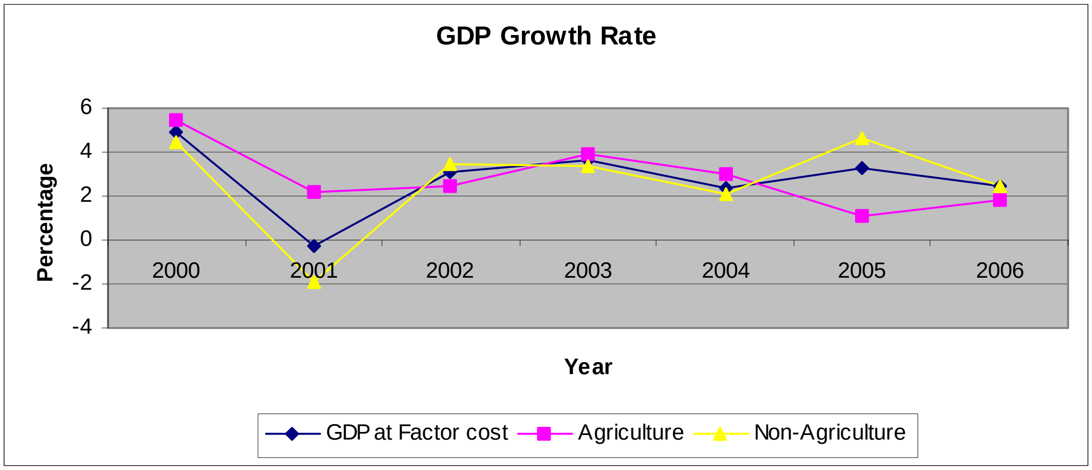
Nepal's economic growth rate remained below 5.0 percent in the last six years due to the country's precarious economic circumstances. In FY 2005/06, Nepal's GDP growth rate remained at 3.3 percent. The growth rate further decelerated in FY 2006/07 to 2.5 percent. In the meantime, Nepal's immediate neighbors, India and China, achieved growth rates of 9.2 percent and 10.7 percent respectively in 2006.

Table 4: GDP Growth Rate

Fiscal Year	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	200/07
GDP at Factor cost	4.9	-0.3	3.1	3.6	2.4	3.3	2.5
Agriculture	5.5	2.2	2.5	3.9	3.0	1.1	1.8
Non-Agriculture	4.5	-1.9	3.5	3.4	2.1	4.6	2.5

Source: Economic Survey, Government of Nepal, Ministry of Finance, July 2007.

Figure 6: GDP and Ratio on GDP



Source: Economic Survey, Government of Nepal, Ministry of Finance, July 2007.

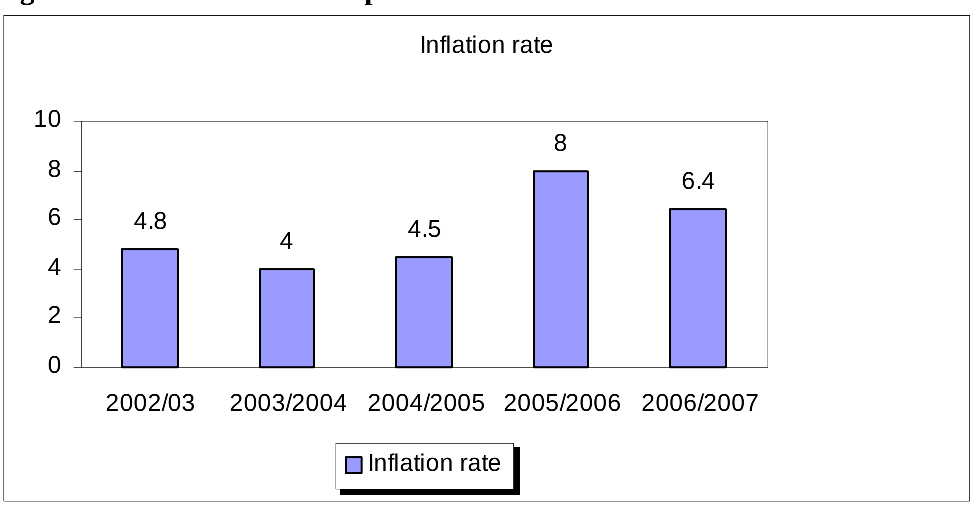
Extremely unfavorable weather, among other things, caused high decline in agricultural production, especially that of the paddy in the FY 2006/07. The impact could clearly be seen on the overall agricultural production index, which increased, by a mere 0.4 percent in 2006/07 against the increase of 1.1 percent in the preceding year.

Ratio of government expenditure to GDP stood at 17.2 percent in FY 2004/05 compared to 17.4 percent in the previous Fiscal year. Similarly, in FY 2004/05, the ratio of revenue mobilization to GDP was 11.2 percent, a decrease by 0.7 percent, compared to 11.9 percent in the previous fiscal year.

b. Inflation Rate

The monetary policy of NRB has been aiming for price stability as a primary objective. To better fine-tune monetary policy for meeting this objective, it is essential to determine the influencing variables of inflation in Nepal. The following graph shows the annual inflation rate of 5 years in Nepal. Subsequently, the table below shows the average 5-year inflation rate of the period more than 30 years.

Figure 7: Inflation Rate in Nepal



Source: Nepal Rastra Bank

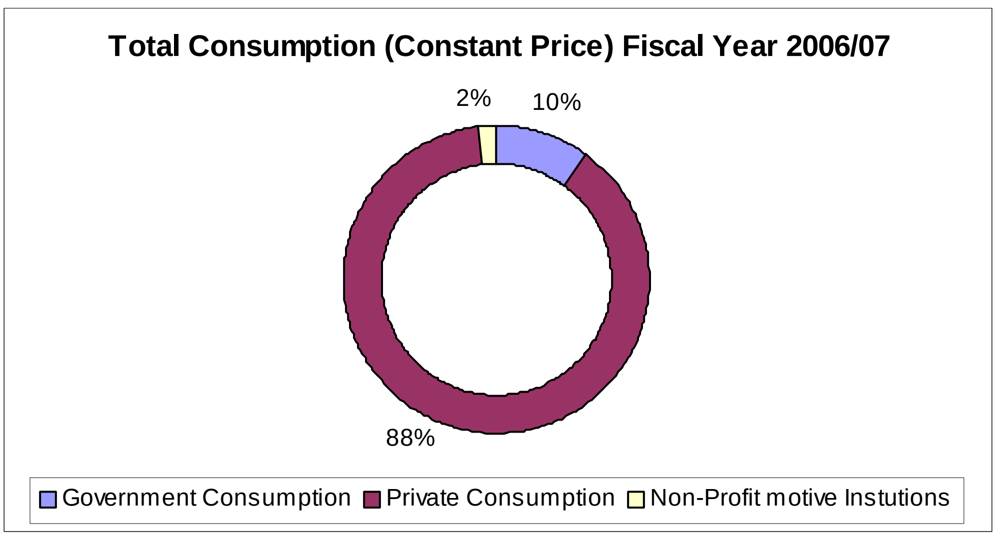
Agriculture continues to play important role in price level in Nepal. This sector is mainly dependent on monsoon rain. This creates uncertainty and low productivity causing rise to high price increase of agricultural products at times of adverse weather led production. So adoption of suitable modern technology based practices is essential to get rid of the uncertainty. Orientation of agriculture to commercial corps instead of traditional crops is also essential.

Nepal Rastra Bank has completed a study on factors affecting price inflation in Nepal in FY 2006/07. According to the Nepal Rastra Bank Act, 2001 and its Strategic Plan (2005/06-2009/10), Bank has a role to play in price stabilization that in order to fulfill this objective, this study was done with a view to develop a short- and long-term price projection tool. On the basis of theoretical and empirical analysis, the study has come out with theoretical hybrid model, which is expected to be suitable for Nepal.

c. Consumption:

Consumption at constant price in FY 2006/07 is estimated to increase by 2 percent to NPR 482 billion 350 million. It had increased by 5.8 percent to NPR 472 billion 970 million in last years. The ratio of total consumption to GDP was 92.8 percent last year. The ratio is estimated to 92.3 percent this year. Of the total consumption government and private sectors share 10 percent and 88 percent respectively n FY 2005/06. This year corresponding shares are estimated to be 9.9 percent and 88.2 percent, having slight change. Private sector's consumption had increased by 6.4 percent last year and is estimated to increase by 1.9 percent this year. The consumption of government sector is estimated to increase by 0.46 percent this year over the growth of 0.80 percent last year.

Figure 8: Total Consumption



Source: Economic Survey, Government of Nepal, Ministry of Finance, July 2007.

Table 5: Total Consumption Trend in the Previous Six Years Is as Follows:

Fiscal Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Total Consumption	90.5	91.4	88.3	88.4	92.1	90.6

Source: Economic Survey, Government of Nepal, Ministry of Finance, July 2007.

d. Investment:

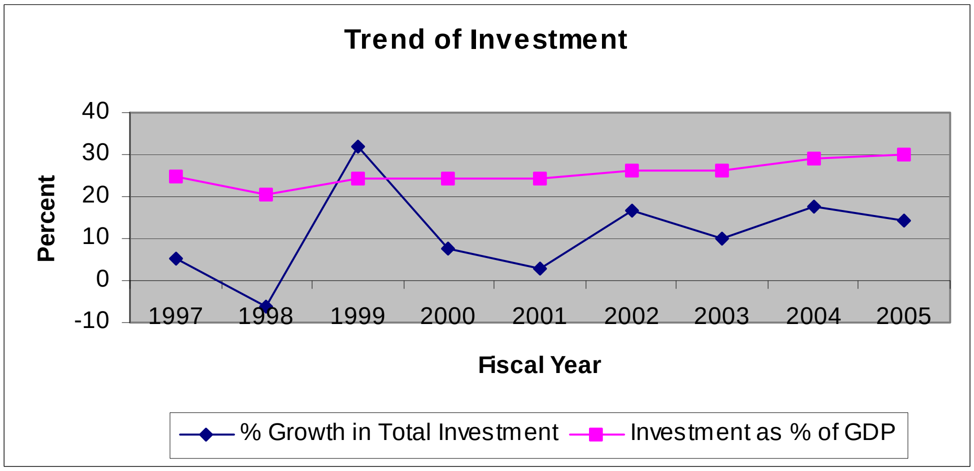
Gross Investment in FY 2004/05increased by 17.7 percent. But it increased by 14.5 percent in 2005/06. The proportion of gross investment to GDP in FY 2004/05 was 28.9 percent and it was30 percent in FY 2005/06.

Table 6: Gross Investment to GDP Ratio

Fiscal Year	1997	1998	1999	2000	2001	2002	2003	2004	2005
% Growth in Total Investment	5.1	-6.2	31.7	7.6	2.9	16.5	10	17.7	14.5
Investment as % of GDP	24.8	20.5	24.3	24.1	24.2	26.1	26.4	28.9	30

Source: Economic Survey, Government of Nepal, Ministry of Finance, July 2007.

Figure 9: Trend of Investment



Source: Economic Survey, Government of Nepal, Ministry of Finance, July 2007.

Various things affect investment in Nepal. Serious disturbances like frequent strikes, lock-outs, donations, menace, load shedding, raw material supply disturbances, recurring cases of misunderstanding between management and labor, lack of industrial security etc, were at work to disturb industrial production. As a result, the situation remains unfriendly to private sector investment promotion.

e. Capital Stock

In FY 2006/07, Gross Capital Formation at constant price is estimated to decrease by 6.1 percent to total NPR.106 billion 520 million compared to the reduction of 0.8 percent to total NPR113 billion 490 million in FY 2005/06. The ratio of Gross Capital Formation to GDP stood at 22.3 percent in FY 2005/06. Such ratio is estimated at 20.4 percent in 2006.07.

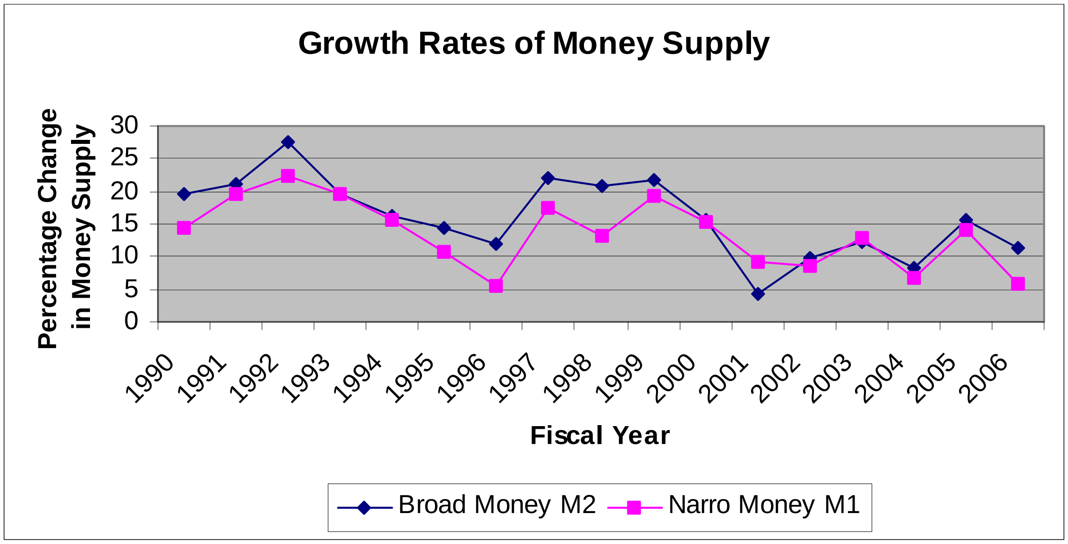
f. Money Supply

During the first eight months of the current FY 2006/07, broad money supply increased by 11.4 percent compared to the 8.4 percent increase during the same period last year. The monetary expansion is attributed to the high rate of increase in monetary sector's net domestic assets. Such domestic assets this year increased by 13.2 percent as against that in last year. Time deposit is one of the components of broad money; it increased by 14.1 percent in fiscal year 2006/07. The reason behind such an increase is the flow of remittances, expansion of service sector and the fixed deposit attractive plans of commercial banks.

There are various factors affecting the supply of money. Among the expansionary factors of money supply, net foreign assets increased by 12.7 percent (NPR 13 billion 650 million) in the first 8 months of the last year. In the same period this year, it increased by 8.7 percent only due to the fall in export and low rate of increase in remittance inflow to last year.

Domestic credit is a major factor of money supply expansion in Nepal. During the eight months of last FY 2005/06, it expanded at the rate of 5.8 percent. This FY 2006/07, it has increased by 8.7 percent.

Figure 10: Growth Rate of Money and Supply



Source: Economic Survey, Government of Nepal, Ministry of Finance, July 2007.

g. Employment

Due to the lack of reliable employment survey and forecast in Nepal, the estimation of the actual status of employment has been complex.[4] According to the Population Census 2002, the economically active population was estimated to be 10.482 million. The Tenth Plan (FY 2002/03-2007/08) forecasted 1.53 million additional employment creations during the plan period. The forecast was based on the effects of production increase in the various sectors of the economy, and the inter-sector linkage.

It was estimated that the employment will reach to be 1,10,12 thousand at the end of Tenth Plan. According to the Tenth Plan, the number of economically active population was estimated to reach to 1,15,80 thousand towards the end of the Plan period (FY 07/08), and out of which 4.1 percent were estimated to remain unemployed, and the disguised employment was estimated to be reduced to 22.3 percent.

The number of unemployed has not been reduced even though the number of Nepalese going for foreign employment is increasing. According to the population census 2002, unemployment rate was 5.1 percent on population above the age of 10 years old. However, according the Nepal Living Standard Survey 2003/04, among the population of the age of 15 or above, 2.9 percent were unemployed, 74.3 percent were employed and, remaining 22.8 percent were economically inactive.

[4] Economic Survey, Government of Nepal, Ministry of Finance, July 2007

Table 7: Employment Status in Nepal FY 2003/04 (In 15 years or above population)

Region	Employed (%)	Unemployed (%)	Economically Inactive (%)	Total
Gender wise				
Male	73.3	3.1	19.6	100
Female	71.7	2.7	25.6	100
Development region wise				
Eastern	74.9	2.9	22.2	100
Central	72.4	3.3	24.3	100
Western	73.2	2.7	24.1	100
Mid Western	77.0	2.8	20.2	100
Far Western	80.4	1.4	18.2	100
Geographical Region wise				
Himal	86.7	1.3	12.0	100
Hills	76.0	2.1	21.9	100
Terai	71.1	3.8	25.1	100
Nepal	74.3	2.9	22.8	100

Source: Economic Survey, Government of Nepal, Ministry of Finance, July 2007.

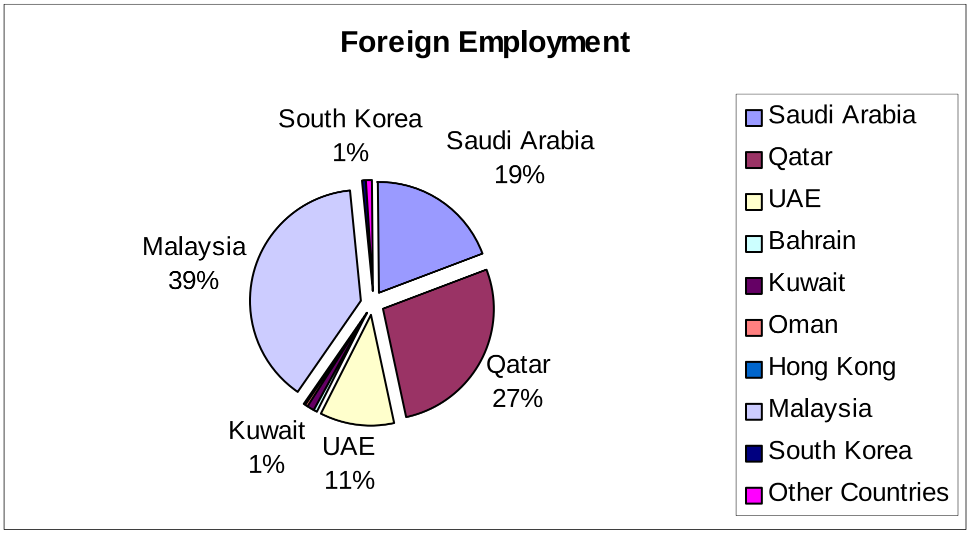
Because of the lack of employment opportunities in the country, the number Nepalese for foreign employment is rising every year. Besides the Malaysia and Korea, most of the workers are going to the Arabian countries to avail jobs. By the end of 2004/05, the number of job seekers going for foreign employment with holding official permission had reached to 591,400.

Table 8: Country wise Number of Foreign Employment of Nepalese workers

S.N.	Country	Total up to FY 2004/05	Total in 2005/06	Total of 9 months FY 2006/07	Grand Total
1	Saudi Arabia	131683	19507	30608	181798
2	Qatar	148152	58233	48937	255322
3	UAE	63585	17184	19442	100211
4	Bahrain	4853	530	955	6338
5	Kuwait	8760	738	1956	11454
6	Oman	758	77	465	1300
7	Hong Kong	3167	176	307	3650
8	Malaysia	220505	84162	62948	367615
9	South Korea	5480	196	683	6359
10	Other Countries	4457	1389	931	6777
	Total	**591400**	**182192**	**167232**	**940824**

Source: Department of Labor and Employment Promotion

Figure 11: Foreign Employment



Source: Department of Labor and Employment Promotion

The tendency of the Nepalese seeking employment shows that the highest number of Nepalese (39%) has gone to Malaysia. Likewise, Quarter (27%) and Saudi Arabia (19%) are the second and third largest destinations of the Nepali workers abroad, respectively. Similarly, United Arab Emirates (UAE) 11%, Kuwait 1%, Bahrain 0.67%, Korea 0.68%, Hong Kong 0.39%, Oman 0.14%, and Other countries share 0.72 % of the total number of employees abroad.

II.2 Fiscal Position

II.2.1 Government Expenditure

Revenue mobilization is the main source of government expenditures. A minimal gap between the expenditures and revenue is desirable to maintain a fiscal balance. However, revenue growth is not maintaining a pace with expenditures growth.

Ratio of government expenditure to GDP stood at 17.2 percent in FY 2004/05 whereas 17.4 in the previous year. Similarly, in FY 2004/05, the ratio of revenue mobilization to GDP was 11.2 percent, whereas it was 11.9 in the previous year. Gap between expenditure and revenue is widening every year.

Government expenditure is mainly divided into to kinds of expenditures- current expenditure and capital expenditures.

Current expenditures increased by 8.64 percent totaling NPR 67 billion 17.8 million in FY 2005/06 from a total NPR 61 billion 686.4 million in the previous Fiscal Year. Of the total expenditures of 2005/06, Constitutional Bodies' expenditure was 1.50 percent, General Administration 13.83 percent, Revenue and Economic Administration 0.91 percent, Economic Administration and planning 0.9 percent, Administration of Justice 0.84 percent, and Foreign Services 1.23 percent. Defense expenditure was 14.48 percent, Social Services 37.87 percent, Economic Services 11.23 percent, Debt Servicing 9.19 percent and miscellaneous expenditure 8.41 percent.

Table 9: Summary of Income and Expenditure

NPR in '000

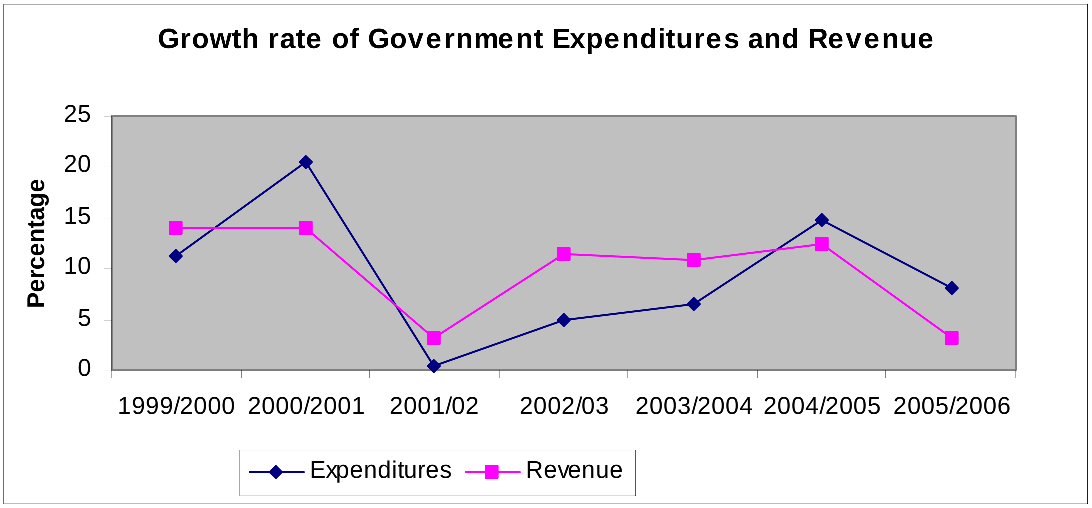
Description	Actual Expenditure of 2006/06	Revised Estimate of 2006/07	Estimate of 2007/08
Revenue	**72282085**	**86135467**	**103667256**
Tax Revenue	57426995	70046185	80962200
Non Tax Revenue	13341473	14843968	21349600
Principal Refund	1513617	1245314	1355456
Total Expenditure	**110889158**	**131851000**	**168995600**
Recurrent	67017778	80331068	98172491
Capital	29606604	36379932	55261682
Principal Repayment	14264776	15140000	15561427
Surplus (+) Deficit (-) Before Foreign Grant	**-38607073**	**-45715533**	**-65328344**
Foreign Grant	13827498	15946000	27460914
Bilateral	7617844	9039420	12954669
Multilateral	6209654	6906580	14506245
Surplus (+) Deficit (-) After Foreign Grant	**-24779575**	**-29769533**	**-37867430**
Foreign Loan	8214305	10331000	17367430
Bilateral	40627	1622250	1617000
Multilateral	8173678	8708750	15750430
Domestic Borrowing	11834200	17900000	20500000
Cash Balance Surplus or Deficit	**-4731070**	**-1538533**	**0**

Source: Budget Speech of fiscal year 2007-08, Government of Nepal, Ministry of Finance 2007

A total of NPR 29 billion 606.8 million was spent under the Capital Expenditures in the FY 2005/06 which has been increased by 8.28 percent over NPR 27 billion 340.7 million expenditure of the previous Fiscal Year. Capital expenditure in FY 2005.06 by major sub heads included economic services 50 percent, Social services 34.3 percent, Defense 5.42 percent, General Administration 4 percent, Administration of Justice 0.58 percent, and Miscellaneous 0.03 percent. Compared to the total capital expenditure of FY 2004/05, expenditure on Social Services was increased by27.84 percent whereas expenditure on Economic Services was decreased by 3.88 percent.

Total government expenditures continued to show increasing trend also in the FY 2005/06. Compared to previous Fiscal Year, total government expenditure increased by 17.7 percent whereas such increase has been 8.12 in FY 2005/06. According to government expenditures classifications, current expenditures in FY 2004/05 increased by 11.0 percent and by 8.64 percent in the following FY 2005/06. As regards to capital expenditures, it increased by 18.4 percent in the FY 2004/05; in FY 2005/06 such expenditures increased by 8.28 percent. Principal repayment expenditures increased by 25.4 percent in the FY 2004/05 compared to that of previous fiscal year. In FY 2005/06, such expenditures increased by 5.4 percent.

Figure 12: Growth Rates of Government Expenditures and Revenue



Source: Economic Survey, Government of Nepal, Ministry of Finance, July 2007.

Principal Repayment Expenditures are rising every year. In FY 2005/06, a sum of NPR 14 billion 264.8 million was spent to meet principal repayment compared to a sum of NPR 13 billion 533.3 million in FY 2004.05 and NPR 10 billion 794.9 million in FY 2003/04. Such expenditure in FY 2005/06 increased by 5.4 percent compared to previous FY's expenditure.

II.2.2 Fiscal Resources:

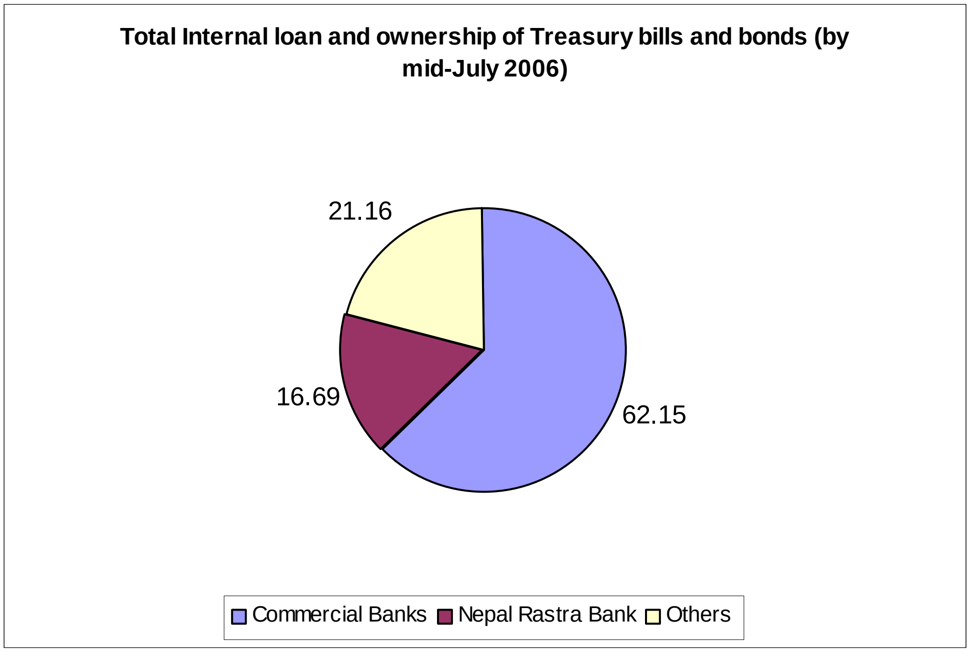
Revenue mobilization, foreign grand and loan, internal debt, and the change in cash balance continued to be major sources in contributing to meet government expenditure. Revenue mobilization has been the major source of financing government expenditures. In Fiscal Years 2003/04, 2004/05, and 2005/06; revenue as a source of financing of government expenditure contributed 69.69 percent, 68.37 percent, and 65.18 percent respectively.

In FY 2005.06, tax revenue was 79.45 percent of the total revenue and not-tax revenue was 20.55 percent. Percentage of tax revenue and non-tax revenue during the corresponding period in the previous FY were 77.16 and 22.84 percent respectively.

II.2.3 Public Borrowing:

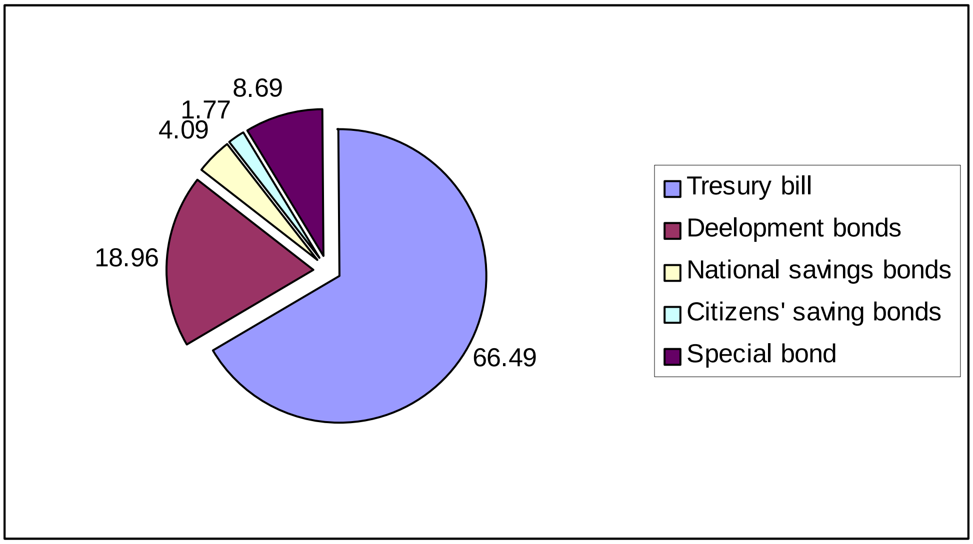
Internal loan totaled to NPR 87 billion 564.2 million by mid-July 2005. It increased by 8.16 million to the total of 94 billion 711 million in mid-July 2006. Of this total, loan owed to central bank was 16.69 percent, to commercial banks 62.15 percent and other corporations and private sector 21.16 percent. Among the instruments of internal loan, Treasury bills shared 66.49 percent, development bonds 18.96 percent, national savings bond 4.09 percent; citizens' saving bonds 1.77 percent and that of special bond is 8.68 percent.

Figure 13 Ownership of Treasury Bills and Bonds



Source: Economic Survey, Government of Nepal, Ministry of Finance, July 2007.

Figure 14 Government Loan Type

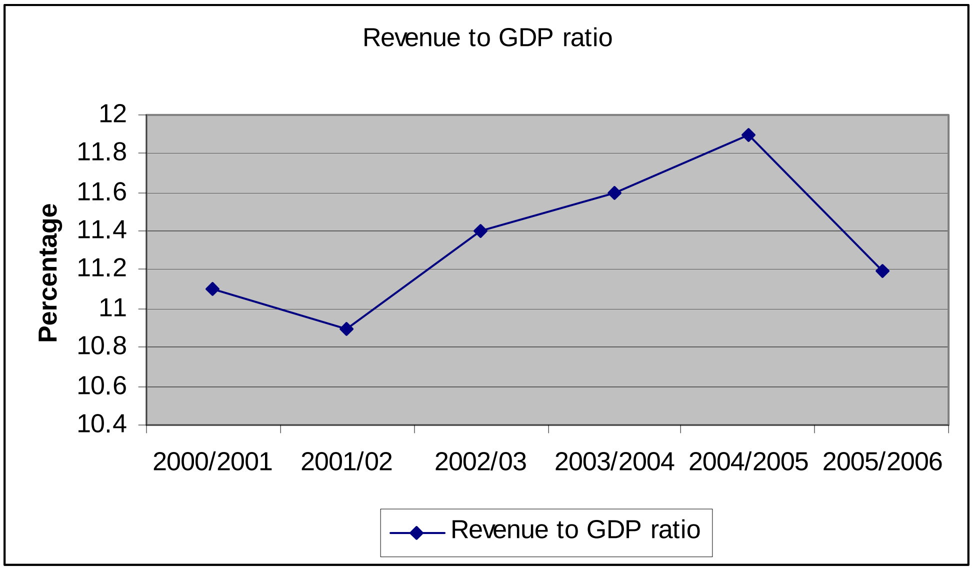


Source: Economic Survey, Government of Nepal, Ministry of Finance, July 2007.

III. Tax Structure: Institutions and Reality

Revenue mobilization is the main source of government expenditure and development of the country. The rate of revenue collection is not satisfactory in Nepal. In fiscal year 2004/05, the ratio of revenue mobilization to GDP was 11.2 percent, a decreased by 0.7 percent, compared to 11.9 percent in the previous fiscal year.

Figure 15: Revenue to GDP Ratio



Source: Economic Survey, Government of Nepal, Ministry of Finance, and July 2007.

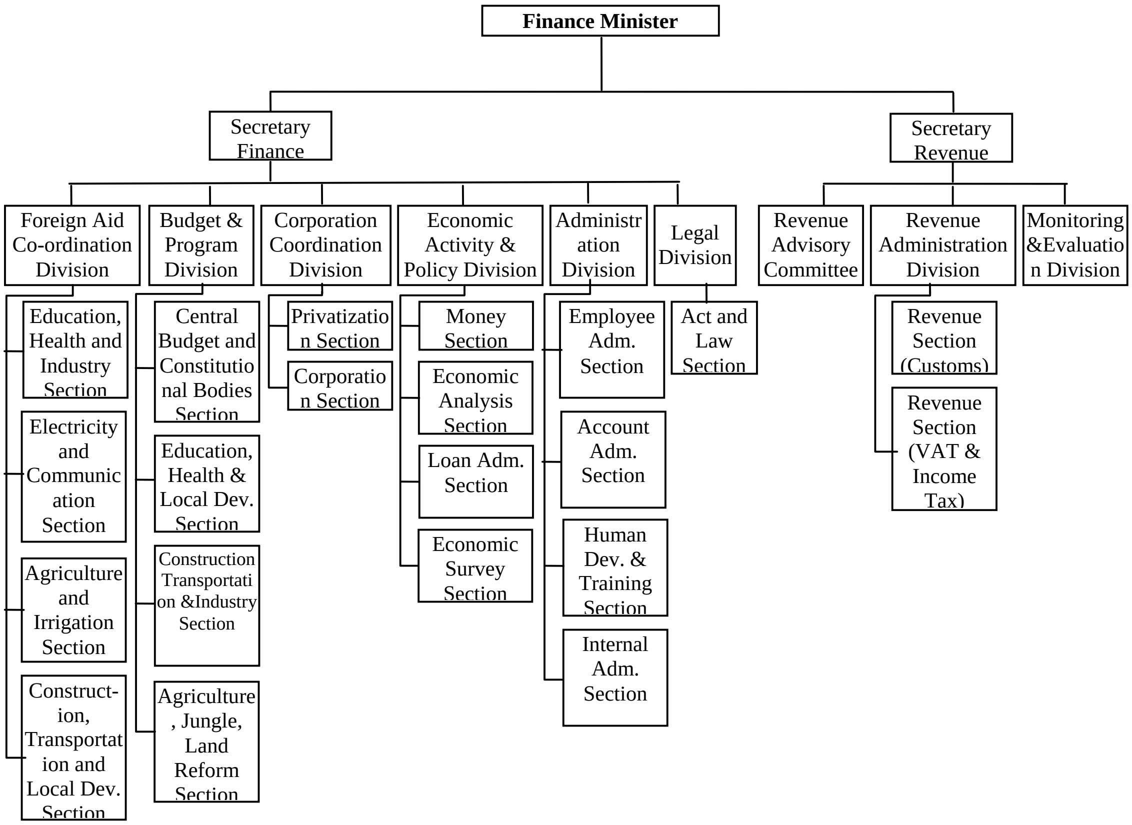
In fiscal year 2005/06 the share of custom was 26.72 percent, and taxes from goods and services production and consumption combined was 48.96 percent. The share of land revenue and registration fees and income on profit and property taxes was 3.8 percent and 20.52 percent respectively.

In tax revenue, contribution of custom decreased by 2.28 percent in FY 2005/06 compared to the amount realized previous year while taxes from goods and services production and consumption increased by 11.0 percent and land revenue and registration fees also increased by 21.22 percent.

III.1 Organizational structure of Nepalese Tax administration

The Ministry of Finance is the apex body to administer tax in Nepal. The ministry comprises 9 divisions and revenue division is responsible for the formulation of tax policy and monitoring the tax administration in the country. The ministry coordinates the functions of the different revenue departments- Inland Revenue Department, Revenue Investigation Department, Custom Department, and so on. The revenue consultation committee reviews the implementation of taxation policy and recommends reform measures in the tax policy and tax administration.

Figure 16: Organization Chart of Ministry of Finance



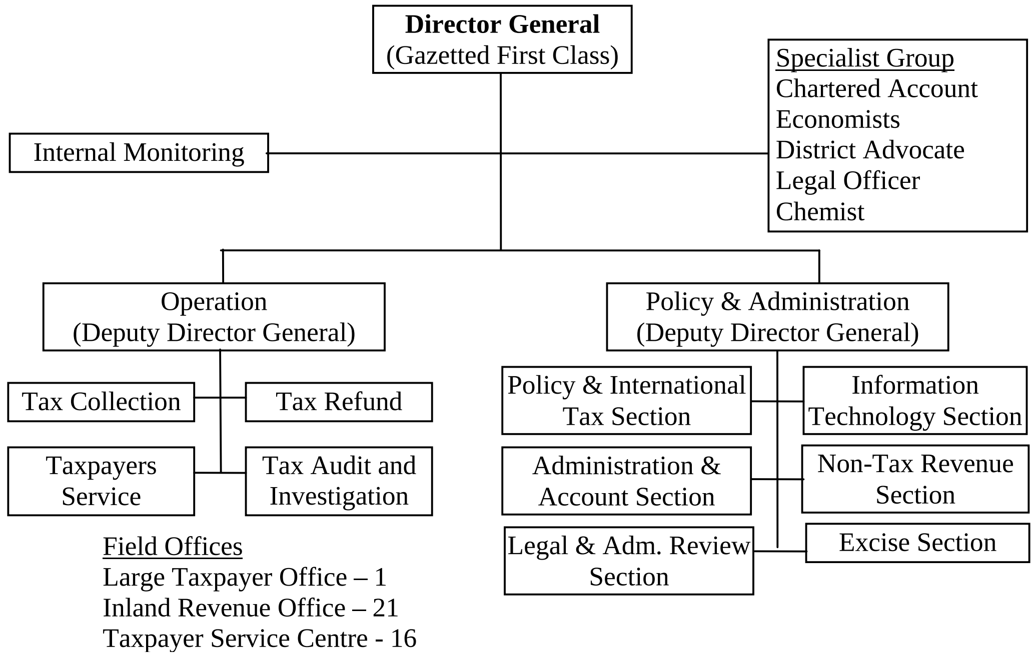
Note: Adm. is Administration in the above chart.

III.2 Inland Revenue Department: Entity to administer Inland Revenue

The Inland Revenue Department is currently responsible for the administration of Value Added Tax, Income Tax, and Excise Duty. Likewise, the Inland Revenue Department is also responsible for monitoring non-tax revenue of the government. Inland Revenue Department covers 1 Large Taxpayers Office, 21 Inland Revenue Offices all over the country. Inland Revenue Department was established in mid-July 2001 by merging then tow separate departments – Tax Department and Value Added Department. In the meantime, 21 field offices were established merging different tax offices and Value Added Tax offices. Large Taxpayers Office was established in mid-January, 2004.

The Inland Revenue Department is structured on the basis of function of the different sections. The functions are mainly divided into three main sections: Taxpayers Service, Tax Collection, and Audit & Investigation. All the Inland Revenue Offices are structured on the same basis. Different officers are responsible for different functions under the organizational structure.

Figure 17: Organization Chart of Inland Revenue Department



III.3 Human Resources

Tax administration is a part of civil service with specialized group within the Nepal Administrative Service. So, the process of recruitment, hiring, transferring and promoting of staff is similar to other fields of public service administration. Public Service Commission, constitutional body, is responsible to select and recommend Government of Nepal the candidates for the appointment in civil service. The commission conducts exams to select from the candidates available.

The following table shows the staff position in Revenue Administration:

Table 10: Staff Position in Revenue Administration

Organizations	Officers	Assistants	Total
Ministry of Finance	71	141	212
Inland Revenue Administration	261	664	925
Custom 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 its Departments

The above figures show that Nepalese Revenue Administration has very little number of employees. Even out of the positions number of positions are already vacant but not filled up in time. It is challenging to meet the objective of collecting targeted revenue with low number of revenue officials. Assistant level staff and driver helper cover the large percentage of the above number. They do not have the adequate knowledge to run the modern tax administration. So, the tax administration needs qualified officials to meet the revenue target set. For that, policy makers should consider to curtail the lower level position and hire more officers to build officer oriented tax administration.

III.4 Types of Taxes administered by Inland Revenue Department

- Income Tax
- Value Added Tax
- Excise Duty

Note: Custom duty is administered by Custom Department

III.4.1. Income tax

The first Parliamentary Government imposed Income Tax in Nepal in 1959. Income Tax Act 1962 was enacted in 1962 replacing business, Profit and Remuneration Tax Act of 1959. The Income Tax Act, 1962 was replaced by Income Tax Act, 1974, which was amended for eight times and existed for a period of 28 years. The Income Tax Act, 1974 and all the income tax related provisions made under other special enactment have been repealed and the existing Income Tax Act, 2058 became effective since Chaitra 19, 2058 (01, April 2002). The Act governs all income tax matters and is applicable throughout the Kingdom of Nepal. It is also applicable to residents residing wherever outside Nepal.

Income Tax Act 2002 has broadened the tax base and tax rates are spelled out in the Act itself and tax and the tax rates and concessions are harmonized on equity grounds. A full-fledged self-assessment system is implemented and the presumptive taxation and current year taxation system are strengthened. The Act has reduced drastically the scope of discretionary interpretation of the tax administration ensuring simplicity, uniformity and the transparency. The Act has also defined the power and authority of the tax administration. Similarly the Act has separated administrative and judicial responsibilities by distinguishing civil liabilities of the taxpayers from criminal liabilities. The appeal system is further streamlined by making it mandatory for the taxpayers to file an objection with the Inland Revenue Department for administrative review before appealing to the Revenue Tribunal.

The Act has categorized the income mainly into three broad heads:

- Employment (an individual's remuneration income from an employment for an income year)
- Investment (profits and gains of a person conducting an investment for an income year),
- Business (profits and gains of a person from conducting a business for an income year)

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 Nepali month named "Shrawan" of a year to the end of the month "Ashad" of the following year (mid-July to mid-July).

Tax base:

Income tax is imposed on and realized from each of the following persons for each income-year:

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

Here, person means natural person, proprietorship, or it also means artificial person, i.e., an entity.

The Income Tax Act has distinguished between resident and non-resident persons. A resident person is an individual whose habitual abode is in Nepal and 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.

Tax Rates:

The taxable income of a resident individual for an income-year will be taxed at the following rates:

Table 11: Tax Rate

S.N.	Income Slab	Rate
1.	One first NPR 100,000 of total income	Not taxable
2.	On next NPR 75,000 of total income	15%
3.	On further remaining all income	25%

Source: www.ird.gov.np

The taxable income of a resident couple if they chose to be treated, as couple will be taxed at the following rates:

Table 12: Tax Rate

S.N.	Income Slab	Rate
1.	One first NPR 125,000 of total income	Not taxable
2.	On next NPR 75,000 of total income	15%
3.	On further remaining all income	25%

Source: www.ird.gov.np

1) Any individual or couple having pension income can enjoy 25 percent of the normal exemption limit as an additional basic exemption.
2) Any individual working in prescribed remote area can deduct prescribed amount as remote area allowance from taxable income.
3) Any individual can deduct the following amount from taxable amount, if he is having investment insurance policy:
    a) "NPR 10,000 or 7% of insured amount or the actual premium paid, which ever is less."
4) Special duty on taxable income is reduced to 1.5%.
5) For the purposes of the Act, net gains from the disposal of non-business chargeable assets are taxed at the rate of 10 percent.
6) The presumptive tax for individuals conducting small businesses (who have a turnover of Rs.1.5 million or an income of Rs.150, 000) in the Metropolitan or Sub-Metropolitans, Municipalities and anywhere else in Nepal amounts to NPR 2,000 NPR 1,500 and Rs.1, 000 respectively.
7) The taxable income of a non-resident individual is taxed at the rate of 25 percent.
8) The taxable income of an entity is taxed at the rate of 25 percent unless prescribed otherwise.
9) The taxable income of a bank, or financial institution, or general insurance business, or an entity conducting petroleum work under Petroleum Act, 2040 for an income-year is taxed at the rate of 30 percent.
10) Gain from Lump sum retirement payment made by an approved retirement fund or Government of Nepal is taxed at the rate of 6 percent as a final withholding tax gain is calculated by deducting 50 percent of the payment or NPR 500,000 whichever is higher from the total lump sum payment.
11) The taxable income derived by an individual from special industry or export business is taxed at the rate of 20 percent.
12) The taxable Income derived by an entity engaged in an industrial enterprise or export business or derived from operating any road, bridge, tunnel, ropeway, or flying bridge. Construction business or any trolley bus or tram manufacturing business is taxed at the rate of 20 percent.
13) The taxable income of an entity engaged in power generation, transmission, or distribution is taxed at the rate of 20 percent.

14) The taxable income of an estate of a deceased resident individual or trust of an incapacitated resident individual will be taxed at the normal tax rate as though the estate or trust was a resident individual.
15) The repatriated income of a foreign permanent establishment of a non-resident person situated in Nepal will be taxed at the rate of 10 percent.
16) The taxable income of a non-resident person deriving income from providing shipping, air transport or telecommunication services in Nepal will be taxed at the rate of 5 percent.
17) The taxable income of an entity wholly engaged in the projects conducted by any entity so as to build public infrastructure, own operate and transfer it to the Government of Nepal in power generation, transmission, or distribution for an income-year shall be taxed at the rate of 20 percent.

Table 13: Tax Rates for Entities at a glance:

S.N.	Business Type	Tax Rate
1.	Bank Financial Institution, General Insurance business, Petroleum business,	30%
2.	-Special manufacturing industry; -An entity constructing public transportation infrastructure; - An entity engaged in public infrastructure in power generation, transmission, or distribution	20%
3.	Other entity	25%

Source: www.ird.gov.np

Exemptions

The following amounts are exempt from tax :

- Amounts derived by a person entitled to privileges under a bilateral or a multilateral treaty concluded between Government and a foreign country or an international organization;
- 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;
- 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.
- Amounts derived by an individual who is not a citizen of Nepal from employment by Government on terms of a tax exemption;
- Allowances paid by Government to widows, elder citizens, or disabled individuals;
- Amounts derived by way of gift, bequest, inheritance, or scholarship, except as required to be included in calculating income under this Act;
- 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 the 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.
- An agricultural income derived from sources in Nepal during an income-year by a person, other than the income from an agriculture business derived by a registered firm, or company, or partnership, or a corporate body, or through the land above the land holding ceiling as prescribed in the Land Act, 2021, is exempt from income tax.
- Incomes derived by cooperative societies, registered under Cooperative Act, 2048 (1991), from business mainly based on agriculture and forest products such as sericulture and silk production, horticulture and fruit processing, animal husbandry, diary industries, poultry farming, fishery, tea gardening and processing, coffee farming and processing, herb culture and herb processing, vegetable seeds farming, bee-keeping, honey production, rubber

farming, floriculture and production and forestry related business such as lease-hold forestry, agro-forestry, cold storage established for the storage of vegetables and business of agricultural seeds, insecticide, fertilizer and agricultural tools (other than machine operated)and rural community based saving & credit cooperatives are exempt from tax. Dividends distributed by such societies are also exempt from tax.

Tax Accounting:

Tax Accounting and Timing

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 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.

International Taxation

For taxation purposes, all payments and gains are 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 charter 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 sourced in each country and will not exceed the average rate of Nepal income tax applied to the assessable foreign income.

Table: 14 List of Countries Having Double Taxation Avoidance Agreement with Nepal

Country	Conclusion Date
India	18 January 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

Source: www.ird.gov.np

Returns of Income and Assessments

Every taxpayer should file a signed return of income not later than 3 months after the end of each income year.

Unless explicitly requested by the Department, no returns are required from taxpayers who have no tax payable 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.

Unless an assessment has been amended or reduced by order of the Revenue Tribunal or of a court, the Department may amend an assessment within 4 years in order to adjust the assessed person’s liability to tax in such manner as, according to the Department’s best judgment, is consistent with the intention of the Act. An assessment may be amended at any time in cases of fraud.

Where the department makes a jeopardy or amended assessment, it will serve a written notice on the taxpayer.

The Super Act

The Act is made supreme in regard to all income tax matters. No other Acts except this Act shall be made capable to make changes, amendment and other tax related provisions other than the provisions relating to imposition, assessment, reduction, increment, exemption, or remission of tax to be made by amending this Act itself by annual Finance Acts

In the past, other Acts could affect the tax matters. For example Industrial Enterprise Act, Provident Fund Act and so on could provide tax exemptions and incentives; but now, Income Act should address such exemptions and incentives.

Withholding Taxes

Tax withholding has been practiced in Nepal since the implementation of income tax in 1959. Under the withholding system, employers withhold tax on income at source when the remuneration of employee is distributed. Withholding agent should deposit the tax amount within the 15 days after the each month. Such agents should prepare and serve on each payee a withholding certificate in the form as prescribed by the Inland Revenue Department. Withholding tax can be final and not final in nature.

Table 15: Withholding Tax Rates

Withholding Agent	Payment	Rate
Not Final Withholding		
Employers	Employment	15% to 25% normal rate
Resident person	Natural resource payment; royalties; service fees	15%
Resident Bank or financial institution	Interest	15%
Resident person	Rent	15%
Resident person	Insurance premium	1.5%
Resident person	Payment against VAT invoice	1.5%
Final Withholding		
Resident company	Dividend	5%
Resident banks and financial institutions	Interest paid for non business purpose	6%
Resident person	Rent for lease of land or building	15%
Approved retirement fund	Gain from lump sum retirement payments	6%
Unapproved retirement fund	Gains from such fund	10%

Source: www.ird.gov.np

Income Tax collection trend

In the mid 1960s the share of income tax to the total tax revenue was less than four percent. Later in 1970s and 1980s this share increased to ten percent. The share of income tax in total tax revenue increased more and reached sixteen percent in 1995/96 and reached to 23.45 percent in 2000/01.

In previous seven years composition and trend of Income tax revenue seems fluctuating. It decreased by 5.01 percent and 6.05 percent in 2001/02 and 2002/03 respectively comparing to the previous years; but in 2003/04 it increased by nearly 17 percent. This increasing trend also lasted on the following years 2004/05, 2005/06 and 2006/07. Estimation for the year 2006/07 seems quite ambitious based on the trend of previous fiscal years.

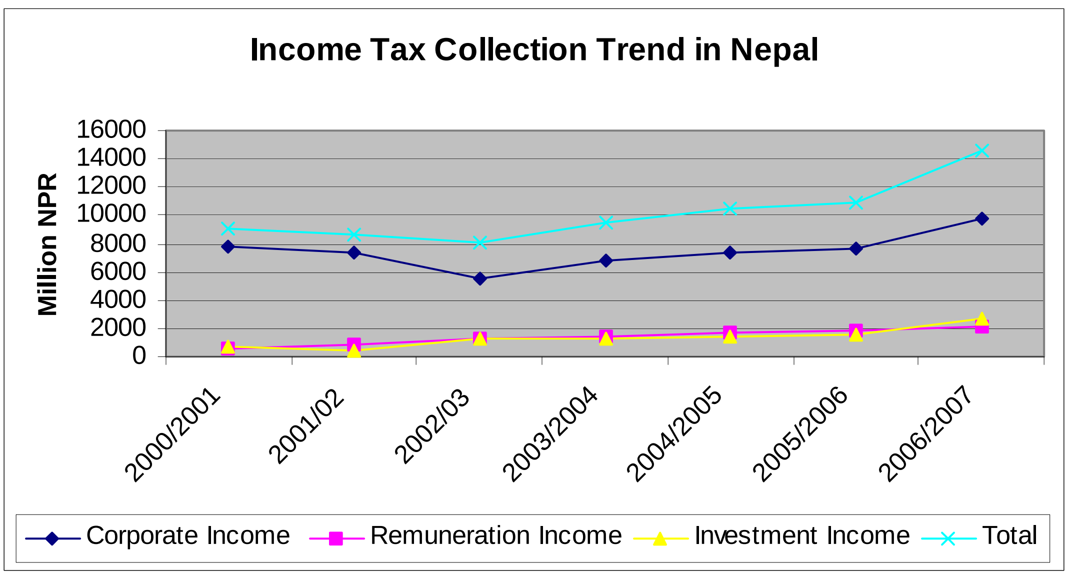
Table 16: Income Tax collection Trend in Nepal

(In Million)

Tax	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07*
Corporate Income	7791	7352	5550	6817	7345	7577	9722
Remuneration Income	597	836	1253	1391	1676	1771	2162
Investment Income	725	468	1322	1292	1425	1547	2692
Wind fall gain			7	14	21	8	9
Total	9113	8656	8132	9514	10467	10903	14585
Percentage change		-5.01	-6.05	16.99	10.02	4.17	33.77

Source: Economic Survey, Government of Nepal, Ministry of Finance, various fiscal years
*Estimated

Figure 18: Income Tax Collection Trend in Nepal



Source: Economic Survey, Government of Nepal, Ministry of Finance, various fiscal years

III.4.2. Value Added Tax: (VAT)

Nepal introduced VAT on 16 November 1997 replacing Sales Tax, Hotel Tax, Contract Tax, and Entertainment Tax. However, political instability and strong opposition from business community caused problem in implementation until FY 1998/99.

(VAT) is a broad-based tax as it also covers the value added to each commodity by a firm during all stages of production and distribution. It is a modern tax system to improve the collection of taxes, to increase efficiency and to lessen tax evasion. It is also regarded as the backbone of income tax system in Nepal.

Registration in VAT:

The current threshold for VAT registration is NPR 2 million. Those vendors whose annual turnover is below the threshold can, however, register voluntarily. After registering, each taxpayer gets a Permanent Account Number (PAN) or commonly known as Taxpayer Identification Number, consisting 9 digit numerals.

Scope of VAT:

VAT is a tax imposed on the value added to goods and services consumed in Nepal or exported outside. The tax is based on the principle that each producer or distributor adds value, in some way, to the materials they have purchased and it is this added value that is taxed at each stage of the production and distribution chain. There is the presumption that VAT is shifted forward completely to the Consumer.

In the VAT system, producers, distributors and people providing services raise VAT on the products or services sold or provided. The difference between the VAT collected on sales and the VAT charged on purchases determines the amount a registrant must remit or the amount that may be claimed as a refund.

In other words, if the tax on sales is more than the tax on purchases, the dealer / businessman remits the difference.

If the tax on sales is less than the tax on purchases, the dealer may carry forward this credit to the next month.

VAT rate is 13 percent and it is zero percent in export.

Duties of Taxpayers:

- VAT registrants are required to:
- Submit VAT return and pay tax within the 25th day of the following month.
- Provide their customers with a tax invoice
- Maintain Purchase Book, Sales Book, and VAT Account.
- Keep their VAT records for a period of 6 years
- Inform the Inland Revenue Office of changes to the business including new address, telephone number or a reorganization of a partnership within 15 days.
- Put their Certificate of Registration in the premises where customers may easily see and read it,
- Allow tax officers to enter the business to examine the business records and the stock on hand.

Input tax credit System in VAT

Registered taxpayers are should collect and remit VAT on their taxable transactions. These registrants are entitled to recover the tax paid on their purchases. This recovery or refund is known as input tax credit.

The Input Tax Credit (ITC) is the total of the tax paid or payable on taxable goods and services purchased in Nepal, and the tax paid on taxable goods imported into Nepal.

Where VAT is paid or payable by a registrant on a purchase or on imports, the registrant is allowed to claim input tax credit for those purchases made by the registrant in his commercial activities.

Most taxpayers can claim input tax credits for the tax paid on acquisitions of capital goods for use primarily in commercial activities. Unlike the income tax deduction rules, the input tax credit for any VAT paid on capital goods is not amortized over the life of the asset. It can be claimed in full in the period in which it is acquired. If the capital goods are later put to a non-commercial use, special change-of-use rules will apply. Taxpayers whose export is more than 50% of total sales or those who are continuously on 6 months credit may claim for refund. Taxpayers are entitled to receive refund within 30 days from the receipt of refund claim.

VAT Exempt

The purchaser will NOT pay VAT on tax-exempt goods and services and the supplier is not allowed input tax credits on purchases related to the following goods and services:

- Goods and services of basic needs which include rice, pulses flour, fresh fish, meat, eggs, fruits, flowers, edible oil, piped water, wood fuel
- Basic agricultural products are also tax-exempt, for example, paddy, wheat, maize, millet, cereals and vegetables.
- The expense of buying goods and services required to grow basic agricultural products are tax-exempt. This includes live animals, agricultural inputs including machinery, manure, fertilizer, seeds, and pesticides.
- Social welfare services including medicine, medical services, veterinary services and educational services.
- Goods made for the use of disabled persons.
- Air Transport.
- Educational and cultural goods and services such as books and other printed materials, radio and television transmissions, artistic goods, cultural programs, non-professional sporting events and admissions to educational and cultural facilities.
- Personal services are also tax-exempt. These are services provided, for example, by actors and other entertainers, sportsmen, writers, translators and manpower supplies agents.
- Exemption from VAT is also extended to the purchase and renting of land and buildings
- Financial and insurance services.
- Postage and revenue stamps, bank notes, chequebooks.

VAT collection trends in Nepal

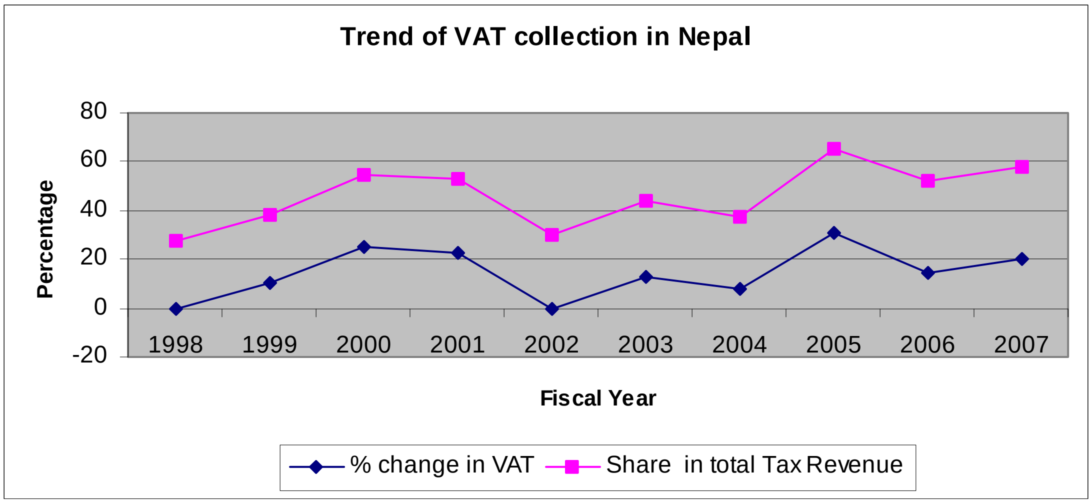
VAT has been one of the major sources of government revenue in Nepal. VAT collection trend shows the optimistic environment. During the first year, of VAT implementation in 1997/98, total VAT was NPR 7123 million holding the contribution on total tax revenue 27.46 percent. Rate of change in VAT collection every year from the beginning was encouraging but it was in downtrend in the FY 2001/02. During the FY 1999/2000, there was great increase in total VAT revenue by 25.03 percent with an increase of contribution in total tax revenue from 27.41 percent to 29.73 percent. During the FY 2004/05 VAT collection exceeded the total Custom revenue for the first time and it is going on. On the same year, total VAT collection was 18885 million NPR with an increase of 30.43 percent to previous year.

Table 17:General Trend of VAT collection in Nepal

Fiscal Year	VAT (in Million NPR)	% Change in VAT	Total Tax Revenue
1997/98	7123	0	27.46
1998/99	7882	10.66	27.41
1999/00	9855	25.03	29.73
2000/01	12048	22.25	31.00
2001/02	11964	-0.70	30.42
2002/03	13460	12.50	31.61
2003/04	14479	7.57	30.06
2004/05	18885	30.43	34.90
2005/06	21613	14.45	37.64
2006/07	26055	20.55	37.20

Source: Economic Survey, Government of Nepal, Ministry of Finance, various fiscal years

Figure 19: Trend of VAT collection in Nepal



Source: Economic Survey, Government of Nepal, Ministry of Finance, various fiscal years

III.4.3. Excise

Excise duty is imposed on the consumption of selected goods such as alcoholic beverages and tobacco products. In the past, these duties had occupied one of the largest sources of tax revenue in Nepal. It had covered a wide range of domestic products (more than fifty commodities) holding for 14.6 percent of total tax revenue during FY 1990/91. But in recent years, excise duties are restricted to a narrow range of domestic products. It covers tobacco products, liquor, beer, flavored soft drinks, cement and plastic goods. It contributed 9.7 percent of total tax revenue during 2001/02. At present, large sales volumes, few producers, limited consumer, inelastic demand and lack of close substitutes are the basic charm of excise system in the country. Basically, the excise duty is very helpful instrument to control the consumption, which is regarded as lacking merit or as likely to cause negative externalities.

Basic provisions:

License Required

License is essential to manufacture, import, sell and store excisable goods. Likewise, the Act prohibits importing excisable services without having license. Person, firm or institutions that need such license may submit a prescribed application form before excise officer at concerned Inland Revenue Office.

Controlling Excise

The excise commodities are closely controlled and supervised by the Government from production to selling stage. Licensing requirement is adopted for all excise commodities. 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.

There is no excise duty on export of any goods that would be taxable if in domestic market. Producer can claim any excise duty paid while producing such exported goods.

Collection trend of Excise duty in Nepal:

The contribution of Excise Duty on the FY 2000/01 was 9.7 percent of the total tax revenue. In recent years, Nepalese Tax system also followed the almost universally accepted norms; excise duties are restricted to a narrow range of domestic products. Excise duty was on of the major source of revenue before 25 years ago. Now, its share in revenue is decreasing, however, in recent years we can see a slight increase due to the introduction of excise duty in some other products like noodles, plastics, cements, tiles, marble etc. In FY 2001/02 the share of Excise duty seems decreasing by in following years the share of it seems increasing slightly.

Table 18: Excise Duty Collection in Nepal

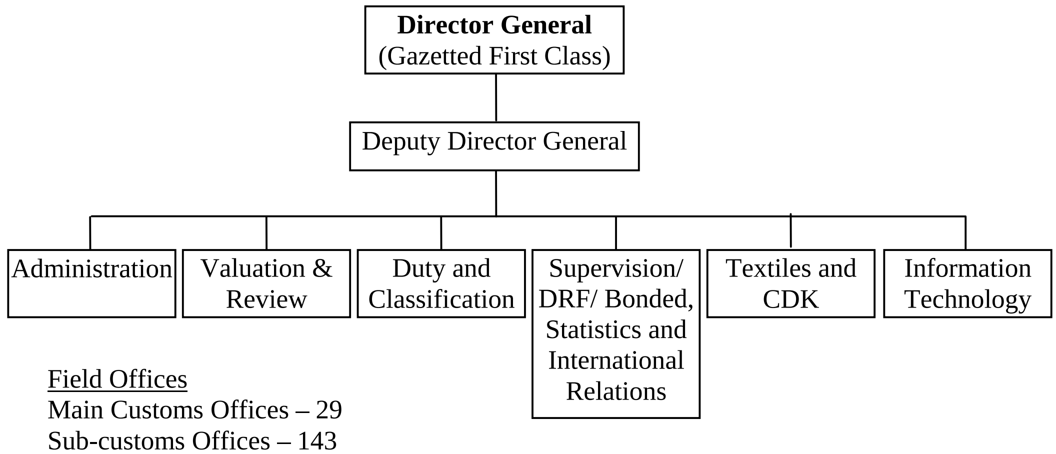
Fiscal year	Excise Duty (Million NPR)	Share of total tax revenue
2000/01	3771	9.7
2001/02	3807	9.68
2002/03	4785	11.24
2003/04	6227	12.93
200405	6446	11.91
2005/06	6507	11.33
2006/07	8686	12.40

Source: Economic Survey, Government of Nepal, Ministry of Finance, various fiscal years

III.4.4 Custom Duty:

The trade relation of Nepal was very limited with India and Tibet, before 1951. At that time, the private sector on contract used to collect the customs since the institutional base was weak and fragmented. Department of Customs and Excise was established 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.

Figure 20: Organization Chart of Customs Department



Customs Duties: -

Following are two types of Customs duties: -

i) Import Duty: - Customs duty is imposed on goods imported from foreign countries into the kingdom of Nepal. 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. The import duty rates shall be imposed in accordance with the rates mentioned in column 4 of the commodity Classification of Chapters 1 to 97 under Section 1 to 21 of Tariff Schedule I.

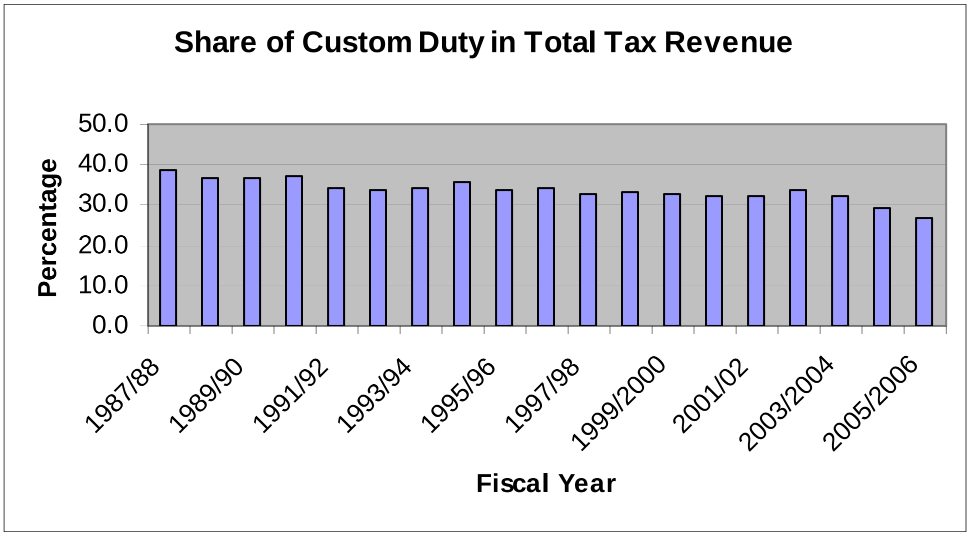
ii) Export Duty: - There are very few commodities that subject to export duty. The objective of levying the export duty is either to protect natural resources or to collect government revenue. However, the government is going to lowering the export duty to reach to zero in the near future. The export duty rates are mentioned in column 4 of the tariff schedule II.

Besides these duties VAT and Local Development Tax are also collected at the Customs Points. So, Custom Department is also the administrator of Inland Revenue tax- VAT.

Custom Duty Collection Trend in Nepal:

During the 1980s, the share of Custom Duty in total tax revenue was around 40 percent. So, it was the largest source of revenue in Nepal. Gradually after 1980s, there was downtrend of share of this duty in total revenue. It was increased in FY 2005/06 with the share of 26.72 percent; whereas, it is in downtrend in every year until now. Nepal has been the member of World Trade Organization (WTO) and its impact in custom may have this kind of trend in custom duty collection.

Figure 21: Share of Custom Duty



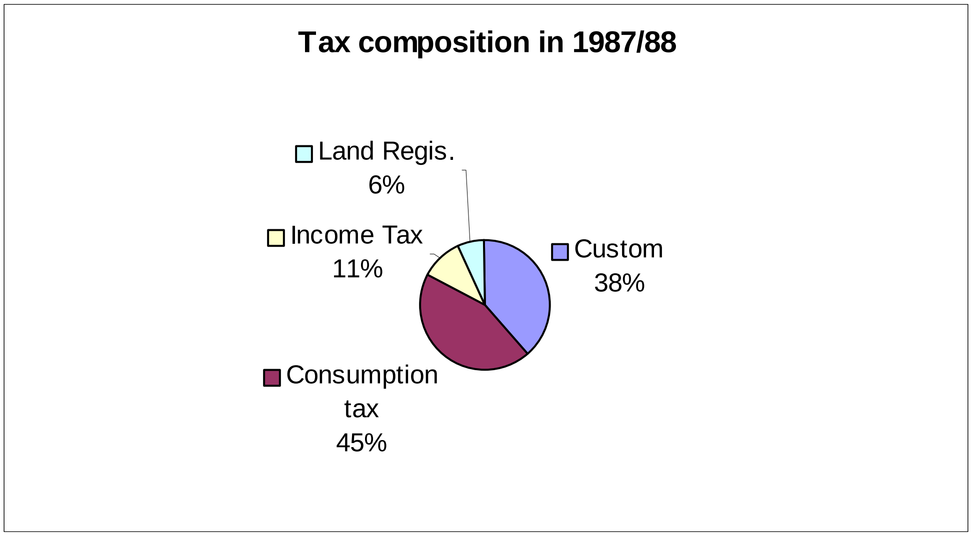
Source: Economic Survey, Ministry of Finance, Nepal 2000/2001 and 2006/07.

The figure 1 above shows the declining trend of custom duty with exception in some years. Since, 2003/04 it has started to decline sharply as Nepal became the WTO member. In the coming days, custom duty will be declining as we can see the trend after FY 2003/04. Commitment to multilateral and bilateral treaties will cause decline in custom duty. In this context, efforts need to be focused on making the direct tax particularly income tax, and indirect tax, particularly value added tax, more revenue productive.

This kind of decline in custom duty has given pressure to overhaul the tax composition within the country. So, the composition of the tax revenue needs adjustment to compensate the custom duty decline and rising need for public expenditures. Imposition of consumption tax and income tax has their own issues. How to achieve the optimal income-consumption tax mix is a tax policy challenge.

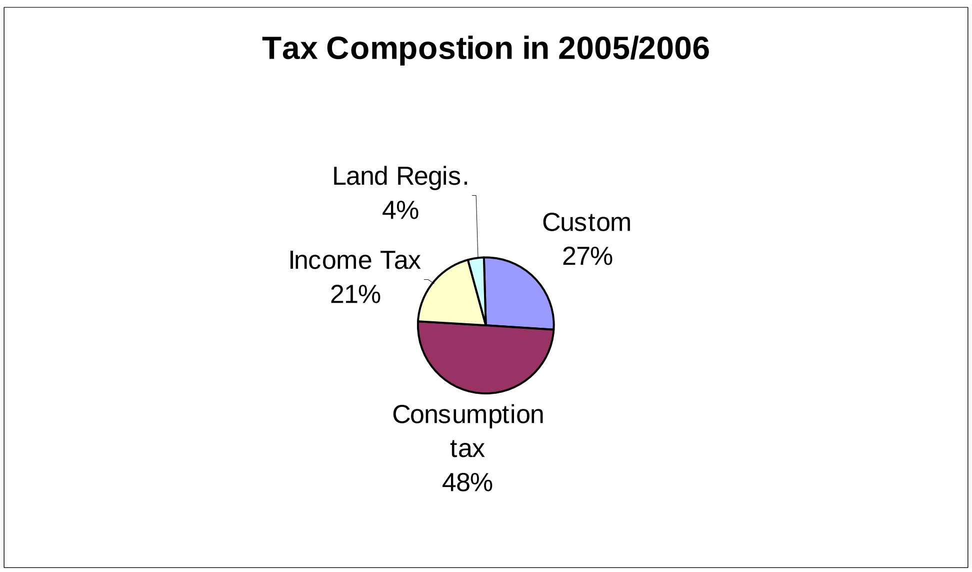
Nepal's tax policy is oriented on how to promote export, revitalize industries and reform investment climate. Incentives on infrastructures industries, tourism industries show the intention of government to get the benefits of globalization. To realize the higher tax revenue along with promoting export and overall development of the country is a issue of tax policy.

Figure 22: Tax composition in 1987/88



Source: Economic Surveys of Various years, Ministry of Finance Nepal

Figure 23: Tax composition in 2005/06



Source: Economic Surveys of Various years, Ministry of Finance Nepal

From the above graphs we can analyse that there has been a significant decline in custom duty (custom) whereas significant increase, almost double, in income tax. Consumption tax's share has also increased. So, compensation measures have already shown the result in a changed composition.

III.5 Taxpayer's Rights in Nepal:

Taxpayer's right is the beauty of modern tax administration. In a democratic environment, taxpayers also should have some rights and duties along with the rights and duties of the tax administration.

Income Tax Act has mentioned the following points as the rights of taxpayers[5]:
A taxpayer with respect of paying tax under this act shall have the following rights: -

- Right to get respectful behavior;
- Right to receive tax related information as per the prevailing laws;
- Right to get the opportunity to submitting proof in own favor in respect of tax matters;
- Right to appoint lawyers or auditors for defense;
- Right to secrecy in respect of tax matters and keep it inviolable

Taxpayers Rights And Assurances[6]

- 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:
- Each taxpayer is treated with due respect and honor.
- Each taxpayer will get an immediate receipt of return submission whilst a receipt of other correspondences is to be provided in ONE hour.
- 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.
- 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.
- Each taxpayer is to get copies of the documents related with him/her or submitted to the Inland Revenue Office or documents or decisions affecting her/him generally in twenty-four hours of his/her request in the concerned Inland Revenue Office.
- 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 Inland Revenue Office and 30 days in Inland Revenue Department upon receiving application for refund.
- Each taxpayer is to get certificate/renewal of Excise/Liquor business generally within twenty-four hour after the request is made.
- Each taxpayer is to get sales and purchase books certified by the Tax Officer generally within twenty-four hours after the request is made.
- 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.
- Each taxpayer is to get Permanent Accounts Number (PAN) or the Certificate generally within 3 days after the request is made, and
- Each taxpayer is to get Tax Clearance Certificate generally within twenty-four hours after the request is made.

[5] Income Tax Act 2002, Section 74
[6] www.ird.gov.np

IV. Country Specific Fiscal Issues:

Fiscal policy and Federal State:

Now there is a great debate about the federal state after the people's movement in April 2006. Very few are debating on the issues of Fiscal Policy once Nepal becomes Federal State. This is very important for the sustenance of democracy, and for the sustenance of each federal province/county (by whatever name it is called) and for their progress.

This issue is significant because of Nepal's Geographical Location. All parts in Nepal do not earn same amount of revenue. The Terai, plain Region is more accessible by Roads and Transports. It is easier to do any kind of national and international business from that region. The Terai Region has border with India, with which Nepal has a maximum third country business. The goods made in Nepal are exported through Terai Region and goods imported in Nepal mostly come from this Terai Region.

Major portion of the agriculture product are from Terai (plain) region. Along with the agriculture products industrial products are exported to India and Bangladesh from Terai region.

Nepal's other parts are Himalayan Region and Hilly areas. They lack good Roads and Transport Systems. Very little economic Activity happens there. In this scenario, we must seriously think about fiscal policy when Nepal is divided into a Federal State. How Economic Resources are collected and how they are distributed?

Who, either Center or Provincial Government, will have power, by Constitution, to collect and distribute such revenue and by what proportion?

Fiscal Status:

Revenue growth is not maintaining a pace with the expenditures growth. Revenue mobilization is the major source of government spending. A minimal gap between the expenditures and revenue is desirable to maintain fiscal balance. However, the ratio of government expenditure to GDP stood at 17.2 percent in FY 2004/05 compared to 17.4 percent in previous fiscal year. Similarly, in FY 2004/05, the ratio of revenue mobilization to GDP was 11.2 percent, a decrease by 0.7 percent unit, compared to 11.7 percent in the previous fiscal year.

Government expenditure plays vital role for the development of the economy of a nation. Generally, more capital expenditures mean more investment in development activities. But in recent years, current expenditures have exceeded the capital expenditure. In early 1990s capital expenditure used to share two third of the total expenditure but in recent years, current expenditure is increasing rapidly. Reason behind such increment in current expenditure is mainly because of the increase in defense expenditure.

Fiscal deficit is one of the features of Nepalese public finance. Foreign grants and loans; domestic borrowing have been the permanent tools to fill the gap of deficit.

Narrow tax base

Tax base broadening has been the slogan of every tax reform. Tax revenue to GDP ratio is below 11 percent; it is less if we compare with many developing countries. The ratio of total individual taxpayers to total population is very low- less than 0.8 percent. Only 46831 taxpayers are registered in VAT. The long list of exemption has made VAT base narrow and it is frequently creating distortion on levying tax.

Strong political determination and administrative efficiency is essential to further reap the potential of tax revenue. List of exemption for VAT purpose and tax exemption ceiling for income tax should be reduce for the broad tax base.

Lack of Trade Diversity:

Nepal's export is confined within very few goods- Carpet, garments, paper, vegetable ghee, yarn, handy- crafts, tea, coffee, leather products, etc. Despite the high economic growth rates of the neighboring countries like India, China and so many countries of the world, Nepalese foreign trade volume has not increased which underlines that fact that Nepal has not been able to get the expected benefit from the world's high economic growth. Nepal's international trade is concentrated with single country, India mainly due to the geo-political conditions of the country. In the FY 2006/07, the export to India has reached 69.4 percent of the total export while the export to other countries stood at 30.6 percent; it was 69.3 percent and 30.7 percent respectively in FY 2005/06.

The preferential treatment for the carpet export, one of the main export commodities of Nepal, in the European market has been extended for additional two years. European Union has been providing the facility of immunity from the rule of origin to the Nepalese product since 1977. However, the share of European market is little in the total export of garments. Nepal is now facing tremendous decline of export of readymade garments, to the other countries especially towards United States.

Remittance as a "Safety Valve"

The remittances are functioning as "Safety Valve" in the Nepalese economy. Remittance has become the main source of earning foreign currency in the country. So it is essential to compose its correct estimation and build the flow of maximum portion of remittance in the country through institutional channel.

Trade deficit is now compensated by remittances finally in balance of payment. During the first eight month of FY 2006/07, trade deficit with India has recorded NPR 44.36 billion with a rise by 8.6 percent where as the trade deficit with other countries has reduced to NPR 30.34 billion with a decline by 6.2 percent. Product diversification and market diversification is essential to reduce the trade deficit in following fiscal years.

Investment Environment

For the rapid and robust development of the economy, Foreign Direct Investment (FDI) is essential. General notion is that investors prefer to investment in developing country to take the advantage of low labor cost as compared to the labor cost of developed countries. So, theoretically, investment should flow from the developed countries to developing countries where labor cost is low. Nepal adopted favorable policies in the sector of industry, trade, finance and the stock exchange to attract more FDI from late 1980s. Nepal could not attract the expected FDI due to several reasons. Why investors do not invest in the countries like Nepal though the labor cost is low? Labor cost is one of the major determinants to decide on the investment but it is not all. Administrative procedures, political environment, level of security and so on affect the investment. Investors cannot take risk of security to take the advantage of labor cost.

Now, the country is in the phase of political transition. Series of demonstration, strike, protest from various kind of ethnic group, protests in different part of the countries have affected the general life and peace throughout the country. In such a situation, investors simply can wait and see for the better situation in future.

V. Conclusion: Where We Stand and Where We Go?

Nepal, a country with a very low per capita GDP is suffering from stagnated economic growth. Poverty is widespread and poverty reduction is the major challenge; national development goal is to alleviate poverty. Irrespective of official data, 40% of the total population of Nepalese people is below poverty line. Economic growth rate remained below 5 percent in the last six years because of the country's precarious economic circumstances. Neighboring India and China are catching rapid economic growth whereas Nepal is wandering within political uncertainty and transition. Security concerns in the wake of the Maoist conflict have led to a decrease in tourism, a key source of foreign exchange. Though Maoist conflict has gone through peace process with the domestic and international endeavor, peace is still far for the foreign investment environment.

Nepal confronts with a number of economic challenges at present: low economic growth, low per capita income, higher level of poverty, poor social indicators, underdeveloped physical infrastructure, and high-cost economy leading to higher cost of production and so on.

Nepal's agriculture, largest sector of economy, continues to be locked in conventional method and monsoon rain dependency. Productivity gain in agriculture is very important for the overall economic development of the country. This sector needs to be modern-technology oriented and to set on a course of commercial scale farming, which will thereby help to develop industrial base. Development of these twin approaches is highly desirable also to reduce poverty, which stands as the major challenge today.

Endeavors of alleviating poverty are spilled over due to various reasons. One of the reasons is that industrial production has suffered a lot due to continued unfavorable situation faced by this sector during past several years. Serious disturbances like frequent strikes, lockouts, donation menace, load shedding, raw material supply disturbances, recurring cases of misunderstanding between management and labor, lack of industrial security, etc. were at work to disturb industrial production. As a result, the emerged situation remains unfriendly to private sector investment promotion.

Despite the above gloomy condition of the country, Nepal has hope for development. Nepal has emerged as one of the major tourist destinations of the world and holds ample opportunities for further developing this sector. Benefits are numerous: enhancement of foreign exchange earning, creation of additional employment opportunities, promotion of cottage and handicraft industry, broadening of country focus, enhancement of awareness, and promotion of Nepalese art and culture. Government will get benefit from increased revenue, eventually.

Similarly, Nepal has enormous hydropower potential. Studies have shown that 83 thousands Mega Watt hydro electricity is possible from the rivers of Nepal. This is one of the largest potentialities of the world. Despite the above-mentioned hydropower potential, less than 1 percent is produced yet. So, if Nepal can attract investment in this sector, country may enjoy a turning point in the pace of development.

Nepal has already got the membership of World Trade Organization (WTO). The world market, now, is open for Nepal. Opportunities and threats are there when doors are open to world. How to reduce the threat and promote opportunities is the challenge.

At this point, Nepal needs greater investment in the infrastructure development. Nation is desperately looking for careful, well-planned revenue and revenue related institutional reform. In the meantime, stable policy of the government and secured environment essential to get the inflow of FDI. If the government can show reliability and consistency in policy, ensure the feeling of security; there is every reason for Nepal to run at least at the same development pace of neighbor, India and China.

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