3 Nepal

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I. Introduction

Nepal is located between two giants of the Asia, People's Republic of China and Republic of India. That is why sometimes it is called as "yam sand witched between two rocks". Nepal is a land-locked country surrounded by Tibet autonomous region of People's Republic of China to the north and by Republic of India to the east, west and south. Modern Nepal was created in the latter half of the 18th century when Prithvi Narayan Shah, the ruler of the small principality of Gorkha, unified many small states. Nepal remained independent throughout its history. The capital city of Nepal is Kathmandu. Basically, Nepalese economy is agro-based which contributes around 32 percent of GDP. In the world economy, Nepal is categorized as a developing third world country. Still 24 percent of its people are living below the poverty line, earning less than a dollar per day. The per capita GDP is only $ 320, lowest among the SAARC region. Besides this, Nepal is blessed with some historical movements, cultural diversity and natural resources. The highest peak of the world also known as the third pole- the Mount Everest lies in Nepal. Eight of ten world's highest Mountains are located in Nepal. Lumbini, the birth place of Lord Buddha proponent of Buddhism which believes in non-violence and peaceful existence of mankind, also lies in Nepal. Pashupatinath, lord Shiva, the epitome of more than one billion Hindus, is situated in Kathmandu. Similarly, Nepal is the safe habitat of thousands of flora and fauna. Nepal has unity among diversity.

Ecology and Climate

The total area of Nepal is 147,181 square kilometer, stretching over an average length of 885 kilometer from east to west and average width of 193 kilometer from south to north. It stretches from 80º 4’ east to 88º 12’ East longitudes and 26º 22’ north to 30º 27’ North latitudes along the southern slope of the Himalayas in south Asia. Nepal is mainly divided into three broad geographical regions stretching from east to west and parallel to each other: the Mountain, the Hill, and Plain.

The mountain region lies in the northernmost at elevated level of more than 4000 meter and includes the highlands, treeless Alpine zones, semi-arid valleys, trans-Himalayan valleys and the highest peak. Eight out of top ten highest peaks of the world including Mt. Everest (8848 meter high) lie in this region. According to census 2001, only 7.3 percent people live in this region even if it occupies 16 percent area and people here mainly engage in growing yaks, some cold-tolerant corps such as potato, barley, maize and apple like fruits. The hills region lies just below the mountain region mostly at the level between 1000 meter and 4000 meter. It covers major ranges of hills like Mahabharata and Chure ranges, several intermountain valleys including Kathmandu Valley. It is the biggest region occupying 67 percent of Nepal's total land area and 44.3 percent population lives in this region according to census 2001. The Plain contains the low tropical plains along with the southern part of the country. The plain region consists of the southern plain up to Indian border in the south, east and west. This covers only 17 percent of its total area and hence densely populated region having more than 48 percent of population living there. Today, most of the cities, towns and industrial areas are located in this region. Before the use of DDT, this region was severely affected by deadly Malaria. This is also known as the food store of Nepal.

As the ecology is varied, the climate in Nepal varies from tropical in the plain to Alpine in the mountains. The climate in different regions is different because diverse level of elevation. The climate is Tropical and sub-tropical in the plains, temperate in the hills and Alpine in the Mountains There are four seasons in Nepal. March- May, June – August, September – November and December – February for spring, summer, autumn and winter respectively. Spring and autumn are the most pleasant seasons in Nepal. The weather and climate is controlled by the altitude and the seasonal alternation of the monsoon winds. The main rainy season in Nepal is from late June to September. This is a period of warm to hot temperatures, much cloud, and frequent heavy rain. Temperature in Plain reaches as high as 40ºC during summer. At this time sunshine averages only two to three hours a day. About 80 percent rain falls in this period. Annual rainfall decreases from east to west due to northwestward movement of moisture-laden summer monsoon. The amount of average annual rainfall in eastern part, Kathmandu and western part is about 2500, 1400 and 1000 millimeters respectively, though there may be some seasonal variations. Pokhara, a touristic city located in western part, receives heavy rain falls. During the rest of the year the weather is much more settled and pleasant. The days are mild or even warm, except on the higher mountains, and sunshine averages from six to nine hours a day. Much colder temperatures prevail at higher elevations. The temperature in Kathmandu Valley ranges from 19-27ºC (67-81ºF) in summer and 2-20ºC in winter, hence pleasant. There are some dangers of floods and landslides during the heaviest rain falls, the climate of Nepal is rarely hazardous and on average is very pleasant. Some indication of variation and irregularities are being noticed in recent years due to global warming.

Natural Resources

Nepal does not have plenty of natural resources in terms of valuable minerals and petroleum. Though there are some indications of iron, copper, gold, zinc, limestone, slate, oil and gas, coal, sulphar, quartz, cobalt etc, yet they are not substantially excavated. Nepal is rich in scenic beauty, water resources and forest. The north part consists of beautiful range of mountains always covered with snow. Nepal has roughly 6000 rivers flowing all the year round from Mountains in the north to the plain in the south. It is estimated that all these rivers have potential of generating 83,000 MW of hydroelectricity out of which 40,000 MW is said to be feasible. It is said that Nepal is the second largest country in terms of water resources in the world, Brazil being the first one. Nepal possesses 2.27 percent of the world water resources. The main sources of water are Mountain Rivers, glaciers, lakes, rain fall and ground water. Beautiful mountains and river systems could be the sectors to attract tourists. Nepal is famous for Mountain flight, Mountain climbing, mountaineering and biking, elephant safari, hot air balloon, Banji jumping, rafting, trekking etc.

Other important natural resource available for Nepal is the forest. It is the main source of traditional fuel such as firewood and coal. Similarly, it is the main source of fodder for livestock and raw materials for forestry based industries. Forest in Nepal is categorized as primary forest-which is primarily intact, protected, conserved and production forest. The forest coverage in Nepal is 39.6 percent. However, optimal utilization of natural resources is yet to be achieved. Income generating activities opportunities can be increased through community development programs and increasing the forest-based exports. Forest helps to maintain ecological balance in the environment. Increased deforestation in recent days has become a serious problem. Deforestation rate was 1.4 % per year during 2000-2005. Nepal is one of the richest countries in the world in terms of bio-diversity with unique geographical position and latitudinal variation. The elevation of the country ranges from 70m above sea level to the highest point on the earth, Mt Everest at 8,848m, within a distance of 150 km. Climate range from subtropical to arctic. This wild variation fosters an incredible variety of ecosystems

Brief History and Political Structure

The early history of Nepal is quite vague, though there is archaeological evidence to suggest that Nepal was already home to quite few groups of people by the first century BC. Neolithic tools found in the Kathmandu Valley indicate that people have been living in the Himalayan region for at least nine thousand years. Many dynasties ruled Nepal in different time periods such as Kirati, Lichhavi, Malla and Shah. Nepal kept its sovereignty intact throughout its history, though Nepal had to fight many wars in which Nepalese people displayed intense courage and bravery.

The political situation in Nepal was very instable and there were conspiracies against each other are those in power. Kota Massacre happened in 1846 slaughtering many people and it paved the way for 104 year long family rule called "Rana autocracy" in Nepal. Lastly, democracy was established in the country in 1950. Democracy was restored in 1990 after nearly 30 years of autocratic rule of Shah Kings in the name of people's democracy. Nepal faced Maoist insurgency for a decade from 1996 to 2006. In 2001, there was Royal massacre killing the then king Birendra with his whole family. The success of popular movement of April 2006 brought the decade-long insurgency to an end. The first meeting of the

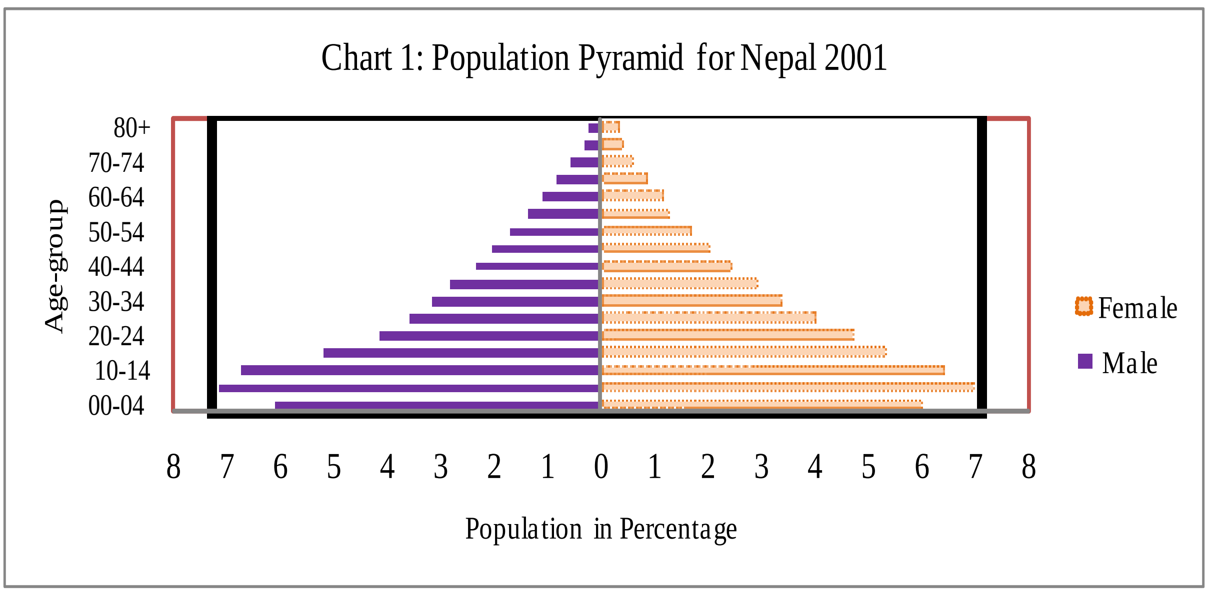
Constitutional Assembly historically declared Nepal as Federal Democratic Republic in May 28, 2008. The then rebellion leader Puspa Kamal Dahal (Prachand) is the prime minister and leading the coalition government now. This is the complete transformation of Nepalese politics. Nepal is now in a transition between political transformation and socio-economic transformation.

Demography

Nepal's population has continuously increased over time. It is estimated to be 26.9 million in 2008. It ranked 40th position in the world in 2008. There is regular census in Nepal in every ten years and the last census was conducted in 2001. According to that census, population of Nepal was 23.1 million. Out of total population the share of male and female was 49.96 and 50.04 percent respectively. Annual average growth rate during 1991 to 2001 was 2.25. Similarly, population density was 157 square kilometer. Majority of people live in rural areas. Geographically, 48.4 percent people live in Plain followed by 44.3 percent in Hill and only 7.3 percent people in Mountain. Crude birth rate, crude death rate, infant mortality and child mortality rate was 33.1, 9.6, 64.4 and 91.2 percent respectively in 2001. Similarly, total fertility rate, maternal mortality rate was 4.1 and 539 per 100,000 live births respectively in the same period. The literacy rate and life expectancy at birth were 54.1 and 60.4 percent respectively.

Nepal is a multilingual, multicultural and multiethnic country. People of different race and religion live there. 80.62 percent people are Hindus followed by Buddhists 10.74 percent, Islam 4.2, Kirat 3.6, Christians 0.45 and 0.39 percent others. People of various ethnicity live here. Some are Chhetri, Brahman, Magar, Newar, Tharu, Tamang, Yadav, Rai, Limbu etc. Nepali is the national official language and about 49 percent people speak Nepali followed by Maithili 12.3, Bhojpuri 7.53, Tharu 5.86 Tamang 5.9 Newar 3.63 percent etc. Nepal fosters unity among diversity along with social harmony, brotherhood and fraternity. 102 ethnic groups live harmoniously and 82 languages are spoken in Nepal. The population pyramid for Nepal for 2001 is presented in figure 1 below.

Figure 1: Population Pyramid for Nepal 2001



Source: Statistical pocket Book Nepal, 2006, Central Bureau of Statistics, Kathmandu, Nepal

The shape of population pyramid of Nepal is expanding. The pyramid shows that both birth and death rates were high in Nepal. The pyramid also shows that in recent years birth rate is slowly decreasing. This is the effect of Government population policy to discourage its high growth through intensive awareness program and providing reproductive health and family planning facilities adequately.

II. Overview of Macroeconomic Activity and Fiscal Position

II.1 Macroeconomic Activity

Nepal started planned development efforts more than 50 years ago. The year 2006/07 which had the lowest growth rate was the last year of its tenth plan. Tenth plan had single most objective of poverty reduction. Despite its long planned development efforts, Nepal still remained low –income developing country in the world. Per capita income was only US $ 320 in 2006 and at 142nd position on the Human Development Index (HDI) in 2007-both were the lowest among the SAARC countries. Still 30.85 percent people live below the poverty line-earning less than a dollar per day. Agriculture is the backbone of the economy and accounts for 36 percent of GDP and, observes 80 percent of workforce. 78 percent of the poor depend upon the agriculture sector as the principal source of income. The Gini coefficient which measures the extent of inequality has increased from 0.34 in 1995/96 to 0.41 in 2003/04. Agriculture sector in Nepal is only limited to subsistence level farming. Annual growth rate of Nepal was very low in recent years. The growth rate was only 2.5 percent in 2007. Its neighbors have become emerging economies. China recorded continuous double digit growth since 2005 and India is about to achieve double digit growth. Nepal could not realize the spillover effects of the high growth in its neighbors India and China.

India is the main trade partner of Nepal. India occupies around 70 percent of Nepal's total trade. Trade deficit with India has been increasing over time. As a result, Nepal's trade deficit reached at18.4 percent of GDP in 2007. The recent past sky-rocketing oil and commodity prices have made imports more expensive. Inflation in recent months crossed the double digit. The end of quota system for developing countries in January, 2005 resulted in decrease in export. It has further pushed the overall trade deficit and reached to 22.6 percent of GDP in 2008. The recent global financial turmoil indirectly affected Nepal through record exchange rate depreciation of Nepalese currency, it being pegged with Indian currency. The recent sharp fall in oil prices has not been realized in Nepal because of depreciation of currency. Currency depreciation will not benefit Nepal rather hurt in terms of expensive import and external debt servicing.

Nepal suffered decade long insurgency and political instability from 1996 to 2006. Defense expenditure increased sharply. Nepal wasted its valuable resources in buying arms and ammunitions, logistics and recruitments of security personnel. A new armed police force was created to fight with insurgency. Many infrastructures were destroyed during that period. Law and order situation was very vulnerable. Frequent industrial disputes, lock outs and strikes gradually decreased the competitive strength of industrial products. Tourism sector, a major source of foreign currency earnings, affected badly falling 43.3 percent in 2005. It discouraged the foreign direct investment and some industries were closed down. These phenomena resulted in low growth, export reduction, erosion of tax base, unemployment etc which ultimately paved the way for adverse balance of payment. Amid this, remittance from abroad worked as the safety valve for the Nepalese economy. It is increasing over time and the increase was about 15 percent in the year 2005, increased by 80 percent in November 2008 as compared to the same period of last year. Nepal's trade deficit is mainly financed by export earning, tourism income, remittance, foreign aid etc.

Since May 2006, Nepal entered into sustainable peace process. It is now in the process of peace building and maintaining political stability in the country. Political stability and peace will create conducive business and investment environment for the economic development. Some positive indications such as export increment, increase in the number of tourists have been seen in recent time. Nepal introduced three year interim plan in 2007 with objectives such as rehabilitation, reconstruction, re-establishment and social reintegration which requires more resources. Nepal may have to depend on external debt for it as domestic resource would not be adequate. Future years are challenging for Nepalese authorities.

II.2 International Environment

(a) Trade Balance

The major trade partners of Nepal are India, USA, Germany, Belgium, France, Japan, Bangladesh, Republic of China, Italy and Singapore. India is the single largest trade partner since ancient times. India occupies more than 98 percent of trade share (export as well as import) of Nepal in SAARC countries. Trade with Bangladesh is roughly about one percent. Trade with other SAARC countries are negligible or even no trade with some countries. Nepal has never experienced trade balance. Trade deficit is continuously increasing owing to ever increasing imports in recent years. Nepal has only certain items to export so far such as cotton, readymade garments, Pasmina, pulses, hides and skins, gold and silver ornaments, handicrafts, tea, Cardamom, Niger seeds, perfume oils and Woolen Carpets etc. Most of the exports are of the raw material in nature, large volume and low profitable, although Nepal's export has changed from agriculture goods in 1980s to manufactured goods after 1990s. As compared to imports, export is decreasing over time. Flow of remittance has increased the imports especially of vehicles, electronics, petroleum products etc whereas, instability and insecurity has decreased the export. Furthermore, abolishment of export quota in 2005 further worsened the trade gap. Trade deficit in the year 2007/08 has reached 22.6 percent of GDP. The direction of Nepal's international trade is presented in table 1 and in figure 2, 3 and 4 below.

Table 1: International Trade Direction of Nepal

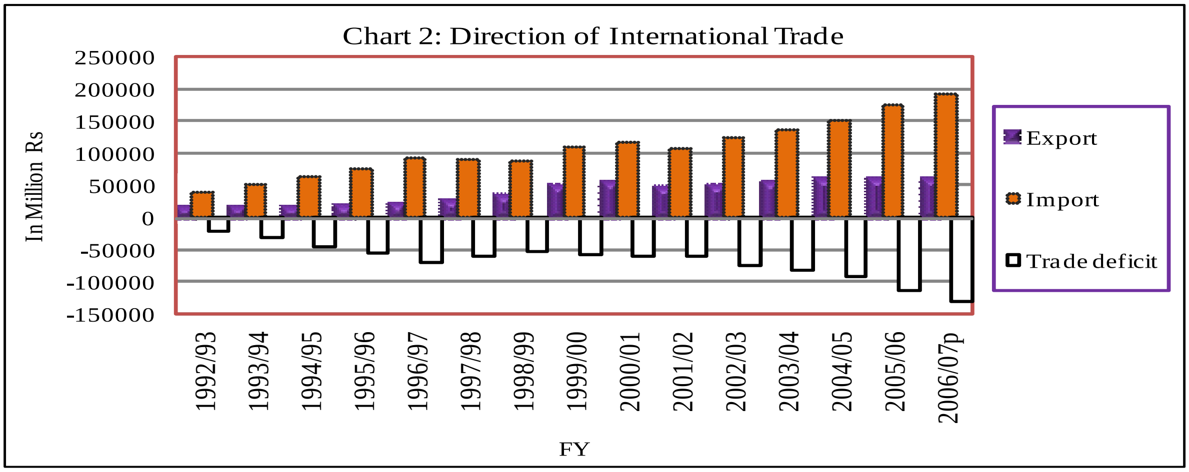
(Rs in Million)

FY	Export	Import	Deficit			Trade share %		Deficit share %	
			Total	India	Others	India	Others	India	Others
1992/93	17266.5	39205.6	-21939.1	-10920.4	-11018.7	25.08	74.92	49.78	50.22
1993/94	19293.4	51570.8	-32277.4	-14626.5	-17650.9	27.44	72.56	45.31	54.69
1994/95	17639.2	63679.5	-46040.3	-16491.6	-29548.7	27.96	72.04	35.82	64.18
1995/96	19881.1	74454.5	-54573.4	-20716	-33857.4	29.77	70.23	37.96	62.04
1996/97	22636.5	93553.4	-70916.9	-19627.1	-51289.8	25.89	74.11	27.68	72.32
1997/98	27513.5	89002	-61488.5	-18536.6	-42951.9	31	69	30.17	69.83
1998/99	35676.3	87525.3	-51849	-19589	-32260	36.24	63.76	37.78	62.22
1999/00	49822.7	108505	-58682.3	-26570.7	-32111.6	43.59	56.41	45.29	54.71
2000/01	55654.1	115687.2	-60033.1	-28670.7	-31362.4	47.12	52.88	47.16	52.24
2001/02	46944.8	107389	-60444.2	-28665.9	-31778.3	54.8	45.2	47.43	52.57
2002/03	49930.6	124352.1	-74421.5	-44494.2	-29927.3	55.86	44.14	59.79	40.21
2003/04	53910.7	136277.1	-82366.4	-47962.4	-34404	57.58	42.42	58.23	41.77
2004/05	58705.7	149473.6	-90767.9	-49758.6	-41009.3	61.29	38.71	54.82	45.18
2005/06	60234.1	173780.3	-113546	-66428.4	-47117.8	63.18	36.82	58.5	49.5
2006/07p	60795.8	191708.9	-130913	-75865.6	-55047	63.21	36.79	57.95	42.05

Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

International trade data of 15 years have been presented in the table 1 above. The export and import in 1992/93 were Rs 17266.5 million and Rs 39205.6 million respectively. It increased to Rs 60795.8 million and Rs 191708.9 million in 2006/07 respectively. During a period of 15 years, export increased by only 3.5 fold against the nearly fivefold increase of imports. From 1996/97 to 2000/01, export increased sharply and import decreased slightly in 1997/98 and 1998/99. Similarly, trade deficit increased from Rs 21939.1 million in 1992/93 to Rs 130913.0 millions in 2006/07, more than six fold during the period of 15 years. Trade deficit with India and other countries was seven and five fold in 2006/07 as the share of trade with India increased gradually and vice versa with other countries. In 2006/07, the trade deficit with India and other countries was 57.95 percent and 42.05 percent respectively. Similarly, trade share was 63.21 percent and 36.79 percent with India and other countries respectively. The general trend of Nepal's foreign trade is presented in the figure 2 below.

Figure 2: Direction of International Trade

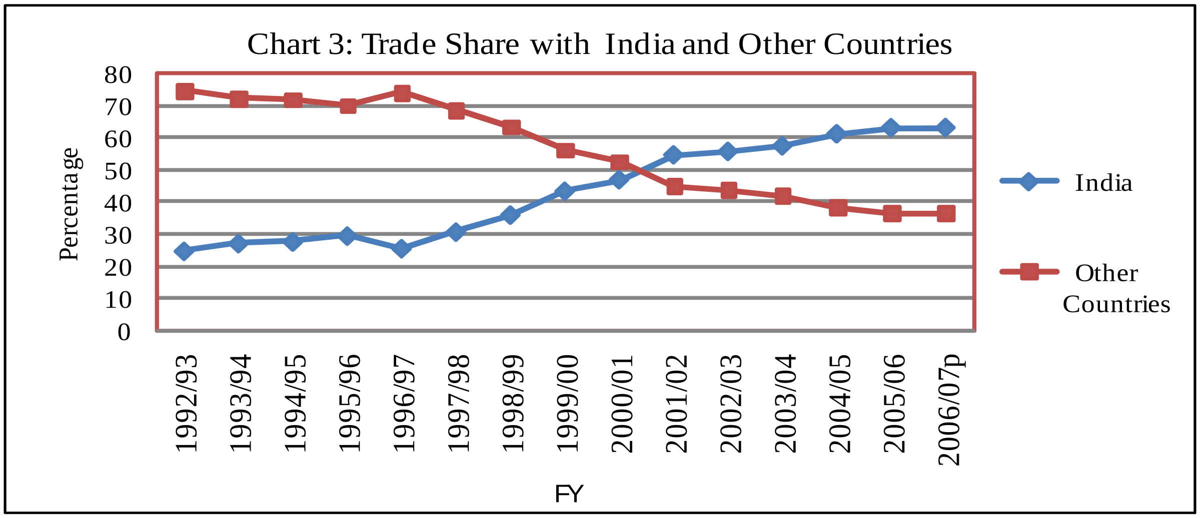


Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

Figure 2 illustrates rapidly increasing trend of imports and slowly growing or even slightly decreasing export trend of Nepal in recent years. The volume of import continuously increased during a period of 5 years from 1992/93 to 1996/97 then it slightly decreased for next two years before taking the increasing trend again in 1999/00. The import again decreased in 2001/02 and since then it increased continuously. The export increased slowly from 1992/93 to 2000/01 and it decreased sharply to Rs 5000 million in 2001/02 from Rs 5200 million in 2000/01. After 2002/03, export increased but marginally. The increasing in import resulted in a widening trade gap further. Trade deficit increased continuously except for some years during the period of 15 years from 1992/93 to 2006/07. It increased from Rs 18233 million in 1992/93 to Rs 130913 million nearly eight times in 2006/07. Trade deficit sharply increased in the year 1996/97 and slightly decreased afterwards. After the year 1998/99, trade deficit continued to increase and it rapidly increased after 2004/05. The ratio of trade deficit and GDP increased from 13.2 percent in 2001/02 to 18 percent in 2006/07 and it further increased to 22.6 percent in 2007/08. This scenario is not favorable for Nepalese economy.

The structure on Nepalese international Trade has been changing in recent years. Trade dependency with India has been increasing. The trend of trade with India and Other Countries has been presented in Figure 3 below.

Figure 3: Trade Share with India and Other Countries

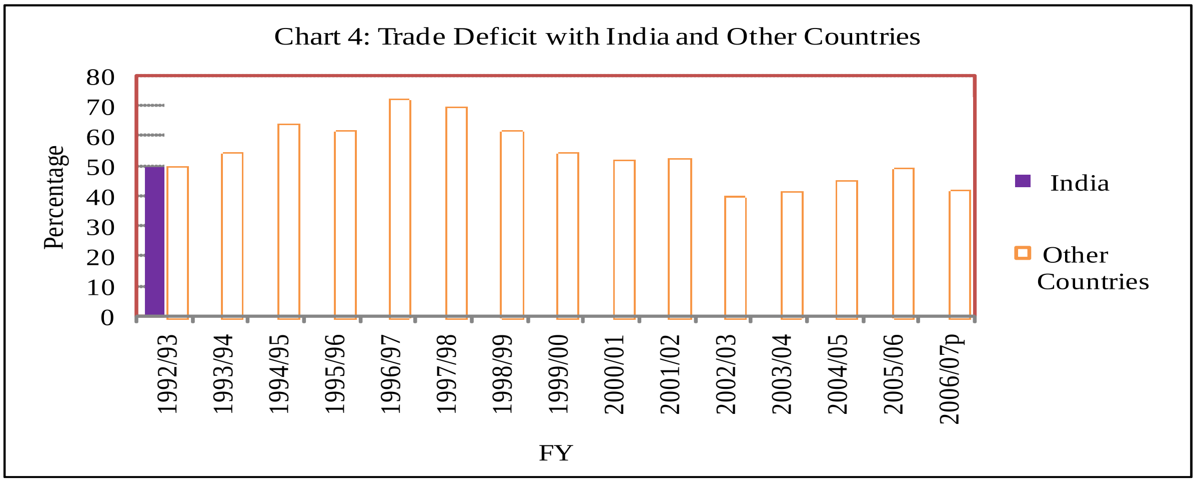


Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

Figure 3 shows that the share of trade with India has continuously increased whereas, trade with other countries has declined during the same period. The trade with India increased from 25.08 percent in 1992/93 to 63.79 percent in 206/07. Trade share of India and other countries was nearly equal in the year 2001/01 and 2001/02. The trade with India continuously increased except the year 1996/97 when it decreased slightly resulting in increase in trade with other countries.

Similarly, the trade with other countries declined from 74.92 percent in 1992/93 to 36.79 percent during the same period. 1996/97 is only the year when trade with India decreased and it increased with other countries. This shows that Nepalese trade is concentrating towards India in recent years. With the increase of the trade share, trade deficit had also increased with India. Trend of trade deficit has been shown in Figure 4 below.

Figure4: Trade Deficit with India and Other Countries



Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

Figure 4 illustrates the decreasing trend of trade deficit from 1993/94 to 1996/97 and it continuously increased for later years with India. Similarly, trade deficit with other countries continued to increase up to 1996/97 and afterwards it continued to decrease up to 2003/04. It again decreased in 2006/07 after a slight increase for two years in 2004/05 and 2005/06 respectively.

There are some reasons for the concentrations of Nepalese trade with India. Nepal concluded new trade treaty with India in 1991 and later renewed it in 1996 with more flexible provisions for Nepalese manufactured goods entering into India which had positive impacts on Nepalese export to India. Nepal received large amount foreign direct investment from India after the treaty which to some extent facilitated the access of Nepalese export products in Indian markets. Nepalese export enjoyed preferential treatment in Indian market. As a result, Nepalese export increased to India during early 1990s. Increased export to India continuously reduced trade deficit with India from 1992/93 to 1996/97. Trade deficit with India was on decreasing trend during this period. Trade deficit with other countries increased during the same period. However, the trend could not last longer. Internal conflict, political instability and industrial insecurity along with renewal of 1991 treaty in 2002 created regressive impacts on Nepalese export to India. India reintroduced the concept of value addition and other non-tariff barriers to Nepalese export. India imposed quantitative restrictions on Nepal's export of vegetable fat, acrylic yarn, copper and zinc oxide to India. Nepalese export to India was also subjected to countervailing duty. Moreover, many multinational companies were established in India after India took the policy of liberalization in 1991. As a result, Nepal started to import many third country products from India. Similarly, the import share of petroleum product has increased to around 31 percent in 2006 from 24 percent in 2001/02. Nepal imports around 99 percent of petroleum products from India. The increasing price of petroleum products in recent years has sharply increased the trade volume and trade deficit with India. In 2006/07, imports volume was three times larger than that of exports.

Even though Nepal is an agriculture country, it is not self sufficient in agriculture products. Nepal has to some extent substitute imports with domestic products and at the same time has to diversify its export goods and services according to competitive advantages. Government has to play a catalyst role to encourage private sector to produce quality exportable goods and services and explore new export markets to diversify the export destination. Attempts must be done to attract foreign Direct Investment in manufacturing, agriculture, tourism, and hydro-power and infrastructure development by creating business environment and proper policy incentives.

(b) Export

Export in recent years has decreased. It is due to internal conflict, restrictions from Indian side and phasing out of Quota from 1 January 2005. Table 2 presents the growth rate of export, import and the ratio of export, import and trade deficit with GDP.

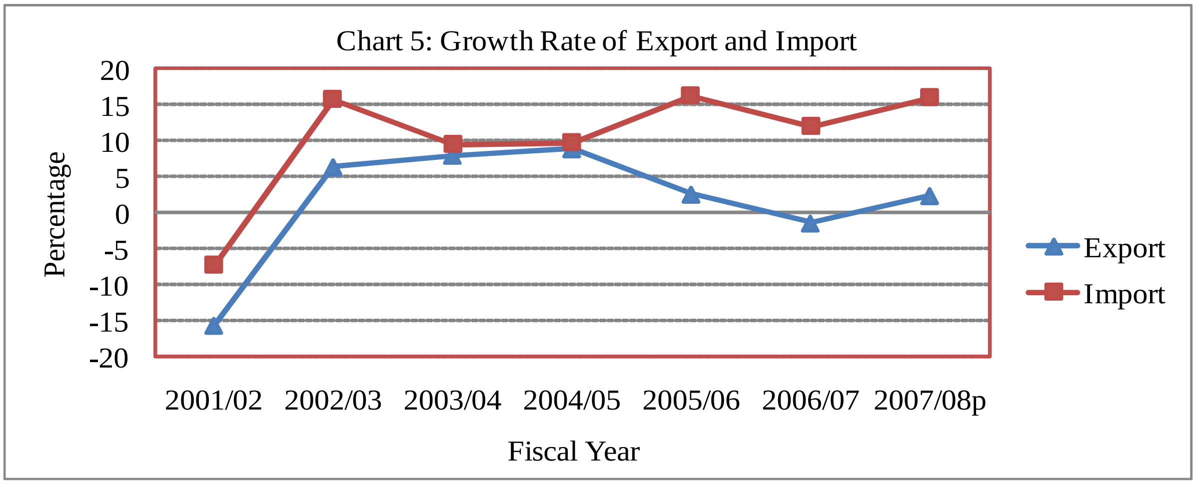
Table 2: Export/ Import Growth Rate, Percentage of GDP

Period	Percentage Growth		Percentage of GDP		
	Export	Import	Export	Import	Trade Deficit
2001/02	-15.6	-7.2	10.2	23.4	13.2
2002/03	6.4	15.8	10.1	25.3	15.1
2003/04	8	9.6	10	25.4	15.3
2004/05	8.9	9.7	10	25.4	15.4
2005/06	2.6	16.3	9.2	26.6	17.4
2006/07	-1.4	12	8.4	26.4	18
2007/08p	2.4	16.1	7.3	27.3	22.6

Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

The ratio of export and GDP drastically decreased from 10.2 percent in 2001/02 to 7.3 percent in 2007/08, whereas the ratio of import and GDP significantly increased from 23.4 percent in 2001/02 to 27.3 percent in 2007/08. The trade GDP ratio had sharply increased from 13.2 percent in 2001/02 to 22.6 percent nearly two fold in 2007/08. The general trend of growth rate of export and import is presented in the figure five below.

Figure 5: Growth Rate of Export and Import



Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

General trend in Figure 5 shows that growth rate of Nepal's export during the period always remained lower than import. Export in 2001/02 decreased sharply and had negative growth of 15.6 percent as compared to previous year. Import also had negative growth but it is less than export growth. Export slightly increased during the year 2003/04 and 2004/05. Import increased in rest of the years. The difference between annual growth rate of export and import was very low between 2003/04 and 2004/05. They both grew more or less at similar rate during that period. Since the year 2004/05, the difference between import and export has increased from around 1 percent to about 14 percent in 2007/08. As a result, the trade deficit also widened from 15.4 percentages in 2004/05 to 22.6 percent of GDP in 2007/08. The major trade destinations from 2002/03 to 2006/07 have been presented in the table 3 below.

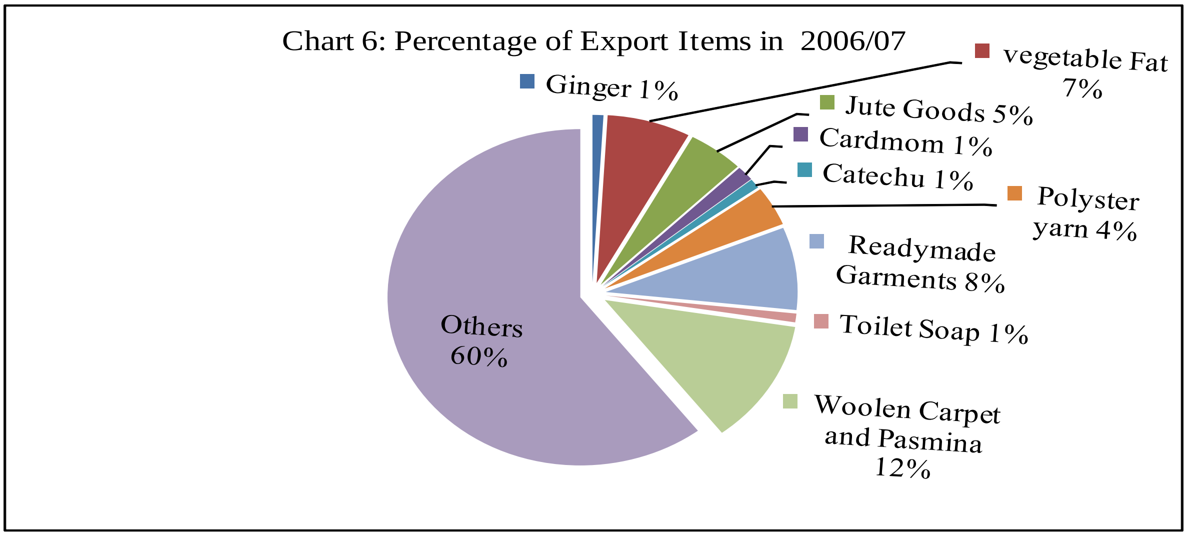
Table 3: Percentage of Export to Different Destinations

Destination	2002/03	2003/04	2004/05	2005/06	2006/07
India	52.9	57	66.6	68.1	70.9
Other Asia	6.18	7.61	6.3	5.02	5.65
Arica	0.2	0.99	0.07	0.21	0.5
America	26.02	19	13.94	12.9	10.58
EU	13.7	14	11.85	12.26	10.96
Europe	0.8	1.2	1.03	1.21	1.01
Oceania	0.2	0.2	0.21	0.3	0.4
Total	100	100	100	100	100

Source: Trade and Export Promotion Centre, Ministry of Industry, Commerce and Industry, Nepal

The share of export to India and overseas countries in the table 3 illustrates the trend from 2002/03 to 2006/07. The export to India continuously increased and that of overseas countries continuously decreased. The share of export to India and overseas was 53 and 47 percent in 2002/03, it reached to 71 and 29 percent in 2006/07 respectively in a period of five years. Among SAARC countries, India occupies almost 98 percent market. In 2006/07, export to India was 97.7 percent followed by Bangladesh 1.2 percent, Bhutan 0.8 percent and Pakistan 0.3 percent. The export to America sharply decreased from 26.02 percent in 2002/03 to 10.58 percent in 2006/07. Similarly, export to European Union decreased from 13.7 percent to 10.96 percent during the same period. Nepal has a limited number of items to export. The major items are woolen carpet, readymade garments, polyester yarn etc. The figure 6 shows the export items in 2006/07.

Figure 6: Percentage of Export Items in 2006/07



Source: Trade and Export Promotion Centre, Ministry of Industry, Commerce and supply, Nepal

The figure 6 shows that Woolen Carpet and Pasmina occupied the largest part of 12 percent followed by Readymade Garments 8 percent, vegetable fat 7 percent, Jute goods 5 percent, polyester Yarn 4 percent and Ginger, Catechu, Toilet Soap and Cardmom each one percent in total export. Out of these export products woolen carpets and readymade garments were exported to the United States of America and European Union, while vegetable fat, jute goods and Polyester yarn were exported mainly to India. Another 60 percent export is covered by many tiny items from handicrafts to coffee, tea etc.

(c) Balance of Payment

Nepal is following the 5th Balance of Payment (BOP) manual of the IMF to compile the BOP statistics since mid-April 2003. Nepal has experienced Balance of Payment surplus in spite of huge trade deficit during the period from 2000/01 through 2006/07 except for the year 2001/02 incurring deficit. Nepal traditionally faces large trade deficits, which is offset by equally large service, transfer and capital account surpluses. Nepal's overall balance of payments in 2006/07 recorded a surplus of NRs 10686.5 million. In FY 2005/2006, Nepal had recorded a balance of payments surplus of NRs 29093.3 million, which declined to 10686.5 million, 63 percent decrease in FY 2006/2007 due to an increased trade deficit and service deficit. Due to the 9.7 percent import growth and only 2.6 percent growth in exports as compared to an increase of 8.9 percent in FY 2005/06 lead the trade gap to wide by 13.16 percent. Income from travel significantly decreased in year 2004/05 and 2005/6, however, it rebounded slightly in year 2006/07 as security situation improved in the country. Similarly, continued increase in trend visiting Nepalese abroad has also increased travel payment resulting negative balance on service. Services net registered negative balance in 2004/05 and continued to increase further onwards. Moreover, balance on goods and services has decreased significantly and about two third of imports made the balance on goods and services in 2006/07.

The current account registered surplus though decreasing over time mainly pushed by foreign grants and worker's remittance. Worker's remittance increased from Rs 47216.1 million in 2000/01 to Rs 100144.8 million in 2006/07. Pension has increased by 58 percent in 2005/06 against the year 2004/05 though slightly decreased in 2006/07. Remittance and pensions have become the main source of earning foreign currency for Nepalese economy. Nepal needs proper foreign employment policy to promote development of foreign employment and channelize it through banking sector so as to make it sustainable. Remittance is still not completely captured by banking sector; it mostly depends on informal sector.

Capital account recorded surplus fluctuating during the period of seven years. It decreased up to year 2004/05 and began to increase afterwards. Financial account was highly unfavorable up to year 2004/05. There is some progress in financial accounts afterwards.

The main problem of Nepal's balance of payment is increasing trade deficit. In 2004/05 even net service has registered deficit. It is in increasing trend since then and the sources of financing deficit are not sustainable. To maintain favorable balance of payment for Nepal is a challenge. Nepal has to expand its foreign earning resources by extending service-oriented industries e.g. tourism, hydroelectricity etc. Attracting foreign direct investment, investment form Non-Resident Nepalese could be a better way to achieve this for resource-constraint country. Balance of Payments statistic of seven years from 2000/01 to 2006/7 has been presented in table 4.

Table 4: Balance of Payment Summary from Year 2000/01 to 2006/07

(Rs in million)

Fiscal Year	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
A. Current Account	20148.5	18161.1	11614.7	14598	11544.6	14224.5	3496
Goods: Export f.o.b.	69788.5	57983.5	50760.7	55228.3	59956.1	61482.5	62900.8
Goods; Import f.o.b.	-126238	-111342	-121053	-132909.9	-145718.2	-171540.8	-187451.3
Balance on goods	-56449.5	-53358.5	-70292.3	-77681.6	85762.1	-110058.4	-124550.5
Service Net	9302.3	3938.4	7049.7	9074.9	-2034.2	-6818.3	-8377.3
Services: Credit	29821.7	23508.2	26518.9	34315.9	26001.9	26469.7	32078.9
Travel	11717	8654.3	11747.7	18147.7	10463.8	9555.8	10125.3
Government N.I.E.	7614.2	8894.5	6624	7143.9	6804.9	7441.5	12336.4
Others	10490.5	5959.4	8147.2	9024.6	8733.2	9472.4	9617.2
Services: Debit	-20519.4	-19569.8	-19469.2	-25241	-28036.1	-32288	-40456.2
Transportation	-9308.7	-8854.4	-8618.4	-9382.1	-10602.2	-12592.3	-14557.4
Government N.I.E.	-55520.4	-5731.1	-6171.5	-10021.5	-9691.9	-11960.8	-15785
Others	-5690.3	-4984.3	-4679.3	-5837.4	-7742	-8734.9	-10113.8
Balance on goods & services	-47147.2	-49420.1	-63242.6	-68606.7	-87796.3	-116876.7	-132927.8
Income Net	1700.7	-604.9	-675.7	-1683.9	1636.5	4955.5	7431.8
Income: Credit	5470.5	4297	4487	3841.5	7751.6	11432.3	14500.8
Income :Debit	-3769.8	-4901.9	-5162.7	-5525.4	-6115.1	-6476.8	-7069
Balance on goods, Services & Income	-45446.5	-49420.1	-63242.6	-68607.7	-87796.3	-116876.7	-132927.8
Current Transfer Net	65595	68186.1	75533	84888.6	97704.4	126145.7	128192
Current Transfer: Credit	67027.7	70157.3	77765.1	89161.1	101310.1	130861.7	133196.8
Grants	12046.4	12650.5	13842.2	19557.8	21071.9	18851.1	18218.2
Worker's Remittances	47216.1	47536.3	54203.3	58587.6	65541.2	97688.5	100144.8
Pensions	6309.1	8269.6	7327.3	7906.2	12502.2	12007.6	12937
Others	1456.1	1700.9	2392.3	3110.2	2194.8	2314.5	1896.8
Current Transfer: Debit	-1432.7	-1432.7	-2232.1	-4273.2	-3605.7	-4716	-4204.8
B. Capital Account	6173.1	5694	5393.9	1452.2	1573.6	3107	4449.9
Capital Transfer: Debit	6173.1	5694	5393.9	1452.2	1573.6	3107	4449.9
Total (A+B)	26321.6	23855.1	17008.6	16050.2	13118.2	17331.5	7945.9
C. Financial Accounts (Ex E)	-28522.2	-37333.4	-17198.9	-21540.1	-25536.9	-1324.4	-2362.1
Direct investment in Nepal	-33	-282.3	961.4	0	-469.7	-362.3	0
Portfolio investment	0	0	0	0	0	0	0
Other investment: assets	-30191.1	-35136.9	-34629.5	-32591.2	-21863.2	-14008.8	-10690
Trade credits	1108.2	-1294.5	1041.2	-2247.6	-323.8	-1629.5	-5127.6
Others	-31299.3	-33842.4	-35670.5	-30343.6	-21539.4	-12379.3	-5562.4
Other investment: liabilities	1701.9	-1914.2	16469.2	11051.1	-3809.7	13154.1	7965.6
Trade credits	-9319	-5279	16899.3	3629.8	-4489	9232.5	1727.8
Loans	6693.4	2899.6	-52.4	3325.2	744.4	526.9	1455.6
General government	6976.5	2963.5	-432.8	3479.1	1300.4	703.7	2150.7
Drawings	11715.1	8040.3	5236	9244.7	7253.7	7691	9689.7
Repayments	-4738.6	-5076.8	-5668.8	-5765.6	-5953.3	-7539	-695.1
Other sectors	-283.1	-63.9	380.4	-153.9	-556	-176.8	-695.1
Currency and deposit	4327.5	465.2	-377.7	4096.1	-65.1	3394.7	4782.2
Nepal Rastra Bank	138.4	-197.4	-23.4	-77.4	46.2	-116.5	2.4
Deposit Money Bank	4189.1	662.4	-354.3	4173.5	-111.3	3511.2	4779.8
Other liabilities	0	0	0	0	0	0	0
Total (A+B+C)	-2200.6	-13478.3	-190.3	-5489.9	-12418.7	16007.1	5583.8
D. Net errors and omissions	11749.5	10600.6	4176.2	25587.2	18098.1	13086.2	5102.7
Total (A+B+C+D)	9548.9	-2877.7	3985.9	20097.3	5679.4	29093.3	10686.5
E. Reserves and related items	-9548.9	2877.7	-3985.9	-20097.3	-5679.4	-29093.3	-10686.5
Reserve assets	-9224.1	3203.4	-3685.2	-2065.4	-6464.6	-29093.3	-13410.2
Nepal Rastra Bank	-7445.1	-1712.7	-7809.9	-19503.8	-3253.7	-21398.1	-10963.2
Deposit Money Bank	-1779	4916.1	4124.7	-1150.2	-3210.9	-7895.2	-2447
Use of fund credit and loans	-324.8	-325.7	-300.7	556.7	785.2	0	2723.7
Change in Net Foreign Assets (- surplus)	-5221.4	3342.9	-4363.5	-16005.2	-5742.1	-25597.8	5904.3

Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

(d) Exchange Rate and Exchange System

Currently, Nepal is adopting dual exchange rate arrangement. It is dual because, on one hand, the Nepali currency (NC) is pegged with the Indian currency (IC) and on the other hand it floats with other major convertible currencies such as US dollar, UK pound Japanese Yen etc. Nepalese currency became fully convertible in current accounts in 1993 after partial convertibility in 1992. So, Nepal introduced dual system of exchange rate since February 12, 1993. Before this, the regime of currency basket system was in use since June 1, 1983. The currency basket, at which NC was pegged, was never disclosed and NC-IC rate remained fixed. This shows that Nepal has been following the de facto pegged exchange rate system since the 1960s. Nepal's exchange rate is determined not by the return of the financial investment but by trade. India is the single largest trade partner. It is also influenced by cultural proximity and open border with India. The peg of NPR-INR has worked as the anchor for price stability in Nepal. The present NPR-INR was fixed in 1993. Since then, it has not been adjusted. The historical adjusted NPR-INR exchange rate is presented in the following Table 5.

Table 5: Fixed exchange Rate of NC and IC

Effective date	Unit	Buying rate	Selling rate	Remarks
04/13/1960	IC 100	RS 159.75	RS 160.00	
06/06/1966	IC 100	RS 101.25	RS 101.60	
12/08/1967	IC 100	RS 135.00	RS 135.15	
12/22/1971	IC 100	RS 139.00	RS 139.15	
03/22/1978	IC 100	RS 145.00	RS 145.15	
11/30/1985	IC 100	RS 170.00	RS 170.15	
05/31/1986	IC 100	RS 168.00	RS 168.15	IC included in Basket
07/02/1991	IC 100	RS 165.00	RS 165.15	
02/12/1993	IC 100	RS 160.00	RS 160.15	

Source: Nepal Rastra Bank, Katmandu, Nepal

Nepal has maintained fixed exchange rate of Nepalese rupee vis-à-vis the Indian rupee for the management of external sector. The pegged exchange rate system has acted as an anchor to maintain price stability and controlling inflationary expectations in the country. Nepal is benefitting from the pegged exchange rate regime because of its high degree of economic ties with India. The risk that could emerge from the large volume of current and capital account transactions with India arising from close economic ties, free labor mobility and prevalence of informal family relationship between India and Nepal are minimized by the fixed exchange rate with India.

Many reforms were initiated in the area of foreign exchange management from early 1990s. 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 restrictions in current account transactions. Nepal has not yet opened its capital account so far, but is in the process of opening it on different phases.

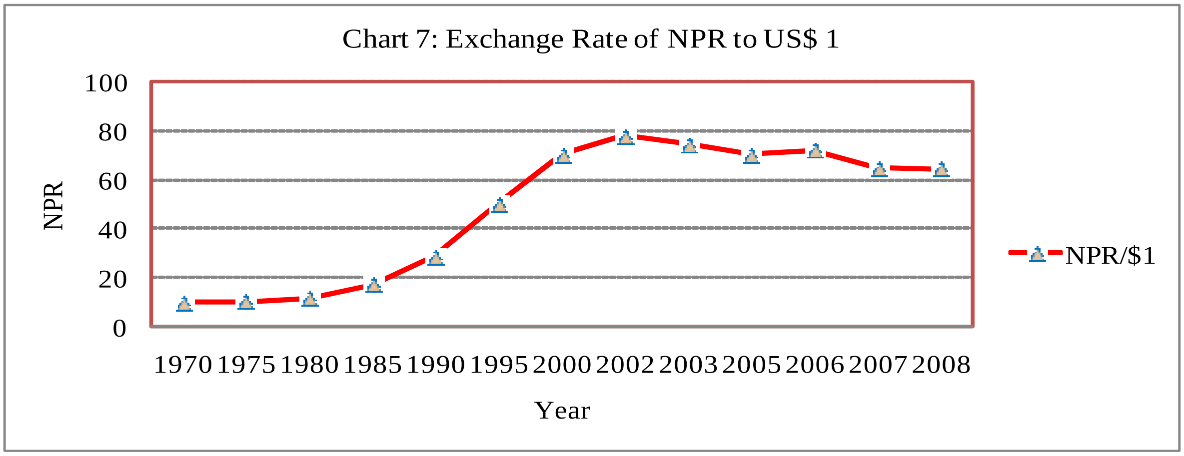
Nepal Rastra Bank publishes the exchange rates of foreign currencies for its own use; it's only indicative for banking sectors. Commercial banks are free to determine their own exchange rate for convertible currencies and other near money instruments. First, banks compute the exchange rate of the US dollar on the basis of IC-Dollar exchange rate. Then, they compute exchange rates for other convertible currencies on the basis of the cross rates of respective currencies with the US dollar in the international market. Though commercial banks are free to determine their own foreign exchange rates, almost banks use similar exchange rates and set a high spread on foreign exchange transactions. Foreign Exchange Dealers Association (FEDAN) coordinates in setting similar exchange rates. Foreign exchange dealers of Nepal blame the pegged exchange rate system with Indian currency which compels to follow the trend of INR against US Dollar as far as determination of exchange rate is concerned. "Whenever there is a rainfall in India, Nepalese banks have no option but to open their umbrellas". This is a commonly used statement among the so-called foreign exchange dealers of Nepal. This is not the whole story behind for maintaining a very primitive domestic foreign exchange market. There is need to create basic infrastructures and educating both bankers and non-bankers about the benefit of exchange rate system. There is debated time and again on the topic of pegged exchange rate of Nepalese currency with Indian currency. In light of external development such as phasing out of the Multi-Fiber Arrangement since January 1, 2005, with its likely risks and challenges for the export growth and volatility of Indian currencies.

Table 6: Exchange Rate of NPR to US$

Year mid-July	1970	1975	1980	1985	1990	1995	2000	2002	2003	2005	2006	2007	2008
NPR/$1	10.5	10.55	12	17.7	29.2	50.7	70.75	78.3	75	70.65	72.39	65.15	64.8

Source: Nepal Rastra Bank, Kathmandu, Nepal

Figure 7: Exchange Rate of NPR to US $1



Source: Nepal Rastra Bank, Katmandu, Nepal

Figure 7 illustrates that from 1970 to 2002 Nepalese currency continuously depreciated against the US$. It depreciated from Rs 10.5 in 1970 to Rs 78.3 in 2002. The NPR depreciated by 645 percent during the period. However, NPR continuously appreciated against the US$ afterwards. It appreciated by 17 percent during the period. What is the reason that appreciated NPR against the US$? Is it good for Nepalese economy? These are the some curiosities with regard to the NPR exchange rate system.

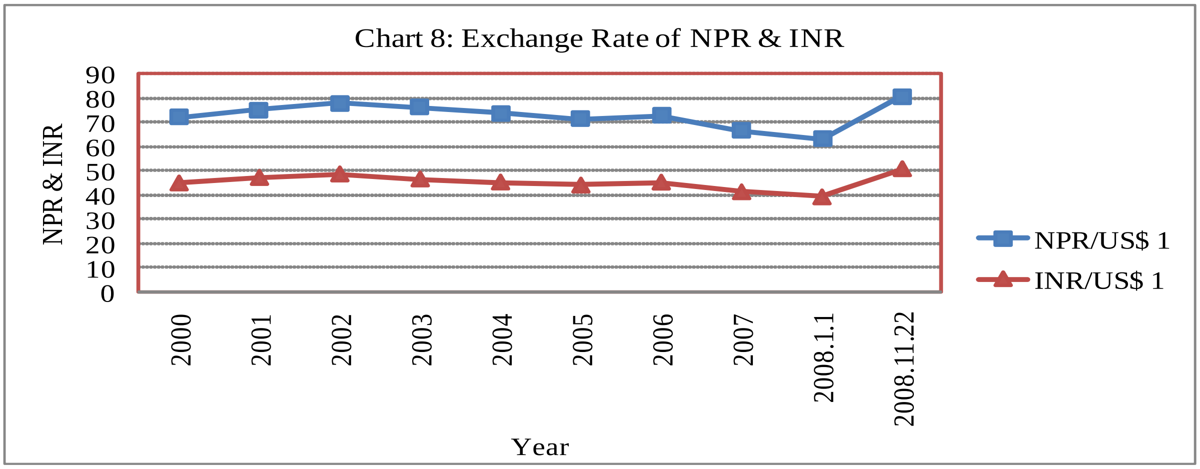
The study of exchange rate system of Nepal is incomplete without the study of exchange rate of Indian Currency because of peg of NPR.

The Indian currency appreciated against US $ in some years in the past and the trend continued until March 2008 and so was the NPR due to its peg with INR. There are various reasons for the appreciation of Indian currency. Some are as follows.

(1) Higher growth rate in recent years.
(2) Flow of large amount of FDI
(3) Low inflation rate
(4) A large sum of fund has been injected in Indian equity market- Foreign Institutional Investors such as Hedge Funds and Mutual Funds.
(5) Higher interest rate.
(6) Investment friendly business environment

All these factors attracted huge foreign capital inflow to India which appreciated the INR against Dollar. The following Figure 8 shows the relationship between NPR and INR against the US$ from 2000 onwards.

Figure 8: Exchange Rate of NPR & INR



Source: Nepal Rastra Bank, Katmandu, Nepal

The exchange rate of NPR and INR with US$ in figure 8 shows the perfect and positive movement of NPR and INR. From 2000 to 2002, both currencies depreciated followed by appreciation afterwards before sharp depreciation in 2008. As NPR-INR exchange rate is fixed, NPR moves in perfect correlation with INR against the Major currencies irrespective of the economic conditions.

In recent months especially due to present global financial crisis, foreign institutional investors are selling their foreign assets in emerging economies including India to avoid risk that has created more demand of US$ in Indian foreign exchange market which sharply depreciated the exchange rate of INR. The same trend has been followed by NPR in recent months. But there is not any convincing fact to support the appreciation of NPR against the US Dollar. The present depreciation of INR may be temporary and INR may rebound in the future.

Nepal's growth rate was very low even negative in some years, very low level of Foreign Direct Investment, negative real interest Rate, political instability, industrial unrest etc has deteriorated investment friendly environment in Nepal nearly for a decade. NPR exchange rate against US$ is not in this line. The result may be the overvaluation of NPR with INR.

(e) Foreign Direct Investment

Foreign direct investment not only brings capital, modern technology, management skills, marketing know-how and technical skills but also provides access to the international markets and develops the competitive trading culture in the economy. It also expands the industrial development and sustainable source of internal revenue. To reap these benefits, Nepal started to attract foreign direct investment from late 1980s and recognized foreign capital, technology transfer as part of its strategy for industrial development. Nepal promulgated its first industrial Act in 1987 opening doors for foreign direct investment in the country. Since then, it has made many policy reforms to create conducive investment environment. The act opened foreign direct investment in medium and large scale ventures in every industry except those related with defense and environment and small-scale industries. The act provided 100 percent foreign ownership with some conditionality. This process further accelerated after the restoration of multiparty democracy. The new democratic government realized that foreign direct investment can promote the development of more diversified manufacturing and export base industries in the country. The government extended the tax holiday period up to 10 years in 1991 and introduced industrial enterprises act 1992 and foreign direct investment and technology transfer act 1992. Other measures taken in this regards are:

(1) Establishment of Investment Promotion Board, fast track committee, one window system to provide different facilities to investors from a single point.
(2) The guarantee of protection of investment. Guarantee against nationalization of industries.

(3) 100 percent repatriation of equity invested and dividends, amount received as payment of principal and interest on foreign loans in convertible currencies.
(4) Settlement of disputes under the rule of United Nations Commission on international trade law.
(5) Provision of different industrial estates, construction of dry port in Birgunj and at other customs.
(6) Privatization of public enterprises. The process began in 1992/93 and 29 public enterprises have been privatized so far.
(7) Investment protection agreement with Germany, France and the U.K.
(8) Further incentives through taxation.
    (a) Zero rate for export and full refund of input tax of export.
    (b) Lower import duty on import of machinery and equipments and exemption of value added tax for these imports.
    (c) Lower import duty on import of intermediate inputs of export-oriented industries. Refund of import duty and VAT under duty drawback scheme.
    (d) Reduced rate of corporate tax to special, export-oriented and construction industries under Built, Operate, Own and Transfer (BOOT) system

A total of 1345 industries were given permission up to first eight month of fiscal year 2007/08. These industries have drawn total of NPRs 39.79 billion of foreign investment and it is estimated that these industries have generated a total of 118934 employments. This can be seen from following table. The number of foreign industrial projects has increased after the year 2005/06 as Nepal entered into stable peace process in April 2006.

Table 7: Number of Industries and Foreign Investment by Fiscal Year

(Rs in million)

Fiscal year	Number of industries	Foreign investment	% of GDP	Total number of employment
1988/89	59	466.84	0.54	10586
1089/90	30	398.51	0.4	9515
1990/91	23	406.28	0.35	2974
1991/92	38	597.84	0.41	5615
1992/93	64	3083.67	1.86	13873
1993/94	38	1378.76	0.72	4734
1994/95	19	477.59	0.22	2386
1995/96	47	2219.86	0.92	8032
1996/97	77	2395.54	o.88	9347
1997/98	77	2000.28	0.69	4336
1998/99	50	1666.42	0.5	2146
1999/00	71	1417.61	0.38	4703
2000/01	96	3102.56	0.75	6880
2001/02	77	1209.65	0.28	3731
2002/03	74	1793.77	0.39	3572
2003/04	78	2764.8	0.55	2144
2004/05	64	1639.52	0.3	5576
2005/06	116	2606.31	0.43	7358
2006/07	121	2453.12	0.37	5398
2007/08*	127	7719.99	0.94	6045
Total	1345	39795.18		118934

*First eight month only, Source: Department of Industries, ministry of Industries and Economic survey 2007/08, Ministry of Finance, Government of Nepal

So far Nepal is able to attract very little amount of FDI. The FDI inflow as percent of GDP in year 1990, 2000 and 2007 was 0.3, 1.3, and 1.6 percent respectively. More than 90 percent projects are equity based.

Only 5 percent projects are based on technology transfer. In this sense, Nepal is not successful to increase the flow of technology transfer. As for the geographical distribution, size and country of origin of these projects is concerned, more than 50 percent projects are located in central region, a few large projects are concentrated on energy sector, most of the industries are small scale and India is the main source of foreign direct investment followed by China, Japan and the USA. India possesses 28 percent of all the foreign direct investment projects.

Nepal could not succeed in attracting sufficient foreign direct investment so far. Political instability, poor infrastructure development, structural constraints etc are some of the reasons responsible for low FDI. Nepal introduced Non-Resident Nepalese (NRN) act in 2007 allowing them to invest convertible foreign currency, to open an account in convertible foreign currency and to repatriate any earnings from such investments in convertible foreign currency. Although Nepal is doing its best to attract foreign investment by creating investment-friendly environment, its ranking of overall ease of doing business in 2009 report increased to 121th position from 111th in 2008. It indicates need for more reforms to create investment-friendly environment. The present government has committed to make necessary amendments in existing industrial policy, foreign investment policy, trade policy and other related laws aiming at creating conducive and business friendly environment in the industrial sector. Procedures of establishing new business will be made further simple, transparent and scientific.

(f) Borrowing from Abroad

Nepal is a resource constraint country. It is heavily relying on external resources for its development activities. Nepal hardly manages its regular expenditure from internal resources. Revenue surplus for capital expenditure is limited. That is why Nepal has to depend heavily on foreign resources for its development expenditures. India, China, Japan and the USA are the major bilateral donors, whereas Asian Development Bank, International Monetary Fund, World Bank and UN Agencies are the major multilateral lending agencies. On average 72 percent of capital expenditure was financed through foreign aid during a period of 7 years from 2000/01 to 2006/07. Foreign aid had played an important role in Nepal's development. However, the volume of external loan is big though decreasing in recent years. The outstanding external loan at the end of first eight months of fiscal year 2007/08 was NPR 216.20 billion. The ratio of net outstanding debt to GDP was 26.3 percent during the period. The three year interim plan estimated to mobilize additional NPR 140.66 billion foreign aid during the plan period.

(g) Foreign Aid

Foreign aid increases efficiency by expanding knowledge, skill and technology and it also bridges the gap between saving and investment in the resource constraint countries. Table 8 presents the trend of foreign aid structure in Nepalese economy.

Table 8: Contribution of Foreign Grants and Loan in Capital Expenditure

(Rs in million)

Fiscal Year	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Capital expenditure	28307	24773	22356	23095	27340	29606	39729
Total foreign aid	18797	14384	15885	18912	23657	22041	25853
Percent of foreign aid	66.4	58.06	71.05	81.88	86.52	74.44	65.07
Foreign grants	6753	6686	11339	11283	14391	13827	15800
Foreign loan	12044	7698	4546	7629	9266	8214	10053
Percent of foreign grants	23.85	26.98	50.72	48.85	52.63	46.7	39.76
Percent of foreign loan	42.54	31.07	20.33	33.03	33.89	27.74	25.3

Source: Economic survey 2007/08, Ministry of Finance, Government of Nepal

Foreign aid consists of foreign grants and loan. Nepal in its Tenth plan (2002/03- 2006/07) realized NPR 57.25 billion foreign grants and NPR 34.6 billion foreign loans i.e. 67.2 % and 37.3 % of total foreign aid respectively. The data from year 2000/01 to 2006/07 shows that the share of foreign grants has increased from 23.85 percent of capital expenditure in 2000/01 to 52.63 percent in 2004/05 just before it slowly started to decrease. However, its share is still high as compared to foreign loan. At the same time, the percentage of foreign loan has decreased from 42.54 percent in 2000/01 to 20 percent in 2002/03, but increased in following years. In the last two years, it was on decreasing trend.

Foreign aid in Nepal is not free from problems. There is lack of proper utilization of foreign aid, corruption and low absorption capacity of the country institutions. Moreover, the disbursement of aid committed is one of the problems foreign aid is facing in the developing countries like Nepal. Foreign aid commitment and disbursement in Nepal for a period of seven years have been presented in the table 9 and the Figure 9 shows its trend during the same period.

Table 9: Foreign Aid Commitment and Disbursement

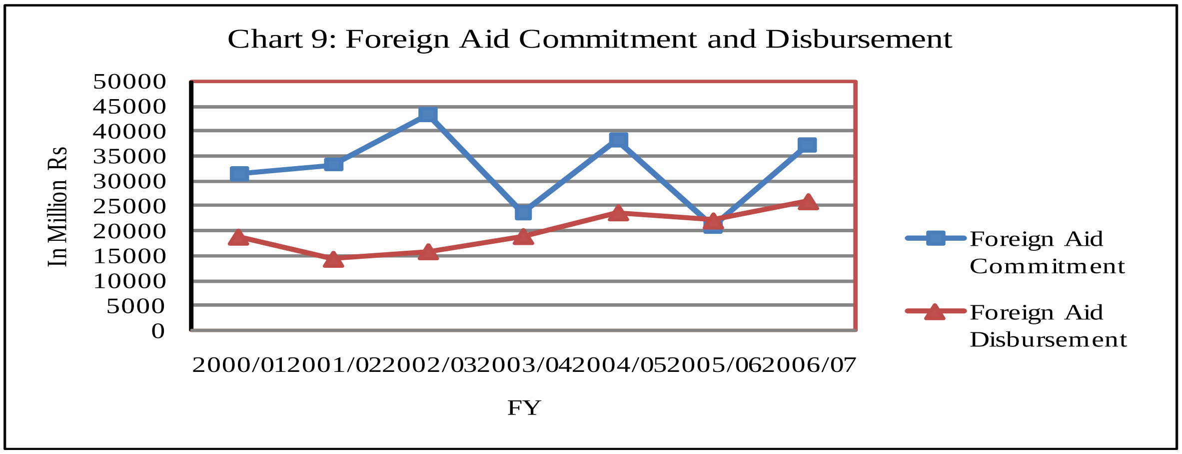
(Rs in million)

Fiscal Year	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Foreign Aid Commitment	31287	33227.7	43202.7	23738	38152.3	20924	37022.9
Foreign Aid Disbursement	18797	14384.8	15885.5	18912	23657.3	22042	25854.3

Source: Economic survey 2007/08, Ministry of Finance, Government of Nepal

Table 9 illustrates that foreign aid disbursement increased from Rs 18797 million in 2000/01 to Rs 25854.3 million in 2006/07. The difference between commitment and disbursement in 2003/04 was the least, disbursing about 80 percent of it.

Figure 9: Foreign Aid Commitment and Disbursement



Source: Economic survey 2007/08, Ministry of Finance, Government of Nepal

The trend in figure 9 shows a wide gap between aid commitment and disbursement up to 2002/03, thereafter it narrowed down. In year 2005/06, aid disbursement surpassed the commitment. It may be due to the disbursement of previous year commitment. However, the gap between aid commitment and disbursement trend increased in the later years.

II.3 Domestic Environment

(a) Economic Growth Rate

Nepal's economic growth rate from 2002/03 to 2007/08 remained below 5.0 percent. The GDP growth rate in 2001/02 was almost zero. Economic growth rate increased up to 4.7 percent in 2003/04 but gradually decreased to 3.2 percent in 2006/07. Sectors trend analysis reveals that growth rate of agriculture sector was the lowest in 2006/07 which was caused by extremely unfavorable weather and the growth rate of non-agriculture sector was even negative in 2001/02. In 2007/08, the growth rate is expected to rebound. It is estimated to be 4.7 percent in this period. The growth rate of agriculture and non-agriculture sector estimated to be 5.7 and 5.6 percent respectively. The growth rate of 16.8 percent in paddy, maize and wheat increased the overall growth of agriculture. In the non-agriculture sector, growth rate of manufacturing sector is estimated at 0.18 percent which made major industrial production index negative. The contribution of agriculture and non-agriculture sector at producers' price is estimated at 34.6 percent and 65.4 percent respectively. The growth rate of real GDP for seven years is presented in table 10 below.

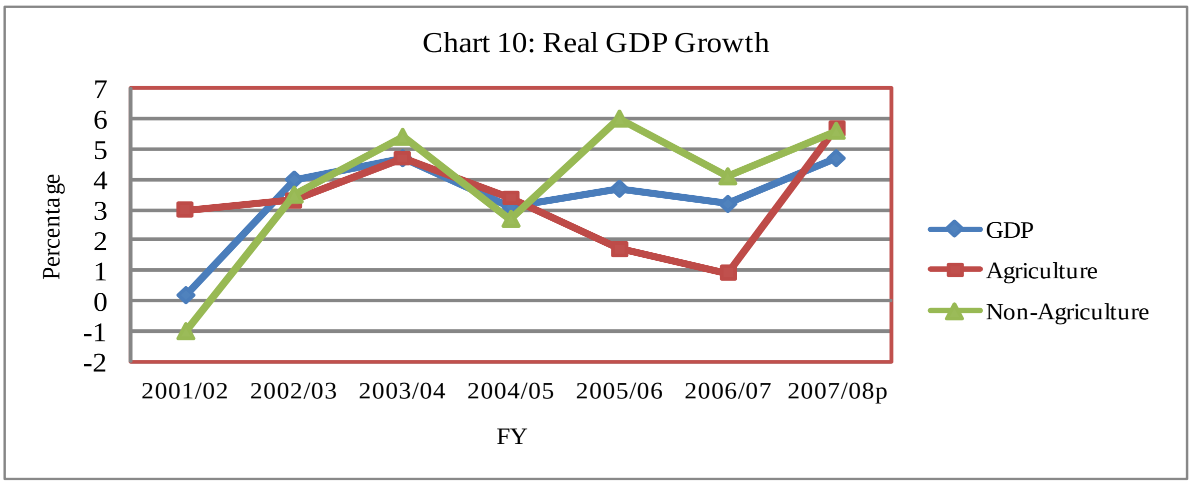
Table 10: GDP Growth Rate (Base = 2000/01)

Fiscal Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08p
GDP	0.1	4	4.7	3.1	3.7	3.2	4.7
Agriculture	3	3.3	4.7	3.4	1.7	0.9	5.7
Non-Agriculture	-1	3.5	5.4	2.7	6	4.1	5.6

Source: Economic survey 2007/08, Ministry of Finance, Government of Nepal

The real GDP growth rate of Nepal during the last seven years was very low. The Non-Agriculture sector had negative growth in 2001/02 which resulted in almost overall negative growth. The growth in 2004/05 and 2005/06 was also low. The growth of agriculture sector in 2006/07 was less than 1 percent which pulled down the overall growth rate. Figure 10 shows the trend of real growth.

Figure 10: Real GDP Growth



Source: Economic survey 2007/08, Ministry of Finance, Government of Nepal

The trend in the Figure 10 shows that the trend of agriculture, non-agriculture sector is oriented towards positive growth. Both the Agriculture and Non-Agriculture sectors have grown almost equally.

(b) Inflation Rate

Nepalese inflation has been affected more by the structural and external factors. Overall supply of goods and services such as agricultural products, industrial products and supply constraints due to closures and strikes come under structural factors. Factors such as price hike of petroleum products in the global market and direct impact of Indian inflation come under external factors that affect inflation in Nepal. However, increase in aggregate demand through the expansion of monetary aggregates as a factor affecting inflation cannot be disregarded.

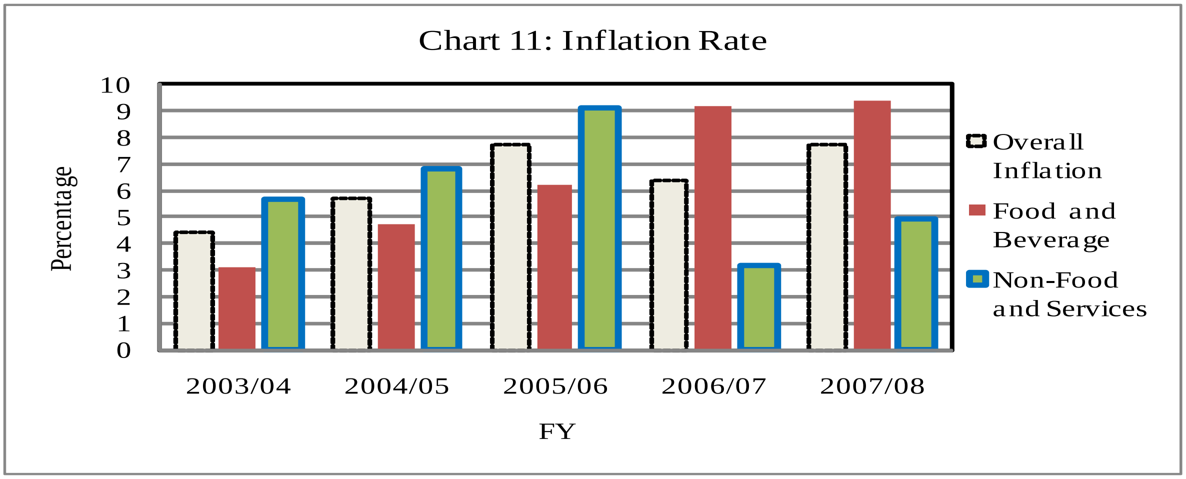
Table 11: Annual Inflation based on National Urban Consumer Price Index (1994/95 = 100)

Group/sub-group	Weight in percentage	2003/04	2004/05	2005/06	2006/07	2007/08
Overall Inflation	100	4.4	5.7	7.7	6.4	7.7
Food and Beverage	53.2	3.1	4.7	6.2	9.2	9.4
Non-Food and Services	46.8	5.7	6.8	9.1	3.2	4.9

Source: Economic survey 2008, Ministry of Finance, Government of Nepal

The overall inflation in Nepal remained moderate during the five years from 2003/04 to 2007/08. Consumer price increased to 7.7 percent in 2007/08 from 6.4 percent in 2006/07. Monetary policy of 2007/08 estimated that the price situation would remain under control at 5.5 percent, but it exceeded the ceiling. The inflation trend of last five years has been presented in figure 11 below.

Figure 11: Inflation Rate



Source: Economic survey 2007/08, Ministry of Finance, Government of Nepal

The figure 11 shows that overall inflation rate fluctuated from 2003/04 to 2007/08. The figure reveals that up to year 2005/06, non-food and services price was dominant and continuously increased up to this year. The situation reversed in the following years. The price of food and beverage became dominant in overall inflation from year 2006/07 onwards. The upward pressure on price was mainly due to international inflationary pressures such as increased price of petroleum and food products and construction materials. Supply constraints caused by Indian export restrictions on some of the food products to Nepal raised the domestic food prices which further pressured the inflation. Food and beverage index has jumped to 9.2 percent in 2006/07 from 6.2 a year ago. The World Food Situation research report has stated that world food demand has increased by 8.0 percent and the world food price has increased by around 50 percent within the six-year period from 2000 through 2006. In last few months, the world food price increased rapidly. The price of wheat increased by 181 percent in the last three years and overall price of food items increased by 82 percent (World Bank). Nepal may face further inflationary pressures in future. Luckily, the monetary growth is not the source of inflationary pressure in Nepal and central bank is aware of this.

(c) Consumption

Structure of consumption pattern, ratio as percent of GDP and growth rate of consumption components from 2002/03 to 2007/08 has been presented in the following table 12 below.

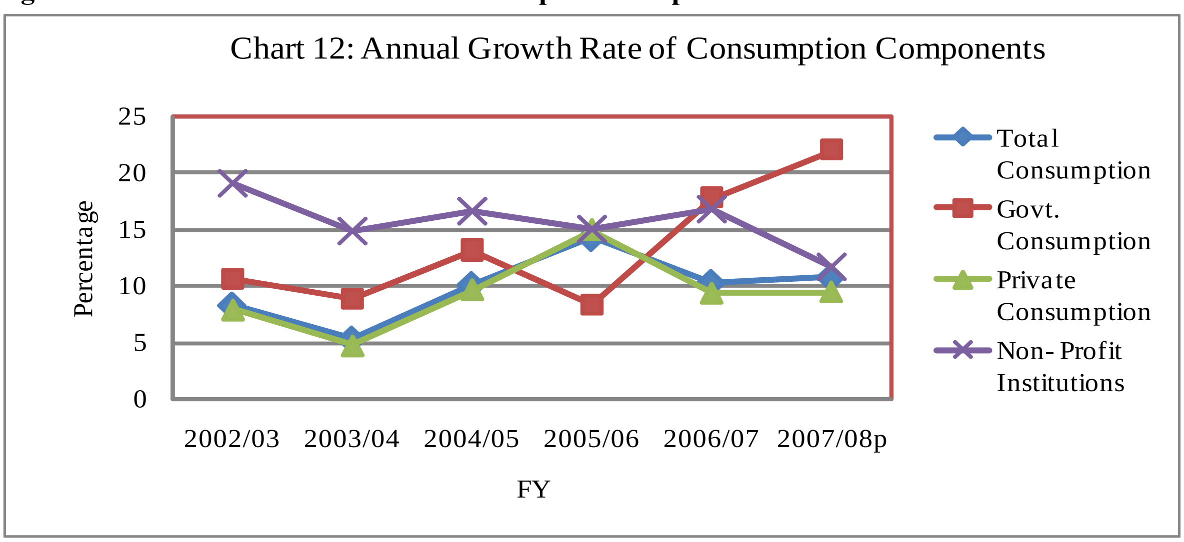
Table 12: Consumption Pattern, Ratio of GDP and Growth Rate

Fiscal Year	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08[p]
Consumption/ GDP Ratio	91.4	88.3	88.4	91	90.3	88.5
Govt. Consumption/ GDP Ratio	8.67	8.64	8.9	8.7	9.2	9.93
Private Consumption/ GDP Ratio	81.36	78.12	77.96	80.7	79.35	76.9
Consumption Growth Rate	8.24	5.24	10.05	14.2	10.23	10.72
Govt. Consumption Growth Rate	10.54	8.78	13.05	8.28	17.7	21.9
Private Consumption Growth Rate	7.83	4.7	9.6	14.86	9.3	9.42
Govt. Consumption Percent	9.48	9.8	10.06	9.53	10.19	11.21
Private Consumption Percent	88.96	88.52	88.15	88.7	87.9	86.86

Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

The ratio of consumption to GDP at current price decreased in 2007/08 to 88.5 percent by 1.8 percent point. The ratio of Government consumption to GDP increased from 9.2 percent in 2006/07 to 9.93 percent in 2007/08. But, the ratio for private consumption, which shares about 90 percent of consumption, decreased from 79.35 percent in previous year to 76.9 percent during 2007/08. The share of government consumption in total consumption has continuously increased from 2002/03 to 2007/08. It nearly increased three times in 2007/08 as compared to that of 2002/03, whereas private sector consumption has fluctuated during the same period. Government consumption in 2007/08 is estimated to increase by 4.2 percent, at a lower rate as compared to 7 percent in last year. It was 17.7 percent in last year. Similarly, private consumption is estimated at 9.42 percent slightly higher than previous year. The share of Non-profit institutions remained less than two percent during this period. However, its percentage has increased continuously from 1.56 percent in 2002/03 to 1.93 percent in 2007/08. Consumption in 2007/08 at constant price increased by 2.7 percent to Rs 498.61 billion, but the ratio of gross consumption and GDP decreased to 89.7 percent in 2007/08 from 91.5 percent in the previous year. Different ratios of consumption GDP are presented in Table 12 and figure 13 below.

Figure 12: Annual Growth Rate of Consumption Components



Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

The figure and table 12 illustrate that government consumption increased normally up to 2004/05 and after 2005/06 it increased rapidly, whereas private consumption fluctuated between 2002/03 to 2005/06 and then decreased sharply. The government consumption decreased only in 2005/06. Even though government expenditure sharply increased after year 2005/06, the overall impact on total consumption is not significant because it has low percentage contribution in total consumption. The growth rate of Non-profit institutions was very high as compared with government and private consumption. This ratio decreased sharply from 16.76 percent in 2006/07 to 11.64 percent in 2007/08.

(e) Investment

The gross domestic savings at constant price was estimated to increase by 26.3 percent to Rs 57.23 billion in the year 2006/07. The gross domestic savings had increased by 9.1 percent to Rs 45.30 billion in 2006/07. The ratio of gross domestic savings to gross domestic product increased to 10.3 percent in 2007/08 from 8.5 percent in 2006/07 revealing a positive trend, although it is very low in relation to gross investment. The saving –investment gap was 20.5 percent in fiscal year 2007/08.

The gross fixed capital formation is estimated to have grown by 6 percent in 2007/08 as compared to 2 percent growth in the previous year. The ratio of gross fixed capital formation to GDP at producers' price was 19.7 percent in 2007/08, higher compared to the ratio of 19.5 percent a year ago. Investment and saving to GDP ratios for past seven years have been presented in the table 13 below.

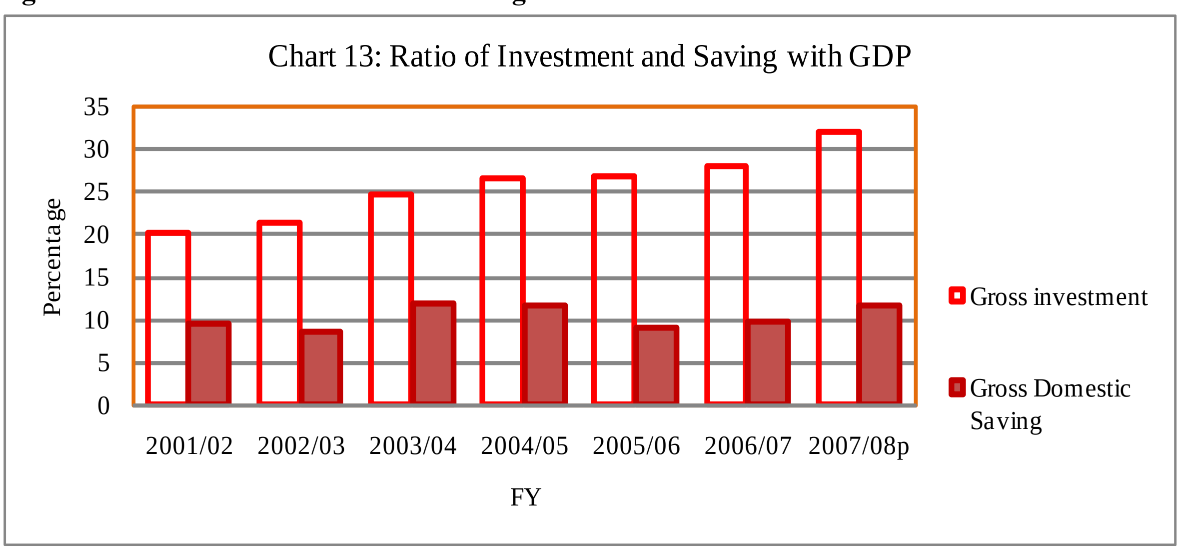
Table 13: Investment and Saving to GDP Ratios

Fiscal Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08p
Gross investment	20.2	21.4	24.5	26.5	26.8	28	32
Gross Domestic Saving	9.5	8.6	11.8	11.6	9	9.7	11.5
Saving- investment gap	10.7	12.8	12.7	14.9	17.8	18.3	20.5

Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

Nepal could not achieve the higher economic growth despite the five decades of planned development efforts. This is perhaps due to resource constraints. Political instability and armed conflict adversely affected the development efforts by deteriorating the internal and external investment environment. Frequent lock outs, obstruction, kidnapping, demand of excessive donation etc have increased the cost of economy, reduced competitive strength, and retarded the normal expansion of economic activities. Also, the dispute between laborers and industrialists has adversely affected the growth of industrial sector. The figure 13 shows the trend of Investment in Nepal for past seven years.

Figure 13: Ratio of Investment and Saving with GDP



Source: Economic survey 2007/08, Ministry of Finance, Government of Nepal

The table and figure 13 reveal the gap between gross domestic saving and gross investment for a period of 7 years from 2001/02 to 2007/08. The gap increased continuously over time. This gap was compensated by the inflow of worker's remittance. Domestic saving slightly increased during 2003/04 and 2004/05, but it could not sustain in later years.

(f) Capital Stock

The gross fixed capital formation at constant price was estimated to have grown by 6 percent to Rs 109.75 billion in 2007/08. Last year, the gross fixed capital formation had grown by 2 percent to Rs 103.51 billion. The ratio of gross fixed capital formation to GDP at producers' price was 21.1 percent in 2007/08, slightly higher compared to the ratio of 20.4 percent a year ago. The ratio of government sector's fixed capital formation to GDP was estimated at 2.9 percent that year compared to the ratio of 2.7 percent a year ago. Similarly, such ratio of private sector was estimated at 16.82 percent compared to 16.75 percent a year ago.

(g) Financial Sector

The banking system dominates the financial sector in Nepal. Nepal started its reform of bank and non-bank financial institutions and capital market in 1980s. The Objective was to develop more efficient, robust and deeper financial system, which can support the growth of private sector**.** Nepal first of all eased the entry barriers followed by the liberalization of interest rates on deposits and loans so as to foster competition. Government tried to increase access to formal financial services for small businesses and low-income households. The government has introduced directed lending programs for small businesses and low-income households, required banks to open branches outside the Katmandu valley, created specialized wholesale and retail institutions, and lowered market entry requirements to foster the development of different types of financial institutions. As a result, the number of banks and financial institutions has increased substantially during the period between 1980 to mid-January, 2008. As in Table 14, the number of financial institutions in Nepal rose from 4 in 1980 to 235 in 2008. The pace of financial development accelerated since 1995. As a result, financial sector in Nepal has deepened over the years. Broad money, M_2, as percent of GDP grew from 24.59 percent in 1988/89 to 57.59 percent in 2006/07. Likewise, bank deposit as percentage of GDP increased from 17.41 percent to 43 percent during the same period. The trend of development of financial institution in Nepal has been presented below.

Table 14: Growth of Financial Institutions from 1980 to Mid-January, 2008

(in number)

Year (mid-July)	1980	1985	1990	1995	2000	2005	2006	2007	2008
Commercial bank	2	3	5	10	13	17	18	20	23
Development bank	2	2	2	3	7	26	28	38	58
Finance companies	-			21	45	60	70	74	79
Micro-credit development bank	-			4	7	11	11	12	12
Saving and credit cooperatives	-			6	19	19	19	17	16
NGOs(financial intermediaries)	-			-		47	47	47	47
Total	4	5	7	44	98	181	193	208	235

Source: Nepal Rastra Bank, Katmandu, Nepal

Despite government efforts, access to formal financial services is not increasing to the desired level. Although there is increase in the number of financial institutions, their performance so far is not satisfactory. Non-performing assets of commercial banks is very high. Public as well as private banks are suffering from this problem. Two largest public banks had NPA of as high as 60 percent in 2003. However, it reduced to 27 percent in 2007. Similarly, Nepal Bangladesh Bank, a private sector commercial bank had 40 percent NPA.

About 38 percent Nepalese households have outstanding loan exclusively from informal sector, 16 percent have from both informal and formal sector and 15 percent have from formal sector (that is, a bank, finance company, financial NGO or cooperative, or microfinance or rural regional development bank).

Family and friends are the largest loan providers who often charge high interest. They resort to this because they do not have to provide any physical collateral to them.

According to the survey conducted by World Bank in 2006, financial NGOs and cooperatives play a large role in providing both deposit accounts and loans, and informal borrowing far exceeds formal borrowing. Only 26 percent of Nepalese households have a bank account. Usually commercial banks are located at urban areas and concentrated to the wealthiest and banks' procedures are perceived as being the most cumbersome among financial institutions. That is why people prefer not to take the service of the banks. An estimated 69 percent of foreign remittances come through informal channels—usually family and friends—even among households with a bank account. Just 6 percent of remittance is saved in financial institutions. Other indicators of financial sectors have been presented in the table 15 below.

Table 15: Other Indicators of Financial Sector from 2001 to Mid-January, 2008

Year	2001	2002	2003	2004	2005	2006	2007	2008
Credit/GDP ratio	26.6	26.8	25.3	26.1	27.8	27.4	32.2	37.9
Credit/Total deposit ratio	60	61.1	61.1	59.9	64.9	60.7	68.7	72.6
Investment/ GDP ratio	6.2	8.1	9.2	9.3	10.2	12.7	13	14
Private credit/ total credit ratio	97.3	97.7	97.7	98.2	98.5	97.2	95.5	96.1
Bank branches	430	413	447	423	422	437	552	574
Population per bank branch(000)	53.8	57.3	54.1	58.5	60	59.2	47.9	46.1
Total Assets/GDP ratio	62	78	72	72	80	78	80.11	82.6

Source: Nepal Rastra Bank, Katmandu, Nepal

Many financial institutions are mainly concerned in profit earning urban areas. Out of total 574 commercial bank branches, 41 percent are located in Terai, 23 percent in Kathmandu and 36 percent in Hilly region. Similarly, 52 percent of total financial institutions are located in Kathmandu followed by 18 percent, 17 percent, 6.5 percent and 4.6 percent in western, eastern, mid-western and far-western region respectively. Furthermore, inhabitants per bank branch by region were like this in 2005: Eastern region- 70,954, Central region- 49,017, Western region- 57,444, Mid-Western region-110,714, Far-Western region- 100,654 respectively.

(h) Capital Market

Securities market play pivotal role in mobilizing savings and channeling it to the productive activities. The security market of Nepal so far is underdeveloped, although its development dates back to 1936 when Biratnagar Jute Mill Ltd floated public shares. Only after 40 years, security exchange centre was established in 1976. It took the job of brokering, underwriting, managing public issues, market making for government bonds and other financial services in initial years as there were no market intermediaries at the moment. There was lack of effective secondary market to ensure liquidity to the securities. To make security exchange centre compatible with liberalized economy, it was divided into two parts- security board and Nepal stock exchange limited. Security board Nepal is the apex regulator of securities in Nepal. It devises policies and programs, provides license to operate stock exchange business and stock broker. It supervises and monitors stock exchange operation and securities personnel.

Moreover, it registers securities and approves the public issues. It introduced security Board Regulations 2007, Securities Market Operation Regulation 2007, Securities Dealers (Broker, Trader and market-maker) Regulation 2007 and Merchant banker Regulation 2008 for the implementation of the legal rights given by the securities Act 2006 to develop capital Market, regulate and inspect activities in the market that relate to the benefit of the investors. Security Board is developing securities data management system. Nepal stock exchange limited imparts free marketability and liquidity to the government and corporate securities through transactions in its trading floor by market intermediaries such as brokers and market makers. The trend of primary market of Nepal is presented in table 16 below.

Table 16: Primary Market Trend

(Rs in million)

	Fiscal Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
1	Capital Mobilization	1579.9	696.6	1090.4	1672.3	2443.3	2295.5
	a. ordinary share	319.5	394.3	657.5	377.5	579.8	380.2
	b. Right Share	621.9	162.2	70	949.3	1013.5	1265.3
	c. Preference Share	140	-	-	-	-	400
	d. Debentures	360	-	300	300	850	250
	e. Mutual Funds	-	100	-	-	-	-
	f. Citizen Unit Plan	138.5	40.1	62.9	45.5	-	-
2	Number of Companies	12	18	14	14	29	34

Source: Economic Survey 2007/08, Ministry of finance, Government of Nepal

Number of companies mobilizing capital from primary market increased and the main tools of mobilizing capital were ordinary share and right share. The portion of preference share and debentures was very low. Mutual funds and citizen unit plan had also mobilized capital in initial years. The amount of primary issues increased gradually during this period. However, it sharply decreased in year 2002/03.

Table 17: Trend of Secondary Market

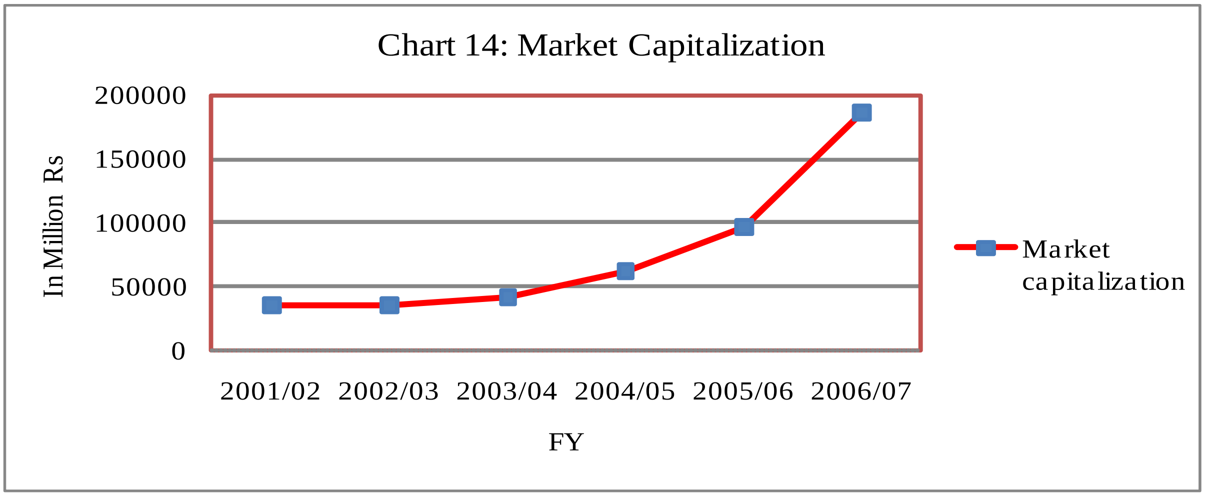
(Rs in million)

Fiscal Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Share transaction value	1540.6	575.8	2144.3	4507.7	3451.4	8360.1
No of share transaction (in 000)	6005	2428	6468	18434	12222	18147
Number of transactions	42028	69163	85533	106246	97374	120510
Market capitalization(MC)	34703.8	35240.4	41424.8	61365.9	96813.7	186301.3
Transaction as % of MC	4.44	1.63	5.18	7.34	3.56	4.48
MC as percentage of GDP	7.5	7.2	7.7	10.4	14.8	20.6
Paid-up value of listed com.	9685	12560	13404.9	16771.9	20008.6	21798.8
Number of listed companies	96	108	114	125	135	135
Companies with share trans.	69	81	92	102	110	116
NEPSE Index (points)	227.5	204.86	222.04	286.67	386.86	683.95

Source: Economic Survey 2007/08, Ministry of finance, Government of Nepal

Table 17 shows the development trend of secondary capital market from 2001/02 to 2006/07. The year 2002/03 was not good for the development of secondary market. Share transaction value, number of share transaction market capitalization and GDP ratio all decreased during the year. This resulted in decrease in the NEPSE index. The reason behind this was the political instability. The elected government was dismissed and the governments were changed frequently in this period. The number of listed companies increased from 96 in 2001/02 to 135 in 2006/07. Similarly, companies with share transaction also increased during this period. Share transaction value increased from Rs 1540 million in 2001/02 to Rs 8360 million in 2006/07, paid up value of listed companies increased from Rs 9685 million in 2001/02 to Rs 21798 million in 2006/07. Market capitalization and index also increased during this period. The trend of market capitalization and NEPSE index is presented in figure 14 and 15 below.

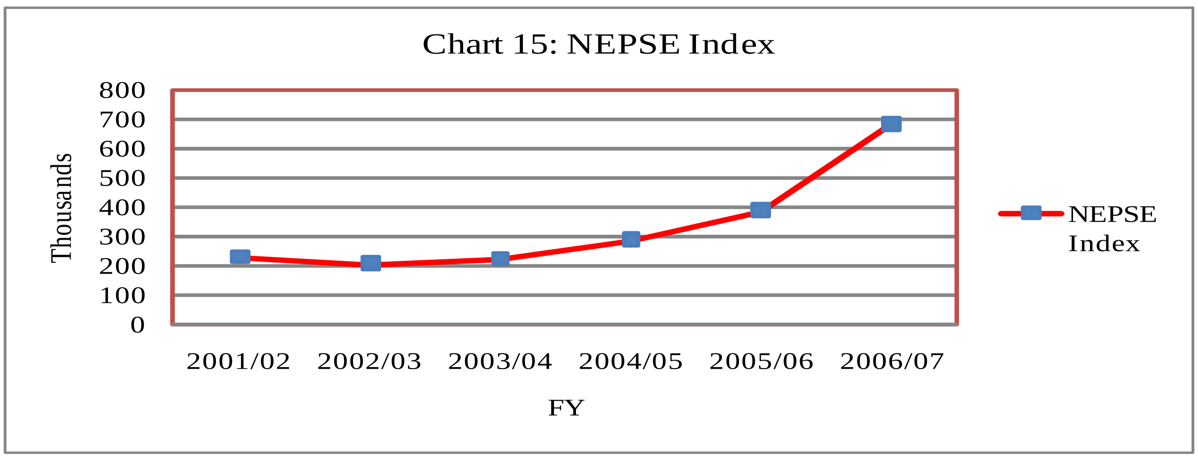
Figure 14: Market Capitalization



Source: Economic survey 2007/08, Ministry of Finance, Government of Nepal

The figure 14 shows that market capitalization continuously increased from 2001/02 to 2006/07. It increased slowly up to year 2004/05, since then it increased sharply. Market capitalization increased from Rs 96813 million in 2005/06 to Rs 186301 million in 2006/07, nearly two times than previous years.

Figure 15: NEPSE Index



Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

The trend of NEPSE index is shown in the above figure 15. The trend is very similar with market capitalization. It increased slowly up to year 2004/05, since then it increased sharply. It increased sharply in the following year and increased very sharply in 2006/07. The NEPSE index nearly doubled from 386 point in 2005/06 to 683 point in 2006/07.

(i) Money Supply

Narrow money (M1), a component of broad money, in the first eight months of FY 2007/08 expanded by 11.3 percent compared to 5.7 percent growth in the same period last year. Time deposit, another component of M2 increased by 14.4 percent in the review period compared to 14.1 percent in the previous year. Currency in circulation increased by 13.9 percent compared to 6.3 percent rise last year. This is mainly due to the expenses on conflict management and large remittance inflows. Many factors affect the money supply. One cause of higher monetary growth is the expansion of the net foreign assets. Net foreign assets (adjusting foreign exchange valuation gain/loss) increased by 10.3 percent in the first eight months of fiscal year 2007/08 compared to the rise of 8.8 percent in the same period in the year 2006/07.

This expansion in foreign assets is caused by high increase in inward remittances and foreign assistance in the eighth month of the review period. Another factor, domestic credit increased by 15.2 percent in the first eight months of the year 2007/08. It had increased by 13.1 percent in the same period last year. Growth rate of money supply is presented in the table 18 and figure 16 below.

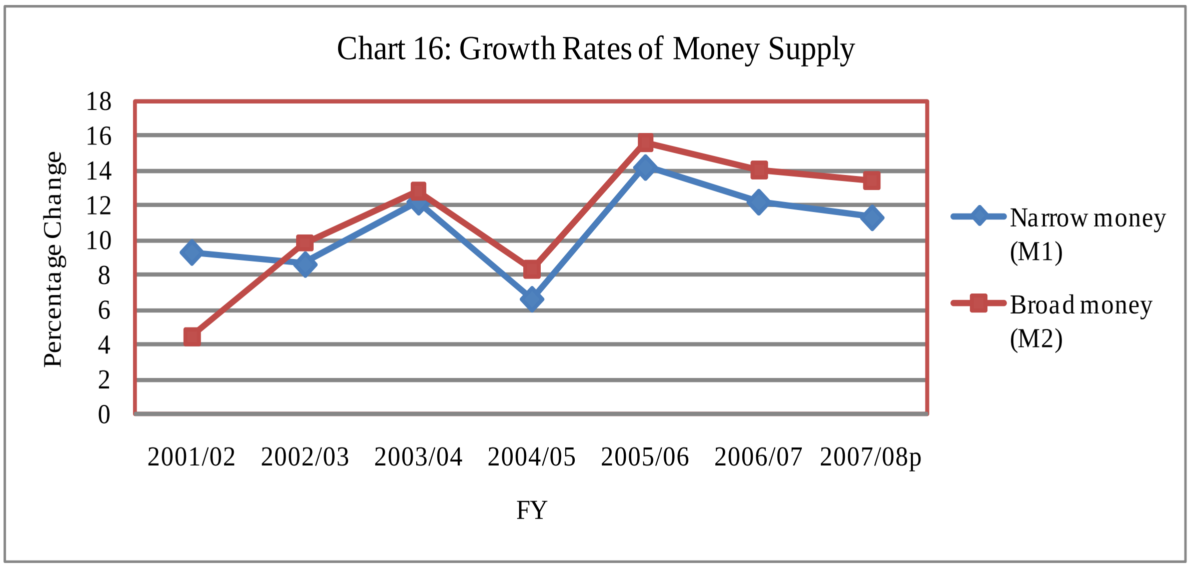
Table 18: Growth Rate of Monetary Aggregates

Fiscal Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Narrow money	9.3	8.6	12.2	6.6	14.2	12.2	11.3
Broad money	4.4	9.8	12.8	8.3	15.6	14.0	13.4

Source: Economic Survey 2007/08, Ministry of finance, Government of Nepal

Table 18 shows that money supply fluctuated over time. The growth of money supply was the highest in 2005/06. In this year, narrow money and broad money grew at the rate of 14.2 and 15.6 percent respectively. Money supply growth was the lowest in 2004/05. Narrow and broad money grew at the rate of 6.6 and 8.3 respectively in this year.

Figure 16: Growth Rates of Money Supply



Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

The figure 16 further illustrates reveals that the difference between the growth rate of narrow money and broad money has slightly increased since 2002/03. The figure also reveals that the narrow money growth was higher than broad money growth in 2001/02.

(j) Employment

Population census 2001 estimated 10.4 million economically active populations in the labor market. The tenth plan mentioned that economically active population at the end of the plan period would number 11.58 million. The plan estimated to create 1.53 million additional jobs keeping fully unemployed population at 4.1 percent and semi-employed population at 22.3 percent. As poverty reduction was the primary objective of the tenth plan (2002/03- 2006/07). It was supposed to achieve through increasing employment and hence various policies were enforced to increase employment. Policies taken to enhance employment opportunities were expanding the economic and social development activities, promoting labor-intensive businesses to enhance access of the poor to employment opportunities, conducting income-generating and employment targeted programs for the backward classes and special regions.

The decade-long conflict in the country negatively affected industries and factories. It forced several industries to completely shut down or partially close. Operating industries too were unable to operate to their optimal capacity. All these increased the unemployment in the country. On the other hand, the campaign of small and efficient government, new opportunities for employment could not be created, which, despite the effort of tenth plan to increase employment, further increased the unemployment. According the Nepal Living Standard Survey 2003/04, among the population of the age of 15 years or above, 2.9 percent were unemployed, 74.3 percent were employed and, remaining 22.8 percent were economically inactive. Foreign employment now is an alternative source of employment for Nepalese.

The number of Nepalese going abroad for foreign employment has been increasing every year. The number was 35543 in 1999/00 and increased to 204533 in 2006/07. The table below shows the trend of foreign employment. The data in table is official data. It is supposed the actual number is more than this because people use informal channels for foreign employment. Traditionally, India is the single largest source of foreign employment for Nepal, but it is not included here. The total number of people went for foreign employment up to year 2007/08 is presented in the follow table 19.

Table 19: Country wise Number of Foreign Employment of Nepalese Workers

S.N.	Country	Total up to FY 2005/06	2006/07	First 9 months of 2007/08	Grand Total
1	Malaysia	304667	74029	33485	412181
2	Qatar	206385	59709	56850	322944
3	Saudi Arabia	151190	39279	26329	216798
4	UAE	80769	25127	29307	135248
5	Kuwait	9498	2441	1435	13374
6	Bahrain	5383	1200	2428	9011
7	South Korea	5676	765	0	6441
8	Hong Kong	3343	361	149	3853
9	Oman	835	509	1548	2892
10	Other Countries	5846	1068	1151	8065
	Total	773592	204533	152682	1130807

Source: Department of Labor and Employment Promotion, and Economic Survey 2007/08, Nepal

The number of people going abroad for foreign employment increased sharply from 773592 in 2005/06 to 1130807 in 2007/08. The number of people going to different countries in table 19 above has been presented in descending order. The most popular destination is Malaysia, followed by Qatar, Saudi Arabia, and UAE and so on. Out of total 1130807 persons, 36.5 percent people went to Malaysia, 28.56 percent to Qatar and 19.17 percent people to Saudi Arabia. Gulf countries are the major destinations of foreign employment. These countries occupy about 85 percent of foreign employment for Nepalese. Table 20 shows number of people going abroad from 1999/00 onwards.

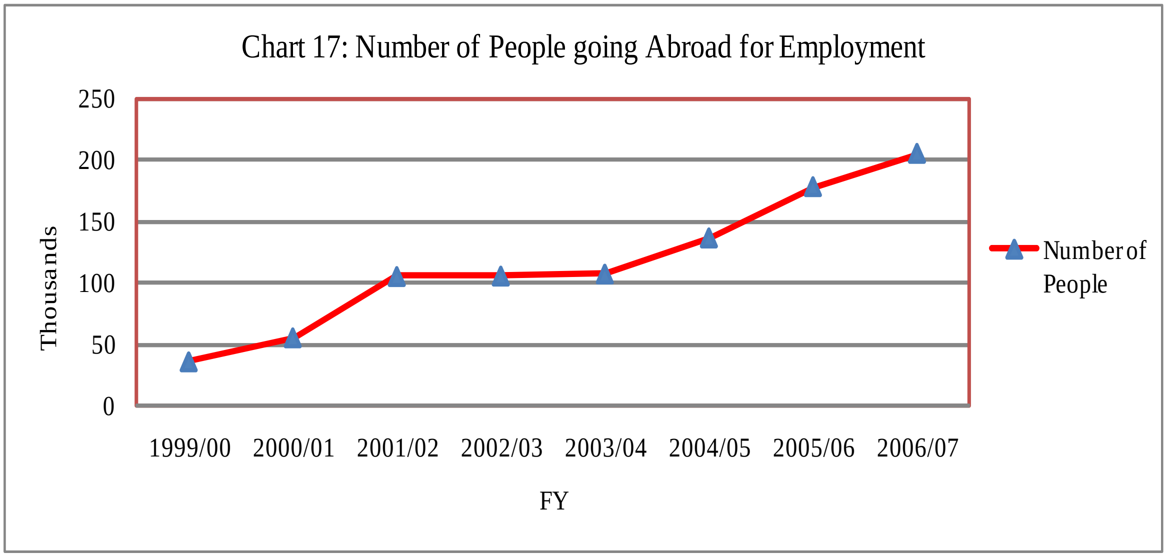
Table 20: Number of People Going for Foreign Employment in Different Years

Fiscal Year	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
Number of People	35543	55025	104739	105055	106660	135992	177506	204553

Source: Department of Labor and Employment Promotion, and Economic survey 2007/08, Nepal

Figure 17 below shows the trend of people going abroad for foreign employment since 1999/00. The number of people for foreign employment doubled from 55025 in 1999/00 to 104739 in 2001/02. For the consecutive three years, the number remained the same. From 2004/05, it increased continuously. In year 2006/07, 204553 people went for foreign employment.

Figure 17: Number of People going Abroad for Employment



Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

II.4 Fiscal Position

(a) Government Expenditure

The ratio of government expenditure to GDP slightly increased from 18.1 percent in 2000/01 to 18.4 percent in 2006/07 and fluctuating in other years. Recurrent and capital expenditure shared 10.6 percent and 5.5 percent respectively. Capital expenditure and GDP ratio decreased to 4.3 percent in 2003/04 from 6.4 percent in 2000/01. This is because of prevalent insurgency. As a result, government was unable to reduce the share of recurrent expenditure. The recurrent expenditure remained more or less same during the period. The share of principal repayment increased significantly from 1.3 percent in 2000/01 to 2.3 percent in 2006/07. Similarly, the ratio of government revenue to GDP increased from 11.1 percent in 2000/01 to 12.1 percent in 2006/07. The rise in revenue GDP ratio reduced the expenditure revenue gap. The gap of 7 percent in 2000/01 was reduced to 5.5 percent in 2004/05. The gap again increased in the following years.

Capital expenditure showed a declining trend during the same period. The share of capital expenditure to total expenditure was 35.5 percent in 2000/01, which further decreased to 25.8 percent in 2003/04. The ratio in following years increased and reached 29.7 percent in 2006/07. The share of principal payment in total expenditure nearly doubled in 2006/07 at 13.2 percent from 7.1 percent in 2000/01, which slightly decreased to 12.6 percent in 2006/07. The share of recurrent expenditure slightly increased in year 2001/02, 2002/03 and 2003/04 to 61, 62 and 62.1 percent. The ratio fluctuated in other years. Income and expenditure summary for the year 2006/07, 2007/08 and 2008/09 is presented in the following table.

Table 21: Income and Expenditure Summary

(Rs in million)

Description	Actual 2006/07	Revised 2007/08	Estimate 2008/09
Revenue	**87,712**	**107,546**	**141,722**
Tax Revenue	71,126	85,025	116,560
Non-Tax Revenue	15,559	19,840	23,905
Principal Refund	1,026	2,681	1,257
Expenditure	**133,604**	**163,313**	**236,051**
Recurrent	77,122	91,409	128,516
Capital	39,729	55,516	91,310
Principal Repayment	16,752	16,386	16,189
Surplus (+) Deficit (-) before foreign grant	-45,892	-55,776	-94,293
Foreign Grant	**15,800**	**22,735**	**47,093**
Bilateral	8,399	10,726	19,129
Multilateral	7,401	12,008	27,963
Deficit after Foreign Grants	-30,091	-33,031	47,200
Sources of Deficit financing			
Foreign Loan	**10,053**	**11,325**	**18,700**
Bilateral	1,048	1,054	4,804
Multilateral	9,004	10,271	13,895
Domestic borrowing	17,892	20,500	25,000
Cash balance surplus(+) Deficit(-)	-2,145	-1,205	-3,500

Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

A total of Rs 133.6 billion was spent as government expenditure in 2006/07, out of which Rs 77.12 billion was recurrent and Rs 39.72 billion was capital expenditure. Government expenditure continued to increase in next year. Government expenditure increased by 22.23 percent in 2007/08 as compared to previous year. Capital expenditure increased by 39.74 percent and recurrent expenditure by 18 percent during the same period. However, principal repayment decreased by 2.18 percent in 2007/08 as compared to previous years. The table further shows that the portion of foreign loan reduced, whereas the share of foreign grants and domestic borrowing increased. The growth rate of government revenue and expenditure has been presented in the following table 22.

Table 22: Growth Rate of Revenue and Expenditure

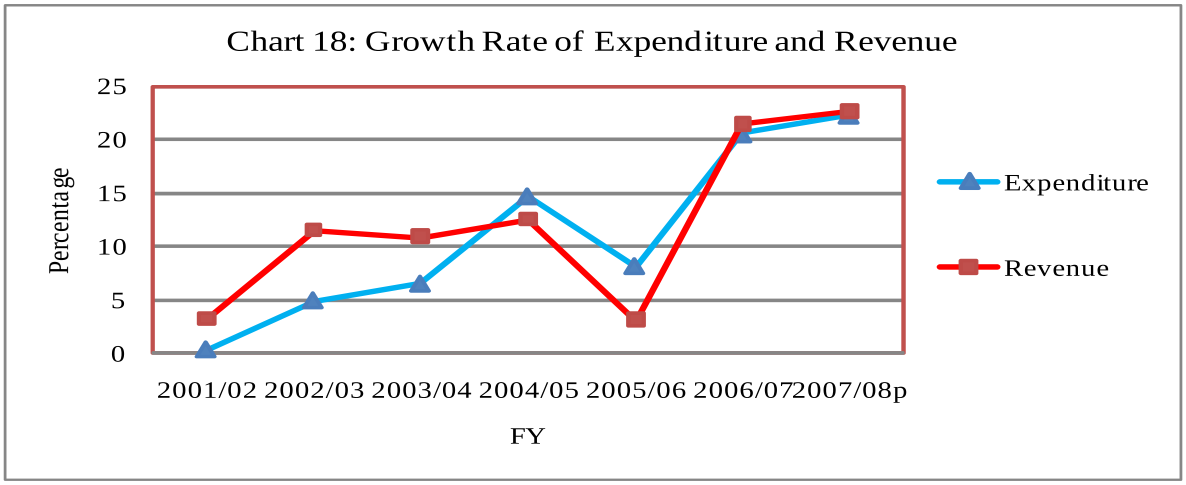
Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08p
Expenditure	0.3	4.91	6.47	14.67	8.12	20.48	22.24
Revenue	3.2	11.47	10.9	12.5	3.08	21.35	22.61

Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal,

The table shows that the growth rate of government expenditure in 2001/02 was nearly zero and so was the growth of revenue in the same year. Expenditure and revenue both increased in next three consecutive years before decreasing in the next year. Growth of revenue decreased sharply in 2005/06. From 2006/07, both the revenue and expenditure growth increased and approached 22.61 and 22.24 percent respectively.

The following figure 18 shows the trend of the growth rate of government revenue and expenditure for a period of seven years from 2001/02 to 2007/08. Up to 2004/05, revenue growth rate was high and since then the trend reversed and continued till 2006/07. The gap between revenue growth rate and expenditure growth rate was the highest in 2002/03. Revenue grew more rapidly than expenditure and the gap was about seven percent in that year. After 2006/07, revenue growth rate was a little bit higher than expenditure growth rate again. This growth of revenue is propelled by the political stability and improving law and order in the country and it is beneficial for the economy.

Figure 18: Growth Rate of Expenditure and Revenue



Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

Internal revenue mobilization must be the main source of government expenditures. A minimal gap between the expenditures and revenue helps to maintain a fiscal balance. However, revenue growth is not sufficient enough to support expenditures growth. There was significant increase in the revenue surplus in 2002/03, 2003/04, 2004/05, 2006/07 and 2007/08 to 13.0, 20.0, 20.6, 18.7 and 29 percent respectively. Revenue surplus is important because it can be used for capital expenditure and principal repayment. Nepal always depends on deficit finance for development expenditure. In 2006/07 and 2007/08, 34 percent expenditure was financed by deficit financing.

(b) Deficit Financing

Deficit financing has important role in development expenditure of Nepal. It had contributed on average 85 percent of capital and principal repayment expenditure for a period of eight years. Detail is presented in table 23 below and illustrated in the accompanying figure 19.

Table 23: Capital Expenditure and Principal Repayment, and Source of Financing

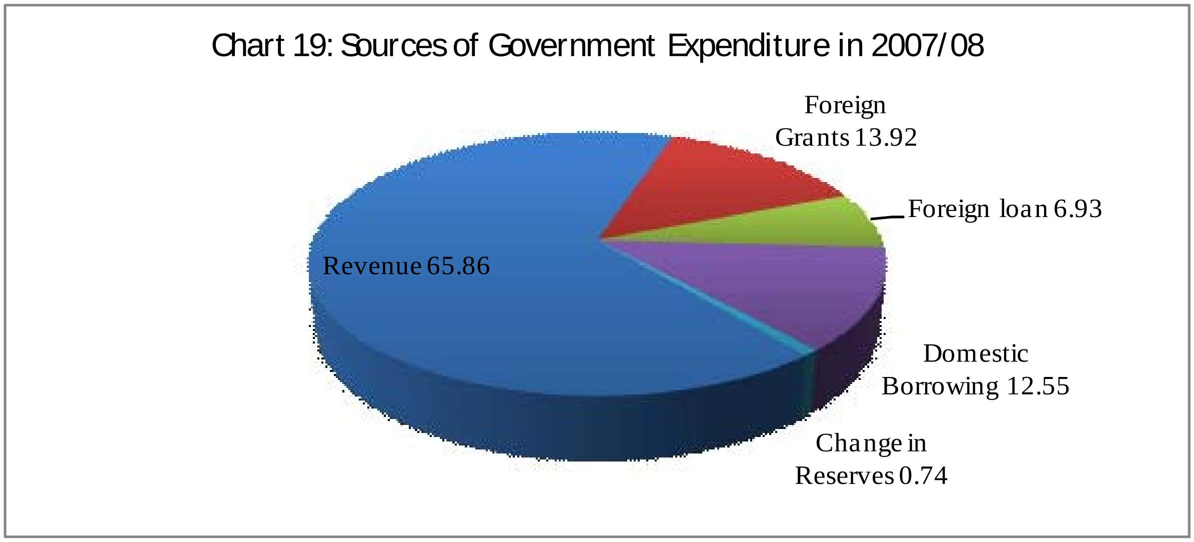
Descriptions	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Capital & Principal Repayment Expenditure (Rs Billion)	34	31.21	31.92	33.89	40.87	43.87	56.48	71.9
a. Capital Expenditure	28.31	24.77	22.36	23.1	27.34	29.6	39.73	55.51
b. Principal Repayment	5.69	6.43	9.56	10.79	13.53	14.26	16.75	16.38
Sources (in Percentage)								
a. Revenue Surplus	9	5.1	13	20	20.6	12	18.7	22.44
b. Foreign Grants	19.9	21.4	35.5	33.3	35.2	31.5	28	31.62
c. Deficit Financing	71.1	73.5	51.4	46.7	44.2	56.5	53.5	45.94
Foreign Loan	-35.4	-24.7	-14.3	-22.5	-22.7	-18.8	-17.8	-15.75
Domestic Borrowing	-20.6	-25.6	-27.8	-16.5	-21.9	-26.9	-31.7	-28.51
Change in Reserves	-15.1	-23.2	-9.4	-7.7	(-0.4)	-10.8	-3.8	-1.68

Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

Revenue surplus to finance capital and principal repayment expenditure is very low, however, in recent years the percentage share of revenue surplus has increased. It increased from 9 percent in 2001/02 to 22.44 percent in 2007/08. This is a good indication for maintaining the fiscal balance.

Similarly, the percentage share of foreign grants in capital expenditure has also increased from 19.9 percent in 2001/02 to 35.2 percent in 2004/05, though it reduced slightly in following years. On the other hand, the percentage share of foreign loan in capital expenditure decreased sharply during this period and reached 15 percent in 2007/08 from 35 percent in 2001/02. The decrease in foreign loan has been compensated by slightly increasing the percentage share of internal borrowing during the same period. It is good to finance deficit with internal borrowing, but it is limited by low level of domestic saving. Even if the internal borrowing increased, it has not distorted the economy so far. Fiscal authorities are aware about its impact in the private sector credit.

Figure 19: Sources of Government Expenditure in 2007/08



Source: Economic survey 2007/08, Ministry of Finance, Government of Nepal

The figure 19 shows the sources of finance of the government of Nepal in year 2007/08. Of the total expenditure, 66 percent was financed from internal revenue, 14 percent from foreign grants. Rest of the 20 percent deficit was financed from foreign loan 7 percent, domestic borrowing 12 percent and change in reserves 1 percent respectively.

Although Nepal has fiscal deficit, it is within the prescribed fiscal limit. The fiscal deficit and sources of financing in terms of Gross Domestic Product have been presented in the table 24 below.

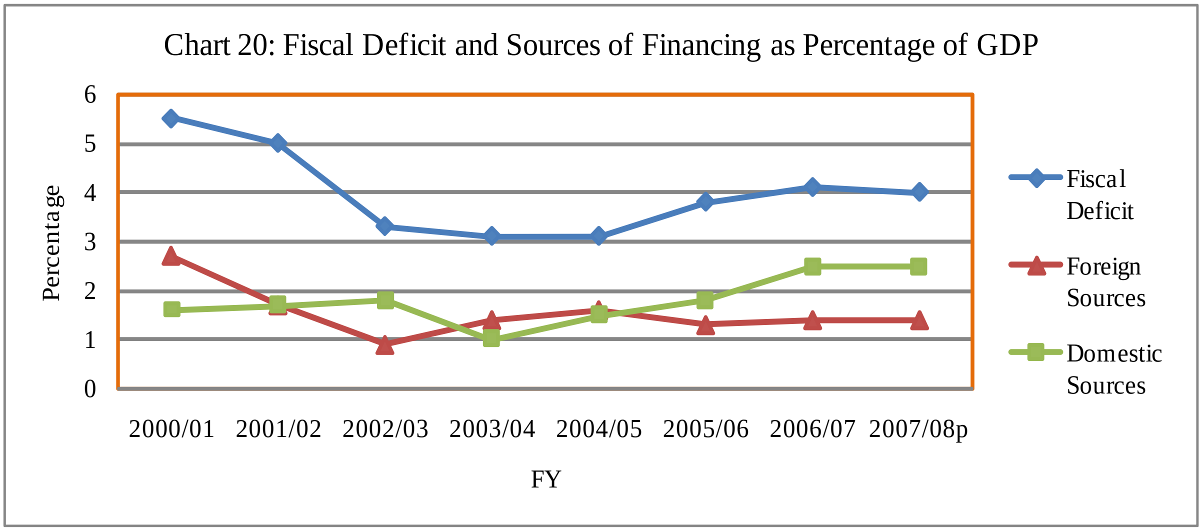
Table 24: Fiscal Deficit and Sources of Financing as Percentage of GDP

Fiscal Year	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Fiscal Deficit	5.5	5	3.3	3.1	3.1	3.8	4.1	4
Foreign	2.7	1.7	0.9	1.4	1.6	1.3	1.4	1.4
Domestic	1.6	1.7	1.8	1	1.5	1.8	2.5	2.5

Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

From table 24, it can be seen that fiscal deficit was slightly higher than five percent of GDP in year 2001/02, but sharply decreased to 3.1 percent in 2004/05. It increased slightly after that period but was still less than five percent of GDP. This is due to increased demand for rehabilitation and reconstruction after the decade-long internal conflict. Foreign loan also decreased from 2.7 percent of GDP in 2001/02 to 1.4 percent in 2007/08. However, domestic borrowing slightly increased from 1.6 percent in 2001/02 to 2.5 percent in 2007/08. The figure 20 also illustrates this.

Figure 20: Fiscal Deficit and Sources of Financing as Percentage of GDP



Source: Economic survey 2007/08, Ministry of Finance, Government of Nepal

The figure 20 shows the trend of fiscal deficit and sources of deficit financing as a percentage of GDP. The deficit as percentage of GDP decreased from 2001/02 to 2005/06 and then slightly increased. Foreign loan fluctuated till 2004/05, since then it decreased and more or less remained constant in following years. Internal borrowing decreased in 2004/05 before continued increase in later years.

(c) Public Borrowing

Nepal collects domestic loan from treasury bills, development bonds, national saving certificates, citizen saving certificates and special bonds. Among these, Treasury bill is the main source. Its share increased from 45 percent in 2001 to 71 percent in 2007. The share of development bonds and national saving certificates has reversed from 9 percent and 20 percent respectively in 2001 to 18 percent and 14 percent in 2007 respectively. Outstanding internal loan increased from Rs 60043 million in 2001 to Rs 103775 million in 2007. It increased by 9.6 percent as compared to the previous year 2006. The structure and ownership pattern of domestic borrowing instruments is presented in table 25 below.

Table 25: Structure and Ownership pattern of Government Bonds and Treasury Bills

(Rs in million)

Year	2001	2002	2003	2004	2005	2006	2007
Treasury Bills	27610.8	41106.5	48860.7	49429.6	51383.1	62970.3	74445.3
Development Bonds	5962.2	11090.7	16059.2	17549.2	19999.2	17959.2	19177
National Saving Certificate	12476.4	11536.1	9629.8	9029.8	6576.7	3876.8	1516.9
Citizen Saving Certificate	0	628.1	931.1	1178.9	1428.9	1678.9	1391
Special Bonds	13994.3	9259.3	9164.5	8946.2	8176.3	8225.6	7225.7
Total	60043.7	73620.7	84645.3	86133.7	87564.2	94710.8	103755.9
Ownership pattern							
Nepal Rastra Bank	17399	24122	23685	19138	17445	15805	20101
Commercial Banks	25392	29361	39469	53796	48550	58861	65836
Others	17251	20137	21490	23198	21567	20044	17837

Source: Economic Survey 2007/08, Government of Nepal, Ministry of Finance

On analyzing domestic borrowing by instruments from table 25, 71.7 percent was Treasury Bills, 18.5 percent development bonds, 1.5 percent National Savings Certificate, 1.3 percent Citizen Savings Certificates and 7.0 percent special bonds. Of the total outstanding debt in 2007, Nepal Rastra Bank held Rs 20.10 billion (19.37 percent), commercial banks held Rs 65.84 billion (63.4 percent) and other non-bank institutions and private sector held Rs 17.83 billion (17.8 percent). In the first eight months of FY 2007/08, outstanding domestic debt increased by 5.2 percent. The outstanding domestic debt increased to Rs 107.66 billion in 2007/08.

III. Tax Structure: Institutions and the Reality

III.1 Revenue

The ratio of revenue to Gross Domestic Product in Nepal is very low. Government in its three year interim plan (2007/08- 2009/10) has targeted to increase the ratio to 13.6 percent by the end of the plan. For this, the growth rate of revenue is expected to be 16 percent during the plan period. It was 13.1 percent in 2007/08. The ratios have been shown in table 26 below.

Table 26: Revenue and Tax Revenue as Percentage of GDP

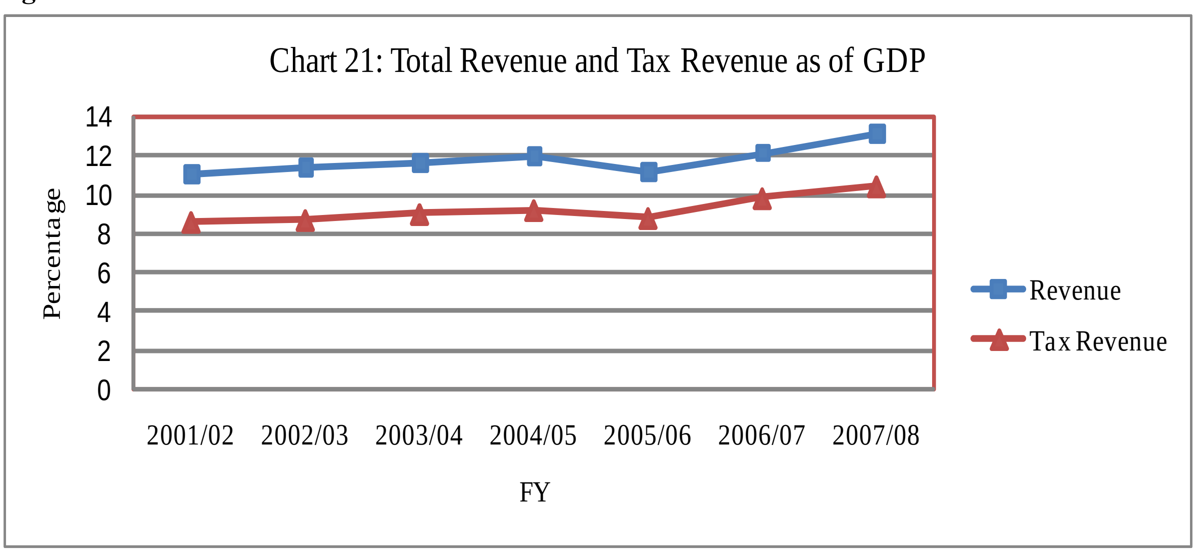
Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Revenue	11	11.4	11.6	11.9	11.1	12.1	13.1
Tax Revenue	8.6	8.7	9	9.2	8.8	9.8	10.4

Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal,

Table 26 shows that the ratio of revenue to GDP continuously increased from 2001/02 through 2004/05 and reached 11.9 percent in 2004/05 from 11 percent in 2001/02, but sharply decreased to 11.1 percent in 2005/06. It increased sharply in 2006/07 and 2007/08 and reached 12.1 percent and 13.1 percent respectively.

The figure 21 below shows that the ratio of tax revenue to GDP slightly increased during a period of seven years, but it decreased in 2005/06 to 8.8 percent and so was the ratio of total revenue to GDP at 11.1 percent. The ratio sharply increased after year 2005/06. It continued to increase by one percentage point of GDP every year after that period.

Figure 21: Total Revenue and Tax Revenue as of GDP



Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

III.2 Tax Revenue and Non-Tax Revenue

Government revenue in Nepal is divided into two parts- tax revenue and non-tax revenue. Tax is the main source of government revenue in Nepal. Government collects about 80 percent of revenue from tax. The composition of tax revenue and non-tax revenue has been presented in the table 27 below.

Table 27: Tax Revenue and Non-Tax Revenue

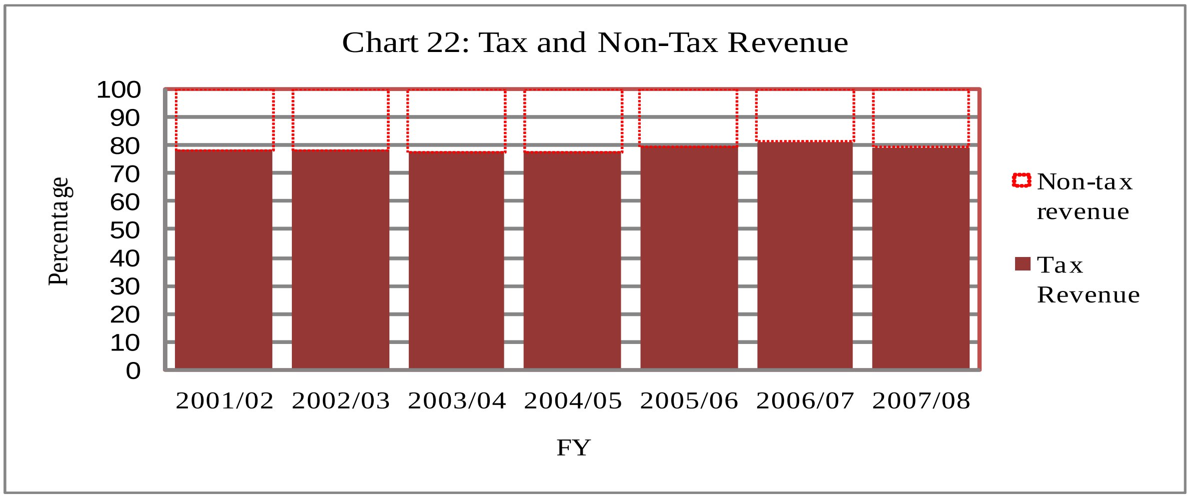
(Rs in million)

Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Revenue	50445	54690	62231	70122	72281	87711	107546
Tax Revenue	39330	42587	48173	54104	57430	71126	85025
Non-Tax Revenue	11115	13642	14148	16018	14851	16585	22521
Tax Revenue %	78	77.9	77.4	77.2	79.4	81	79
Non-Tax revenue %	22	22.1	22.6	22.8	20.6	19	21

Source: Economic Survey 2007/08, ministry of Finance, Government of Nepal

The tax revenue contributed to Rs 39330 million and non-tax revenue contributed to Rs 11115 million in 2001/02 and both the components of revenue increased continuously over time and reached Rs 85025 million and Rs 22521 million in 2007/08. The percentage share of tax and non-tax revenue is presented in figure 22.

Figure 22: Tax and Non-Tax Revenue



Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

The figure 22 shows the share of tax revenue in total revenue slightly fluctuated from 2001/02 to 2007/08. It decreased from 78 percent in 2001/02 to 77.2 percent in 2004/05 and then increased next year before decreasing in 2007/08. The taxes imposed in Nepal are value added tax, income tax, custom duty and excise duty. Similarly, non-tax revenue began to decrease from 2004/05 after slight increase for three years but again increased in 2007/08. This is mainly due to the sale of shares of Nepal Telecom amounting to Rs 15 billion through secondary markets.

III.3 Direct Tax and Indirect Tax

Taxation in Nepal can be further divided into direct tax and indirect tax. Direct tax consists of income tax. Value added Tax, custom duty and excise duty are the components of indirect tax. The structure of direct and indirect tax has been presented in Table 28 and figure 23 below.

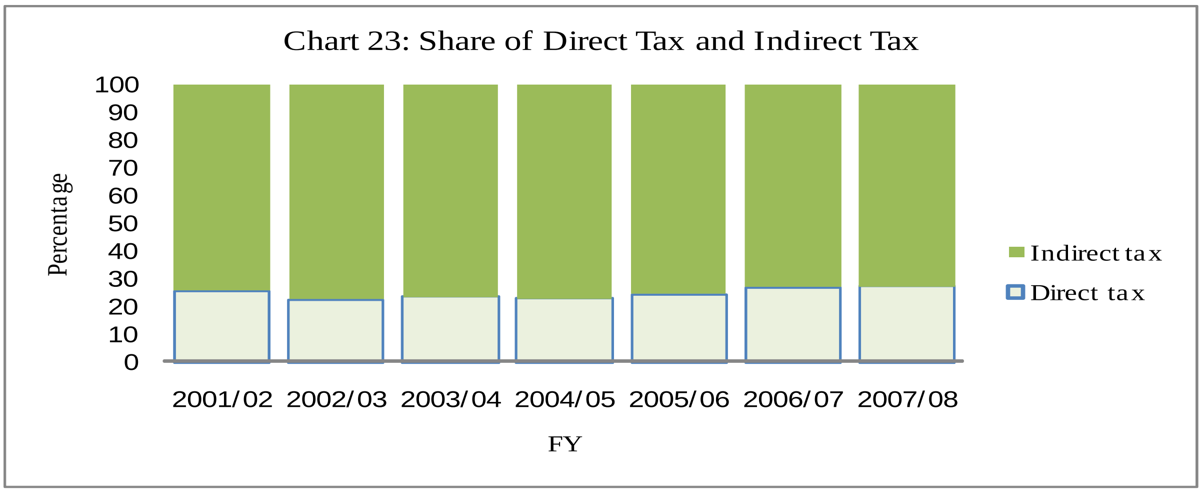
Table 28: Composition of Direct and Indirect Tax

Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Indirect Tax	29292	33040	36961	41839	43465	52146	62019
Direct Tax	10037	9546	11211	12265	13961	18980	23006
Revenue	39329	42586	48172	54104	57426	71126	85025
Direct Tax %	25.5	22.4	23.3	22.7	24.3	26.7	27
Indirect Tax %	74.5	77.6	76.7	77.3	75.7	73.3	73

Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

Nepalese taxation is heavily relies on indirect taxes such as Value Added Tax, Custom Duty, excise duty etc. In recent years, the share of direct taxes has increased but it is not significant. Direct tax and indirect tax contributed to Rs 10037 and Rs 29292 million in 2001/02. It increased to Rs 23006 million and Rs 62019 million in 2007/08. The percentage contribution of direct and indirect tax has been presented in the following figure 23.

Figure 23: Share of Direct Tax and Indirect Tax



Source: Economic Survey 2007/08, Ministry of Finance, government of Nepal

The figure 23 above shows that around more than 75 percent government tax revenue came from indirect taxes e.g. VAT, custom and excise duty for a period of seven years. There was some fluctuation but no significant change during the period. This reflects the level of economic development of Nepal. As majority of people are poor, more than 30 percent of population lives below the poverty line and corporate sector is not well-developed, there is less scope for income tax. Owing to this, government has to rely on indirect taxes.

III.4 Tax Revenue

Tax revenue contributed around 81 percent in 2006/07 and 79 percent in 2007/08. The share of tax revenue total national revenue has not been increased for a long time. It remained more or less same though there are some fluctuations in some years. The ratios of different components of tax revenue to GDP have been presented in the table 29 below.

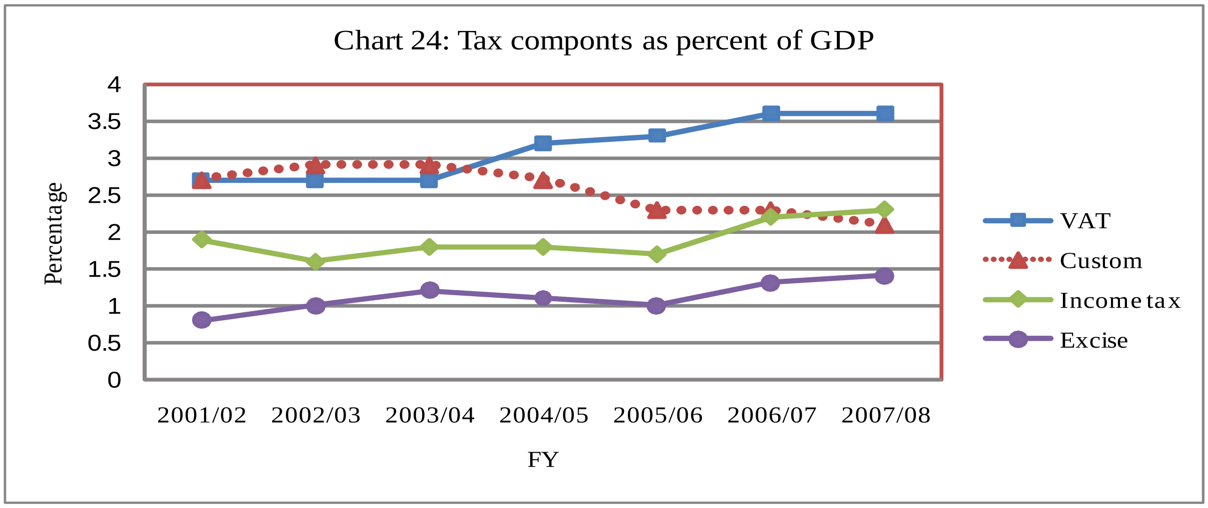
Table 29: Revenue Components as Percentage of GDP

Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
VAT	2.7	2.7	2.7	3.2	3.3	3.6	3.6
Custom	2.7	2.9	2.9	2.7	2.3	2.3	2.1
Income tax	1.9	1.6	1.8	1.8	1.7	2.2	2.3
Excise Tax	0.8	1.0	1.2	1.1	1.0	1.3	1.4

Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

Income tax drastically decreased to 1.6 percent in the year 2002/03 from 1.9 percent in 2001/02. It increased after 2005/06, still not at satisfactory level. Similarly, custom duty decreased from 2.7 percent in 2001/02 to 2.1 percent in 2007/08. Share of VAT and excise revenue increased over time. The percentage share of the components has been graphically presented in the figure 24 below.

Figure 24: Tax Comports as Percent of GDP



Source: Economic Survey 2007/2008, Ministry of Finance, Government of Nepal

The year 2003/04 was the turning point for VAT revenue and custom revenue. In this year the share of VAT continuously increased and vice versa for custom revenue. Income tax did well in later years and so was the excise revenue. The decrease of income tax in 2002/03 was very sharp. This might be the effect of new Income tax Act 2002 which was enforced at the end of fiscal year 2001/02. The new Act adopted full-fledged self assessment system. Taxpayers who were used to have official assessment might have reduced tax liability by self assessment. Government tried to encourage taxpayers to report the correct amount of tax through taxpayer education and by conducting audit and investigation etc, but it could not affect the business community. Moreover, there were many other reasons too.

The custom revenue decreased because of tariff reduction in line with commitments under WTO, SAFTA and BIMSTEC arrangements and it will further decrease in the future. On the contrary, since 2003/04 Value Added Tax continuously increased. Although custom revenue has continuously decreased from year 2003/04, the increase in revenue was boosted by the increase of its other components. This was partially increased by the increase of VAT rate from 10 to 13 percent in 2004/05 and government had tried to broaden its base so as to offset, to some extent, the loss of revenue from custom duties. The share of custom revenue and the VAT revenue was equal in 2001/02 but since then they have moved in the opposite direction- increase in VAT revenue and decrease in custom revenue. This clearly indicates that VAT is going to be the major source of internal revenue for Nepal in the years to come. Similarly, excise revenue also increased during the period. It has become potential source of offsetting revenue loss from custom tariff reduction.

III.5 Composition of Tax Revenue

The structure of tax revenue has changed in recent years. The major component of revenue in the past, the custom duty, has decreased drastically**.** The structure of tax revenue for a period of seven years has been presented in the table 30 below.

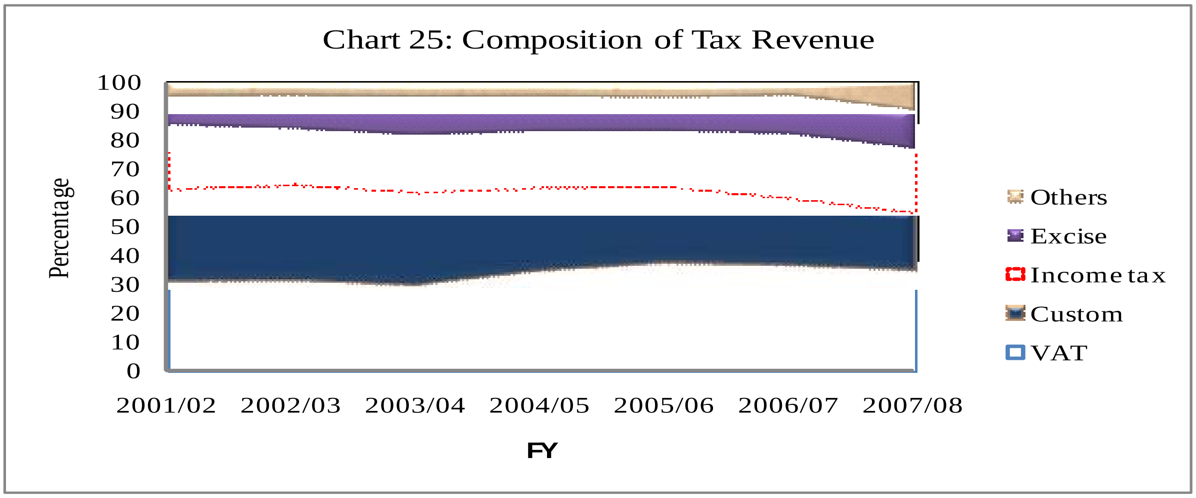
Table 30: Structure of Tax Revenue in Percentage

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
VAT	31.2	31.6	30	34.9	37.6	36.7	35
Custom	32.2	33.4	32.3	29	26.7	23.5	20.1
Income tax	22	19.1	19.7	19.3	19	22.1	22.4
Excise	9.7	11.2	12.9	11.9	11.33	13.1	13.2
others	4.9	4.7	5.1	4.9	5.37	4.6	9.3

Source: Economic Survey 2007/08, Ministry of Finance, Nepal

VAT revenue increased from 31.2 percent in 2001/02 to 37.6 percent in 2005/06 and it was 35 percent of total tax revenue in year 2007/08. Similarly, the share of excise and other taxes increased significantly and reached 13.2 and 9.3 percent in 2007/08 respectively, whereas revenue from income tax remained almost the same during the same period.

Figure 25: Composition of Tax Revenue



Source: Economic survey 2007/08, Ministry of Finance, Government of Nepal

Figure 25 above shows that value added tax has become major source of internal revenue of the government of Nepal, followed by income tax, custom duty and excise duty. The share of VAT, excise and other taxes such as land revenue, transport revenue has increased, whereas that of income tax has remained almost the same for last seven years. The share of custom duty decreased sharply from 32.2 percent in 2001/02 to merely 20 percent in 2007/08.

III.6 Growth Rate of Taxes

The growth rate of different components of tax revenue has been presented in table 31 below for a period of seven years from 2001/02 to 2007/08.

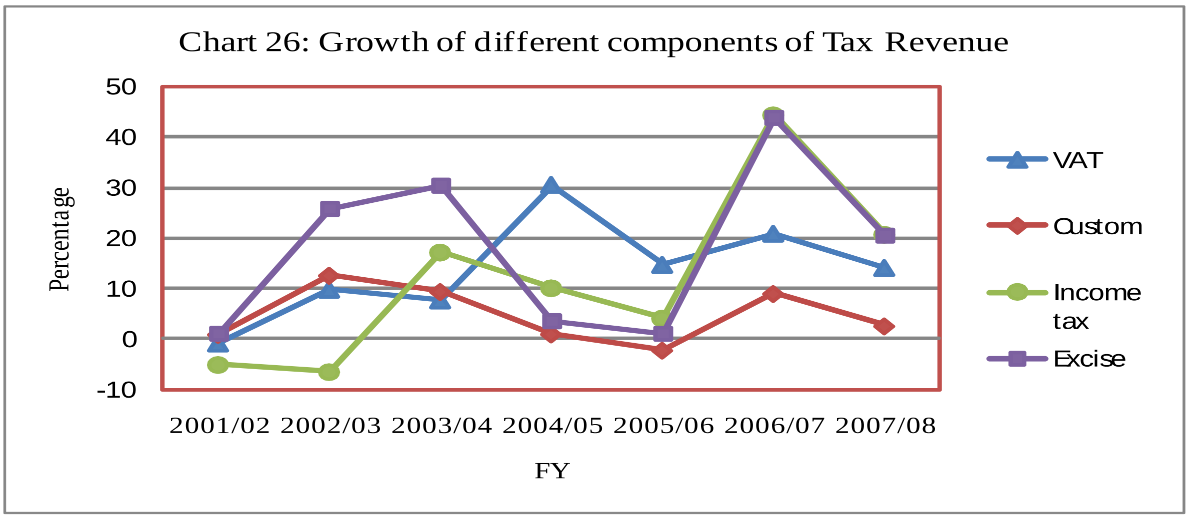
Table 31: Growth Rate of Taxes

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
VAT	-0.9	9.71	7.6	30.4	14.6	20.75	14
Custom	0.84	12.5	9.3	0.9	-2.3	8.9	2.5
Income tax	-5.1	-6.5	16.99	10.02	4.17	44.27	20.65
Excise	0.95	25.7	30.1	3.51	0.96	43.6	20.3

Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

The growth rate of taxes in the year 2001/02 was almost negative. VAT and Income tax had negative growth rate and custom duty and excise had almost zero growth rate. Growth rate of excise duty was very high except the years 2001/02 and 2005/06. The growth rate of custom duty was same for the year 2001/02 and 2004/05. The growth trend of different components has been graphically presented in the figure 26 below.

Figure 26: Growth of Different Components of Tax Revenue



Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal

The figure 26 shows negative growth of income tax in 2001/02. It also illustrates the negative growth of income tax in 2002/03 and that of custom duty in 2005/06. The introduction of self-assessment system, merger of the then Value Added Tax and Income tax department resulted in some transition that adversely affected the revenue growth. Figure 26 shows that income tax increased after 2002/03. Excise revenue sharply increased from 2001/02 to till 2003/04. After 2003/04, the growth rate of every tax except the VAT continually decreased till 2005/06. The growth of custom duty was negative in the same year.

The reason behind the high growth of VAT in 2004/05 was that government increased the VAT rate from 10 to 13 percent in this year. Similarly, the reasons behind the negative growth of custom duty in 2005/06 might be the political instability and the drastic reduction of tariffs in that year. The growth decreased next year. Declining growth rate from 203/04 to 2005/06 might have resulted from internal conflict, political instability, industrial unrest and obstacles in revenue collection and enforcement. All the taxes increased in 2006/07 and income tax and excise revenue increased sharply in the same period. The reasons might be the end of insurgency and increase of tax rates tax base. Reduced tariff of some items in 2005/06 were increased, excise duty was imposed on some new items to offset the revenue loss from reduced tariff and increase of five percent income tax rate for alcoholic beverage and cigarettes industries might be the factor for the high growth rate of taxes. Hence, the trend could not sustain in the next year e.g. 2007/08. As compared to last year's sharp high growth, the growth rate in 2007/08 seems very low, but in reality the growth rate was still very high as high as 20 percent for income tax and excise duty. It is natural to decrease custom revenue because the tariffs were reduced in line with WTO and other multilateral trade commitments.

III.7 Income Tax

The first Parliamentary Government imposed Income Tax in Nepal through business profit and remuneration tax act in 1960. At that time, only business profit and remuneration was subject to tax. 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, 2002 became effective since 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 being implemented and the presumptive taxation and current year taxation system were being strengthened. The Act has reduced drastically the scope of discretionary interpretation of the tax administration ensuring simplicity, uniformity and 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:

(1) Employment income
(2) Investment income and
(3) Business income

(a) Tax Base

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

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

Here person means both natural person and legal entity. They are collectively treated as person in income tax act 2002.

The income tax act distinguishes between resident and non-resident persons. A resident person is one whose normal place of abode is in Nepal, or is present in Nepal for 183 days or more in any period of 365 consecutive days. Income tax in an annual basis is normally imposed only on the income of residents. A non-resident with residential income is subject to income tax in final withholding basis.

A special rule applies to government officials. The income of employees or officials of Government of Nepal is fully taxable in Nepal even if they are posted abroad.

(b) Taxpayer Registration

Taxpayer must register with Inland Revenue office as soon as possible. IRO provides Permanent Account Number, a unique number randomly generated, to each taxpayer who is required to use the number on all his business transactions. Income tax and Value Added Tax both use the same taxpayer identification number. Every taxpayer does not have to go for the registration in VAT at the very first beginning because exemption of some items and threshold.

Table 32: Number of Taxpayers in Income Tax and Value Added Tax by 206/07

Serial number	Fiscal year	Income tax	increase	VAT	increase
1	2001/02	104617		25149	
2	2002/03	139944	34	29872	18
3	2003/04	162167	16	34174	14
4	2004/05	191156	18	39776	16
5	2005/06	225304	18	46831	18
6	2006/07	245550	9	52965	13

Source: Annual Report 2006/07, Inland Revenue Department, MOF, Kathmandu, Nepal

The current threshold level in Nepal is NPR 2 million. The number of taxpayer registered from 2001/02 to 2006/07 has been presented in the table 32 above. The number of taxpayer has increased nearly two times from 2001/02 to 2006/07. The number increased significantly in 2002/03 and increased slightly in 2006/07. Similarly, the number of taxpayer registered in VAT has also increased during the period. However, the number is not sufficient as compared the population of the country. Population is around 26 million in Nepal and the number of taxpayer was hardly one percent of population.

(c) Tax Rate

The tax is calculated by applying the tax rate to the taxable income. Nepal has divided taxpayers into two groups for taxation purpose- individual and corporations with different tax rates. The individual tax has two brackets from 15 percent to 25 percent and for the corporation it is flat rate of 25 percent, though there are some exemptions such as 30 percent for some corporations and less than 25 percent for other corporations. Tax reform through reducing tax rate and broadening the tax base is going on in Nepal for a long time. As a result, tax rate in Nepal is fairly low in South Asia. The tax rates for 2008/09 for individual and corporation have been presented in following tables respectively.

Table 33: Individual Income Tax Rate for 2008/09

Natural Person	Tax Rate
(a) Individual	15 to 25 percent
less than 115,000	no tax
up to 200,000	15 percent
more than 200,000	25 percent
(b) Couple	15 to 25 percent
less than 140,000	No tax
up to 225,000	15 percent
more than 225,000	25 percent
(c) Presumptive tax (turnover of 1500,000 or, income 150,000)	lump sum tax of
Metropolitan and Sub-metropolitan Areas	5,000
Municipal Areas	2,500
other Areas	1,500
(d) Export Income	20 percent
(e) Special industry Income	20 percent
(f) Non- Resident person	25 percent
(g) Technology transfer & management service and Royalty income of foreign investor in special economic zones	12.5 percent
(h) Net gains from the disposal of non-business chargeable assets	10 percent
(i) Income from shipping, air transport or telecommunication	5 percent
(j) Trust of incapacitated resident individual treated as resident individual	15-25 percent

Source: Income Tax Act, 2002, Ministry of Finance, Government of Nepal, Kathmandu

Some additional deductions and exemptions for Individual taxpayers

(1) Any individual or couple having pension income can enjoy additional exemption of 25 percent of the normal exemption limit. Similarly, disabled individual or couple gets additional exemption of 50 percent of normal exemption.
(2) Any individual working in prescribed remote area can deduct prescribed amount as remote area allowance from taxable income (6,000 – 30,000).
(3) Annual insurance premium or 20,000 whichever is less is deductible from taxable income.
(4) 75 percent of foreign allowance of Nepalese civil servants working on diplomatic missions abroad is deductible.
(5) 10 percent discount on total tax liability for women who has only remuneration income.

Table 34: Corporate Income Tax Rate to Domestic and Foreign Investment

Type of industry	Normal Rate	Holiday	Applicable Rate
Industries engaged in Alcoholic beverage, Cigarette Bank and Finance, insurance, petroleum products etc	30 percent	No	100 percent
(a) Special industries & information technology industries*	20 percent		
In Undeveloped Areas		No	70 percent
In Underdeveloped Areas		No	75 percent
In Developed Areas		No	80 percent
Providing 600 employment per year		No	90 percent
(b) Export Industry	20 percent	No	100 percent
(c) Built, own, operate and transfer (BOOT)	20 percent	No	100 percent
(d) Powerhouse construction, production and transfer	20 percent	No	100 percent
(e) Industries in special economic zones	25 percent		
Located in hill and mountains- income tax		10 yrs	50 percent
Located in other areas-income tax		5 yrs	50 percent
Dividend tax	5 percent		
Payment of Dividend – special economic zones		5 yrs	50 percent
Repatriation of Income by foreign employment establishment	5 percent	No	100 percent

* Special industry means industries other than those whose input or raw material is composed of alcohol and Nicotine and involved in the production of such goods. Developed, undeveloped and underdeveloped as for the Industrial Enterprises act 1992.

Source: Income Tax Act, 2002, Ministry of Finance, Government of Nepal

(e) Withholding Tax Rates

Withholding tax has been practiced in Nepal since the implementation of income tax in 1959. Under the withholding system, employers or payee withhold tax on income or payment at source when the remuneration of employee or payment is made. Withholding agent should deposit the tax amount in revenue account within the 15 days after the end of 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 adjustable in nature. The withholding tax rates have been presented in table 35 below.

Table 35: Withholding Tax Rates

Withholding Agent	Payment	Tax Rate
I. Adjustable Withholding		
Employers	Remuneration	15- 25 %
Resident person	Natural resource payment; royalties; service fees etc	15.0%
Resident Bank or financial institution	Interest	15.0%
Resident person	Rent	15.0%
Resident person	Insurance premium	1.5%
Resident person	Payment against VAT invoice	1.5%
Resident person	Service contract	10.0%
Resident person	Other contracts	5.0%
Resident person	Gain from stock	15 %
II. Final Withholding		
Resident company	Dividend	5.0%
Resident banks and financial institutions	Interest paid for non- business purpose	5.0%
Resident person	Rent for lease of land or building	10.0%
Retirement Fund	Retirement Benefit	5.0%
Resident employment company	Commission to non-resident	5.0%
Resident person	payment of Insurance premium	5.0%
Resident person	Insurance premium to non-resident company	1.5%

Source: Income Tax Act 2002, Ministry of Finance, Government of Nepal

(f) Income Tax Returns, Tax Assessment and Payment

Generally, every taxpayer has to file a self-assessed income tax return within the three months of the end of the fiscal year. In case of reasonable explanations, it can be further extended up to next three months. The income year ends in mid July every year in Nepal. However, the persons with no taxable income or income from exclusively from employment in Nepal and have only one employer at a time during the year do not have to file the return. Taxpayers other than those paying presumptive tax have to pay current year taxes in 3 installments –up to 40 percent by December, up to 70 percent by March and finally 100 percent at the year end. At the time of self-assessment, taxpayer has to adjust the installment tax payment. Fluctuation of more than 20 percent between installment payment and self-assessment is liable to interest.

Nepal adopted universal self-assessment system science 2002 and hence, does not use official assessment. However, in some cases if deemed necessary can make jeopardy assessment. Tax offices always make amended assessment on taxpayer's self-assessment whenever necessary such as after audit and investigation etc. Self-assessment has drastically reduced the time spent on assessment of tax officials. They can use this spare time to focus more on revenue risk and fraud areas. Taxpayers are selected for audit on the basis of revenue risk and scrutiny of the books of accounts and supporting documents in detail which helps to increase compliance and reduce the tax evasion and delinquency.

(g) Standard Exemptions, Deductions and Concessions

Several sources of income have been exempted from income tax e.g. agriculture. The income tax Act 2002 has following provisions regarding exemptions.

(1) Amount derived by a person entitled to privilege under a bilateral or multilateral treaty concluded between 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 fund 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 an individual who is not a citizen of Nepal from employment by government of Nepal on terms of tax exemption.
(5) Allowances paid by government of Nepal to widows, elder citizens or disabled individuals.
(6) Amounts derived by way of gift, 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.
(9) 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.
(10) 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, dairy 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.

(h) Set Off, Carry Forward and Carry Back of Losses

Losses are in principle deductible but are treated differently depending on whether they result from conducting business or investment and whether they are of domestic or foreign nature. Separate provisions with regard to loss set off are made in new income tax Act 2002. The loss adjustment provision applicable to business is more liberal than that of investment loss adjustment. Business itself is categorized into different parts and treated separately for the purpose of loss off set .The categories of business for loss off set purpose are: ordinary business, special industry, infrastructure or BOOT projects, non-taxable business, banking and insurance business, foreign based business etc. The different provisions regarding loss recovery are as follows:

(1) **Recovery of Loss from Ordinary Business:** Section 20 of the income tax Act 2002 has made the provision of loss recovery under ordinary business. According to section 20 (6), the loss of ordinary business can be offset from the profit of any business or investment in the same year. If it is not recovered from these sources of income, it can be carried forward to next seven years within the same head. The loss of ordinary business can be recovered from the gain of the disposal of business assets and liabilities also.
(2) **Recovery of Loss from Investment:** Under Section 20 (1) of the act, the loss from investment can be recovered from the income of another investment only. The loss of investment cannot be recovered from any business income. Like, business loss, the loss on investment can be carried forward to next seven years.
(3) **Recovery of Loss from Foreign Source Income:** The loss from foreign source business income can be recovered from the income of foreign source only. Within foreign source income too, loss from investment cannot be recovered from the business income whereas the loss from business based on foreign country can be recovered from the foreign source investment income. However, any unrelieved loss of Nepal source business can be recovered from foreign source income.

(4) **Recovery of Loss from Special Industries:** Section 20 of the Act does not say anything about loss recovery of special industries. It means special industries, as ordinary business, get the period of seven years to carry forward loss. However, the loss recovery provision of special industries is some tougher than that of other business. Section 11(3) of the act says that while computing the income of the person attracting special rate, a separate treatment is needed. The special industries do not get such loss recovery facility as that of ordinary business or investment because of lower taxes rate. They have to recover loss from its own business profit in the year to come.

(5) **Loss Recovery from Banking and Insurance:** As per section 59 (1) and 60 (1) of the income tax act 2002, banking and ordinary insurance business should be taken as a separate unit of taxation and the income and loss should be treated accordingly. These businesses get intra head carry backward facility provided that the loss should be recovered from the risk bearing fund of section 59 (1) if it exists. Then, the left-unrelieved loss is deducted from the last fifth years profit and so on. The income tax act 2002 has taken investment business too, as a separate unit of taxation for loss adjustment purpose and the provision of loss carry forward to next seven years is equally applicable to it also.

(6) **Loss Recovery from Long-Term Investment:** There is different provision of loss recovery for long term contract obtained through international competition. Under section 20 (4) of the act the loss on the competition or otherwise disposed of can be carried forward. If the total loss is not recovered from carry forward process, then Inland Revenue department, in writing, can allow the unrelieved loss to carry back to the preceding year or years. Since the loss carry back period of long-term contract is not stated in the act it depends on the discretion of IRD.

(7) **Loss Recovery from Non-Taxable Business:** According to section 20 (3) of the income tax act 2002, the loss from such businesses as cooperatives based on agriculture etc. can be recovered from its own profit of the next income year or years. Such type of loss cannot be recovered from taxable income heads.

(8) **Loss Recovery from Infrastructure, BOOT Projects and Petroleum business:** The loss from public infrastructure projects which are constructed operated and transferred to government of Nepal or projects related to powerhouse construction, power generation and transmission can be carried forward to next 12 years. Similarly, the loss incurred in relation to petroleum business can be carried forward to next 12 years.

(9) **Loss Recovery from Disposal of Asset:** Income tax act 2002 has divided assets into 5 categories. They are trading stock, depreciable assets, business assets, non-business chargeable assets and other assets. The loss due to sale of trading stock is normal loss, so it is eligible for offset and so is the loss incurred on the sale of depreciable assets provided that the sale value of pool is less than depreciation basis. Section 36 (1) of the act says that the loss from disposal of business assets or liabilities can be recovered from the gain on disposal of other business assets or liabilities of the same year. The net loss on disposal of such assets cannot be recovered from ordinary business income. But, in case of profit, it is included in taxable income. The loss incurred on disposal of non-business chargeable assets can be recovered from gain incurred on disposal of other non-business chargeable assets. The net loss incurred on disposal of non-business chargeable assets cannot be recovered from ordinary business income, though it can be carried forward to next years.

(i) Selection of the Source of Income to Off Set Loss

Section 20 (6) and 36 (4) have entitled the person to select the source of income to deduct an unrelieved loss from more than one business or investment. Taxpayers himself/herself can priorities from which business or investment, the loss or part of loss is to be deducted.

(j) International Taxation

Residents of one country may engage themselves in business and investment in other countries too as many countries in recent years are attracting foreign investment. They can be simultaneously taxed in resident and source country basis two times for the same income leading towards double taxation. It may discourage the foreign investment especially in developing countries. Countries may have foreign tax credit provisions in their domestic tax law that may not be sufficient to avoid double taxation. Similarly, the exchange of information of transactions is very important and useful for tax authorities in respective countries. Nepal is a resource constraint country and needs foreign investment for its socio-economic developments. Keeping this point in views, Nepal has so far conducted double taxation treaty with ten countries. The list is presented in table 36 below.

Table 36: List of Countries Having Double Taxation Avoidance Agreement with Nepal

S.N	Country	Conclusion Date
1	Republic of India	18-Dec-87
2	Kingdom of Norway	13-May-96
3	kingdom of Thailand	2-Feb-98
4	Democratic Socialist Republic of Sri Lanka	6-Jul-99
5	Republic of Mauritius	6-Aug-99
6	Republic of Austria	15-Dec-00
7	Islamic Republic of Pakistan	25-Jan-01
8	People's Republic of China	14-May-01
9	Republic of Korea	5-Oct-01
10	State of Qatar	15-Oct-06

Source: Annual Report 2006/07, Inland Revenue Department, MOF, Kathmandu, Nepal

(k) Income Tax Collection Trend

Income tax is the second largest component of tax revenue. Income tax collection reached Rs 19025 million in 2007/08 from Rs 8656 million in 2001/02. The main source of income tax was the corporate tax. It contributed around 85 percent of total income tax in 2001/02. Its contribution in recent years had decreased sharply from 85 percent in 2001/02 to 68 percent in 2002/03. The trend is more or less same since then. This is natural for developing country like Nepal where income level of people is low. Only one percent of population pays the income tax. The collection amount and the percentage of corporate income tax are presented in table 37.

Table 37: Structure of Income Tax

Fiscal Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Corporate Income	7352	5550	6817	7345	7577	11605	13249
Remuneration Income	836	1253	1391	1676	1771	2007	2430
Investment Income	468	1322	1292	1425	1547	2080	3260
Wind fall gain		7	14	21	8	38	86
Total income tax	8656	8132	9514	10467	10903	15730	19025
Share of corporate income	84.9	68.2	71.7	70.2	69.5	73.8	69.6

Source: Economic Survey 2007/08, Ministry of Finance, Nepal

III.8 Value Added Tax (VAT)

Value Added Tax is a broad-based tax imposed on the value addition to each commodity at all stages from production, distribution and consumption. It is a modern tax system that improves the collection of taxes, increases efficiency and reduces tax evasion. It does not distort the economy. It removes the cascading effects of sales tax and it has self-polishing feature to catch up the loss of revenue in one stage in other stages. It is also regarded as the backbone of income tax system in Nepal as it helps to record the true transactions.

Nepal introduced VAT on 16 November 1997 replacing the then existing Sales Tax, Hotel Tax, Contract Tax, and Entertainment Tax. However, political instability and strong opposition from business community caused some problems in implementation until FY 1998/99. Since the collection of both customs duties and income tax depends, to a great extent, upon the effectiveness of VAT, it is expected to help enhance revenue collection.

(a) Registration, Return and Payment in VAT

Every taxpayer who wants to engage in the business of taxable goods and services has to register before the onset of the business according to Value Added Tax act 1995.The current threshold for VAT registration is NPR 2 million. Taxpayers whose annual turnover is more than Rs 2 million is required to register in VAT compulsorily. Taxpayers who come under this criteria are required to register in VAT within 30 days of their annual transaction reaching or crossing Rs 2 million. However, there are other proxy criteria for registration. Taxpayers doing business of taxable transaction less than the threshold annually do not need to register compulsorily. However, they can register themselves voluntarily for VAT.

Taxpayer registered in VAT is automatically registered for Income tax as well. After registering, each taxpayer gets a Permanent Account Number (PAN) or commonly known as Taxpayer Identification Number, consisting 9 digit numerals. The number of returns and payments is determined by the transaction of last 12 months. Taxpayer has to submit the return and payment within 25 days after the end of tax period. The tax period is three times a year for turnover less than 2 million in the last 12 months, 6 times a year for turnover between 2 million and 10 million in the last 12 months and Hotel and tourism industry, and 12 times a year for turnover of more than 10 million in the last 12 months. The number of taxpayers and the trend of returns have been presented in the following table 38 below.

Table 38: Number of Taxpayers and the Return Status

Year	2000	2001	2002	2003	2004	2005	2006	2007
Taxpayer	17947	21093	25149	29872	34174	39776	46831	52965
Increase Percent	86.13	17.53	19.23	18.78	14.4	16.39	17.73	13.1
Taxpayer filing Returns	17271	19710	21473	23099	25049	28525	33633	36457
Percentage of Returns	96.21	93.28	84.82	82.41	78.57	77.04	78.37	85.42
Percent of Debit Returns	34.9	35.39	32.3	31.06	33.87	33.2	31.06	31.43
Percent of Credit Return	44.97	41.86	41.19	41.36	38.42	36	38.17	37.29
Percent of Zero Return	20.12	22.68	24.25	25.85	27.08	29	30.14	30.29
Percent of Non-filer	3.79	6.72	15.18	17.59	21.43	22.96	21.63	14.58

Source: Annual Report 2006/07, Inland Revenue Department, MOF, Kathmandu, Nepal

The increase in taxpayer registered in VAT has increased three times since 2000. The major concern is the non-filers which have increased six times to a level of 14.58 percent in 2005 as compared to 3.79 percent in 2000. To trace the taxpayer for compliance has become challenging for tax administration. Similarly, the numbers of debit returns have decreased while zero returns have significantly increased. It reached to 30 percent in 2007. If put those together 35 percent taxpayer are not contributing any revenue to the government. To reduce non-filer and zero return is a great challenge for revenue authorities.

(b) Tax Base of VAT

For domestic transactions**,** the taxable value includes all the expenditures related to transportation and distribution which is borne by a supplier in connection with the transactions, and the amount of profit; and all other taxes imposed. But the taxable value does not include the amount of discount, commission or other similar commercial rebate granted on value in supplying goods or services.

For imports**,** customs value includes transportation, insurance, freight, commissions of agents and other persons, plus customs duties, countervailing duties plus any other taxes if levied on imports excluding VAT.

(c) Input Tax Credit system in Nepal

Taxpayer engaged in the transaction of taxable goods and services can deduct tax on purchase. However, this is directly applicable only to the transaction of taxable goods and services. For mixed transaction of taxable and non-taxable goods and services, the credit is based on proportion of taxable sale to the total sale. To calculate input tax credit, the following formula is used.

[Proportion of taxable sales] = [Taxable sales in a tax period] ÷ [Gross sales in a tax period]
[Deductible amount of taxes] = [Amount of taxes on taxable purchases] × [Proportion of taxable sales to total sales]

(d) Refund of VAT

When purchase tax could not be recovered even after 6 months of transaction or exporter exporting more than 50 percent of total sale and the accredited diplomat for the taxable purchase of more than Rs 1500 purchase tax, can get refund. They have to provide sufficient supporting documents. Exporters and diplomats can get refund within 30 days of claim and credit of more than 6 month will get refund within 60 days. VAT does not tax export and investment. Hence, refund of input tax is very important. Government of Nepal refunded Rs 4.29 billion in fiscal year 2007/08 to industries, bilateral and multilateral investment projects and diplomatic missions. Refund procedure is further simplified through the bank guarantee. Exporters can import raw materials on bank guarantee which is released according to the amount of exports of finished goods.

(e) Exemptions

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:

(1) Goods and services of basic needs which include rice, pulses flour, fresh fish, meat, eggs, fruits, flowers, edible oil, piped water, wood fuel etc.
(2) Basic agricultural products are also tax-exempt, for example, paddy, wheat, maize, millet, cereals and vegetables.
(3) 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.
(4) Social welfare services including medicine, medical services, veterinary services and educational services.
(5) Goods made for the use of disabled persons.
(6) Air Transport.
(7) 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.
(8) Personal services are also tax-exempt. These are services provided, for example, by actors and other entertainers, sportsmen, writers, translators and manpower supplies agents.
(9) Exemption from VAT is also extended to the purchase and renting of land and buildings
(10) Financial and insurance services.
(11) Postage and revenue stamps, bank notes, cheque books.

(f) VAT Collection Trend

VAT is the major source of government revenue in Nepal. It is equally imposed on imports and domestic transaction of taxable goods and services. The contribution share of domestic and imports from 2001/02 to 2007/08 has been presented in the table 39 and figure 27 below.

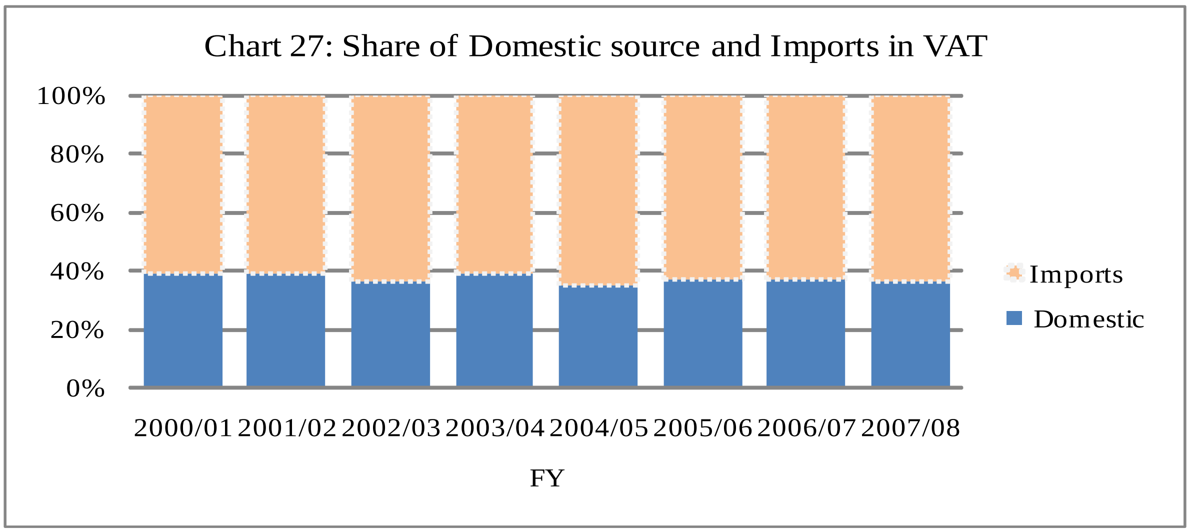
Table 39: Percentage Share of VAT from Domestic Transactions and Imports

Particular	Fiscal year							
	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Domestic transactions	39	39	36	39	35	37	37	36
Imports	61	61	64	61	65	63	63	64

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

Table 39 above shows that more than 60 percent of VAT revenue came from imports. The percentage contribution of domestic transaction in VAT was 39 in 2001/02 which increased up to 39 percent in 2003/04. The trend decreased in the next year to 35 percent. This remained almost stable at 37 in the last two years. Contribution of domestic transactions decreased in the year 2007/08 to 36 percent from 37 percent in previous year. More than 60 percent of Value Added Tax came from import of goods and services. The figure 27 below and the table 39 above show that the share of import was 61, 64 and 65 percent in 2001/02, 2002/03 and 2004/05 respectively. The highest contribution of import in VAT revenue was 65 percent in 204/05. This percent decreased in latter two years and slightly increased in 2007/08.

Figure 27: Share of Domestic Source and Imports in VAT



Source: Economic Survey 2007/08, Ministry of Finance, Government of Nepal, Kathmandu

III.9 Excise

In the past, excise duty was a major source 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. The trend changed slowly in late 1990s. The items imposed excise were nearly 100 in 1990/91 which reduced to only 7 items in 2000/01. Excise duty was primarily imposed on the goods harmful to human health, environmental pollutants and luxury goods to discourage their consumption rather collect revenue. Excise duty is imposed on the consumption of selected goods such as alcoholic beverages and tobacco products. Once, alcohol and tobacco had become the synonyms for excise duty.

Excise duty was the most neglected taxation in Nepalese tax authorities a few years ago. Nepal's accession to WTO and BIMSTEC in 2004, implementation of SAFTA from 2006 compelled to reduce import tariffs which eroded the tax base. To offset revenue loss, excise duty was imposed on some additional goods in 2004/05 and since then it got importance in revenue of the government. As a result, it contributed around 14 percent of tax revenue in 20007/08 from 9 percent in 2001/02. License is required to engage in manufacturing, importing, selling and storing of excisable goods. Likewise, the excise act 2002 prohibits importing excisable services without having license. The number of HS heads/ sub-heads imposed excise duty in different years have been presented in the following table.

Table 40: Number of HS Heads/ Sub Heads Imposed Excise Duty

S.N.	Year	Number	S.N.	Year	Number
1	1961/62	5	5	2000/01	7
2	1983/84	41	6	2004/05	28
3	1990/91	100	7	2007/08	46
4	1994/95	16	8	2008/09	50

Source: Annual Report 2006/07 and Economic Act 2008, Inland Revenue Department, MOF, Nepal

Table 40 shows that now excise duty is not only imposed for social regulation and environmental protection but also to collect government revenue. Excise commodities are subject to physical control and supervision in all stages of production, distribution and selling. Self-removal system is being implemented for many items in recent days to reduce the burden on tax administration and taxpayers. However, alcoholic beverage and tobacco are still on physical control and supervision because more than 80 percent excise revenue comes from these items and there are some negative externalities to the society. There are some problems in the administration of excise duty. The preset ratio of excise revenue to GDP is only 1.4 percent. Government has targeted to increase it up to two percent of GDP. A study by Puskar Bajracharya showed that about 40 percent of excise revenue was evaded. Illegal production of liquor and the duty free facility is the main challenge for excise revenue. Attempts are being done to control the illegal production of liquor, and duty free liquor in the market, but it is not effective so far.

III.10 Custom Duty

Department of Customs and Excise was first established to collect revenue from international trade in 1962. Before this, custom revenue was collected through contracts. As the volume of trade and trading partners grew, there was a need of separate custom department to cope with emerging challenges. Therefore, customs was separated from Excise in 1966 and established as a separate department under the Ministry of Finance. In present time, custom duty contributes about 16 percent and 20 percent of total revenue and tax revenue respectively. Similarly, custom at import points collects about 60 percent of VAT revenue and 20 percent of excise revenue. On aggregate, custom collects 40 percent of tax revenue. Custom has important role to enhance the economic development through trade facilitation in a simple and effective manner. Besides this, some other functions like Control of illegal activities in the border, enforcement of custom law and other related laws, prevention and detection of smuggling of commercial frauds, provide trade information, and Penalize offenders and seizure etc. Following are two types of Customs duties: -

1) 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, 20, 25 and 30 in percentage term. Some exemptions are provided by special provision to promote certain crucial sector of the economy. Import duty rates are gradually declining under WTO regime.
2) Export Duty: - There are very few commodities that are 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.

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

(a) Custom Duty Collection Trend

The composition of custom revenue from 2001/02 to 2007/08 has been presented in the following table 41. The custom revenue increased from Rs 12658 million in 2001/02 to Rs 21034 million in 2007/08. In percentage form, the contribution of custom has decreased drastically. It was 2.1 percent, 15 percent and 20 percent of gross domestic product, total revenue and tax revenue respectively. The table 41 shows that the main component of custom revenue is the import duty. It occupies more than 90 percent of total custom revenue. It reached to 95 percent in 2007/08 from 93 percent in 2006/07.

Table 41: Composition of Customs Revenue

(Rs in million)

Customs Revenue	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Imports	11378	12937	14548	14487	14058	15522	20117
Exports	917	855	527	697	625	708	2997
Others	362	442	478	516	659	476	499
Total Custom Revenue	12658	14236	15554	15701	15344	16707	21034
Percentage of Imports	90	90	93	92	91	93	95

Economic Survey 2007/08, Ministry of Finance, Government of Nepal

III.11 Institutions Involved in the Tax Administration

The Ministry of Finance is the apex body to administer tax in Nepal. The ministry comprises nine divisions and five departments. Revenue division in coordination with respective departments is responsible for the formulation of tax policy and monitoring the tax administration in the country. The ministry coordinates the functions of its different departments- Inland Revenue Department, Revenue Investigation Department, Custom Department, and so on. The revenue Advisory committee regularly studies on current economic activities, economic policy and revenue policy and reviews the implementation of existing tax policies and recommends reform measures in tax policy and tax administration. This committee works as a think tank and enhances public- private cooperation for revenue policy formulation and its proper implementation.

Inland Revenue Department, department of customs and department of Revenue Investigation are the main implementing agencies of tax policies. They do involve in policy formulation too. Implementation of tax policies is mainly carried through field offices. Department of Revenue Investigation works as an enforcement agency and mainly concentrates to the revenue leakages and foreign currency related matters. It works through its four field offices all over the country.

Custom Department collects custom duty, Value Added Tax, Excise duty and other supplementary taxes at import and export points. It has a large network of field offices all over the country. There are 30 main customs offices in all over the country under the direct supervision of the department and 143 sub-customs offices under the supervision of main customs offices. The main custom offices include one international airport custom. Since Nepal is a land locked country, it does not have any sea port customs. Similarly, Inland Revenue Department has 21 revenue offices, one large taxpayer office and 16 service centers all over the country. 142 personnel in Department of Revenue Investigation, 1317 personnel in Department of Customs and 924 personnel in Inland Revenue Department are working presently. The table 42 presents the personnel in IRD.

Table 42: Number of Personnel Working in Inland Revenue Department

Position levels	Approved position	Full filled position	Vacant position	Vacant Percent
Gazette 1st class	7	7	0	0
Gazette 2nd class	48	35	13	27
Gazette 3rd class	205	183	22	10.73
Non-gazette 1st class	309	231	78	33.3
Non-gazette 2nd class	157	101	74	47.3
Other Assistants	198	190	8	4.04
Total	924	747	195	21.1

Source: Annual Report 2006/07, Inland Revenue Department, MOF, Kathmandu, Nepal

III.12 Reforms and Modernization of Tax Administration

(1) A Large Taxpayer Office was established in 2005 to administer the state owned public enterprises, banks, finance companies and big business houses exceeding turnover of Rs 250 millions. It is one window point for tax payment, refund for the large taxpayers. To provide quality service through

transparent and efficient tax administration, to reduce the compliance and transaction cost and promote trade through trade facilitation performance based incentives program is extended to other Inland Revenue Offices and Customs in 2007-08. Recently, this program is being implemented in all the revenue offices.

(2) The revenue consultative committee, a think-tank body was formed for policy advice
(3) Introduction of new Custom Act 2007, compatible with WTO valuation system.
(4) VAT has already been computerized and the computerization of income tax is about to complete.
(5) Provision of Electronic Permanent Account Number- to facilitate taxpayer registration, Electronic Tax Deduction at Source- to facilitate the reporting of tax withholding, Electronic Installment- to facilitate filing return and, Electronic Cash Register/ Fiscal Printer-to facilitate billing of retail sellers and department stores.
(6) Mobile SMS system which provides instant information about taxpayer registration status e.g. PAN registered in income tax, PAN registered in income tax and VAT, PAN suspended etc. This information is supposed to reduce the tax evasion.

IV. Country Specific Fiscal Issues:

Nepal has recently recovered from a decade-long internal conflict and political turmoil. The transition from political change to socio-economic transformation is presently going on. Nepal has the challenge of institutionalizing political achievement along with socio-economic development of the country. The economic growth of Nepal remained continuously fairly low for few years in the past. Similarly, the growth of revenue was also not satisfactory during that period. The main priority of the present government is the reconstruction, rehabilitation and relief to the victims of insurgency and it requires huge resources to spend. This is constrained by many factors. Nepal has to tackle many fundamental issues of which some are discussed in the following paragraphs below.

Economic Growth

Last decade is the lost- decade for Nepal. Its growth rate was very low in real terms, whereas its two neighbors have achieved double digits growth during this period. More than 30 percent people still live in dire poverty. Similarly, unemployment rate is very high in Nepal. To reduce poverty, there is need to provide employment and other income generating economic activities to the common people. This is only possible through higher economic growth. But the expenditure on development has decreased in recent years. The growth rate achieved in tenth plan was 3.4 percent, which was not sufficient for poverty alleviation.

Government in 2008 budget aimed to accelerate the current sluggish growth and lay foundation for the double-digit growth in next three years. Commensurate with this, government is willing to direct investment towards priority areas to achieve the high growth rate in the years to come. Public-Private Partnership (PPP) Approach will motivate domestic and foreign investors to invest in the priority sectors. Similarly, mobilization of abundant labor force existing in the country will help to compensate the insufficiency of capital and technology in the prioritized development projects. Specifically, government aimed to produce 10 thousands Megawatt hydroelectricity in the next 10 years and irrigation of the planes and hill's large valleys and fields through the diversion of major rivers to achieve the higher growth rate. It is challenging to mobilize resources for development activities.

Investment Environment

Larger amount of saving and investment is required for sustainable high economic growth. Gross domestic saving is low due to less saving habit of high income people, low access and availability of saving instruments in the remote areas, and low interest rate for saving etc. low interest rate is encouraging people to spend money on unproductive ways such as real estate, housing etc. Due to low level of domestic saving, Nepal needs foreign investment for the rapid and robust development of the economy.

Although Nepal adopted favorable policies in the sector such as industry, trade, finance and the stock exchange to attract more FDI from late 1980s, it could not attract the expected amount of FDI.

Many factors affect the investment in a country like administrative procedures, political environment, level of security, and labor cost etc. In last few years, some industries were forced to operate in low capacity and some were even forced to shut down. Demonstration, strikes, and protests and frequent power cut had badly affected the growth of industries during internal conflict. Labor law is rigid. Investors could not hire and fire the labors. Labor unions are often politically motivated and they frequently engage themselves in strike and debate for political interest. This has severely hindered the pace of investment and consequently of development. In spite of ongoing peace process, the situation has not improved yet. The power cut has increased up to 16 hours a day and it is impossible to correct the situation even in next few years. The present situation is the result of decade long insurgency. The Maoist affiliated labor union and others are disturbing the industrial production with some vested interests. Even domestic investors are unwilling to invest further and they are in a position of watch and see. So, for the overall development and achieve the target of rapid and high economic growth, creation of investment friendly environment is the crucial determinant.

Trade Deficit and Lack of Trade Diversification

Nepal's export is confined both in terms of product diversification and destination. Nepal exports very few goods such as Carpet, garments, paper, vegetable fat, yarn, handy-crafts, tea, coffee, leather products etc. The main destination of Nepalese export is mainly India, USA and European Union. Among SAARC countries, India is the biggest export market for Nepalese exporters. Other countries of the region have only two percent market.

The price rise of food commodities, construction materials and petroleum products and appreciation of NPR sometimes back has increased the volume of imports resulting in wide trade gap. The trade gap in 2007/08 was estimated to be 22.6 percent of GDP. It was 18 and 15 percent in 2006/07 and 2005/06 respectively. Export to India was more than 70 percent in 2006/07. As a result export to European and American market significantly decreased. It nearly decreased by one third during the period of five years. The overseas export decreased due to the end of quota from European and the US market for export from third world countries. Some restrictions from Indian side, the largest export market of Nepal also contributed to decrease the export in recent years. Moreover, internal factors such as conflict are also responsible for this. The import and other payments in convertible currency are mainly supported by worker's remittances and foreign aid inflows. The present financial crisis may adversely affect the remittance and foreign aid to Nepal. To lessen the trade deficit and sustain the favorable balance of payment, Nepal should explore new export markets and produce qualitative, competitive goods and services, develop hydropower, tourism, human capital etc.

Broaden Tax Base

Internal revenue mobilization is very low though it is in increasing trend from last two years. It increased from 11.1 percent in 2005/06 to 12.1 percent in 2006/07 and further increased to 13.1 percent in 2007/08. But, still it is not sufficient to meet the government expenditure. The present ratio of revenue to GDP is very low as compared to other developing countries. Government mobilized one third total expenditure from foreign resources in 2006/07 and 2007/08. The amount is expected to increase up to 40 percent in 2008/09. Government initiated many reform programs to increase the revenue but the result is not satisfactory.

The tax base is eroded by exemption such as long list of exemptions in VAT and agriculture sector not being in the tax net. Agriculture sector which contributes around 32 percent of GDP is still undeveloped. So, additional revenue can be mobilized through increased national income based on the modernization of agriculture. Moreover, illegal trade because of long open border with neighboring countries and practice of under-invoicing reduced the actual revenue collection. Furthermore, adjustment of non-tax revenue rate based on the cost of service delivered is necessary to broaden the base of government revenue. Besides this, the administrative capacity of tax official must be developed through provision of proper training, logistics support etc.

Maintain Price Stability

Price level in recent years has become a burning issue in Nepalese economy. This is mainly accelerated by commodity and food price increase. In September 2008, inflation reached 13 percent. This is the official data; it is even more in reality. Increased price of petroleum product incurred about Rs 16 billion loss to the state owned Nepal Oil Corporation due to subsidy to the petroleum price in one hand; on the other hand it increased price level very sharply in the economy. By creating artificial shortages, businessman engaged themselves in the speculation charging higher price. Petroleum price has multiplier effect on price level. It is mainly due to the lack of effective supervision and monitoring of petroleum dealers and proper supply management.

Similarly, the price of food commodities skyrocketed but neither the government nor the actual farmers were benefited from this in terms of revenue increase. Some portion of increased profit is not paid as tax as well. Besides, the decrease of petroleum and commodities prices especially after September 2008 is not reflected in the domestic prices. Moreover, the depreciation of NPR against US$ is also pushing price level higher especially after the beginning of recent global financial crisis.

Fiscal Federalism

Nepal has become federal democratic republic in May 28, 2008. Constituent Assembly is going to make new federal constitution in one and half years. The discussion is going on about the structure of the federalism- nature of federalism, number and size of provinces etc. Equally important is the fiscal federalism. Political federalism is incomplete and unsustainable without the fiscal federalism. How to raise and share revenue among centre and local level is a very important and difficult task. How to allocate the taxing power among eligible authorities or institutions? The different level of revenue potential in different areas complicates the resource allocation among different level of governments in case of Nepal. Plain region and some urban areas in hills such as Kathmandu and Pokhara have large revenue base, whereas rest of the regions are resource scarce. Similarly, the situation is also same for five development regions. Eastern Development Region and Central Development Regions comprised 24.79 and 74.98 percent of total overseas export (excluding India) in 2006/07 respectively. Other three regions had only 0.23 percent share during the same period. The situation is more or less same for export to India too. The conflict is going on to include or exclude the particular territory in a specific province that is propelled by revenue potentials. So, resource base is becoming the bone of content in the determination of federal structure. Economic factor may become the decisive factor for the nature of structure and this makes consensuses very difficult because nobody is ready to sacrifice.

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

Nepal is poor not because of lack of resources, it is poor because of improper development policies of the past governments. In general, Nepal could never focus its endeavor to the economic agenda. Nepal spent fifty-eight years in political recriminations from 1950 to 2008. The country is still in transition after the political transformation of May 28, 2008. Government is still not able to concentrate properly on economic agenda.

Nepal remained politically instable throughout its modern history. Neighboring countries have made tremendous progress during the last two decades. There was little difference among China, India and Nepal in terms of development indicators in 1970s. And, in some areas, China was even behind Nepal. For example, GDP per capita of China was US$ 114 and that of Nepal was US$ 146 respectively in 1970. But in 2008 it was 2000 and 320 respectively. Similarly, FDI in India and Nepal in 1990 was 0.3 and 0.5 percent of GDP, but it was 6.7 and 1.6 percent in 2007 respectively. In 2007 the economic growth rate of China and India was 11.4 and 9.2 percent respectively, whereas that of Nepal was only 2.5 percent. This tremendous achievement of neighbors was possible through accumulation of physical and human capital followed by sound policy environment which contributes factor productivity growth. A data set from 1960 to 1998 showed Nepal's total factor productivity negative. The TFP may have further worsened after 1998. These limited statistics disclose the fact that Nepal is falling behind its neighbors.

The economic growth rate in Nepal was very low for the last decade, below 4 percent. The agriculture sector which contributes around 32 percent of GDP is undeveloped and unorganized so far. It is characterized by subsistence farming. It heavily depends on monsoon rain. Protest, lock out, conflict between industrialist and workers, power cut and rampant insecurity deteriorated the investment environment. Many industries were shot down; many have run below the capacity which increased the production price. As a result, Nepalese products could not compete in the global market. The end of quota further aggravated the down trend. As a result, export decreased continuously. On the other hand, the volume of imports increased sharply resulting in large trade deficit.

The domestic environment has become very competitive for Nepalese industries. All these factors reduced the income level of general public increasing the unemployment rate. As there are less numbers of jobs available, potential labor force is compelled to go abroad in search of employment. Government targeted to reduce poverty and the whole tenth plan was solely focused on poverty reduction, but due to many reasons as mentioned above hindered the path of development. The inequality between the poor and the richer has increased.

Low growth rate, low level of income and adverse security had negative impact on the government revenue. Reduction in the import tariffs after the membership of World Trade Organization further decreased the percentage contribution of customs revenue in tax revenue. The government expenditure on development sector decreased, which also hindered the development and growth of the country. Destruction of physical capital during decade-long internal conflict has drastically reduced the physical infrastructure stock in the country. Social infrastructure such as health and education investment has also been affected by the conflict.

Nepal has great potentials for its development. The largest sector of economy, agriculture needs modernization. Modern-technology, irrigation facility, improved seeds and fertilizer will help to increase the productivity of agriculture. Similarly, around 40 percent of total area of Nepal occupies forest. Due to climatic variations from temperate to tropical, large number of flora and fauna are found in Nepal. Plants of medicinal values, herbs etc are found in different regions. Many new species of herbs can be cultivated here. Different species of fruits and vegetables can be grown. Agro-based and forestry-based industries which have comparative advantage could be extended and the finished products of these industries could be exported in the world market. Nepal has large stock of labor force suitable for the development of agro and forestry products, raw materials etc needed for these industries. The membership of WTO has opened the opportunities by broadening the market access for Nepalese exporters all over the world, though it has brought some challenges too. Similarly, rapid growth in China and India is another advantage for Nepalese industrialists.

Besides, Nepal has unique geography, climate, culture, people and diverse biodiversity. It has different climate from tropical to alpine and different geographical altitude ranging from low level of 70 meter and the highest peak of 8848 meter within a range of 150 kilometers. Nepal is full of thousands of flora and fauna. The highest peak, the mount Everest, Pashupatinath, the epitome of 1 billion Hindus and Lumbini, the birth place of Gautama Buddha, the proponent of Buddhism which has about 1 billion followers in the world lie in Nepal. There is a beautiful range of Himalayas in the north always covered with snow. Nepal has scope to expand it as the popular destination for adventure, sightseeing and religious touristic hub in the world. Tourism could be the sustainable source of foreign exchange earnings and generating employment opportunities.

Moreover, another main instrument of Nepal's development could be the development of its abundant water resources. Nepal has altogether around 6000 rivers, rivulets and streams. The demand for electricity is increasing in Nepal as well as in India. At the same time, India is suffering from low irrigation and flood problem every year. It can be used for hydroelectricity generation, irrigation ad flood control. Studies have shown that 83 thousands MW of hydro electricity is possible from the rivers of Nepal. Hydroelectricity can be exported to high demand Indian market. This is one of the largest potentialities for the development of Nepal. Unfortunately, less than 1 percent of total potential is produced so far and it is not sufficient to meet the domestic demand of electricity. So, if Nepal can attract foreign investment in this sector, country may enjoy a turning point in the pace of development.

The first republican government has taken the objective of accelerating sluggish economic growth and to achieve the double digit growth within the next three years. For this, government is adopting the public–private partnership approach to attract domestic as well as foreign investment in the country. Government is committed to sustain peace, commercialize and modernize the subsistence-oriented agriculture sector. Enhance export through boosting forest and agro-based industries that have a comparative advantage, and earning foreign exchange is the strategy of developing agriculture. Special attention have been placed on the development of physical infrastructure such as roads, railways, communication etc as well as social infrastructure of human resource through investment in health and education. There is possibility of earning foreign currency, creating employment and collecting revenue through development of tourism. The budget 2008 aimed to develop intensive triangular tourism infrastructure between Kathmandu, Pokhara and Lumbini so as to create tourism revolution. Lastly, a high level economic council under the chairmanship of prime minister has been proposed to consolidate all the economic matters including foreign direct investment through one channel. All these measures will enhance the pace of economic development and reduce rampant unemployment and poverty in Nepal.

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