4 Nepal

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I. Introduction

Nepal is a landlocked country with a total land area of 141,181 square kilometres. It lies between $26^0$22' N to $30^0$27' N latitudes and $80^0$4'E to $88^0$12' E longitudes. Roughly rectangular in shape, the land extends approximately 885 kilometres east west and 145 kilometres as its narrowest to 241 kilometres at its broadest north south. The country is bordered by China in the north and by India in the south, west and east.

The land mass is divided into three geographical zones, the Himalayas, the mountainous region with valley and flat sub tropical terrain.

The high Himalayan region extends in the north from west to east at an altitude of 400 meter to 8000 meter. The world famous peaks of Mount Everest, Kanchenjunga Annapurna and many others dominate the formidable range of eternal snows. The mountains range varies in height from 1525 meter to 4877 meter. The southern belt stretches east west with a width of 26 to 32 kilo meters and maximum elevation of about 305 meter.

Draped along the greatest heights of Himalayas, Nepal is where the ice cold of the mountains meets the steamy heat of Indian plains. It is a land of yaks and yetis, stupas and some Sherpas and some of the best trekking on the earth. The Himalaya's most sophisticated urban cultures took shape here, in the three major cities of Kathmandu valley- Kathmandu, Patan and Bhaktapur – home of world-class artistic and architectural heritage.

Climate

Nepal experiences four seasons spring (March- May), summer (June-August), autumn (September-November) and winter (December- February). The climate is varied ranging from the sub- tropical Terai to the cool dry temperate and alpine climates in the northern Himalayan ranges. In the Terai, the hottest part of the country, summer temperatures may rise as high as 40^0C. The climate is hot and humid. In the mid - mountainous region the summer climate is mild with temperatures around 25-27^0C. The winter temperatures range from 7^0 to 23^0C in the Terai and sub zero to 12^0C in the mountain regions and valleys. The northern Himalayan region has an alpine climate. The valley of Kathmandu has a pleasant equable climate with average summer and winter temperature of 190-27^0C and 2^0-12^0C respectively. Rainfall is wide spread during the south- west monsoon period from June to august with the eastern part receiving maximum rainfall. The period from October to May is generally dry in most parts of the country. Annual precipitation varies from around 300 mm in the northern and western areas to over 250 mm. in the eastern region. Kathmandu valley receives around 1300 mm of annual rainfall with a heavy concentration from June to August.

History

Nepal enjoys the distinction of having always been an independent country. It has never been under foreign domination. Ancient Nepal consisted of many small autonomous principalities. It was King Prithivi Narayan Shah who unified Nepal by creating one nation in 1679. Since that time, Kathmandu has been the capital of the country. After Nepal – Anglo war the present territory covers the modern Nepal. Prime Minister Jung Bahadur Rana greatly increased his power and established the Rana line of hereditary Prime ministers who ruled Nepal until 1951. The late king Tribhuvan led a popular revolution which over through the family autocracy. In 1959 the first general election was held and parliamentary Government set up for a short period since then Nepal was govern by the monarchy assisted by the Rastriya Panchayat (Parliament)based a partyless panchayat system . A popular people's movement ushered in a new era of democracy in 1990. A new constitution enshrining the sovereignty of the people was adopted in that year and multi party elections held in 1991 to elect a truly democratic government under a constitutional monarchy. Political stability did not last long, and the late 1990s were littered with dozens of broken coalitions, dissolved governments and sacked politicians. In 1996, with increasing political instability, the moist movement gained momentum and the launched movement to abolish monarchy and People's Republic. On 2001 June, Royal massacre took place and all the members of King Birendra and his entire family members were killed which resulted reduction on faith of Nepalese denizen over new Royal family. In 2005, The parliament were dissolved , most of the political parties were paralyzed in the name of corruption control , state of emergency was declared and killing of Maoist guerrillas was increase which also intensified the people's revolutionary want against kingship. Consequently, with 12 point agreement between rebellion and Democrats was become benchmark for people's movement and that movement-restored parliament which reduced the king to a figurehead, ending powers the royal Shah lineage had enjoyed for over 200 years.

In 2008, the result of the constitutional assembly disclosed that Nepalese people are serious about peace and then rebellion moist achieved highest seat in parliament and a month later parliament abolished the monarchy by margin of 560 votes to four. By 2008 a new government was formed, with former guerrilla leaders Pushpa Kamal Dahal (known by his nom de guerre Prachand, which means 'the Fierce') as prime minister.

There has still been plenty of potential for political instability. In 2009, Maoist lead dissolve and new government formed under the support of the twenty-two among the twenty-four political parties of the legislative parliament.

International Affairs

Nepal is a land locked country; her geographic location has been instrumental to shape her foreign policy. Before 1951, Nepal's foreign relation was limited with four countries; namely – India, United Kingdom, USA and France. Nepal becomes member of the united nation in 1955. Thereafter democracy, extension of diplomatic relations with various countries of the world increased considerably. The main features of Nepalese foreign policy are based on:

- Principles of Panchasila
- Adherence to the united nations charter and to the belief that all member countries should follow the charter,
- Principles of 'non alignment'.
- The peace as a basic tenet.

Because of effectiveness of her foreign policy, Nepal has established diplomatic relation with 116 countries and maintained her reputation in the international society. Nepal's foreign policy undertook a glorious turning when the SAARC, of which Nepal is an active member, summit 1986 unanimously, agreed to established SAARC secretariat in Kathmandu.

Natural Resources

For the all round, development of the country a careful utilization of natural resources is necessary. The economic development of a country depends upon not only on the availability of natural resources, but also on the extent of its rational utilization. Three major resources are – water, mineral and forest.

Water resource

Water resource is the most important natural resource of the country. Nepal is the second richest country in the world possessing about 2.27 percent of the world's water resource. The major sources of water are - glacier, snowmelt from Himalayas, rainfall and groundwater. It is estimated that there are altogether 6000 rivers (including rivulets and tributaries) having about 45000 Kilo meters length. Koshi, Gandaki and Karnali are the main river systems getting major part of their water supply from the snow, glacier and small tributaries. Other important rivers are Babai, Kamala, Narayani, Bagmati, Rapti, Seti, Kankai and Mahakali.

Mineral resource
In the lack of scientific and geological survey of the country, reliable statistics on mineral resource are yet available. Whatever is available is based on simple preliminary survey. Studies on mineral resources indicate that iron, copper, mica; gold and zinc, limestone, slate, mineral oil and gas, coal, nickel, sulphur, graphite, dolomites are available in the country. However, the proper exploitation of these minerals requires financial resource, technical know-how and good transportation system.

Forest resource
Another major natural resource of the country is the forest resource. It provides more than 50 percent of fodder to the livestock; several industries in the country are based on forest products for their raw materials. The benefits and the beauty that are derived from the forest and its usefulness to maintain natural and ecological balance cannot be measured in the economic term.

People and Development
Nepal is a one of the least developed country of the world. Among 23.1 million people of the country as per the census of 2001, 85.80 percent of people live in the rural areas. Real GDP growth in 2009/10 is expected to be resilient at 4 percent, slightly down from 4.7 percent in 2008/09. Population, which is growing rate of 2.25% per annum, has produced a broad based, increased dependency ratio. Literacy rate from the year 2001 is 54.1 percent, which is however in increasing but still much lower to upgrade the pace of development by making optimum use of human resource. 31 percent of the population still lives below poverty line. Keeping in view of challenge efforts are under way to improve the quality of life of Nepalese people.

II. Overview of Macroeconomic Activity and Fiscal position

II.1 Macroeconomic Activity

Nepal has been adopting mixed economic development approach after the end of Rana regime in 1951. Ten periodic plans have been completed in the five decades of Nepal's effort on planned development. During this period, development efforts focused on different aspects like the development of infrastructure, regional development, fulfilment of basic needs and poverty alleviation. Some of the past plans had been implemented with poverty alleviation as the principal objective. The past experiences show that the objective of poverty alleviation might not be achieved even if the overall economic indicators remain positive. According to Nepal Living Standard survey (NLSS) 2003/004 during the last eight years, the people living below the absolute poverty line, has fallen to 31 percent from 42 percent. However, during this period, the Gini-coefficient, which shows the inequality of income distribution, has increase from 0.34 to 0.41, which indicates that the gap between the rich and the poor has increased further. Similarly, according to the human development report 2009 human development index increased from 0.534 to 0.630 and ranked 142nd position in the global development index.

Nepal's economic growth rate in fiscal year 2008/09 is estimated to decline in comparison to 5.3 percent GDP growth achieved at producers' price in 2007/08 is estimated to grow in this fiscal year only by 4.7 percent. Non agricultural sector of the economy that recorded expansion in fiscal year 2008/09 in comparison to the previous fiscal year have been , education (from 3.3 to 9.9 percent), construction (3.1 percent to 5.7 percent); and transport, communication, and warehousing (from 7.1 percent to 7.8 percent). Similarly real estate, rent, professional service (4.4 percent to 4.5 percent) and public administration and defence (from 0.4 percent to 3.3 percent) also have recorded growth during this period.

Nepal's two neighbours, China and India achieved 9.0 and 7.3 percent respective growth rates in 2008, with estimates of such growth limited to 6.6 percent and 4.5 percent respectively in 2009. The spill over impact of neighbouring country to Nepal is yet to be realized.

The ratio of domestic saving to GDP at current prices in Fiscal Year 2008/09 stood at 8.0 percent as compared to 11.2 percent in Fiscal Year 2007/08. Similarly, the ratio of national saving has reached 32.3 percent in Fiscal Year 2008/09 from 31.6 percent in the previous year. Consequently, the ratio of investment to GDP has gone down from 31.8 percent to 29.7 percent between two periods. Ratio of net exports of goods and services to GDP, which remained adverse by 20.6 percent in the previous year, has reached 21.7 percent during this period.

The ratio of revenue mobilization to GDP grew to 14.8 percent as compared to the ratio of 13.2 percent in Fiscal Year 2007/8 because of encouraging growth in revenue collection and thanks to the new policies and peace process. Inflation rate in the current fiscal year has remained very high. The point –to point based CPI, which rose by 7.2 percent in mid march 2008 recorded a growth rate of 13.1 percent by mid march 2009.

Exports had decreased by 2.9 percent. Import has shown the rising trend with 26.1 percent growth in fiscal year 2007/8. A big question mark has emerged due to double digit inflation on overall economic management which adversely affecting the purchasing power and living standard of Nepalese people.

II.1.1 International Environment

(a) Trade Balance

The main foreign trade partners of Nepal are India, China, USA, Germany, Belgium, Bangladesh, Italy, France, Japan and Singapore. Due to the various reasons like geographical nearness, direct access to the market, easy communication and pegged exchange rate etc Nepalese foreign trade is bouncing around the Indian market. In Fiscal Year 2008/09 the volume of total foreign trade reached to NRs. 220.32 billions. The share of foreign trade with India is 57.5 percent whereas the share with other countries is 42.5 percent.

Nepal never experienced trade balance. More dependency on import resulted the increasing trend of trade deficit. Trade diversification is still remaining in far behind the finding of niche product needs more research and study. The major exportable Nepalese goods are readymade garments, shoes, rice, toothpaste, GI Pipes; noodle. whereas recently export of vegetable ghee, CGI Sheets, jute and jute product .M.S. pipe and plastic goods had decreased. Likewise woollen carpet, pashmina and herbal product shares significantly in third country export (except India) with limited items of exportable goods, Nepal shifted its traditional export of primary product and raw material to manufactured goods.

Nepal is heavily depends on import for daily consumption to development works. There are substantial volume of goods like petroleum products, vehicles and their accessories, cold rolled sheets in coils, other machineries with their parts, garments, M.S. bullet, wire goods, chemical fertilizer, rice and M.S. wire rod in the structure of import.

Table 1: Direction of International Trade#[1]

Rs. in Million

Description	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2008/09*
Export F.O.B.	46944.8	49930.6	53910.7	58705.7	60234.1	59383.1	44295.6
India	27956.2	26430.0	30777.1	38916.9	40714.7	41728.8	26720.1
Other Countries	18988.6	23500.6	23133.6	19788.8	19519.4	17654.3	17575.5
Import C.I.F.	107389.0	124352.1	136277.1	149473.6	173780.3	194694.6	176022.8
India**	56622.1	70924.2	78739.5	88675.5	107143.1	115872.3	100069.1
Other Countries	50766.9	53427.9	57537.6	60798.1	66637.2	78822.3	75953.7
Trade Balance	-60444.2	-74421.5	-82366.4	-90767.9	-113546.2	-135311.5	-131727.2
India	-28665.9	-44494.2	-47962.4	-49758.6	-66428.4	-74143.5	-73349.0
Other Countries	-31778.3	-29927.3	-34404.0	-41009.3	-47117.8	-61168.0	-58378.2
Total Volume of Trade	154333.8	174282.7	190187.8	208179.3	234014.4	254077.7	220318.4
India	84578.3	97354.2	109516.6	127592.4	147857.8	157601.1	126789.2
Other Countries	69755.5	76928.5	80671.2	80586.9	86156.6	96476.6	93529.2
% Share in Total Trade	1000.0	1000.0	1000.0	1000.0	1000.0	1000.0	1000.0
India	548.0	558.6	575.8	612.9	631.8	620.3	575.5
Other Countries	452.0	441.4	424.2	387.1	368.2	379.7	424.5

* Provisional(First Eight Months)

** Petroleum import since FY 1999/00 has been included in the import from India

Based on customs data

Source: Nepal Rastra Bank

International trade data from 2001 to 2009 have presented in above table. The export in 2001 /02 amounted NRs. 46944.8 millions and import was of 107389 millions. The trend of export was increasing up to 2005/06 and reached to Nrs. 60234.1 million. After this period, the downward trend began and declined to Nrs. 59266.5 millions in 2007/8 .but the amount of import was increasing every year and it reached 221937.7 millions in 2007/08. During this period the export was increased by 26.24 percent whereas import was increased by 206.67 percent. The volume of trade deficit is increasing every year the figure in the above table shows that it was 60444.2 million in 2001/02 and in 162671.2 million in 2007/08.

During the first eight months of the current fiscal year, the total trade deficit increased by 29.5 percent amounting to NRs. 131.73 billion because of the substantial rise in imports and diversification of its bases as compared to total exports. The trade deficit in the corresponding period of the previous year had increased by 30.2 percent amounting to NRs. 101.75 billion with 17 percent growth. Whereas the trade deficit with other countries totalled NRs. 58.38 billion with a notable growth of 49.4 percent the trade deficit with India rose by 45.2 percent in comparison to the rise in trade deficit with other countries during the corresponding period of the previous Fiscal Year.

Considering the reality the government of Nepal declared the new foreign trade policy replacing the 19 years old policy, which embraced norms of WTO and other regional arrangements with special attention towards WTO – service, trade and intellectual property policy. The policy has given emphasis to Tourism, Education, Health and the Four Modes of WTO under the Service Trade. Mode 4 has conceptualised the guarantee of protection for foreign workers visiting abroad for employment. In order to encourage Mode 4 at national and international levels, this policy has been included in our new Trade policy. However, Mode

[1] Ministry of Finance (2008/09), *Economic Survey,* Singh Durbar, Kathmandu , Nepal

4 is yet to be adopted. The new policy has mentioned about the formation of trade promotion council to promote service trade. For the first time of history, the policy has envisioned the provision of initiating legal arrangements for the protection Nepali goods under Intellectual Property Right Act. At this moment, Necessary legal arrangements are the matters of concerning for Patent rights, Trade Mark, geographical Indication and Copy Right including Industrial Properties Protection act. As far as the goods for trade is concerned, readymade garments, carpet, Pashmina, wool and handicrafts has been given priority as before. Likewise, special priority is given to tea, leather goods vegetable seeds, cardamoms, lentils/ pulses and floriculture, ginger medicinal herbs etc. The policy has envisaged a 23 member board of trade and commerce promotion which has also mentioned that trade promotion council will be formed by integrating the present export promotion centre for the growth and promotion of Nepali goods , high priority has been given to Special Economic Zone.

(b) Current account balance

Despite large recorded trade deficit, Nepal often maintains a surplus in its current account thanks to surpluses in services (including tourism) official aid transfers and increasingly large remittance from Nepalese living aboard and in spite of unrecorded trade and smuggling across the Indian boarder. The IMF reporting format has been using since 2003 which clearly mentioned the foreign currency from various sources. Total export with adjustment of the trade transactions bypassing the customs, has reached Rs 46.32 billion with a growth of 17 percent whereas import totalled Rs 172.78 billion with an increase of 25.9 percent. As a result, trade deficit grew by 29 percent Rs 126.47 billion as compared to last year’s 32 percent in the previous year.

Table 2: Balance of Payments Summary

Rs in million

	Fiscal Year				First Eight Months*	
	2004/05	2005/06	2006/07	2007/08	2007/08	2008/09
A. Current Account	11544.6	14224.5	-902.2	23679.6	-1539.7	28944.0
Goods : Exports F.O.B.	59956.1	61482.4	61488.4	61971.1	39593.0	46306.9
Oil	0.0	0.0	0.0	0.0	0.0	0.0
Other	59956.1	61482.4	61488.4	61971.1	39593.0	46306.9
Goods : Imports F.O.B.	-145718.2	-171540.8	-190437.1	-217962.8	-137268.2	-172781.1
Oil	-26653.6	-33657.2	-33567.6	-40815.7	-23437.4	-27893.0
Other	-119064.6	-137883.6	-156869.5	-177147.1	-113830.8	-144888.1
Balance on Goods	-85762.1	-110058.4	-128948.7	-155991.7	-97675.2	-126474.2
Services Net	-2034.2	-6818.3	-8377.3	-11092.0	-9563.1	-9313.0
Services : Credit	26001.9	26469.7	32078.9	42236.1	24884.0	34467.6
Travel	10463.8	9555.8	10125.3	18653.1	10891.0	16825.2
Government N.I.E.	6804.9	7441.5	12336.4	13301.8	8049.2	10070.4
Other	8733.2	9472.4	9617.2	10281.2	5943.8	7572.0
Services : Debit	-28036.1	-33288.0	-40456.2	-53328.1	-34447.1	-43780.6
Transportation	-10602.2	-12592.3	-14557.4	-22675.9	-15025.5	-16041.1
Government N.I.E.	-9691.9	-11960.8	-15785.0	-20862.0	-13324.9	-21066.2
Other	-7742.0	-8734.9	-10113.8	-9790.2	-6096.7	-6673.3
Balance on Goods and Services	-87796.3	-116876.7	-137326.0	-167083.7	-107238.3	-135787.2
Income Net	1636.5	4955.5	7431.8	7946.8	3099.4	7216.2
Income : Credit	7751.6	11432.3	14500.8	13447.7	6627.7	10852.3
Income : Debit	-6115.1	-6476.8	-7069.0	-5500.9	-3528.3	-3636.1
Balance on Goods, Services and Income	-86159.8	-111921.2	-129894.2	-159136.9	-104138.9	-128571.0
Current Transfer Net	97704.4	126145.7	128992.0	182816.5	102599.2	157515.0
Current Transfer : Credit	101310.1	130861.7	133196.8	185462.9	104225.1	160453.0
Grants	21071.9	18851.1	18218.2	20993.2	9610.8	17620.2
Workers' Remittances	65541.2	97688.5	100144.8	142682.7	82422.5	131007.9
Pensions	12502.2	12007.6	12937.0	18789.9	10040.2	10160.0
Other	2194.8	2314.5	1896.8	2997.1	2151.6	1664.9
Current Transfer : Debit	-3605.7	-4716.0	-4204.8	-2646.4	-1625.9	-2938.0
B. Capital Account	1573.6	3107.0	4449.9	7912.5	6722.2	4633.5
Capital Transfers	1573.6	3107.0	4449.9	7912.5	6722.2	4633.5
Total (Group A plus B)	13118.2	17331.5	3547.7	31592.1	5182.5	33577.5
C. Financial Account (exclu.group E)	-25536.9	-1324.5	-2362.1	11032.6	6350.2	18481.4
Direct investment in Nepal	136.0	-469.7	362.3	293.9	-133.1	1062.2
Portfolio investment	0.0	0.0	0.0	0.0	0.0	0.0
Other investment : assets	-21863.2	-14008.8	-10690.0	-11396.1	-5793.0	-3408.5
Trade credits	-323.8	-1629.5	-5127.6	853.2	-1286.7	-38.5
Other	-21539.4	-12379.3	-5562.4	-12249.3	-4506.3	-3370.0
Other investment : liabilities	-3809.7	13154.0	7965.6	22134.8	12276.3	20827.7
Trade credits	-4489.0	9232.5	1727.8	12483.6	9820.9	8804.7
Loans	744.4	526.9	1455.6	3391.5	2016.4	-458.3
General Government	1300.4	703.7	2150.7	3455.9	2040.3	-408.1
Drawings	7253.7	7691.0	9689.7	11325.5	6216.2	5013.2
Repayments	-5953.3	-6987.3	-7539.0	-7869.6	-4175.9	-5421.3
Other Sectors	-556.0	-176.8	-695.1	-64.4	-23.9	-50.2
Currency and deposits	-65.1	3394.6	4782.2	6259.7	439.0	12481.3
Nepal Rastra Bank	46.2	-116.5	2.4	-5.6	-9.1	-3.6
Deposit Money Banks	-111.3	3511.1	4779.8	6265.3	448.1	12484.9
Other liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Total (Group A through C)	-12418.7	16007.0	1185.6	42624.7	11532.7	52058.9
D. Net Errors and Omissions	18095.7	12985.4	9500.9	-6690.3	2539.3	-4767.4
Total (Group A through D)	5677.0	28992.4	10686.5	35934.4	14072.0	47291.5
E. Reserves and related items	-5677.0	-28992.4	-10686.5	-35934.4	-14072.0	-47291.5
Reserve assets	-6462.2	-28992.3	-13410.2	-37002.0	-15139.7	-47291.5
Nepal Rastra Bank	-3251.3	-21297.1	-10963.2	-29636.8	-13024.4	-38001.3
Deposit Money Banks	-3210.9	-7695.2	-2447.0	-7365.2	-2115.3	-9290.2
Use of Fund credit and loans	785.2	-0.1	2723.7	1067.6	1067.7	0.0
Change in Net Foreign Assets (- Surplus)	-5742.1	-25597.8	-5904.3	-29674.7	-13633.0	-34810.2

* Provisional

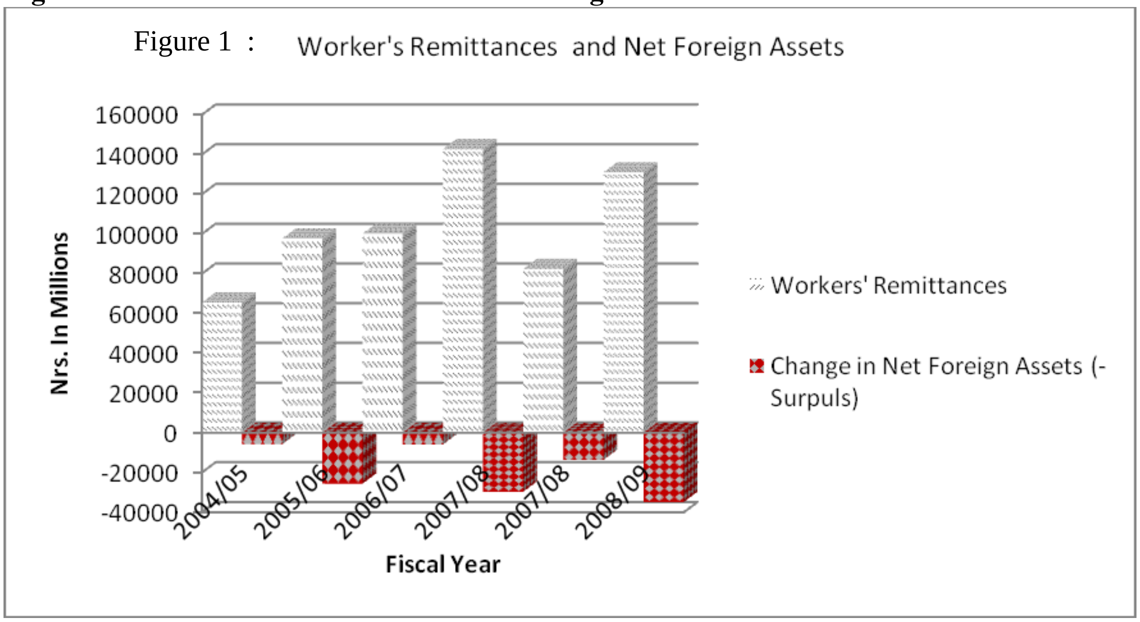
Source : Nepal Rastra Bank

The table 2 shows that income from tourism sector has increased by 54.5 percent with compare to the previous year and incomes of the government other than included elsewhere by 25.1 percent and income from other services by 27.4 percent. Consequently, total income from service sector reached Rs. 34.47 billion with a growth of 38.5 percent as compared to the corresponding period of the previous fiscal. The growing trend of Nepali students going abroad for higher education has resulted in an increase of travel expenses during the period 2008/9 by 58.1 percent. Since travel, expenses and other payments have increased total service repayment increased by 27.1 percent

amounting to Rs 43.78 billion as compared to the corresponding period of the previous year. Thus, the net service income has remained negative by Rs 9.31 billion during 2008/9.

The Capital Account has recorded a capital transfer equivalent to Rs 131.01 -13824 with the growth of 58.9 percent . Grants and pension have increased by 83.3 and 1.2 percent respectively. The net transfer income has reached to 157.52 billion with a growth of 53. 5 percent, and hence the net surplus in the current fiscal year is Rs.28.94 billion, which was in deficit by Rs. 1.54 billion in the corresponding period of the previous year.

Figure 1: Worker's Remittances and Net Foreign Assets



During the review period, the Capital Account transfer stood at Rs. 4.63 -13824 as compared to such transfer receipts of Rs. 6.72 billion in the corresponding period of the previous year, showing a marginal decline than in the previous fiscal year. In Financial Account, other investment assets of Rs 3.41 billion is added to the previous fiscal year's income of Rs. 5.79 million during the same period of the last year. So far as other investments and liabilities are concerned, the government borrowing amounted to Rs 5.1 billion, while repayment of the principal amount equalled to Rs 5.42 billion. The total foreign deposit liability increased by Rs 12.48 billion during the review period with the Balance of Payments recording a surplus of Rs.14.81 billion by Mid-march of current fiscal year in comparison to Rs. 13.63 billion for the corresponding period of last year.

(c) 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 by trade not by the return of the financial investment. 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.

Table 3: Exchange Rate of Nrs to US $[2]

Year (mid of July)	Nrs per US $	Year (mid of July)	Nrs per US $
1970	10.5	2002	78.3
1975	10.55	2003	75
1980	12	2005	70.65
1985	17.7	2006	72.93
1990	29.2	2007	65.15
1995	50.7	2008	64.4
2000	70.75	2009	78.65

Nepal has maintained fixed exchange rate of Nepalese rupee with the Indian rupee for the management of external sector. The pegged exchange rate system has acted as safeguard to maintain price stability and controlling inflationary turbulences. With the high degree of economic ties with Indian economy Nepal is compelled to peg its exchange rate with Indian rupees.

In 1990's, Nepal initiated various reform to manage foreign exchange. Mainly in the sector of Market determination of exchange rate except Indian rupee, relaxation on availability foreign currency for various purposes (travel, business) and Operation of foreign currency account in commercial bank.

During the process of market determination of exchange rate of foreign currency and other near currency instruments commercial banks have power to set it for their own purpose on the basis of value of US $ on international market, domestic demand and supply of foreign currency, government exchange rate and IRs. To US $. Beside US$ exchange rate for all other currencies are based on the value of exchange rate of Nrs to US$.

Table 4: Fixed Exchange Rate of Nrs to Irs[3]

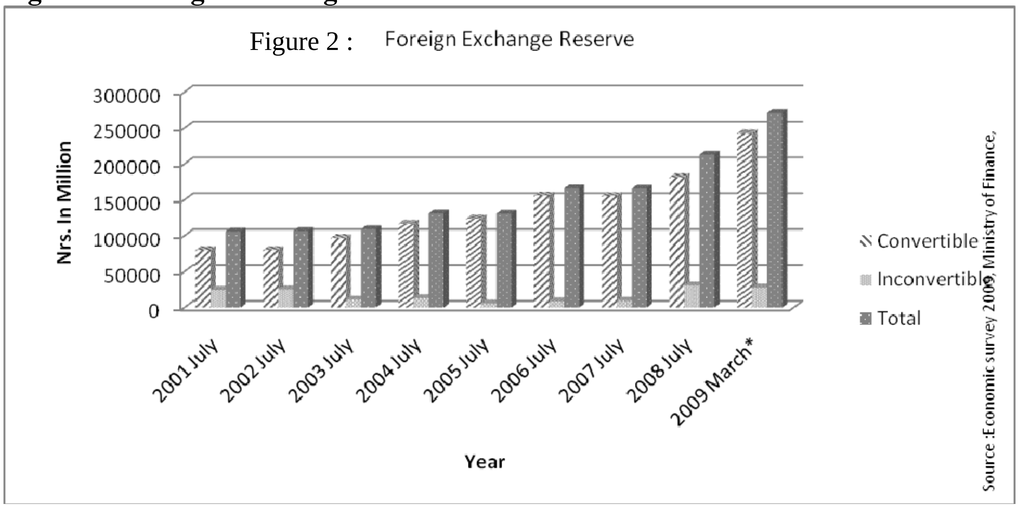
Effective date	Unit	Buying rate	Selling rate
13/04/1960	Irs 100	Nrs 159.75	Nrs 160.00
06/06/1966	Irs 100	Nrs 101.25	Nrs 101.60
12/08/1967	Irs 100	Nrs 135.00	Nrs 135.15
22/12/1971	Irs 100	Nrs 139.00	Nrs 139.15
22/3/1978	Irs 100	Nrs 145.00	Nrs 145.15
30/11/1985	Irs 100	Nrs 170.00	Nrs 170.15
31/5/1986*	Irs 100	Nrs 168.00	Nrs 168.15
07/02/1991	Irs 100	Nrs 165.00	Nrs 165.15
02/12/1993	Irs 100	Nrs 160.00	Nrs 160.15

*Irs included in basket

The data 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. A mixed trend in the exchange rate of Nepalese currency against major international currencies was noticed during the first eight months of current fiscal year. Nepalese Currency depreciated by 17.02 percent against the US dollar between the period of July 2008 and March 2009, which had appreciated by 0.56% in the corresponding period of Fiscal Year 2007/08.

[2] www.nrb.org(Official website of Nepal Rastra Bank)
[3] Nepal Rastra Bank and various Issues of Economic Survey

Figure 2: Foreign Exchange Reserve



(d) Foreign Exchange Reserve

Due to various measures taken to manage foreign exchange, the total foreign assets of banking sector reached Rs 217.46 billion with an increase of 27.3 percent till mid of current fiscal year (2009) as compared to the increase of 10.2 percent for the corresponding period of last year. As compared to mid – July of 2008, the total foreign exchange reserve with the banking sector increased by 27.4 percent amounting to Rs 270.80 billion by mid- March of 2009. During the same period of the previous year, such reserve had increased by 10.2 percent. The contribution of Nepal Rastra Bank in the reserve was 80.7 percent, while that of other commercial banks was 19.3 percent of the current reserve. Viewing the import tendency as of now, the foreign exchange reserve with banking sectors seems enough to afford the import of goods for 12.3 months and goods or services for 9.9 months. Until Mid March 2008, the reserve with banking sector was enough to afford the import of 11.3 months and that of goods and services for 8.9 months.

Table 5: Bank wise Gross Foreign Exchange Reserves

NRs. in million

Description	Mid-July	Mid-March	Mid-July	Mid-March	Mid-July	Mid-March	Percentage change July-March	
Year	2006	2006	2007	2007	2008	2009	2008	2009
Nepal Rastra Bank	131,970	142,060	129,610	144,290	169,680	218,460	11.30	28.70
Commercial Banks	33,060	35,020	35,500	37,690	42,940	52,340	6.20	21.90
Total Reserves	165,030	177,080	165,110	181,980	212,620	270,800	10.20	27.40

Source : Nepal Rastra Bank, Kathmandu, Nepal.

(e) Foreign Direct investment

Foreign investment and technology transfer is essential for leading the nation's economic system towards attainment of self-sufficiency through building a robust strong, dynamic and competitive economy through optimum utilization of available resources. Foreign investment fosters capital modern technology, managerial and technical skill, access to international market and culture of professional competition. In addition to this, the country heads for a strong and internal revenue generation. It also expands the industrial development. To obtain these benefits, Nepal started to attract foreign direct investment from late 1980s and accepted foreign capital, technology transfer as parts of industrial development strategy. 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 defence, 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:

- Establishment of Investment Promotion Board, fast track committee, one window system to provide different facilities to investors from a single point
- The guarantee of protection of investment: Guarantee against nationalization of industries.
- 100 percent repatriation of equity invested and dividends, amount received as payment of principal and interest on foreign loans in convertible currencies.
- Settlement of disputes under the rule of United Nations Commission on international trade law
- Provision of different industrial estates and construction of dry port in Birgunj and at other customs
- Privatization of public enterprises: This process began in 1992/93 and 29 public enterprises have been privatized so far.
- Investment protection agreement completed with Germany, France and the U.K.
- Further incentives through tax rebate like Zero rate for export and full refund of input tax of export, Lowered import duty on import of machinery and equipments and exemption of value added tax for those imports, Lowered import duty on import of intermediate inputs of export-oriented industries. Refund of import duty and VAT under duty drawback scheme, Reduced rate of corporate tax to special, export-oriented and construction industries under built, operate, own and operate (BOOT) system

Foreign investment and technology transfer act has been amended to ensure effectiveness and align it with changing context and for opening the door for foreign investment in new sector. one window committee has been reformed for an easy access to tax exemption and duty drawback facilities to foreign investors. With the objective of granting necessary permission, services and facilities to foreign investor through one window system, for attracting foreign investment as per existing act to achieve rapid economic growth in the country, foreign investment Promotion Committee working procedure, 2005 is already in effect. Likewise, considering the foreign investment, which is essential for country's economic growth, new industrial and foreign investment policy is being introducing in Fiscal year 2008/09 to achieve the economic growth rate as envisaged through public private partnership. Special attention is paid for easy processing promotion of technology transfer ,flow of foreign investment , productivity and enhancement of industries 's work efficiency of the private sector to be able to compete in global market by utilizing the comparative advantage as per the recent policies. Similarly arrangement have been made to provide diesel at subsidized rate by the government to industries willing to generate electricity through the means of captive and co-generation. Customs duty and other taxes will be fully exempt on imports of generators to compensate for electricity shortage faced by the industries due to load shedding.

To attract foreign investment through healthy an competitive market supporting , adoption of relevant , practical, and liberal policy like Company Act, Insolvency Act, Non- Resident Nepali Act , Competition Act, Cyber Act has been implemented as in the form of second phase enhancement program .

Table 6: Number of Industries and Foreign Investment[4] (by Fiscal Year)

(in million NRs.)

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	212	9811.00	0.94	10677
2008/09[5]	136	5142.00		7708
Total	1567	47031.93		131291

From the table 6 we can see, a total of 1567 industries were given permission up to first eight month of fiscal year 2008/09. These industries have drawn total of NRs 51.42 billion of foreign investment and once in operation, these industries will generated a total of 131291 employments. Of 212 industries that were granted permission in the fiscal year 2007/08, 51 were related to industrial production, 55 were service industries, 67 were tourism industries, 13 were construction, eight were energy, 11 were agriculture and 7 were related to mining industries. From the country-wise investment prospective in these industries, china has investment in 39 industries, India in 37 industries, South Korea in 23, UK in 19, USA in 13, Germany in 11, Australia in 8, Netherland in 6 , Japan in 5 and other nations have their investments in 40 industries.

In the first eight months of fiscal year 2008/09, permission has been granted to 136 industries with fixed capital of Rs. 6.62 billion And foreign investment of Rs. 14 billion to establish industries in foreign and joint investment. Of the 136 industries permitted for such investment, 25 are in production sector, 38 are in service industry, 45 are tourism, seven are energy, three are agriculture, and 17 are in mineral sector. As per the country-wise distribution of these 136 industries, 46 industries are invested by China, 27 by India, 9 by UK, 7 by USA, 5 by Japan, 4 each by France, Singapore and South Korea and 2 each by Germany, Netherlands, Spain and Switzerland and 24 by other countries. Of the 127 permitted industries for foreign investment in the first eight months of the previous fiscal year 2007/08, India is involved in 26 industries, china in 13, Japan in 5, USA in 7, UK in 10, South Korea in 15, Germany in 8 and other countries in the rest 43 such industries.

(f) Borrowing from aboard (Foreign Aid)

Nepalese economy is encircled by poverty and stagnation. The pace of economic development is clearly in behind other countries in the SAARC region. The GNI of Nepal is pocket-sized equivalent to US$12.698 billion, and GNI per capita is low hanging around US$ 460 as of 2008[6]. The population below international poverty line receiving less than US $1 a day is estimated to be 24.1 percent as of 2006, and

[4] Department of Industries, Kathmandu Nepal.
[5] Data of the First 8 month of the current fiscal year
[6] International Monetary Fund, World Economic Outlook , April, 2009

around 30.9 percent population is still found to be below the national poverty line[7]. Although extent of poverty declined moderately attributable to growing remittances in recent times, a large segment of the population is still below the abject poverty. Nepalese economy is, therefore, an apparent case of sluggish economic growth, perhaps lowest in the SAARC region. Nepal's GDP growth rate remained below 5.0 percent during the last six years, and it is further compressed to 2.5 percent in 2007 attributing to both economic and non-economic factors[8]. The economic growth rate is projected to be 5.5 percent during the Three-Year Interim Development Plan, 2007-2010[9]. The magnitude of external debt exceeded US$ 3.5 billion, which is 34 percent of GNI as of present value in 2005[10].

Nepal has been receiving foreign aid from 1951.the first aid entered as a point four programme from USAID. Nepal adopted mixed economy for development though public sector is stronger than private sector. It already completed 10th plan. The current plan (2007-2010) is interim one since Nepal is in transitional phase with respect to eco-political development. The projected structure of investment in this plan is as below:

Table 7 Projection of Government Budget (at FY 2006/07 constant prices)[11]

(Rs in millions)

	2006/007	As percentage of total	Three years total budget Amount	Percentage
Total Expenditure	131181	100	511378	100
Current expenditure	80331	62.46	285483	55.8
Capital expenditure	36380	27.13	178990	35.0
Principal repayment	15140	10.41	46905	9.2
Source of Financing				
Revenue	86136	62.38	318893	62.4
Foreign aid	26277	24.23	140660	27.5
Grant	15964	13.62	84137	16.5
Loan	10331	10.61	56522	11.1
Domestic borrowing	19439	13.39	51826	10.1

As regards to the foreign aid during the plan period (at constant price of 2006/07), a total of Rs 140.66 billion is expected to be mobilized. Of this, this grant is estimated to be Rs 84.14 billion and loan Rs 56.52 billion. As a proportion to the GDP, it comes out to be 3.56% in 2006.07 it is expected to gradually increase to 6.05% in the final year of the plan. (Nrs 80 = 1 US$)

The foreign aid commitment in fiscal year 2007/8 increased by 32. Percentage in comparison to 76.9 % growth registered in FY 2006/7 than its preceding fiscal year. In monetary term, committed foreign aid amounted to Rs. 37.23 billion, In Fiscal Year 2006/7 while such aid in Fiscal Year 2007/8 totaled to Rs. 49.186 billion. Of total foreign aid commitment, bilateral assistance constituted Rs. 13.106 billion Whereas the multilateral assistance totaled to Rs. 36.080 billion. While classifying the foreign aid into grant and loan components for Fiscal Year 2007/8, grants amounted to Rs. 41.064 billion, And loans Rs. 8.122 billion. As compared to the previous year, foreign grants had increased by 33.1% and loans by 31.8 Percent in Fiscal Year 2008/9.

In the first eight months of Fiscal Year 2008/09, the share of bilateral assistance among the total commitment was 51.8 percent while that of multilateral assistance was 48.2 percent. In the same period last year, the shares of bilateral and multilateral assistance were 26.9 percent and 73.1 percent respectively. While analyzing sector-wise, foreign aid commitment in the first eight months of Fiscal Year 2008/09, the share of electricity sector was Rs. 3.541 billion (8.2 percent); education was Nrs. 1.308 billion (3.0

[7] Nepal Living standard survey , Nepal Bureau of Statistic and World Bank 2003.04.
[8] Asian Development Bank 2007
[9] Three years Interim Plan , National Planning Commission Nepal 2007
[10] World Development Report 2007
[11] Three years interim plan(2007-2010) , National planning commission, Kathmandu Nepal 2007

percent); rural development was Rs. 12.512 billion (29.0 percent); drinking water and sewerage was Rs. 1.883 billion; agriculture, irrigation and forestry was Nrs. 1.727 billion (4.0 percent), transport and communication Rs. 2.517 billion (5.8 percent), health Rs. 3.488 billion (8.1 percent) and other sectors Rs. 16.16 billion (37.5 percent).

Table 8: Foreign Aid Commitment by Major Sources[12]

Rs. in Million

Heading	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09*
Bilateral	15312.40	8223.60	21225.40	14755.50	17706.10	13106.40	22355.50
Grant	15183.10	8223.60	21225.40	14755.50	17706.10	5620.90	18814.00
Loan	129.30	0.00	0.00	0.00	0.00	7485.50	3541.50
Multilateral	27890.30	15514.40	16926.90	6168.70	19316.80	36079.80	20778.80
Grant	12174.50	733.40	4167.30	3508.80	13154.10	35443.30	19440.80
Loan	15715.80	14781.00	12759.60	2659.90	6162.70	636.50	1338.00
Total	43202.70	23738.00	38152.30	20924.20	37022.90	49186.20	43134.30
Grant	27357.60	8957.00	25392.70	18264.30	30860.20	41064.20	38254.80
Loan	15845.10	14781.00	12759.60	2659.90	6162.70	8122.00	4879.50

* Provisional (First Eight Months)
Source: Ministry of Finance

Disbursements of foreign aid in Fiscal Year 2007/08, as compared to FY 2006/07, increased by 13.3 percent to Rs. 29.306 billion. Of the total foreign aid disbursement in Fiscal Year 2007/08, Rs. 20.321 billion (69.4 percent) was grants and Rs. 8.98 billion (30.6 percent) as loans. In the previous year, foreign aid disbursement amounted to Rs. 25.85 Billion, of which Rs. 15.80 billion (61.1 percent) was foreign grants and Rs. 10.53 billion (38.9 percent) foreign loan. Of the total foreign aid disbursement in Fiscal Year 2007/08, Rs. 19.093 billion (65.2 percent) was through multilateral assistance and Rs. 10.208 billion (34.8 percent) as bilateral assistance. In the previous year, the multilateral aid disbursement had amounted to Rs. 9.45 billion (36.5 percent) and bilateral assistance Rs. 16.46 billion (63.5 percent).

Table 9 : Foreign Aid Disbursement by Major Sources[13]

Rs. in Million

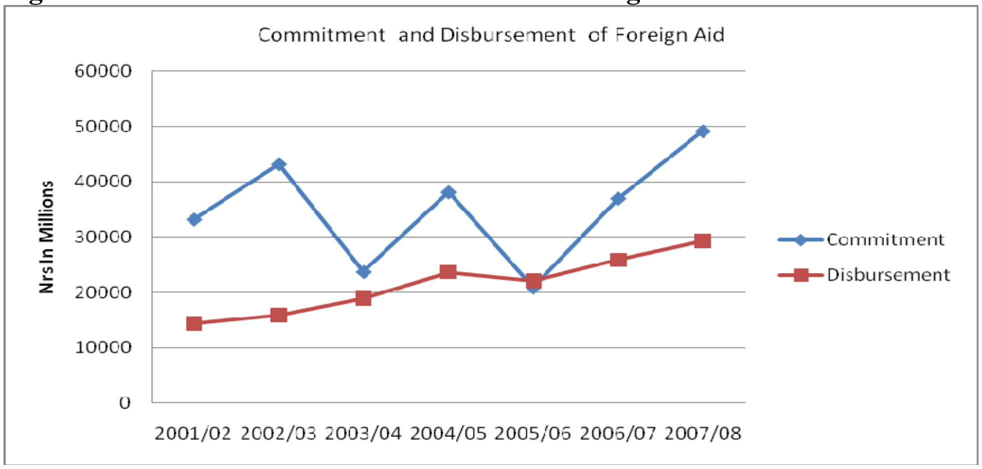
Heading	2001/02	2002/03	2003/04	2004/05	2005/06	2005/06	2007/08
Bilateral	4675.30	10044.40	9013.20	9230.80	7658.40	16406.43	10207.75
Grant	4588.30	9387.20	8947.20	9104.30	7617.80	7401.84	9575.64
Loan	87.00	657.20	66.00	126.50	40.60	9004.59	632.11
Multilateral	9709.50	5841.10	9899.20	14426.50	14383.40	9447.94	19092.85
Grant	2097.90	1951.90	2336.20	5286.90	6209.70	8399.01	10745.09
Loan	7611.60	3889.20	7563.00	9139.60	8173.70	1048.93	8347.77
Total	14384.80	15885.50	18912.40	23657.30	22041.80	25854.37	29300.60
Grant	6686.20	11339.10	11283.40	14391.20	13827.50	15800.85	20320.73
Loan	7698.60	4546.40	7629.00	9266.10	8214.30	10053.52	8979.88

Source: Financial Comptroller General Office

Foreign loan has been playing vital role in the Nepalese economy. The net outstanding foreign loan was Rs. 216.629 billion in FY 2006/07 which further increased by 15.4 percent reaching Rs. 249.965 billion in Fiscal Year 2007/08. Net outstanding foreign loan by the end of first eight months of Fiscal Year 2007/08 (adjusting gross Figure 3 : and principal repayment in the first eight months) was Rs. 216.207 billion, which increased by 26.6 percent totalling Rs. 273.607 billion by the same period of Fiscal Year 2008/09. As per the available data for the first eight months of the current fiscal year, the ratio of net outstanding debt to GDP is 28.5 percent. These ratios were 35.8 percent in FY 2005/06, 29.7 percent in FY 2006/07 and 30.5 percent in Fiscal Year 2007/08.

[12] Economic survey 2009, Ministry of Finance, Singh durbar , Kathmandu, Nepal
[13] Economic Survey 2009, Ministry of Finance , Singh Durbar Kathmandu Nepal ,

Figure3: Commitment and Disbursement of Foreign Aid



II.1.2 Domestic environment

(a) Economic Growth Rate (GDP and GNP)

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 it decreased to 3.34 percent in 2006/07. In the mean time in Fiscal Year 2007/08 the economy showed some positive growth rate and GDP growth rate become 5.35 percent. Sectors trend analysis reveals that growth rate of agriculture sector was the lowest in 2006/07, which was caused by extremely unfavourable weather, non-commercialization of agriculture sector, natural disasters and unscientific farming, and the growth rate of non-agriculture sector was even negative in 2001/02. In 2008/09, the growth rate is expected to decline slightly. It is estimated to be 4.66 percent in this period. The growth rate of agriculture sector is estimated to be 2.13 and due to political instability and non-conducive environment of manufacturing sector and energy sector, it is forecasted that there will be negative growth rate in forthcoming Fiscal Year. The service sectors mainly the education and transport, storage and communication will show remarkable growth rate that is 9.93 percent and 7.85 percent respectively. Growth rate of non-agriculture sector in FY 2008/09 is estimated at 4.8 percent. This growth rate is less as compared to 5.7 percent growth recorded in the previous fiscal year. Major reason for this decline is the shortage of energy supply. Sub-sector that recorded negligible or negative growth is electricity, gas and water. This sub-sector is estimated to record a negative growth of 1.1 percent, which had recorded 3.7 percent growth in the previous fiscal year. In the previous fiscal year, Marshyangdi Hydropower Project completed under the German government assistance contributed to record growth in the sector. On the contrary, disruption in energy production of Kulekhani and flood in Sapta Koshi this year made energy supply situation uneasy thereby negatively affecting a number of economic activities. The growth rate of real GDP from 2001/02 to current Fiscal Year is presented in Table below.

Table 10 : Annual Growth Rate of GDP by Economic Activities [14] (at constant price)

In percentage

Industries	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08 R	2008/09P
Agri.& forestry	3.01	3.32	4.72	3.45	1.67	0.94	4.67	2.13
Fishing	8.71	4.00	12.23	7.13	9.91	2.99	7.09	4.50
Mining & Quarrying	8.79	3.20	-0.43	6.80	8.26	1.47	2.84	2.50
Manufacturing	-5.32	0.04	2.15	2.62	2.00	2.55	0.18	-0.50
Electricity gas and water	11.37	19.04	4.07	3.97	4.01	13.00	3.73	-1.06
Construction	6.41	2.10	-0.35	2.90	7.67	2.49	3.11	5.71
Wholesale and retail trade	-11.57	2.26	10.81	-6.24	3.66	-4.53	7.04	4.70
Hotels and restaurants	-18.23	2.01	12.74	-5.41	5.99	3.46	8.48	5.12
Transport, storage and communications	8.37	5.20	7.49	1.98	6.95	4.57	7.05	7.85
Financial intermediation	3.82	1.66	6.19	24.30	24.35	11.39	13.81	3.25
Real estate, renting and business	-4.89	-3.97	-2.09	10.03	6.34	11.76	4.42	4.50
Public Adm.& defence	36.85	11.52	-0.64	6.64	6.88	1.35	0.37	3.32
Education	21.05	13.71	5.12	9.82	3.75	6.24	3.33	9.93
Health and social work	7.38	15.26	6.11	11.33	5.91	6.71	13.57	6.54
Other community, social and personal service activities	-8.62	4.40	13.43	-3.38	3.34	19.24	11.06	6.09
Total Gross Value Added including FISIM	0.46	3.45	5.13	3.34	4.00	3.11	5.31	3.87
Financial intermediation (FISIM)	10.67	-6.62	30.13	6.23	11.20	12.41	6.48	5.50
GDP at basic prices	0.16	3.77	4.41	3.23	3.73	2.74	5.26	3.80
Tax less subsidies on products	-0.47	6.55	8.60	6.88	-1.51	11.83	6.49	15.70
GDP at producers' prices	0.12	3.95	4.68	3.48	3.36	3.34	5.35	4.66

P = Preliminary, R = Revised
Source: Central Bureau of Statistics

Aggregate production of agriculture sector comprising of Agriculture, Forestry and Fishery is estimated to increase by 2.2 percent (at constant prices of FY 2000/01). Growth of this sector in the previous fiscal year was 4.7 percent. Contribution of this sector to GDP in the current fiscal year is estimated at 32.3 percent against previous year's 32.1 percent.

[14] Economic survey 2009, Ministry of Finance, Kathmandu, Nepal.

Table 11: Composition of GDP by ISIC Division (at current price)

In percentage

Industries	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08 R	2008/09P
Agriculture and forestry	36.15	36.92	36.03	35.45	34.71	33.09	32.04	32.11	32.35
Fishing	0.43	0.49	0.46	0.48	0.47	0.49	0.47	0.49	0.47
Mining and Quarrying	0.43	0.48	0.49	0.48	0.49	0.50	0.49	0.49	0.48
Manufacturing	9.03	8.50	8.20	8.05	7.92	7.59	7.48	7.16	6.79
Electricity gas and water	1.82	2.06	2.42	2.31	2.26	2.09	2.13	2.01	1.74
Construction	6.01	6.49	6.54	6.42	6.47	6.50	6.46	6.53	6.42
Wholesale and retail trade	16.44	14.59	14.51	15.29	14.09	14.31	13.43	13.94	13.72
Hotels and restaurants	1.99	1.61	1.59	1.73	1.57	1.49	1.44	1.49	1.52
Transport, storage and communications	7.39	7.87	8.31	8.94	9.06	9.72	9.91	9.58	10.46
Financial intermediation	2.69	2.75	2.72	2.65	3.06	3.49	4.08	4.86	4.79
Real estate, renting and business activities	8.29	8.23	8.08	7.72	8.69	9.53	10.15	8.77	8.33
Public Adm. and defence	1.24	1.63	1.70	1.55	1.69	1.74	1.75	1.83	1.96
Education	4.08	4.69	5.19	5.08	5.59	5.55	5.81	6.00	6.02
Health and social work	0.98	1.04	1.14	1.12	1.24	1.24	1.26	1.29	1.32
Other community, social and personal service activities	3.03	2.66	2.63	2.73	2.69	2.67	3.12	3.44	3.64

P = Preliminary, R = Revised

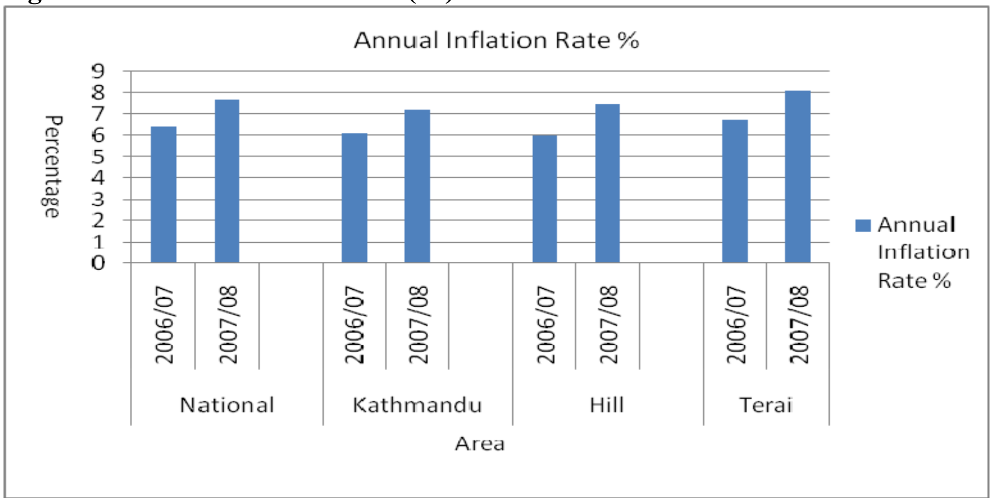
Source: Central Bureau of Statistics

(b) Structure of Inflation

Nepalese price situation tends to have affected more by structural and external factors. Structural factors include overall supply of goods and services available within the country such as agricultural and industrial products, and effects of closures and strikes on supply arrangements. Factors such as price hike of petroleum products in international markets and direct impacts of Indian inflation come under external factors. As monetary aggregates obviously affect aggregate demand, its impact in turn get reflected on the price situation. The rate of inflation increased by double digit due to excessive price hike of food and petroleum products towards the end of last fiscal year i.e., Mid-June 2008. Several efforts were made to maintain smooth supply arrangement, contain the money supply at the desirable level, and adopt anti-inflationary measures in the context of inflationary situation getting more challenging at the international level. Due to fall in the price of petroleum products and economic recession that hit western countries specially the United States of America around November 2008, commodity prices like fuel, rice, wheat, edible oil, iron, and copper fell notably at the international level, with a minimal impact in Nepal. Even falling prices in India during this period could not bring significant impact like in the previous years, nor did the rate of inflation fall. Still, inflationary pressure is persistent due to negative effect of strikes, and closures badly affecting the internal supply system. Effects of gradual depreciation of Nepalese Rupees against the US Dollar is also seen to some Extent on the inflation especially in an import dependent country like Nepal to keep its supply system running.

Annual urban CPI (base year 1994/95=100) increased by 10 percentage point in mid-march 2009. This index during the same period of Fiscal Year 2007/08 was 7.2 percent. Analyses of CPI on the basis of geographical regions reveals that, these indices increased by 13.4 percent, 12.4 percent and 13.3 percent in mid-March, 2009 in Kathmandu valley, Hills, and Terai respectively in comparison to increases of 7.0 percent, 7.5 percent and 7.1 percent in respective regions in the same period of the previous fiscal year.

Figure 4: Annual Inflation Rate (%)



Annual point-to-point CPI-based inflation rate remained at 13.1 percent, which was 7.2 percent for the same period of Fiscal Year 2007. The average inflation rate in mid-March 2009 stood at 13.8 percent in the first eight months of current FY 2008/09, which was 6.4 percent during the same period of the previous fiscal year. As per the Monetary Policy of FY 2008/09 announced by Nepal Rastra Bank, it was expected that the average CPI-based inflation would remain under control at 7.5 percent. However, through the mid-term review of monetary policy, the revised estimated CPI-based inflation is estimated to go up to 11.0 percent in Fiscal Year 2008/09. Even in a situation when rate of inflation remained low in most of the countries and wholesale price index in the neighbouring country India remained below 4.0 percent, rate of inflation in Nepal did not fall. Prices of food and services and inflation are less likely to fall due to increased hour of load shedding, closures, strikes, political instability, and the country passing through the transition period.

(c) Consumption

The consumption at purchaser's price is reached 524.938 billion, which is 6 percent higher than that of previous year. This amount is 90.7 percent of GDP, which was 89.6 percent in the preceding year.

Figure 5: Consumer Price Index

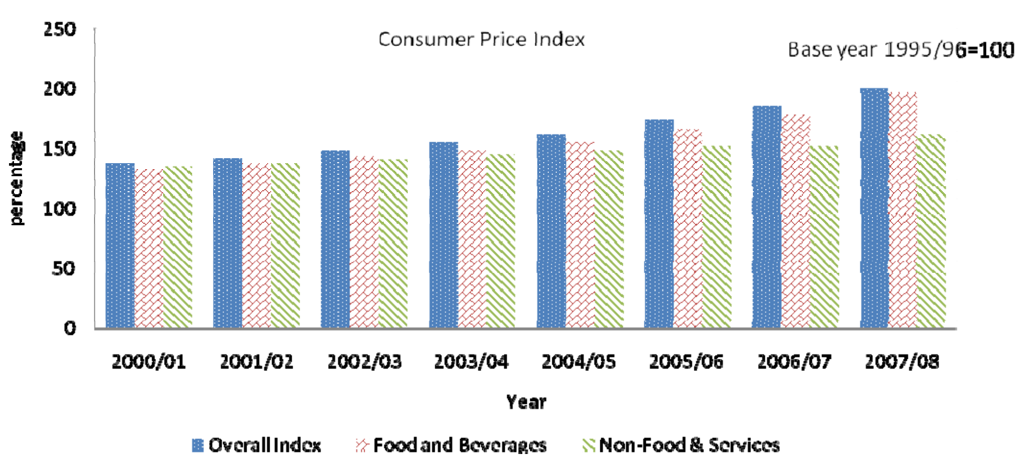


Table 12 : Intermediate Consumption by Industrial Division (at current price) (Fiscal Year)

Rs. Millions

Industries	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08 R	2008/09 P
Agriculture and forestry	55268	56689	59656	62323	65591	69465	75849	88210	96701
Fishing	477	478	480	489	499	501	503	505	573
Mining and Quarrying	466	554	596	649	708	810	879	989	1132
Manufacturing	100963	97434	100063	10726	11530	123035	134324	143718	157501
Electricity gas and water	4963	6343	6009	7587	8338	9465	10265	11625	11770
Construction	25538	29343	31461	33677	37521	42195	46647	53038	61657
Wholesale and retail trade	13279	12342	13093	14936	15222	17151	17865	20779	23811
Hotels and restaurants	17027	15574	16321	18679	19156	20079	22379	26269	31152
Transport, storage and communications	25708	27869	30718	34986	38992	46099	52085	54856	61362
Financial intermediation	3736	4582	5035	5639	5697	5960	8430	8528	10050
Real estate, renting and business activities	12256	12917	13975	15000	18448	25656	29784	34150	39419
Public adm. and defence	1476	2072	2461	2663	3296	3321	4297	4860	6716
Education	4539	5529	7023	7662	9471	9983	12231	13843	17685
Health and social work	1588	1774	2084	2338	2808	3088	3916	4793	5525
Other community, social & personal service activities	4916	4371	4960	5794	6460	6840	9120	11037	17884
Intermediate consumption at purchasers' prices	272201	277872	293936	319689	347509	383648	428574	477200	542938
P = Preliminary, R = Revised	272201	267452	274434	286876	294250				308738

Note: NSIC Division 16 & 17 are included in the Division 15.

Source: Central Bureau of Statistics

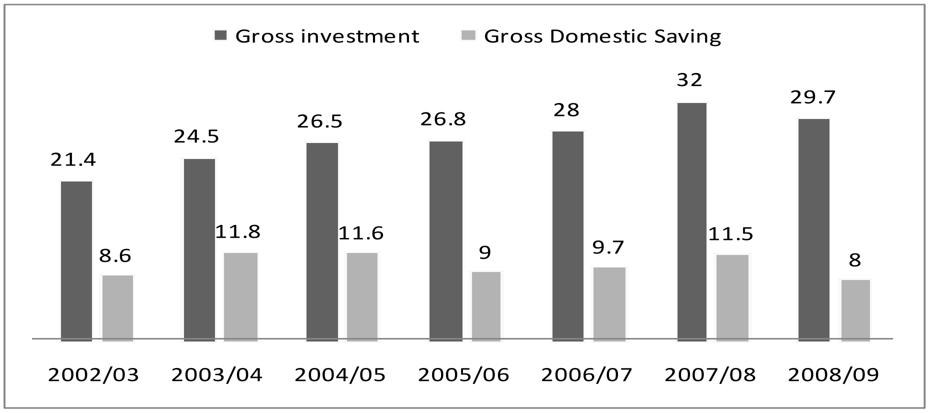
The share of consumption structure shows that manufacturing sector occupying in highest 29 percent followed by agriculture and forestry 18 percent.

(d) 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 is 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 below

Figure 6: Ratio of Investment and Saving with GDP Percentage



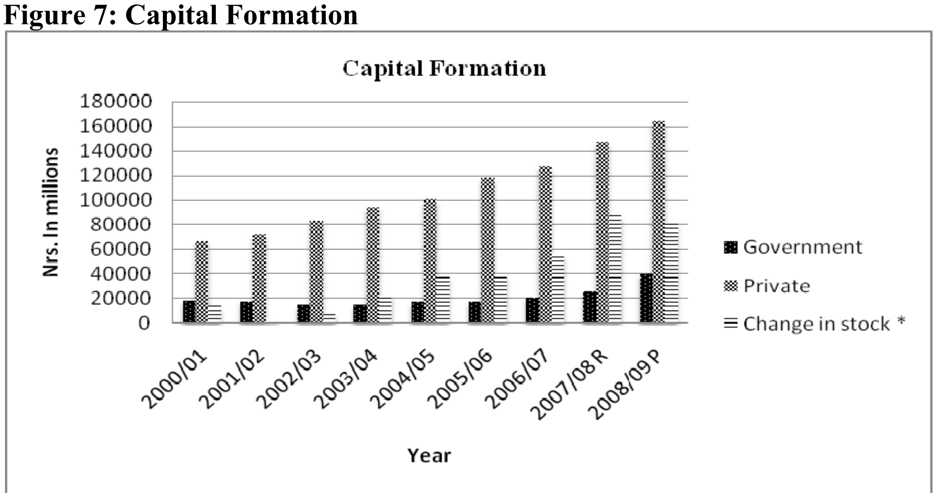
The ratio of domestic savings to GDP at current prices in FY2008/09 stood at 8.0 percent as compared to 11.2 percent in FY2007/08. Similarly, the ratio of national saving reached 32.3 percent in

FY 2008/09 from 31.5 percent in the previous year. Consequently, the ratio of investment to GDP down slid from 31.8 percent to 29.7 percent between these two periods. Ratio of net exports of goods and services to GDP, which remained adverse by 20.6 percent in the previous year, has reached 21.7 percent during this period. The widening of gap between the Gross Domestic Savings Ratio and Investment will hinder regular development activities on one hand while making resource management and foreign loan services more complex on the other. Therefore, it is necessary to give special attention to increase Gross Domestic Savings Ratio, control unproductive recurrent expenditure and increase productive utilization of development funds by maintaining foreign debts and services at a healthy level for sustainable Government finance and overall economic development of the country.

(e) Capital stock

The amount of capital investment of private sector is less with compared to government investment though the projected trend in 2008/09 is less than revised capital formation in 2007/08 and reached to 81201 million. The government invest is increasing in current expenditure and private sector are shy for capital investment.

Figure 7: Capital Formation



There is a challenge to develop efficient and competitive financial market through the integrated and collective effort of Financial Market Regulatory Agency, Nepal Securities Board, Nepal Rastra Bank, and

Insurance Board (Beema Samiti) to enhance the level to support infrastructure building and other development activities through enhancing access to the capital stock.

(f) 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 figure8 and data affecting to it is mentioned in table 13.

Table 13 : Factors Affecting Money Supply (annual change in percent)

Rs. in Million

Heads	Mid-July					First 8months			
	2001	2002	2003	2004	2005	2006	2007	2008	2008/09*
Net Foreign Assets	6.5	-3.8	4.9	17.5	5.3	23.8	4.2	22.5	20.3
Net Domestic Assets	21.9	10.2	13.0	10.0	10.3	11.1	20.6	26.6	10.1
Domestic Credit	18.9	10.4	10.4	9.9	13.8	7.8	11.7	21.3	7.5
Domestic Credit							16.7	20.4	0.0
Net Claims on Government	29.5	22.4	5.9	-1.8	11.3	10.4	10.4	11.2	-23.1
a. Claims on Government	29.5	22.4	6.7	-1.3	9.9	10.4	14.8	11.7	2.7
b. Govt. Deposits				63.1			0.0	26.4	572.0
Claim on Govt. Enterprises	15.6	21.1	1.6	10.9	18.7	-11.3	12.1	10.4	5.3
a. Financial	14.0	17.2	4.2	12.8	-4.6		1.1	30.0	40.4
b. Non Financial	22.9	38.4		2.9	125.3	-32.1	-5.3	-2.5	-13.8
Claims on Non-Financial Govt.Enter						85.3	7.6	59.2	70.1
Claims on Private Sector	15.8	5.2	13.2	14.3	14.2	8.8	12.3	24.3	14.9
Claims on Private Sector						14.4	18.9	22.9	0.0
Net-Non Monetary Liabilites	12.5	11.0	5.3	9.6	21.5	0.5	-4.3	6.7	0.0
Net-Non Monetary-Liabilites						13.1	9.6	5.8	0.0
Broad Money, M2	15.2	4.4	9.8	12.8	8.3	15.6	14.0	25.2	13.6
Narrow Money, M1	15.7	9.3	8.6	12.2	6.6	14.2	12.2	21.6	11.9
a. Currency	14.6	15.2	2.2	11.1	8.8	13.3	7.4	19.9	21.9
b. Demand Deposits	18.3	-3.5	25.0	14.5	2.2	16.0	22.8	25.0	-6.6
Time and Saving Deposits	15.0	2.1	10.4	13.1	9.2	16.4	14.9	27.0	14.4

Provisional

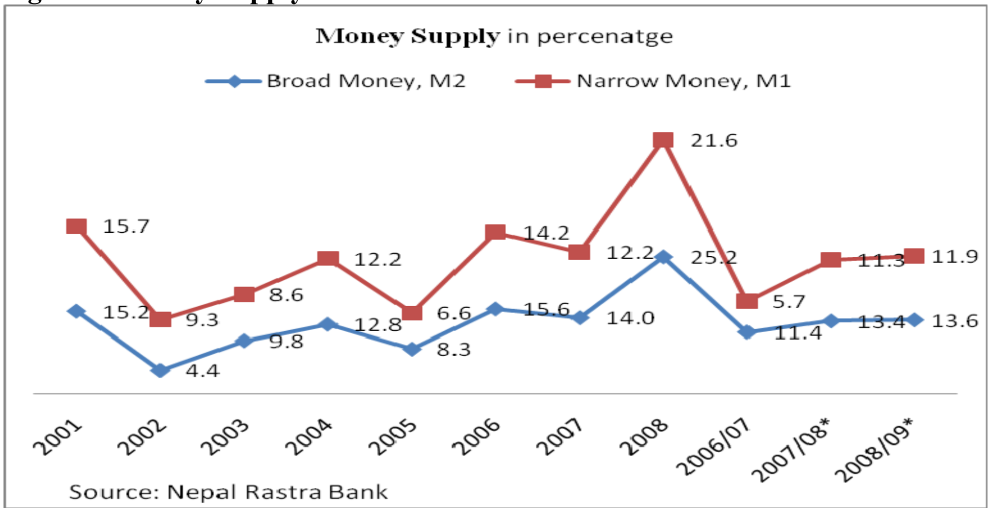
Adjustment of exchange valuation gain/loss

Adjusting credit write-off of Rs 11.05 billion in the series of Mid-July 2006 and credit write-off of Rs 2869.3 million (Rs 821.7 million principal and Rs 2047.6 million interest) as at mid Oct-2006 by Nepal Bank Ltd. and Rs 13.2 billion (Rs 4055.2 million principal and Rs 9099.3 million interest) by RBB as at mid Dec-2006

Including Margin Deposits

During the first 8 months of FY2008/09, broad money supply has grown by 13.6 percent in contrast to 13.4 percent in the same period of the previous year. Despite some respite in the expansion of domestic credit than in the previous year, a substantial growth in net foreign assets in the monetary sector has resulted in the expansion of broad money supply this year.

Figure 8: Money Supply



As compared to the review period of the previous fiscal year, the narrow money (M1) supply grew marginally from 11.3 percent to 11.9 percent during the same period of this fiscal year. Although there has been a decline in demand deposits by 6.6 percent, the growth of the money in circulation from the previous year's 13.9 percent to 21.9 percent this year is also one of the reasons for the growth in M1 during this period. During the review period, demand deposits decreased by 6.6 percent, while that of time deposits has increased by 14.4 percent in the review period like in the previous year. Cash reserve has reached Rs20.95 billion with a growth of 14.5 percent against its increase of 12percent the previous year. Net foreign assets (adjusted to profit/loss on foreign exchange valuation) increased by 20.3 percent to Rs. 34.81 billion during the first 8 months of current fiscal year against Rs. 13.63 billion in the same period of the previous fiscal year. The growth in net foreign assets is due to the encouraging growth in the inflow of remittances and foreign assistance to the Government.

(g) Employment

According to the population Census 2001, economically active population in the labour market was estimated at 10.482 million. The Tenth Plan made a forecast for generation of additional 1.53 million employment opportunities during the plan period. The Forecast was based on the potential effects of production increase in various sectors of the economy, and inter-sector al linkages. Thus, it was estimated that the total employment would reach to 11.012 million at the end of the Tenth Plan. According to the Tenth Plan, the number of economically active population was estimated to reach to 11.580 million toward the end of the plan period, out of which only 4.1 percent were estimated to remain unemployed. The number of semi-employed was estimated to decline by 22.3 percent by the end of the Plan period. Since an extensive performance review of the Tenth Plan is yet due, exact status of the progress could not be established.

The main objective of the Tenth Plan was poverty reduction, and realizing this objective could be possible only through raising employment opportunities. As such, various policy measures have been in operation toward this end. With a target of reducing poverty to 32 percent from the 42 percent by the end of the Plan period, various programmes were implemented with the major focus on the Plan strategy i.e. high, sustainable and broad-based economic development, Social sector and Rural Infrastructure Development, Targeted programs and Good Governance.

At present, a number of policies are in operation. for instant: Enhancement of employment opportunities through the expansion of economic and social development activities; Promotion of labour intensive businesses for increasing access of the poor to employment opportunities; Implementation of income generation and employment programmes targeting the backward class of the people and geographical regions; Carry along the aspects of the professional efficiency and basic rights of labourers in a balanced way; and Maximization the foreign employment opportunities by producing the skilled human resources. Information as how much employment was created as a result of implementation of these policies during the Plan period is not available as progress review of the Plan is not complete yet.

Despite the growing number of Nepalese going on foreign employment, the number of unemployed persons does not seem to have come down. According to the population Census 2001, the unemployment rate was 5.1 percent of the population above the age 10 years old. However, the Nepal Living Standard Survey (NLSS) 2003/04 indicates 2.9 percent unemployed among the people of 15 or above age group; 74.3 percent were employed; and remaining 22.8 percent were economically inactive. Among the unemployed 3.1 persons were male and 2.7 percent female.

Table 14: Employment Situation in Nepal (Population of 15 years of age or above)

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

Source: Nepal Living standard Survey .2003/04, central Bureau of Statistics

The decade-long conflict in the country had negative impact on industries and factories, by which some factories were fully closed, some were partially closed, and many of the functioning factories also could not operate in their full capacities. Consequently, many of the factory workers were compulsorily deprived of employment opportunities. On the other hand, the government's inability to create new employment opportunities as a result of its campaign of making a small and efficient government is also reflected in the rise in unemployment.

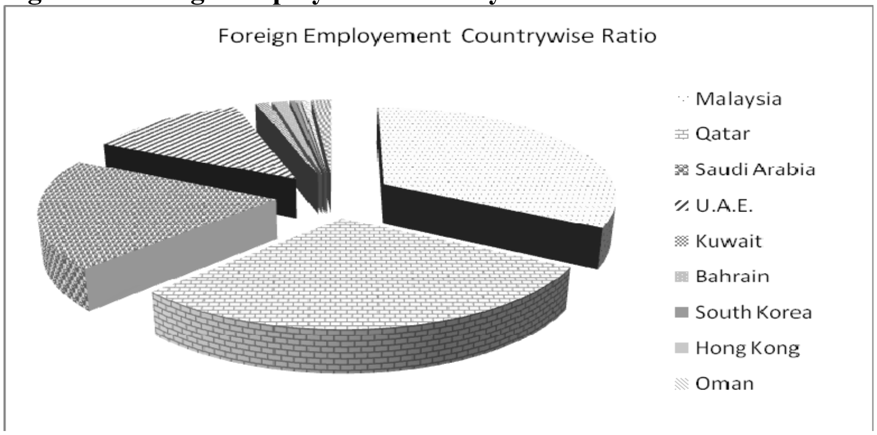
Because of the insufficient employment opportunities, the number of Nepalese going abroad for employment is growing year by year. The number of people going abroad for employment to Arabian countries except Malaysia and South Korea is high. By the end of FY2006/07, the total number of people going abroad with institutional approval is 978,125. Likewise 229,373 people receive approval during FY2006/07 and by Mid April of 2008/09. In addition 86,783 persons received approval making the total approved number for foreign employment to 1,394,281

Table 15: Destination for Foreign Employment

Country/Area	*Total Number by FY 2006/007*	*Target for FY 2007/08*	*The number by mid May FY 2008/09*	*Total Number*
Malaysia	378,696	44,445	30,036	458177
Qatar	266,094	83,896	66,031	416,021
Saudi Arabia	190,469	42,214	39,406	272,089
U.A.E.	105,941	43,828	26,890	176,659
Kuwait	11,939	1,461	1,608	15,008
Bahrain	6,583	4,335	5,691	16,609
South Korea	6,441	0	56	6,497
Hong Kong	3,704	189	56	3,949
Oman	1,344	2,205	3,143	6692
Other countries	6,914	1800	13,866	22580
Total	978,125	229,373	186,783	1,394,281

Source: Ministry of Labour and Transport management. Kathmandu Nepal.

Figure 9: Foreign Employment Countrywise Ratio



Observation of the trend of Nepalese seeking jobs abroad, the majority of them, i.e. 458,177 persons (32.9 percent) have gone to Malaysia followed by 416,021 (29.8 percent) to Qatar. The third destination is Saudi Arabia 272,089 (19.5 percent). Similarly, 176,659 (12.7 percent) to U.A.E., 15,008 (1.1 percent) to Kuwait, 16,609 (1.2 percent) to Bahrain 6,457 (0.5 Percent) to South Korea 6,692 (0.5 percent) to Oman, 3,949 (0.3 percent) to Hong Kong, and 22,580 (1.6 percent) Nepalese have gone in other countries for employment.

By mid April of the fiscal year 2008/09, the total number of people going abroad for foreign employment was 186,783, out of which 30,036 to Malaysia, 66,031 to Qatar, 39,406 to Saudi Arabia, and 26,892 to UAE. Of the people gone abroad for employment during the same period, 5,691 are in Bahrain, 3143 in Oman.

II.2 Fiscal Position

(a) Government expenditure

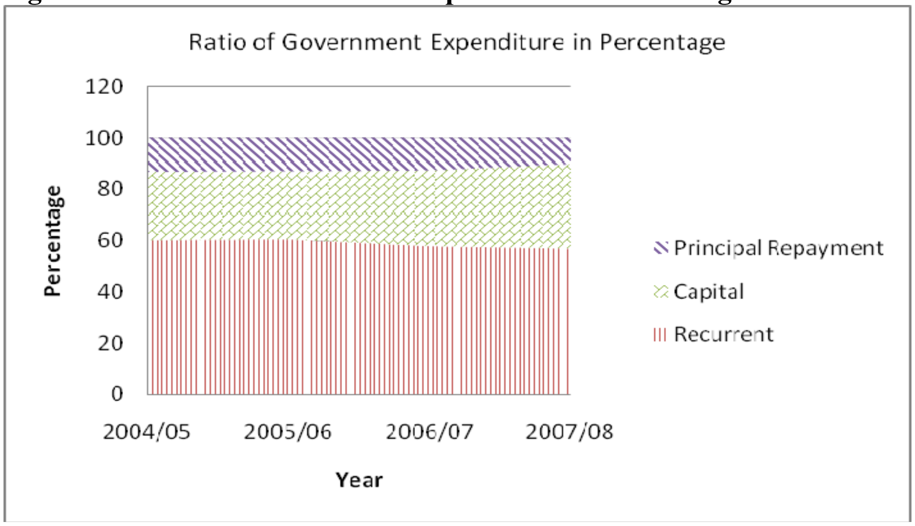
The total government expenditure in FY2006/07 had increased by 20.5 percent compared to the previous fiscal year while it increased by 20.8 percent in FY2007/08. Of this, recurrent expenditure in FY2006/07 was 15.1 percent while it increased by 18.6 percent in FY2007/08. The capital expenditure in FY2006/07 had increased by 34.2 percent while it increased by 34.7 percent in FY 2007/08. As compared to 17.4 percent growth on the repayment of principal in FY2006/07, it declined by 2.2 percent in FY2007/08.

The Government expenditure in FY2007/08 totaled Rs. 161.350 billion. Of the total expenditure of Rs. 133.605 billion in FY2006/07, revenue mobilization financed 65.7 percent, foreign grants 11.8 percent, foreign loan 7.5 percent, domestic borrowing 13.4 percent while the change in reserves shared 1.6 percent. Among the sources of financing the expenditure in FY2007/08, revenue mobilization contributed 66.7 percent, foreign grants 12.8 percent, foreign loan 5.6 percent, domestic borrowings 12.7 percent and change in reserves shared 2.4 percent.

The recurrent expenditure in FY 2007/08 totaled Rs. 91.44 billion, which is 18.6 percent higher than that of the previous fiscal year. This expenditure for the previous fiscal year stood at Rs. 77.12 billion. Of the total recurrent expenditure, the share of constitutional bodies was 1.8 percent, general administration 15.2 percent, revenue and fiscal administration 1.0 percent, fiscal administration and planning 0.4 percent, judicial administration 0.7 percent and the share of foreign services was 1.1 percent. Likewise, share towards defense expenditure was 11.6 percent; social service 38.4 percent, economic services 10.1 percent, principal interest payments 7.0 percent and share of miscellaneous expenditure was 12.8 percent.

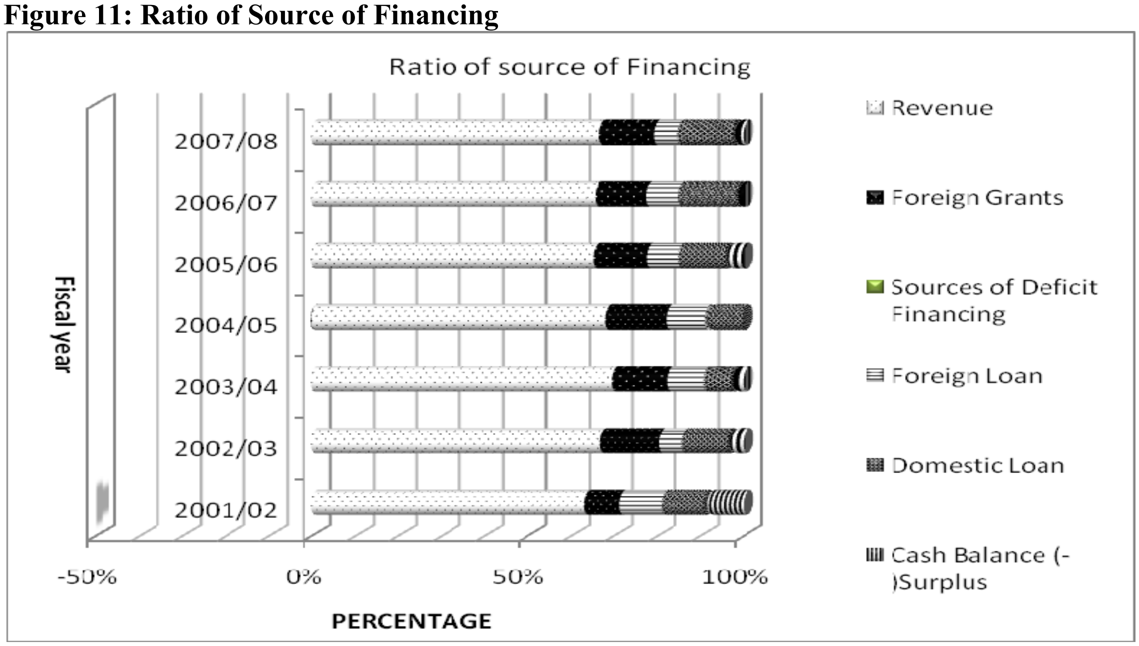
Of the total recurrent expenditure in FY2007/08, major portion of such expenditure (Rs. 35.73 billion) was on education, health, drinking water, local development, and other social services. Similarly, other major recurrent expenditures were on general administration constituting Rs. 13.94 billion, defense Rs. 10. 565 billion and economic services with Rs. 9.20 billion. In the same fiscal year, expenditure towards interest repayment of Principal was Rs. 6.374 billion.

Figure 10: Ratio of Government Expenditure in Percentage



Analyses of some of the major recurrent expenditures show that expenditure on social services increased by 18.9 percent in FY2007/08 compared to the fiscal year 2006/07. During the same period, such expenditures on defense rose by 4.3 percent, general administration by 25.8 percent, judiciary administration by 16.0 percent, foreign services by 20.5 percent, economic services by 9.7 percent, constitutional body by 87.5 percent, and miscellaneous expenditures by 47.8 percent. However, such expenditure on revenue and fiscal administration has declined by 8.4 percent followed by a fall of 45.5 percent decline in expenditures on fiscal administration and planning. Expenditure on interest repayments, however, increased by 3.4 percent in FY2007/08 as compared to the previous fiscal year.

Figure 11: Ratio of Source of Financing



Compared to the previous fiscal year, capital expenditure in FY2007/08 rose by 34.7 percent totaling Rs. 53.516billion. Such expenditure in FY 2006/07 was Rs. 39.730 billion. Among the major components of capital Expenditure, economic services expenditure remained at Rs. 22.143billion, social services at Rs.

20.284billion and defense at Rs. 809.2 million. Likewise, capital expenditure on general administration stood at Rs. 1.774 billion, judicial administration Rs. 277.1 million, loan and investment Rs. 6.903 billion, constitutional organs Rs. 96.0 million, revenue and fiscal administration Rs. 191.1 million, fiscal administration and planning Rs. 79.8 million, foreign services Rs. 53.6 million, and miscellaneous expenditure Rs 906.2 million. On the total capital expenditure, economic services shared 41.4 percent, social services 37.9 percent, defense 1.5 percent, general administration 3.3 percent, judicial administration 0.5 percent, loan and investment 12.9 percent, constitutional bodies 0.2 percent, revenue and fiscal administration 0.4 percent, fiscal administration and planning 0.1 percent, foreign services 0.1 percent and miscellaneous expenditures 1.7 percent. When compared to the capital expenditure of FY2006/07, such expenditure rose by 30.6 percent on social services and that for economic services by 23.4 percent, while defense and general administration expenditures declined by 19.1 percent and 60.7 percent respectively. The expenditure on revenue and fiscal administration was increased notably by 141.0 percent. Likewise, expenditure on administration rose by 15.2 percent while that of fiscal administration and planning put together rose sharply by 204.5 percent.

Table 16 : Ratio of Fiscal Heads to Total Government Expenditure

Descriptions	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Expenditure	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Recurrent	61.0	62.0	62.1	60.1	60.4	57.7	56.7
Capital	30.9	26.6	25.8	26.7	26.7	29.7	33.2
Principal Repayment	8.0	11.4	12.1	13.2	12.9	12.6	10.2
Income	71.4	80.4	82.3	82.4	77.7	77.5	79.3
Revenue	63.0	66.9	69.7	68.4	65.2	65.7	66.7
Foreign Grants	8.4	13.5	12.6	14.0	12.5	11.8	12.6
Saving (+)/Deficit(-)	-28.6	-19.6	-17.7	-17.6	-22.3	-22.5	-20.7
Foreign Loan	9.6	5.4	8.5	9.0	7.4	7.5	5.6
Domestic Borrowings	10.0	10.6	6.3	8.7	10.7	13.4	12.7
Change in Reserve (-) surplus	9.0	3.6	2.9	-0.2	4.3	1.6	2.4

Source: Financial Comptroller General Office

In FY 2007/08, the interest repayment on principal has remained at Rs. 16.387 billion. Such expenditure was Rs.16.752 billion in the previous fiscal year. Of the total principal repayment expenditures, the share of principal repayment against domestic borrowing was 52.0 percent and that of foreign loan was 48.0 percent in FY2007/08.When compared to the previous fiscal year. The principal repayment against domestic borrowings in FY2007/08 had decreased by 7.6 percent while that of foreign loan by 4.4 percent.

Table 17: Government Expenditure and Sources of Financing

Rs. in Million

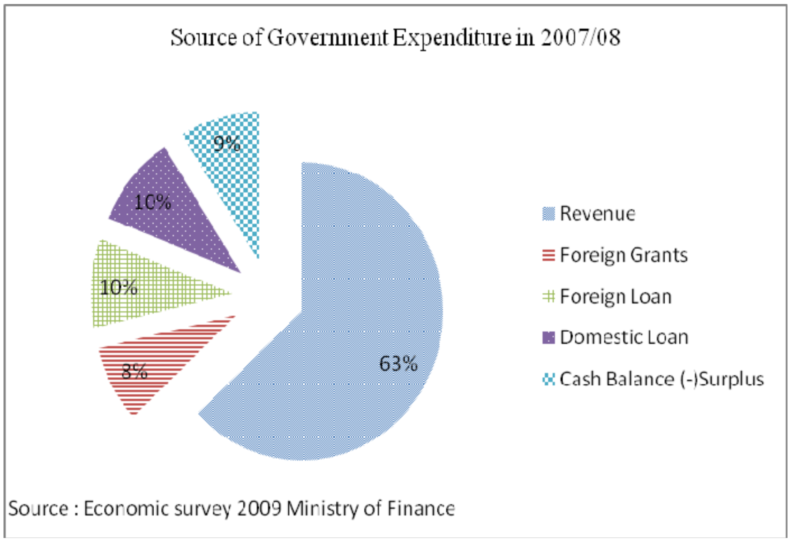
Description	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Expenditures	80072.20	84006.10	89442.60	102560.40	110889.20	133604.60	161349.90
Recurrent Expenditure	48863.90	52090.50	55552.10	61686.40	67017.80	77122.40	91446.90
Capital Expenditure	24773.40	22356.10	23095.60	27340.70	29606.60	39729.90	53516.10
Principal Repayment	6434.90	9559.50	10794.90	13533.30	14264.80	16752.30	16386.90
Receipts	57131.60	67568.90	73614.40	84513.90	86109.60	103512.90	127943.20
Revenue	50445.50	56229.80	62331.00	70122.70	72282.10	87712.10	107622.50
Foreign Grants	6686.10	11339.10	11283.40	14391.20	13827.50	15800.80	20320.70
Surplus (+) Deficit (-)	-22940.60	-16437.20	-15828.20	-18046.50	-24779.60	-30091.70	-33406.70
Sources of Deficit Financing	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Foreign Loan	7698.70	4546.40	7629.00	9266.10	8214.30	10053.50	8979.90
Domestic Loan	8000.00	8880.00	5607.80	8938.10	11834.20	17892.30	20496.40
Cash Balance (-)Surplus	7241.90	3010.80	2591.40	-157.70	4731.10	2145.90	3930.40

Note: The expenditure heads till FY 2003/04 were classified as regular and development. Since FY 2004/05, the expenditure has been classified as recurrent, capital and principal repayment. The expenditure heads and sub-heads since 1998/99 through 2003/04 may not tally with previous heads/ sub-heads, as these have been presented here by reclassifying as recurrent, capital and principal repayment.

Source: Financial Comptroller General Office

Based on total disbursement and operation of current accounts, total expenditure had increased by 12.7 percent totaling Rs. 114.799 billion in the first eight months of the current fiscal year as compared to the same period of the last fiscal year. In the same period of FY2007/08, such expenditure was Rs. 101.823billion. Of the total expenditure in the review period of FY 2008/09,

Figure 12: Source of Government Expenditure in 2007/08

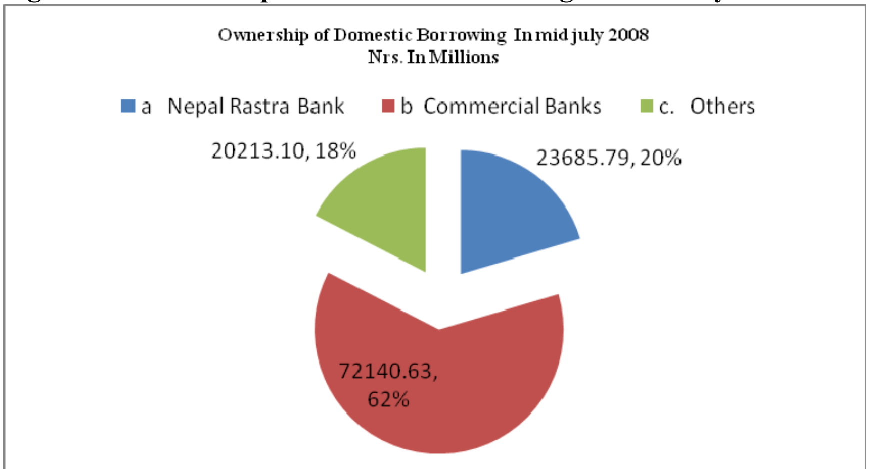


Recurrent expenditure accounted for Rs. 77.328 billion, capital expenditure Rs. 25.913billion and principal repayment Rs. 11.559 billion. In the first eight months of FY2008/09, recurrent expenditure totaled to Rs. 64.606 billion, capital expenditure Rs. 26.693 billion, and principal repayment Rs. 10.521billion. When compared to the first eight months of FY2007/08, recurrent expenditure has increased by 19.7 percent, while capital expenditure decreased by 2.9 percent in the same period of current fiscal year. Likewise, principal repayment expenditure also increased by 9.9 percent in the same period.

(b) Public Borrowing

Regarding the total public borrowing foreign aid and loan has described in previous chapter and this part content domestic borrowing and some comparative analysis.

Figure 13: Ownership of Domestic Borrowing in Mid-July 2008



Source : Economic Survey 2009, Ministry of Finance

Outstanding domestic debt increased by 11.8 percent to Rs.116.4 billion in mid-July 2008 from Rs.103.776billion in mid-July of 2007. Of the total outstanding debt by mid-July 2008, the share of Nepal Rastra Bank was Rs.23.686 billion (20.4 percent), with Rs.72.141 billion (62.2 percent) that of commercial banks, and other nonbank institutions and private sector shared Rs. 20.213 billion (17.4 percent). On analyzing domestic borrowing by instruments, 73.3 percent was Treasury Bills, 18.7 percent development bonds, 1.0 percent National Savings Certificate, 2.6 percent Citizens Savings Certificates and 4.4 percent special bonds.

Table 18 : Pattern of Government Bonds and Treasury Bills

Rs. in Million

Description	As of Mid July						
	2002	2003	2004	2005	2006	2007	2008
Treasury Bills	41106.50	48860.70	49429.60	51383.10	62970.30	74445.34	85033.03
Development Bonds	11090.70	16059.20	17549.20	19999.20	17959.20	19177.10	21735.43
National Savings Certificate	11536.10	9629.80	9029.80	6576.70	3876.80	1516.92	1116.92
Citizen Saving Certificate	0.00	931.10	1178.90	1428.90	1678.90	1391.00	3014.36
Special Bonds	9259.30	9164.50	8946.20	8176.30	8225.60	7245.69	5139.77
Total	24122.30	23685.70	19138.80	17445.80	15805.00	20101.86	23685.79
a Nepal Rastra Bank	29361.20	39469.30	43796.30	48550.70	58861.40	65836.42	72140.63
b Commercial Banks	20137.20	21490.30	23198.60	21567.70	20044.40	17837.75	20213.10
c. OthersGrand Total	73620.70	84645.30	86133.70	87564.20	94710.80	103776.04	116039.51

* Includes CBPASS, 20 Years Special Bonds and Forest Compensation Special Bonds
Source: Nepal Rastra Bank

(c) Fiscal deficit

The result of imbalance between expenditure and non-debt resources, is being financed through foreign loan, domestic borrowing and cash balance. The persistence of fiscal deficit is due to less receipt of revenue and foreign grants as compared to the level of expenditure. As such, fiscal deficit increased by 11.0 percent to Rs.33.407 billion in FY2007/08 from Rs.30.092 billion in FY 2006/07. The fiscal deficit that was in a decreasing trend since fiscal year 2001/02 started showing increasing trend again from FY2004/05. The ratio of fiscal deficit to GDP, which was at 4.1percent in

Table 19 : Fiscal Deficit

(Rs. in Millions)

Fiscal Year	Fiscal Deficit	Fiscal Deficit/GDP Ratio (in percent)
2000/01	24,188.10	5.5
2001/02	22,940.60	5
2002/03	16,437.20	3.3
2003/04	15,828.20	2.9
2004/05	18,046.50	3.1
2005/06	24,779.60	3.8
2006/07	30,091.70	4.1
2007/08	33,406.70	4.1

Source: FCGO, and Central Bureau of Statistics

FY 2006/07 remained unchanged during FY 2007/08 as well.Of the fiscal deficit of Rs.33.407billion in FY2006/07, Rs.8.980 billion (26.9 percent) was financed through foreign loan, Rs.20.496billion (61.4 percent) through domestic borrowing and remaining Rs.3.934 billion (11.7 percent) through the change in cash reserves. Sources of financing the fiscal deficit of Rs.30.092 billion in FY 2006/07 were foreign loan (Rs. 10.053 billion), domestic borrowing (Rs. 17.892 billion) and change in cash reserves (Rs.2.146 billion).

(d) Outstanding debt liability

The outstanding debt liability of the government was Rs. 303.9 billion (domestic Rs. 80.5 billion and foreign Rs. 223.4 billion) in mid-July 2003. This increased at an annual average of 1.3 percent to reach Rs. 323.9 billion (domestic Rs. 107.7 billion and foreign Rs. 216.2 billion) in mid-July 2008. The domestic debt stock recorded an annual increment of 6 percent while the foreign debt stock declined at an annual rate of 0.7 percent during the period. The outstanding debt/GDP ratio fell from 61.7 percent (domestic 16.3 percent and foreign 45.4 percent) in mid-July 2003 to 39.4 percent (domestic 13.1 percent and foreign 26.3 percent) in mid-July 2008. The debt stock, especially the foreign debt portion, has fallen quite substantially.

(e) Revenue

Revenue mobilization, foreign grants and loan, domestic borrowings and Change in cash reserves are used as fiscal instruments for financing Government expenditures. When compared to FY2006/07, revenue mobilization in FY2007/08 increased by 22.7 percent to Rs107.625 billion. In FY2006/07, revenue collection had increased by 21.3 percent compared to its preceding fiscal year. The Government revenue had financed 65.7 percent of the total government expenditure in FY2006/07 while this source contributed to 66.7 percent of the total expenditure in FY 2007/08.

Table 20: Ratio of Government Expenditure and Revenue to GDP, (GDP at current producer's price)

	Fiscal Years				*(Percentage)*		
Description	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Recurrent Expenditure	10.6	10.6	10.3	10.5	10.2	10.6	11.2
Capital Expenditure	5.4	4.5	4.3	4.6	4.5	5.5	6.5
Principal repayment Expenditure	1.4	1.9	2	2.3	2.2	2.3	2
Net Expenditure	17.4	17.1	16.7	17.4	17	18.3	19.7
Revenue Mobilization	11	11.4	11.6	11.9	11.1	12	13.2
Different between Expenditure and Revenue	6.4	5.6	5.1	5.5	5.9	6.3	6.6

Source: FCGO, and Central Bureau of Statistics

The ratio of total expenditure and revenue to GDP has increased in FY2007/08 compared to that of FY2006/07. The ratio of Government Expenditure increased to 19.7 percent in FY2007/08 from 18.3 percent in FY2006/07. The revenue ratio increased to 13.2 percent in FY2007/08 from 12.0 percent in FY2006/07. The gap between revenue mobilization and total expenditure has reached to 6.6 percent in FY2007/08 from 6.3 percent in FY2006/07.

There has been significant improvement in the revenue surplus in FY2007/08 compared to that of the previous fiscal year, calculated as the difference between revenue mobilization and recurrent expenditure. Such surplus is considered as a sustainable source to finance the capital expenditure and principal repayments. The ratio of revenue surplus to the Capital expenditure and principal repayments in FY2006/07 was 18.7 percent while this ratio is calculated at 23.1 percent in FY2007/08. Of the sources to finance capital and principal repayments, the share of foreign grants in FY2007/08 has increased by 1.1 percentage point to 29.1 percent compared to that of the previous fiscal year. Similarly, such ratio of deficit financing in FY2007/08 decreased by 5.5 percent to 47.8 percentage point compared to that of the previous fiscal year.

Table 21 : Tax Revenue

Rs. in Million

Heading	Fiscal Year							
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09*
Customs	12658.75	14236.43	15554.80	15701.60	15344.00	16707.60	21062.50	15403.90
Tax on Consumption and Product of Goods and Services	16074.35	18244.82	20705.60	25331.30	28118.30	35438.80	41005.32	32962.10
Excise on Industrial Products	3807.05	4785.12	6226.70	6445.90	6507.60	9343.20	11189.58	9221.30
Value Added Tax	12267.30	13459.70	14478.90	18885.40	21610.70	26095.60	29815.70	23740.80
Land Revenue and Registration	1131.82	1414.30	1697.50	1799.20	2181.10	2253.50	2940.74	2722.70
Tax on Property, Profit & Income	9465.73	8691.36	10215.10	11272.60	11787.00	16726.80	20147.02	16991.50
Income Tax – PE	1769.33	1251.02	2056.60	1332.40	195.70	1019.70	204.58	481.40
Income Tax -Private Corporation	1412.01	1236.27	1531.30	2467.80	3404.30	5717.10	7186.46	5062.90
Income Tax - Individuals	4419.09	3362.20	3533.40	3926.30	4234.70	5234.40	6381.21	5739.10
Income Tax - Remunerations	835.56	1252.60	1391.20	1675.90	1764.10	2007.90	2451.04	1806.40
Urban House and Land Tax	2.29	0.04	0.00	0.00	0.00	0.00	0.00	0.00
Vehicle Tax	559.74	559.48	700.60	806.50	847.60	995.00	1069.21	1256.40
Tax on Interest	467.70	864.00	733.40	757.00	774.90	1054.90	1087.93	1188.90
Other Taxes	0.00	165.77	268.60	306.70	565.70	697.80	1766.59	1456.40
Total	39330.64	42586.92	48173.00	54104.70	57430.40	71126.70	85155.54	68080.20

*Provisional

Note : Value Added Tax includes Sales Tax, Entertainment Tax, Hotel Tax, Air Flight Tax and Contract Tax.

Source : Financial Comptroller General Office

Tax revenue increased by 19.7 percent in FY 2007/08 compared to that of the previous fiscal year. Such revenue had increased by 23.8 percent in FY 2006/07 compared to its preceding fiscal year. Of the total tax revenue in FY 2007/08, the share of customs duty was 24.7 percent while the share of tax on production and consumption of goods and services was 48.2 percent. Likewise, the share of land revenue and registration was 3.4 percent and that of income, profit, and property tax was 23.7 percent.

Customs revenue increased by 26.1 percent on the tax revenue front in FY2007/08 as compared to FY 2006/07 while tax levied on production and consumption of goods and services increased by 15.7 percent. Income, profit, and property tax increased by 20.4 percent and land revenue and registration fees by 30.5 percent. Of the customs revenue, revenue from imports increased by 25.7 percent while that from exports decreased by 37.1 percent, and Indian excise refund increased by 58.0 percent in FY 2007/08. Excise duty levied on the production and consumption of goods and services has increased by 19.8 percent and value added tax by 14.3 percent.

Table 22 : Non-Tax Revenue

Rs. in Million

Heading	Fiscal Year							
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09*
Charges, Fees, Fines and Forfeiture	518.81	579.62	1202.50	1359.90	1927.70	1945.40	2554.77	3547.00
Receipts from sales of Commodities	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Dividend	2512.82	2497.64	2661.10	4589.90	3394.80	4937.70	5025.92	4226.60
Royalty and Sale of Fixed Assets	723.87	1945.4	1465.00	1931.40	1196.80	1091.80	5773.65	1943.90
Principal and Interest Payment	3109.41	2464.28	3507.1	2714.30	3251.30	2085.70	3440.06	2974.50
Miscellaneous Items	1638.82	3092.84	1825.30	1572.60	1148.70	1748.10	774.84	190.80
Total	11114.90	13642.86	14158.00	16018.00	14851.60	16585.50	22466.95	16123.00

*Provisional

Source: Financial Comptroller General Office

Non-tax revenue increased by 35.5 percent to Rs. 224.67 billion in FY 2007/08 compared to that of FY 2006/07. Of the total non-tax revenue, the share of fees, fines, forfeitures was 11.4 percent; the share of income from government service and sales of goods was 21. 8 percent, dividend was 22.4 percent, sales of royalty and government's properties was 25.7 percent, principal and interest was 15.3 percent and miscellaneous non-tax revenue was 3.4 percent. On the non-tax revenue front, the growth of firm registration fees was 41.6 percent and administrative fees, penalties, fines and forfeitures was 7.2 percent in FY 2007/08 compared to previous fiscal year. Dividend of service-oriented organizations is found to have increased by 2.0 percent and income of other government sectors by 2.9 percent. On non-tax revenue side, principal repayments from companies and enterprises rose notably by 164.3 percent while payments of interest fell by 28.9 percent in FY2007/08 as compared to the previous fiscal year. A total Revenue of Rs. 84.203 billion has been collected till mid-March of FY2008/09. Total revenue of Rs. 60.892 billion was collected in the same period of the previous fiscal year. Thus, the rate of revenue growth has been 38.3 percent till mid-March of FY2008/09 as compared to the same period of the previous fiscal year. Of the total revenue collection, Rs. 68.080 billion came from the tax revenue, and Rs. 16.123 billion from non-tax revenues. The tax revenue growth rate was 33.8 percent till mid-March of FY 2008/09 while the growth of non-tax revenue was 61.3 percent. Customs revenue until mid-March of FY2008/09 compared to the same period of the previous year increased by 9.8 percent to Rs. 15.404 billion. During this period, tax on production and consumption of goods and services has increased by 36.3 percent to Rs. 32.962 billion compared to the same period of the previous fiscal year. Tax on imports has increased by 13.4 percent in the review period and the share of import revenue on the total customs revenue of this year stood at 82.9 percent whereas this share was 80.3 percent during the same period of the previous fiscal year. Export tax revenue has increased by 97.8 percent and the Indian Excise refund has decreased by 22.6 percent. Likewise, Registration fees increased by 102.0 percent, income tax (private sector) by 38.9 percent and vehicles tax by 43.2 percent.

III. Tax Structure: Institution and Reality

The overall Tax structure of Nepal comprises direct and indirect taxes. Details of the taxes have mentioned in previous table. This chapter describes organizational structure and administration of different taxes in Nepal.

Inland Revenue Department has established with the objectives of mobilization of maximum revenue by providing taxpayers friendly service through transparent, efficient, effective, modern and economy tax administration. To ease and simplify the tax administration then his majesty's government Nepal had converted then sales tax department to value added tax department, which was established by merging of department of sales tax and excise department. Thereafter, tax department, which was engaged in the administration of direct taxes, had also merged with value added tax department and named as Inland Revenue department in 2001.

The Inland Revenue Department (IRD) is currently responsible for the enforcement of Tax Laws and administration of the following taxes: Income Tax, Value Added Tax, Excise duty, Vehicle Tax and certain fee and duties like Entertainment fee(film Development Fee), Special fee etc. Likewise, the department is also responsible for monitoring the non-tax revenue such as dividend, royalties etc. of the government.

Inland Revenue Department carries out following functions related to Tax Administration (Income Tax and VAT), Tax Policy, Taxpayer Services, Collection, Audit, Enforcement and investigation, Review & Appeal, Refund, Advance Ruling, Tax Treaty and International Taxation, Excises and Liquor Administration and Monitoring of Non Tax

IRD is centrally located in Kathmandu. There are 22 field offices throughout the nation including a Large Taxpayers Office located in Kathmandu valley. The previous Department of Taxation was established in 1960. IRD and its district offices are totally running on functional line. Major functions include Taxpayer`s Service, Audit and Collection.

Likewise, for the administration of taxes from foreign trade; Department of Customs has major role for Customs duties, VAT, Excise and other taxes at the border point. it accounts 48% of the total Tax revenue and Customs duty itself contribute 22 % of the total Tax revenue. Customs Administration is in the forefront in terms of internal revenue mobilization.

Tax revenue contributed around 79.12 percent in 2007/08 and 82.27 percent in 2008/09 in the composition of total revenue. 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 GDP and different components of tax revenue are presented in the table below.

Table 23 : Revenue Components as Percentage of GDP

Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
VAT	2.7	2.7	2.7	3.2	3.3	3.6	3.6	4.16
Customs	2.7	2.9	2.9	2.7	2.3	2.3	2.1	2.23
Income tax	1.9	1.6	1.8	1.8	1.7	2.2	2.3	2.87
Excise Tax	0.8	1	1.2	1.1	1	1.3	1.4	1.16

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 duty increased over time. The share of VAT to GDP shows hopeful scenario in the revenue structure and reached to 4.16 percent of GDP. In 2008/09, the ratio of income Tax dominated the ratio of Customs Revenue, which is the result of restructuring of tariff after WTO accession of Nepal.

The year 2003/04 is the turning point for VAT revenue and custom revenue. From this year the share of VAT continuously increased and vice versa for custom duties till 2007/08 there is slightly increase in customs revenue in 2008/09. Income tax is doing well in later years and so is the excise duty revenue. The decrease of income tax in 2002/03 was very sharp. This might be the effect of transitional period created by new Income tax Act 2002, which was enforced only at the end of fiscal year 2001/02. The new Income Tax Act adopted full-fledged self assessment system, having the characteristics of modern super law. Taxpayers who were used to have official assessment might have reduced tax liability by self assessment due to ignorance of law. Government tried to encourage taxpayers to report the correct amount through taxpayer education, audit and investigation etc, but the effect of such effort was not significant and could not able to encourage business community for more compliance.

The custom duty decreased till 2007/08 because tariff rates were reduced because of tariff reduction in line with commitments under WTO, SAFTA and BIMSTEC arrangements but the Government of Nepal argued that it had launched performance incentive plan which result minimum revenue leakage in customs points and the amount of collection in customs increased significantly. On the contrary, since 2003/04 Value Added Tax continuously increased. Although the ratio of contribution of other Tax and duties has continuously dominated by VAT collection from 2003/04, the increase in revenue was boosted by the increase of its other components. The increment of VAT collection possible due to 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 some adjustment of Excise has also done . The share of custom duty and the VAT 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 had also increased during the period. It has become potential source of offsetting revenue loss from custom tariff reduction.

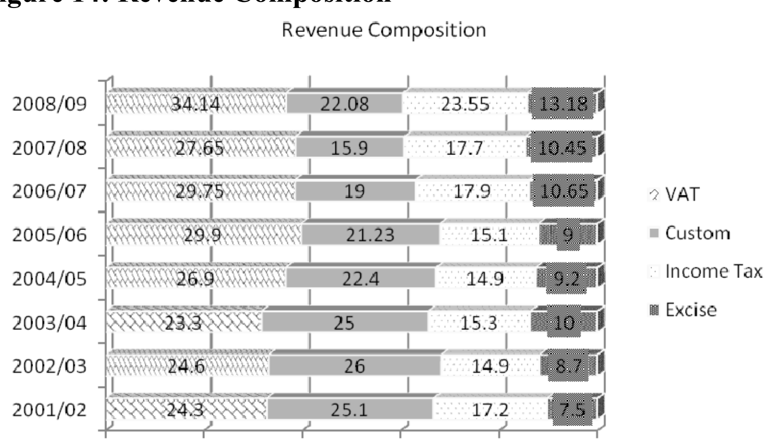
The structure of tax revenue has changed in recent years. The major component of revenue in the past, the custom duty, has decreased drastically. The structure of tax revenue for last eight years can be seen as follow:

Table 24 : Various Taxes as Percentage of Total Revenue

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
VAT	24.3	24.6	23.3	26.9	29.9	29.75	27.65	34.14
Custom	25.1	26	25	22.4	21.23	19	15.9	22.08
Income Tax	17.2	14.9	15.3	14.9	15.1	17.9	17.7	23.55
Excise	7.5	8.7	10	9.2	9	10.65	10.45	13.18

VAT revenue increased from 24.3 percent in 2001/02 to 34.14 percent in 2008/09 of total tax revenue likewise the ratio of Income Tax dominates the amounts of revenue collection by customs duties from 2006/07 and it maintained the same trend in this year too.

Figure 14: Revenue Composition



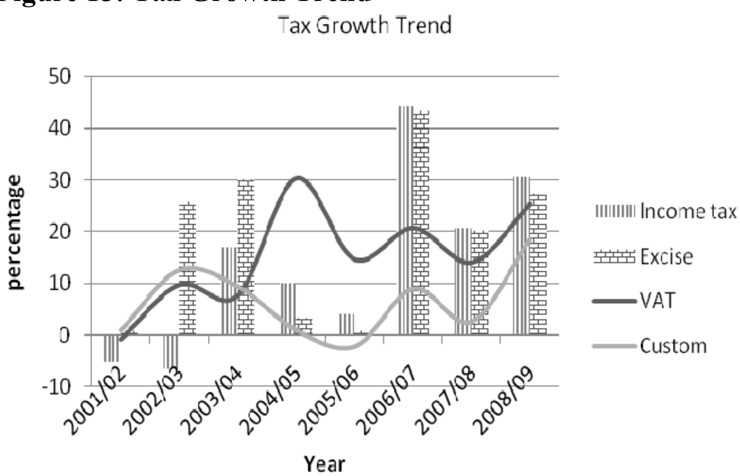
Similarly, the share of excise Tax used as revenue compensation mechanism for WTO compliance showed significant contribution on revenue structure.

The figure 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 gained momentum in this year and reached to 23.55 percent from 17.7 percent. The share of custom duty decreased from 25.1 percent in 2001/02 to merely 22.08 percent in 2008/09. The declining trend of customs duties had turned back current year with compare to last seven years.

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 taxes in 2008/09 shows high growth rate thanks to voluntary declaration of income statement and performance incentive scheme to employee.

Data shows negative growth of income tax in 2001/02. It also illustrates the negative growth of income tax in 2002/03 and custom duty in 2005/06. The introduction of self-assessment, merger of the then Value Added Tax and Income tax department resulted in some transition that adversely affected the revenue growth. Chart shows that income tax increased after 2002/03. Excise duty 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.

Figure 15: Tax Growth Trend



The reason behind the high growth of VAT in 2004/05 is 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 this 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 duty increased sharply in the same period. The reasons might be the end of insurgency and increase of tax rates and increasing the 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.1 Income Tax

The first Parliamentary Government imposed Income Tax in Nepal in 1959. Income Tax Act 1962 was enacted in 1962 replacing business, Profit and Remuneration Tax Act of 1959. The Income Tax Act, 1962 was replaced by Income Tax Act, 1974, which was amended the income tax related provisions made under other special enactment have been repealed and the existing Income Tax Act, 2058 became effective since Chaitra 19, 2058 (01, April 2002). The Act governs all income tax matters and is applicable throughout the Nepal. It is also for eight times and existed for a period of 28 years. The Income Tax Act, 1974 was applicable to residents residing wherever outside Nepal. 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 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 imposed tax on those activities contributing toward the creation of wealth. Wealth is crated with the heal pod capital, labour and capital labour mixed activities that generate income from employment , investment and business respectively . The Act has categorized the income mainly into three broad heads:

i) Employment income (an individual`s remuneration income from an employment for an income year)
ii) Investment income and (profits and gains of a person from conducting an investment for an income year)
iii) Business income (profits and gains of a person from conducting a business for an income year)

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

III.1.1 Tax base

The taxpayers on whom income tax is imposed are persons. A person can be a natural person, who is an individual or a couple but includes also a proprietorship, or it can be an artificial person, i.e. an entity. An entity means a partnership, trust, company, and foreign permanent establishment or government body. The Act distinguishes between resident and non-resident persons. A resident person is an individual whose normal place of abode is in Nepal and who is present at any time of the year, or who is present in Nepal for 183 days or more, or who is an employee of Government of Nepal posted abroad at any time during the year. A trust is a resident person if it is established in Nepal, or has a resident person as a trustee, or is controlled by a resident person. A Company which is residing in Nepal, if it is incorporated under the laws of Nepal or it has effective management in Nepal. Partnerships are always resident persons. Permanent establishments are places where a person carries on a business and are subject to tax if they belong to a non-resident person and are situated in Nepal

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

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

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. 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.

III.1.2 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 because exemption of some items and threshold.

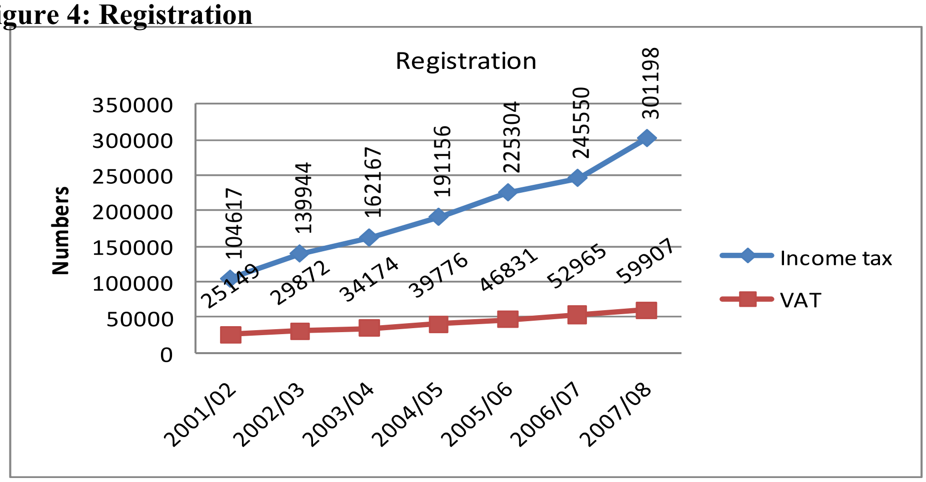
Table 25: Number of Taxpayers in Income Tax and Value Added Tax by 2007/08

year	Income tax	VAT
2001/02	104617	25149
2002/03	139944	29872
2003/04	162167	34174
2004/05	191156	39776
2005/06	225304	46831
2006/07	245550	52965
2007/08	301198	59907

Source : Annual Report Inland Revenue Department , 2009

The current threshold level in Nepal is NPR 2 million. The number of taxpayer registered from 2001/02 to 2007/08 has been presented in the table above. The number of taxpayer has increased nearly three times from 2001/02 to 2006/07. The number increased significantly in 2002/03 and increased slightly in 2006/07.

Figure 4: Registration



Similarly, the number of taxpayer registered in VAT has also increased during the period more than double. However, the number is not sufficient as compared the population of the country. Population is around 28 million in Nepal and the number of taxpayer was hardly one percent of population.

III.1.3 Assessable Income

For every person the tax is imposed and calculated for an income year. The income year corresponds with Government’s Fiscal Year, i.e. the period from the start of Shrawan (Mid July) of a year to the end of Ashad (Mid July) of the following year (mid-July to mid-July). The assessable income of a person for an income-year from any employment, business, or investment is: Income and gains are ascertained only after deducting the corresponding expenses. The income from each business and investment needs to be calculated separately.

- In the case of a resident person, the person`s income from the employment, business, or investment of the year irrespective of the location of the source of the income and
- In the case of a non-resident person, the person`s income from the employment, business, or investment of the year but only to the extent the income has a source in Nepal.

The assessable income does not include any income exempted under sections 11 or 64 of the Act. For instance : Income from non-business agriculture and agriculture business conducted in the land of the type that is mentioned in clauses (d) and (e) of section 12 of the Land Act, 2021, Income of cooperative society from business mainly based on agriculture and forest products and cooperative, saving and credit scheme based on rural community and income of approved retirement fund.

III.1.4 Taxable Income

The taxable income of a person for an income-year is equal to the amount as calculated by subtracting allowable deduction, if any, claimed for the year under section 12 (gifts to an exempt organizations) or 63 (retirement contribution to an approved retirement fund) from the total of the person`s assessable income for the year from each of the income heads Business, Employment and Investment

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 taxable income of a resident individual for an income-year 2066/67 (2009/10) will be taxed at the following rates:

Table 26 : Tax Rate for Individual

Slab	*Rate*
Up to Rs.160,000	1%
From Rs.160,000 - up to Rs.260,000	15 % plus Rs. 1600
Above Rs. 260,000	25% plus Rs.16600

Source: Finance Act 2009/10, Ministry of Finance

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

Table 27 : Tax rate for Couple

Slab	*Rate*
Up to Rs.200,000	1%
From Rs.200,000 -up to Rs.300,000	15 % plus Nrs. 2000
Above Rs. 300,000	25% plus Rs.17000

Source: Finance Act 2009/10, Ministry of Finance

The business person who have registered own Proprietary firm should not pay above 1 (one) % tax. Any individual or couple having pension income can enjoy 25 percent of the normal exemption limit as an additional basic exemption. Any individual working in prescribed remote area is entitled to deduct prescribed amount as remote area allowance from taxable income. Any individual is entitled to deduct the following amount from taxable amount, if he is having investment insurance policy: "Rs. 20,000 amount or the actual premium paid, whichever is less." For the purposes of the Act, net gains from the disposal of non-business chargeable assets will be taxed at the rate of 10 percent. The presumptive tax for individuals conducting small businesses (who have a turnover of Rs.2 million or an income of Rs.200, 000) in the Metropolitan or Sub-Metropolitans, Municipalities and anywhere else in Nepal amounts to Rs 5,000 Rs. 2,500 and Rs.1,500 respectively. The taxable income of a non-resident individual is taxed at the rate of 25 percent. The taxable income of an entity will be taxed at the rate of 25 percent unless prescribed otherwise.

The taxable income of a bank, or financial institution, or general insurance business, or an entity conducting petroleum work under Petroleum Act, 2040 for an income-year is taxed at the rate of 30 percent. Gain from Lump sum retirement payment made by an approved retirement fund or GON is taxed at the rate of 5 percent as a final withholding tax. Gain is calculated by deducting 50 percent of the payment or Rs. 500,000 whichever is higher from the total lump sum payment. The taxable income derived by an individual from special industry or export business will be taxed at the rate of 20 percent. The taxable Income derived by an entity engaged in an industrial enterprise or export business or derived from operating any road, bridge, tunnel, ropeway, or flying bridge. Construction business or any trolley bus or tram manufacturing business is taxed at the rate of 20 percent. The taxable income of an entity engaged in power generation, transmission, or distribution is taxed at the rate of 20 percent. The taxable income of an estate of a deceased resident individual or trust of an incapacitated resident individual will be taxed at the normal tax rate as though the estate or trust was a resident individual. The repatriated income of a foreign permanent establishment of a non-resident person situated in Nepal will be taxed at the rate of 10 percent. The taxable income of a non-resident person deriving income from providing shipping, air transport or telecommunication services in Nepal will be taxed at the rate of 5 percent. The taxable income of an entity wholly engaged in the projects conducted by any entity so as to build public infrastructure, own operate and transfer it to the HMG/N in power generation, transmission, or distribution for an income-year shall be taxed at the rate of 20 percent.

III.1.5 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 28 below.

Table 28 : Withholding Tax Rate

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, Government of Nepal

III.1.6 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 mid January, up to 70 percent by mid March and finally 100 percent at the yearend i/e.mid July. 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 has adopted universal self-assessment system since 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 the books of accounts and supporting documents in detail which helps to increase compliance and reduce the tax evasion and delinquency. Unless explicitly requested by the Department, no returns are required to submit from taxpayers who have no tax payable for the year likewise who is non resident individuals who have income exclusively from an employment having a source in Nepal or who have only one resident employer at a time during the year and who do not claim a deduction of their taxable income by gifts to exempt organizations.

Unless an assessment has been amended or reduced by the order of the Revenue Tribunal or of a court, the Department may amend an assessment within 4 years in order to adjust the assessed person's liability to tax in such manner as, according to the Department's best judgment, is consistent with the intention of the Act. An assessment may be amended at any time in cases of fraud. Where the department makes a jeopardy or amended assessment, it ill serve a written notice on the taxpayer.

III.1.7 Capital Gain Tax

The Act has introduced capital gain tax. However, the Act does not cover all such gains i.e. only those gains, which are received from the disposal of business assets or liabilities and those from the disposal of non-business assets of an investment of a person, which are regarded as chargeable and will be taxed accordingly.

Business assets comprise assets to the extent to which they are used in a business. Non-business chargeable assets mean securities or an interest in an entity as well as land and buildings. Both definitions exclude depreciable assets or trading stock. Not included in non-business chargeable assets are also private residences of an individual owned and lived in continuously for 1 year or more if they are not disposed of for more than Rs.5 million. Since profits and gains are different bases of taxation they need to be calculated separately. The tax is imposed on the net gains, which are the total gains minus the total losses including unrelieved losses for the current income year and those from a previous income year, which thus can be carried forward forever. Gains and losses are defined as the difference between incoming and outgoing for the asset or liability.

III.1.8 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 29 below.

Table 29: 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

In 2009 march 2 to 5, A meeting for the revision of double taxation avoidance agreement was held. The director general of Inland Revenue Department led on behalf of government of Nepal whereas Joint secretary of Department of Revenue of India was the leader of the delegate. The draft revised agreement was sent to Ministry of Finance for final approval. Likewise IRD initiated to make agreement between Bangladesh and Nepal and another revision attempt were also in process with the Srilankan tax authority.

III.1.9 Administrative Review and Appeal

A taxpayer who is aggrieved by a review able decision may file an objection within 30 days after the decision is made. In doing so, such Taxpayer has to deposit 50% of due amount. The Department may extend this period for another 30 days upon request. The Department may stay or amend or do necessary corrections with regard to these review able decisions. If the Department fails to serve a taxpayer with a notice of an objection decision, within 90 days, the taxpayer may elect to treat the Department as having refused his objection and appeal to the Revenue Tribunal. Until the end of 2008/9, 2,719 taxpayers have made appeal amounting Nrs. 449368 thousands. Offences are dealt with in the Act in a sense of criminal offences of taxpayers as well as tax administrators. They lead to punishment in the form of fines and imprisonment on conviction. The offences attracting both a fine and the imprisonment include failures to comply with the Act, failures to pay tax, maintaining documentation or filing income returns and statements of estimated tax, making false or misleading statements, impeding or coercing the tax administration, offences by the authorized and unauthorized persons, offences of aiding or abetting, etc. In case if the Tax return file is not submitted within the period prescribed by the act, the late fee will be charged at the rate of 0.1% per year of the turnover.

III.1.10 Taxpayer's right and duties

In addition to the specific rights and assurances provided in the concerned Acts, taxpayers in general are assured of the following rights. These assurances will be strictly adhered to. The Taxpayers rights, among others, include:

- Each taxpayer is treated with due respect and honour
- Each taxpayer will get an immediate receipt of return submission whilst a receipt of other correspondences is to be provided in ONE hour.
- Each taxpayer willing to seek an advance ruling may apply either in the Department or through concerned Inland Revenue Office. There is a legal provision that a decision should be made within 45 days after the request is made.
- Each taxpayer can represent or make any correspondence by an authorized person including legal assistants and the accounts specialist or auditors just in case if he/she is unable to represent or make any correspondence.
- Each taxpayer is to get copies of the documents related with him/her or submitted to the IRO or documents or decisions affecting her/him generally in TWENTY-FOUR hours of his/her request in the concerned IRO.

- Each taxpayer is to get refund of his excess input tax (VAT) and other taxes. The exporter will get refund generally within 15 days in IROs and 30 days in IRD upon receiving application for refund . G. Each taxpayer is to get certificate/renewal of Excise/Liquor business generally within TWENTY-FOUR hour after the request is made.
- Each taxpayer is to get sales and purchase books certified by the Tax Officer generally within TWENTY-FOUR hours after the request is made.
- Each taxpayer is to get initials of the Tax Officer on stock transfer or sales to the non-registrants generally within TWENTY-FOUR hours after the request is made.
- Each taxpayer is to get Permanent Accounts Number (PAN) or the Certificate generally within 3 days after the request is made, and
- Each taxpayer is to get Tax Clearance Certificate generally within TWENTY-FOUR hours after the request is made.

III.1.11 Income Tax collection trend

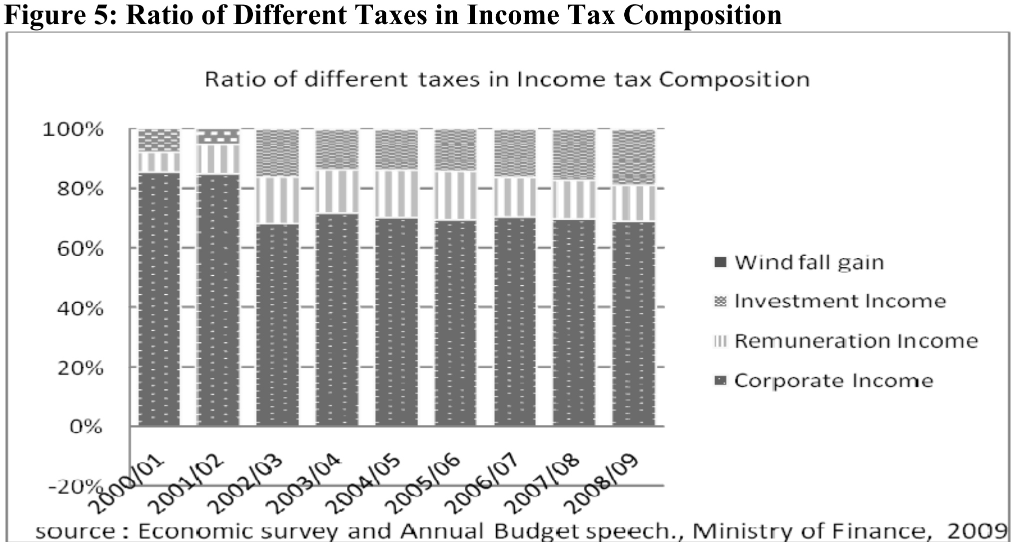
Income tax is the second largest component of tax revenue. Income tax collection reached 27452 million in 2008/09 from 8656 million in 2001/02. The main source of income tax is the corporate tax. It contributed around 85 percent of total income tax in 2001/02. Its contribution in recent years had decreased 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 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 30 and figure18.

Table 30 : Income Tax collection Trend in Nepal

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Corporate Income	7791	7352	5550	6817	7345	7577	11605	13269	18981
Remuneration Income	597	836	1253	1391	1676	1771	2162	2451	3270
Investment Income	725	468	1322	1292	1425	1547	2692	3271	5176
Wind fall gain			7	14	21	8	9	19	25
Total	9113	8656	8132	9514	10467	10903	14585	19010	27452
Percentage change		-5.01	-6.05	16.99	10.02	4.17	33.77	30.34	44.41

Source : Economic survey and Annual Budget speech., Ministry of Finance, 2009

Figure 5: Ratio of Different Taxes in Income Tax Composition



III.2 Value Added Tax

Value Added Tax is a broad-based tax imposed on the value addition to each commodity at all stages from production and distribution and consumption. VAT is a modern tax system that improves the collection of taxes, increase efficiency and reduces tax evasion. 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 another stages. It is also regarded as the backbone of revenue in forthcoming future.

In Nepal, Value Added Tax (VAT) was introduced on 16 Nov. 1997. This tax was levied in place of the Sales Tax, Hotel Tax, Contract Tax and Entertainment Tax. However, it could not be implemented fully until the FY 1998/99 due to political instability and strong opposition from the business community. VAT replaces the old Sales Tax, Contract Tax, Hotel Tax and Entertainment Tax. It has been designed to collect the same revenue as the four taxes it replaced. 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. (VAT) is a broad-based tax as it also covers the value added to each commodity by a firm during all stages of production and distribution. It is a modern tax system to improve the collection of taxes, to increase efficiency and to lessen tax evasion. It is also regarded as the backbone of income tax system in Nepal. The current threshold for VAT registration is Rs. 2 million. Those vendors whose annual turnover is below the threshold can, however, register voluntarily. There is a persistent increase in the number of VAT registrants. It has crossed the 40,000 mark. At the time of conversion from the then existing sales tax to VAT, a total of 2045 taxpayers of then sales tax were converted as VAT registrants. As the taxpayers are increasing, the amount of revenue collection and the level of tax compliance are improving today.

III.2.1 Operating system

VAT is a tax imposed on the value added to goods and services consumed in Nepal or exported outside. The tax is based on the principle that each producer or distributor adds value, in some way, to the materials they have purchased and it is this added value that is taxed at each stage of the production and distribution chain. There is the presumption that VAT is shifted forward completely to the Consumer. In the VAT system, producers, distributors and people providing services raise VAT on the products or services sold or provided. The difference between the VAT collected on sales and the VAT charged on purchases determines the amount a registrant must remit or the amount that may be claimed as a refund. In other words, if the tax on sales is more than the tax on purchases, the dealer / businessman remits the difference. If the tax on sales is less than the tax on purchases, the dealer may carry forward this credit to the next month, which is known as input tax credit.

III.2.2 Input tax credit

Registered businessmen are obliged to collect and remit VAT on their taxable transactions. These registrants are entitled to recover the tax paid on their purchases. This recovery or refund is known as input tax credit. The Input Tax Credit (ITC) is the total of the tax paid or payable on taxable goods and services purchased in Nepal, and the tax paid on taxable goods imported into Nepal. Where VAT is paid or payable by a registrant on a purchase or on imports, the registrant is allowed to claim input tax credit for those purchases made by the registrant in his commercial activities. However, even though the purchase of goods or services may relate in part to a commercial activity, in certain circumstances the purchase may not generate input tax credit entitlement when he sells goods or services, which are tax-exempt. Most registrants are entitled to claim input tax credits for the tax paid on acquisitions of capital goods for use primarily in commercial activities. Unlike the income tax deduction rules, the input tax credit for any VAT paid on capital goods is not amortized over the life of the asset. It can be claimed in full in the period in which it is acquired. If the capital goods are later put to a non-commercial use, special change-of-use rules will apply. Taxpayers whose export is more than 50% of total sales or those who are continuously on 6 months credit may claim for refund. Refund shall be made within 30 days from the receipt of refund claim. 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 taxable period] ÷ [Gross sales in a taxable period]
[Deductible amount of taxes] = [Amount of taxes on taxable purchases] × [Proportion of taxable sales to total sales]

III.2.3 Refund of VAT

When Tax paid on 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 4.29 billion in fiscal year 2007/08 to industries, bilateral and multilateral investment projects and diplomatic missions. Refund producer 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.

In fiscal year, 2008/09 Nrs. 3.45 billion had refunded as per the article 25 of VAT act. This amount comprises Nrs. 2.78 billion of industrial Enterprises, Nrs. 6,943 thousand to Diplomatic missions and 325,969 thousand to multilateral and bilateral project. Despite the delegation of authority to different level has made by department, the refund amount is decreased in the current year by 8 %.

Likewise, the provision for refund of VAT paid by tourist travelling by air transport is maintained in Tribhuvan International Airport. For this purpose, the amount of purchase should not be less than Nrs. 15000 and tourist should claim only the accompanied goods and can get refund at Rastriya Banijaya Bank on departure counter.

III.2.4 Taxable and Exempt Transaction

VAT divides all goods and services into two basic categories, taxable and tax-exempt. Either goods and services are taxed at the standard rate of 13 percent or they are taxed at 0%. Those taxed at the standard rate include all goods and services except those which are specified as taxed at 0% or tax-exempt.

III.2.4.1 Tax-Exempt

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

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

III.2.4.2 VAT on Import and Export

The VAT Act, Schedule I lists imports which are tax-exempt. Some of these include prescription drugs, basic groceries, medical devices and agricultural products. Most imports, however, are fully taxable at customs point. Thereafter these are treated on the same basis as domestically produced goods. The VAT on imported goods is collected by Customs. It is calculated on the dutiable value of the goods, in other words, on the value of the goods including transportation, insurance, freight and commissions PLUS any duty or other taxes (other than VAT) payable on the goods. The value for the duty of the goods is determined in accordance with the valuation provisions contained in the Customs Act. Registrants may claim input tax credit for the VAT paid on imported goods used in their commercial activities.

VAT is applicable only to the consumption of goods and services in Nepal. However, supplies made in Nepal that are exported are taxable at 0%. Exporters are allowed to claim input tax credits for VAT paid or payable on purchase of goods and services relating to their commercial activities. Exports taxed at 0% include exports of both goods and services.

III.2.5 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 inception of the business according to Value Added Tax act 1995.The current threshold for VAT registration is NPR 2 millions. Taxpayers whose annual turnover is more than Rs 2 million Belonging to a conglomerate which has an aggregate annual taxable turnover exceeding 2 million rupees or Belonging to a conglomerate, which has an aggregate annual taxable turnover exceeding 2 million rupees, 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. Such as :

- If the stock of the tax payer exceeds the specified amount when the tax officer inspects the stock or if the monthly sale exceeds Rs. 2 Lakh or more during a month;
- If the annual expenses of the tax payer on the telephone and the rent exceeds Rs. 1 Lakh; or
- If the premises of the taxpayer lies within the specified area of the market or the street as specified by the Department (IRD)

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=+

963.onths, 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

Table 31: Registration and Return Status of VAT

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008
Taxpayer	17947	21093	25149	29872	34174	39776	46831	52965	59907
Increase Percent	86.13	17.53	19.23	18.78	14.4	16.39	17.73	13.1	13.1
Taxpayer filing Returns	17271	19710	21473	23099	25049	28525	33633	36457	400139
Returns %	96.21	93.28	84.82	82.41	78.57	77.04	78.37	85.42	83.34
Debit Returns %	34.9	35.39	32.3	31.06	33.87	33.2	31.06	31.43	30.02
Credit Return %	44.97	41.86	41.19	41.36	38.42	36	38.17	37.29	37.49
Zero Return %	20.12	22.68	24.25	25.85	27.08	29	30.14	30.29	31.83
Non-filer %	3.79	6.72	15.18	17.59	21.43	22.96	21.63	14.58	16.66

Source: Annual Report 2007/08, Inland Revenue Department, 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 16.66 percent in 2008 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 30.02 percent in 2008. If put 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.

III.2.6 Scope

In addition to consumers, VAT affects persons involved in commercial activities. A person means an individual, firm, company, association, cooperative, institution, joint business, partnership, trust, government body or religious organization claim a refund of the VAT they have paid in producing their goods and services for sale. These would include unregistered small suppliers, that is, persons with annual sales of taxable goods and services of Rs. 2 million. There are categories of persons and organizations, which are not required to collect VAT nor allowed credit claim. However, even such people can voluntarily register for VAT purposes. In assessing the value of taxable supplies a vendor must include the value of the supplies taxed at the standard VAT rate and his sales of supplies sold at 0% (the zero rated supplies). Sales of exempt supplies will not be included. If he has had / would expect an abnormally large sale, he should contact to the concern IRO to determine if this sale should be taken into account when calculating his registration threshold.

For domestic transactions, the taxable value includes all the expenditures related to transportation and distribution, which was 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.

III.2.7 Deregistration

A VAT registration may be cancelled by anyone whose total taxable sales for four consecutive calendar quarters is not more than 2 million rupees and who has been registered for a full fiscal year or by persons who no longer has a commercial activity because of bankruptcy, receivership, or cessation of the business. Trend of deregistration of taxpayers can be seen in the table below:

Table 32 : Deregistration Status of VAT

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total Registered Taxpayer	17947	21093	25149	29872	34174	39776	46831	52965	59907
Deregistered and Closure of business	N/A	N/A	N/A	549	600	475	683	824	1013

Source: Annual Report 2007/08, Inland Revenue Department, MOF, Kathmandu, Nepal

III.2.8 Tax invoice

The tax invoice will require the name and address of the seller and the purchaser, the seller`s PAN number and invoice number, the date of the transaction and a description of the sale including the number of items purchased, the unit cost of each item and a mention of any discounts given. The tax invoice must be prepared in three copies and the first copy should be clearly identified as a tax invoice. The original copy is to be given to the purchaser; the second copy is to be retained for audit purposes while the bottom copy is for use by the seller in preparing a record of the transaction.

III.2.9 Offences and Remedies

Fines will be imposed if the taxpayer fails to file his return within the specified time a registrant will make his VAT payment at a bank where he will receive a bank voucher as proof of payment. This number is to be entered on his VAT return to be submitted within 25 days after the end of the month of business transaction. The VAT Act imposes fines for failing to register. Similarly, if a registrant fails to use his registration number or clearly display his registration certificate in the business premises, he is liable to fine. Other penalties may be imposed if, for example, a registrant fails to file a return, issue invoices, keep an up-to-date account of transactions, obstructs visits by a tax officer in investigation, prepares false accounts and invoices or attempts to evade tax. Similarly, IRO/IRD may purchase or cause to purchase under invoiced goods.

A taxpayer who is not satisfied with the Tax Assessment of a Tax Officer may submit an application to the DG of IRD for administrative review within 30 days from the time of receiving such decision.

III.2.10 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 2008/09 have been presented in the chart below.

Figure 6: VAT Collection Sharing (in percentage)

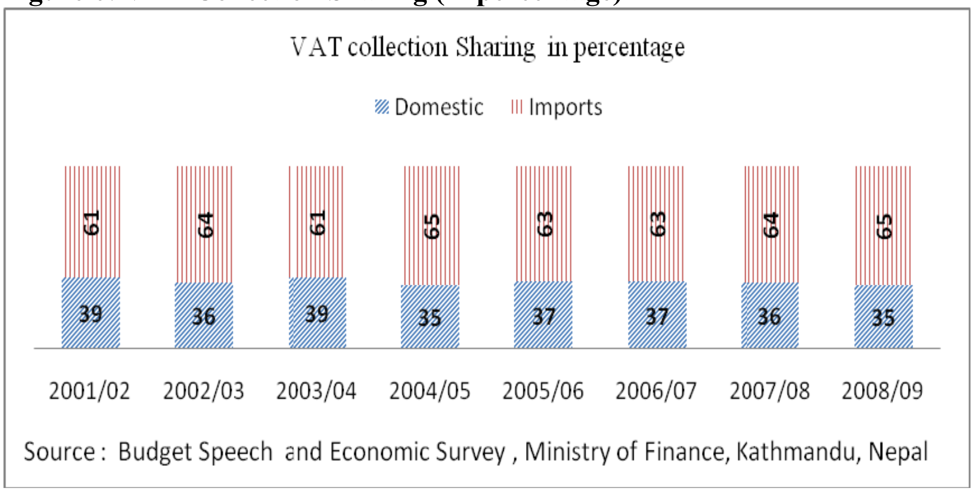


Figure 18 and table 33 shows that more than 60 percent of VAT revenue came from imports. The percentage contribution of domestic transaction in vat was 39 in 2001/02 which increased up to 39 percent in 2003/04. The trend decreased in the next year to 35 percent. The remained almost stable at 37 in the last two years. Contribution of domestic transactions decreased in the year 2008/09 to 35 percent from 36 percent in previous year. More than 60 percent of Value Added Tax comes from import of goods and services. The chart above and the table below show that the share of import was 61, 64 and 65 in 2001/02, 2002/03 and 2004/05 respectively. The highest contribution of import in VAT revenue was 65 percent in 2004/05 and again it reached in 2008/09. This percent decreased in latter two years and smooth increased in 2007/08 and 2008/09. The effectiveness of inland revenue department is still seems challengeable in this regard. The domestic revenue mobilization is dominated by more than 60 % from import Tax.

Table 33: Percentage share of VAT

Particular	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Domestic	39	36	39	35	37	37	36	35
Imports	61	64	61	65	63	63	64	65

Source : Budget Speech and Economic Survey , Ministry of Finance, Kathmandu, Nepal

The data in table 34 shows that the contribution of VAT on Total Tax revenue reached 34.14 % where as the share of customs revenue has reduced significantly and reached 22.08 % in 2008/09. By comparing the data of 2001 to 2004, the percentage of customs revenue is higher than VAT after this period the sharing of VAT is continuously dominating revenue from customs, this shows that The dependency over VAT is increasing in the days coming in future.

Table 34 : Contribution of VAT in Tax Revenue (Rs in million)

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Tax	39330	42587	48173	54104	57430	71127	85155	116997
Customs	12658	14236	15554	15701	15344	16708	21062	25829
VAT	12267	13459	14478	18885	21610	26095	29816	39947
% of	32.16	33.41	32.28	29.02	26.71	23.48	24.73	22.08
% of VAT	31.17	31.58	30.03	34.89	37.62	36.68	35.01	34.14

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

III.3 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 has 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 35 : 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 35 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, 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 and 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 is 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.

Table 36: Excise Collection

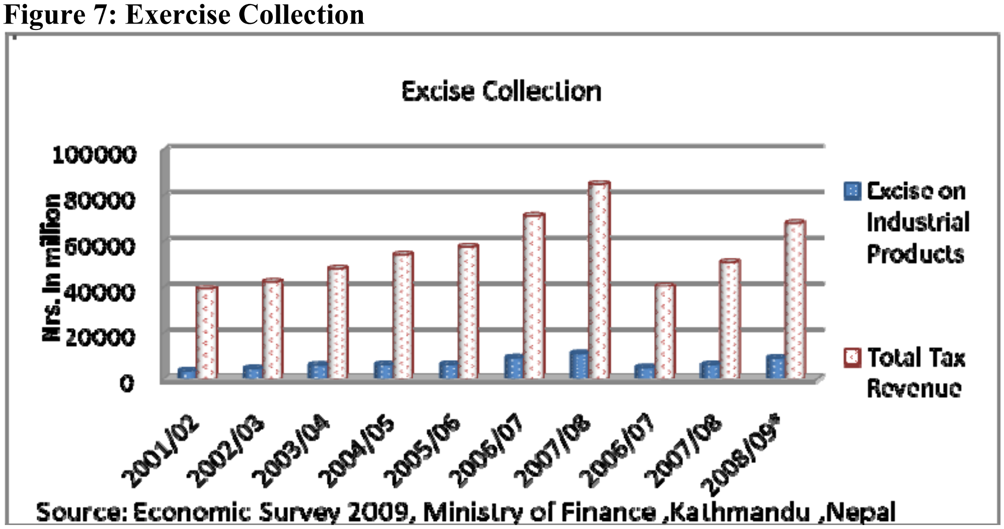
Nrs. In Million

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2006/07	2007/08	2008/09*
Excise on Industrial Products	3807.05	4785.12	6226.70	6445.90	6507.60	9343.20	11189.58	5213.60	6462.00	9221.30
Total Tax Revenue	39330.64	42586.92	48173.00	54104.70	57430.40	71126.70	85155.54	40550.30	50898.80	68080.20
Ratio of Excise on Total tax	9.68	11.24	12.93	11.91	11.33	13.14	13.14	12.86	12.70	13.54

Excise duty is imposed on the consumption of selected goods such as alcoholic beverages and tobacco products. Historically, these duties had constituted one of the largest sources of tax revenue in Nepal. It had covered a wide range of domestic products (more than fifty commodities) accounting for 14.3 percent of total tax revenue during 2048/49 (1990/91). But in recent years as follows the almost universally accepted norms, excise duties are restricted to a narrow range of domestic products. It covers tobacco products, liquor, beer, flavoured soft drinks, cement and plastic goods. It contributed 9.7 percent of total tax revenue during 2058/59 (2001/02). The effect of excise duty is also faced by narrow range of population. At present, large sales volumes, few producers, limited consumer, inelastic demand and lack of close substitutes are the basic charm of excise system in the country. The basic relatively simple administrative efforts provides limited opportunities for tax evasion. The excise duty is very helpful instrument to control the consumption which is regarded as lacking merit or as likely to cause negative externalities.

Government of Nepal imposes this Tax as a revenue compensation tools for the reduction of customs tariff after WTO accession.

Figure 7: Exercise Collection



The amount of collection is increasing from 9.68 percent in 2001/02 to 13.54 percent in 2008/09. As 10 decreased the customs collection percent but this Tax is compensating the revenue loss only by 4 to 5 percent.

III.3.1 Features

A striking feature of present structure of excise duty is that excise duties on liquor, beer and tobacco have been progressively increased at their importance as revenue sources over the years. The levies on tobacco products and alcoholic beverages have been accounted for over ninety five percent of excise duty receipts. Given the relative inelasticity of demand for these commodities, the duties have contributed to generate substantial revenues with frequent increase in tax rate over the years.

The excise duty has been governed and regulated by the Excise Act 2058 (2002), Excise Regulation 2059 (2003), and Alcohol Regulation 2033 (1976). As provisioned in the law, the excisable commodities are closely controlled and supervised by the Government from their production to selling stage. Licensing requirement is adopted for all excise commodities and it is given by both department as well as field offices. Excisable commodities are realized for sale with an excise stamp to assure the sales of taxed commodities. Among the excise commodities, special provision is made for alcoholic beverages and tobacco because of high sensitivity with respect to the revenue as well as negative externalities. They are controlled and supervised physically from their starting stage of manufacturing to last selling stage. The excise personnel are stationed in the factory to maintain controls of production and sales. The deployed persons have been responsible to control, supervise and monitoring the products. In respect of less sensible goods such as cement, soft drink and some plastic products they have been regulated by self-removal system.

III.3.2 License Required

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

III.3.3 Credit Claim: A Typical System

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

III.4 Custom Duty:

The existence of customs duty was prevailing from long history of Nepal though there is no mass transaction of international trade and limited connection with the foreign country. Nepal had collected Customs Duty from contract basis till 1950. After the overthrown of Rana’s regime, Nepalese administration had also compelled to reform its way of operation and make changed according to political changes. The customs administration was also a part of Nepalese administration, Hence Department of Customs and Excise was first established to collect revenue from international trade in 1957 by converting then Bazaar Adda to Customs office in 1962. As the volume of trade and trading partners grew, there was a need of separate Custom Department to cope the contemporary demand of the revenue organization and growing challenges. Therefore, Customs administration was separated from Excise and Customs Department in 1966. Then establishment of a separate Department of Customs under the Ministry of Finance were done.

The organization strength of this department has about 1400 employees working around the border side of Nepal. 30 main customs office and 143 sub customs office have been in operation for the trade facilitation and revenue mobilization through customs. As a role of revenue collector, at present, custom duty contributes, about 22 percent of total tax and around 50 percent of total tax is collected through department of customs. Despite the heavy reform in customs administration and tariff, structure the Department of Customs is still has significant role over the revenue mobilization of Nepal. The ratio of Gross Domestic Production to Customs revenue is 2.23% in 2008/09 where as vat stands about 4 %. Similarly, custom at import points collects about 60 percent of VAT revenue and 20 percent of excise revenue. On aggregate, custom collects 50 percent of total 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 etc. Beside the export and import trade management the department of customs, collect the various duty as mentioned above. The collection process of revenue in customs administration begins at two different stage such as export stage and import stage . in this stage customs collects import duty along with various taxes such as VAT, Excise duty, Health tax , pollution control fee, local development tax etc whereas at the stage of export customs can collect only customs duty. –

III.4.1 Import Duty

Customs duty is imposed on goods imported from foreign countries into the 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. After the accession on World Trade Organization the structure of tariff is changing from higher to lower to inline with the commitment made with international sector.

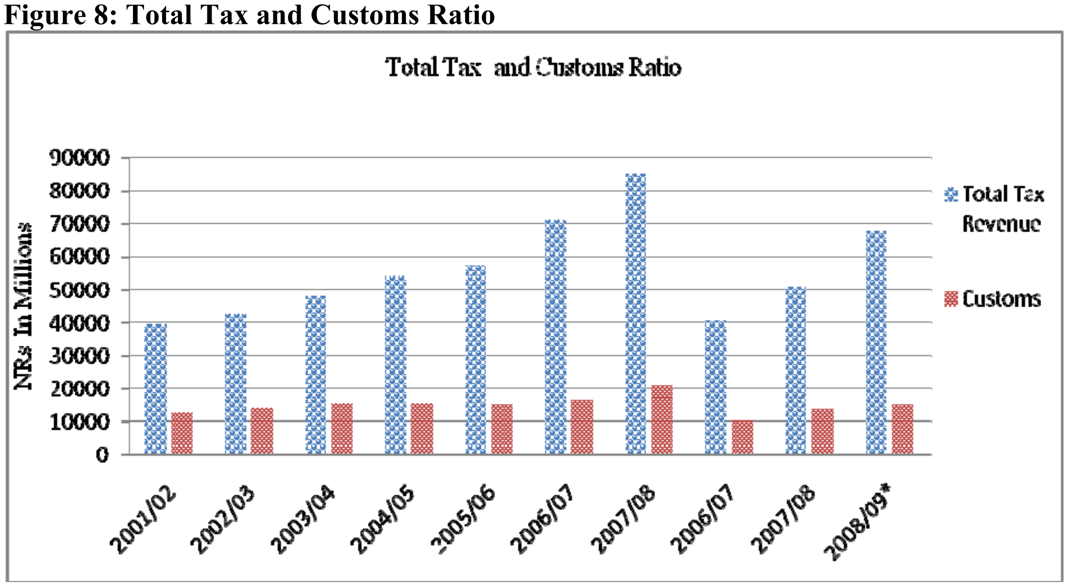
III.4.2 Export Duty

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

III.4.3 Custom Duty Collection Trend

The composition of custom revenue from 2001/02 to 2008/09 has been presented in the following table. The customs revenue increased from Rs12658 million in 2001/02 to 21063 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 main component of custom revenue is the import duty. It occupies more than total custom revenue. It reached to 95 percent in 2007/08 from 93 percent in 2006/07.

Figure 8: Total Tax and Customs Ratio



Recently, a memorandum of understanding was sighed between the government of Nepal and India to abolish Indian Excise refund system. This is another fundamental step taken by the Government of Nepal to reform customs administration of Nepal.

Table 37: Collection of Customs with Respect to Total Tax Revenue

Rs. in Million

	Fiscal Year							First Eight Months		
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2006/07	2007/08	2008/09*
Total Tax Revenue	39330.64	42586.92	48173.00	54104.70	57430.40	71126.70	85155.54	40550.30	50898.80	68080.20
Customs	12658.75	14236.43	15554.80	15701.60	15344.00	16707.60	21062.50	10204.80	14033.90	15403.90
Imports	9678.36	10567.68	10666.90	12299.10	11744.60	13626.10	17128.17	8107.20	11265.20	12774.00
Exports	917.38	855.65	527.10	697.90	625.60	708.70	445.55	502.60	267.20	528.40
Indian Excise Refund	1700.90	2370.61	3882.70	2188.30	2314.40	1896.50	2997.07	1312.70	2151.60	1664.80
Others	362.11	442.50	478.10	516.30	659.40	476.30	491.62	282.30	349.90	436.70

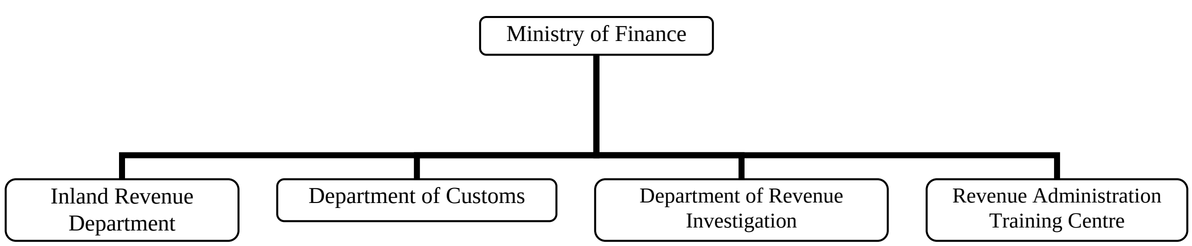
Source: Economic Survey 2009, Ministry of Finance, Kathmandu, Nepal

III.5 Organization structure of Nepalese Revenue Administration

The Ministry of Finance is the apex body to administer tax in Nepal. The ministry comprises nine divisions and five departments. At ministerial level, there are two major divisions are involving in the revenue policy matters. As a policy wing revenue advisory committee is working, which suggests, reviews, evaluates and forecast the future need of reform in Tax policy matters. This committee comprises various intellectual from economic sectors, representative of private sector and high-level bureaucrats and department heads from different revenue organizations. The composition of structure is efficient to address the voice of private sector regarding the reform in revenue policies. The 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 through this division. The main responsibility of this division is to facilitate the departments for the smooth operation of Tax policies and make timely decision as required in the field level offices. As mentioned above, the revenue Advisory committee conducts regular studies on current economic activities, economic policy and revenue policy, 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 enforcement agency and mainly concentrates to the revenue leakages and foreign currency related matters. In 2009, anti money laundering act has been come in to effect. Until the formation of new Department is done, the present department of Revenue Investigation is involving in this matter additionally. It works through its four field offices all over the country.

Figure 9: Organogram of Revenue Administration (policy level)



Custom Department collects export, import, 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 sea port customs. Similarly, Inland Revenue Department has 21 revenue offices, one large taxpayer office and 16 service centres all over the country. 142 personnel in Department of Revenue Investigation, 1317 in Department of Customs and 924 in Inland Revenue Department are working presently. The table below presents the personnel in IRD.

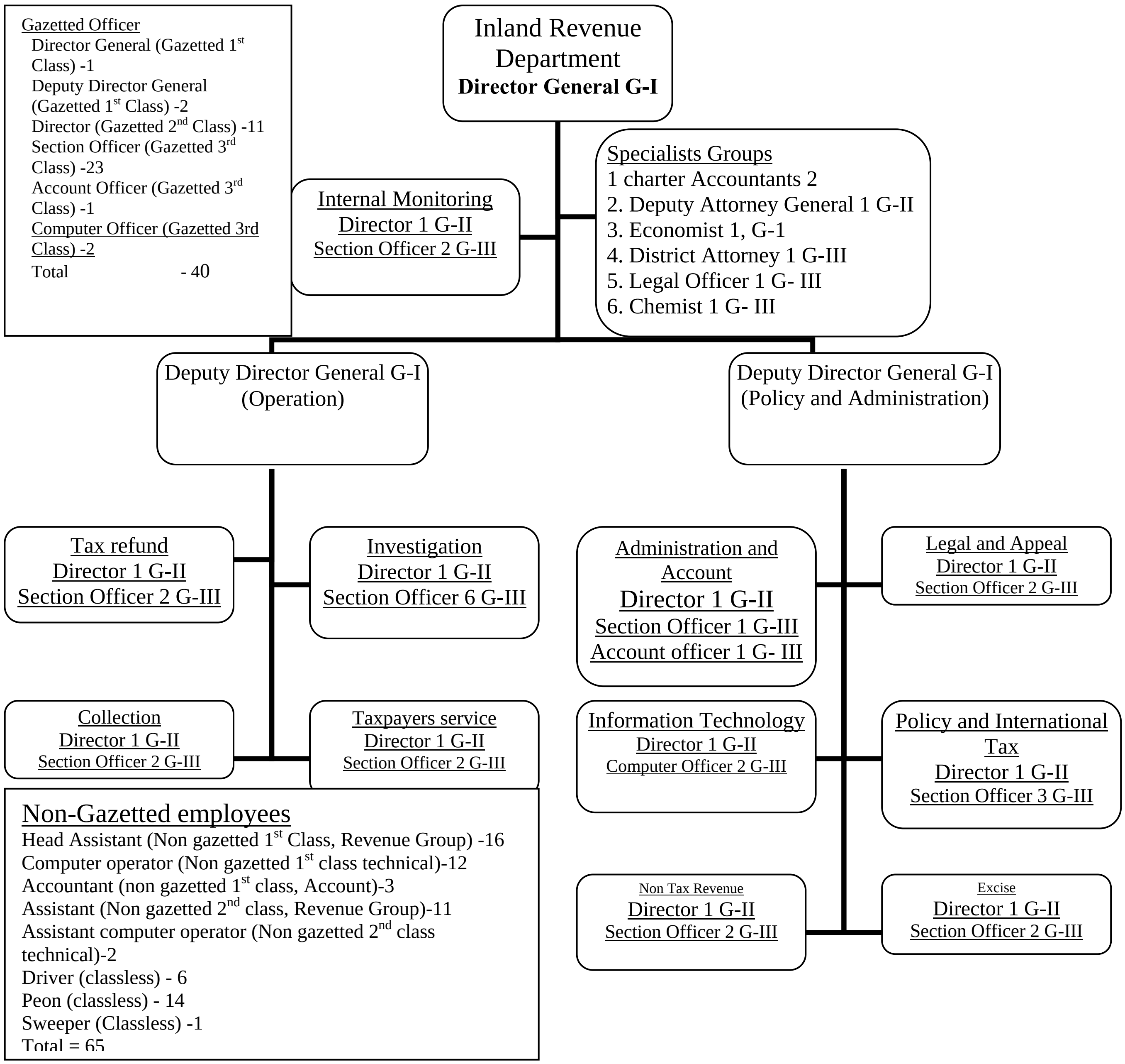
Table 38: Number of Personnel working in Inland Revenue Department[15]

Position level	*Approved position*	*Fulfilled position*	*Vacant position*	*Ratio of strength*
Gazetted 1st class	7	7	0	00.8
Gazetted 2nd class	48	37	11	5.2
Gazetted 3rd class	205	180	25	22.3
Non gazetted 1st class	309	237	72	31.5
Non gazetted 2nd	157	116	41	18.9
Drivers	38	31	7	4.1
Office Assistants	160	156	4	17.2
Total	924	764	160	100

Source: Annual Report 2007/ 08, Inland Revenue Department, MOF, Kathmandu, Nepal

[15] Annual Progress report 2008/09, Inland Revenue Department , Kathmandu Nepal

Figure 4 : Organization Structure of Inland Revenue Department[1]



III.6 Reforms and modernization of tax administration

To make taxpayers friendly, modern and e Tax administration Inland Revenue department has initiated following reform programme in 2008/09.

- 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 250 millions NRs. 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 all the revenue offices all over the country.

- The revenue consultative committee, a think-tank body was formed for policy advice
- Introduction of new Custom Act 2007, compatible with WTO valuation system
- VAT has already been computerized and the process of income tax computerization is about to complete.
- Provision of Electronic Permanent Account Number- to facilitate taxpayer registration, Electronic Tax Deduction at Source- to facilitate the reporting of tax withholding, Electronic Instalment- to facilitate filing return and, Electronic Cash Register/ Fiscal Printer-to facilitate billing of retail sellers and department stores.
- 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.
- Internet based Electronic filing system in VAT administration has been in operation from fiscal year 2008/9. Taxpayers can submit their returns as well as payment of Tax can be made by using this system.
- E-PAN system has also introduce to issue the taxpayers registration number and card (PAN Card) .by using this electronic way taxpayer can deduct their Tax as source
- SMS System to verify the status of taxpayer this system is launched. This system provide various information related to the taxpayer mainly TPIN status,

IV. Country Specific Fiscal Issues:

Nepalese political situation is in still volatile from. The post conflict period has various agenda to address for the sustainable peace, development and prosperity of the country. The reshuffle of government becomes a culture in political level, which always hinders the stable peace process. After a decade long conflict and political turmoil phase of socioeconomic transformation has began through election of constitution assembly. With the mandate of this assembly, present coalition government has formed under the support of the twenty -two among the twenty-four political party of the legislative parliament. The newly formed government has common agendas to build socialism oriented, just, non-discriminatory, competent and prosperous Nepal by formulating the new constitution as per the ideologies of historic people's movement, comprehensive peace accord and directive of the constitution assembly. The major priorities of Nepal at this moment are building consensus among all the political parties; constitutional supremacy; rule of law; guaranteeing the good governance. Likewise, bring the peace process to a logical end by implementing all the agreements signed and consensus reached in the past to end the anarchy, elimination of lawlessness and insecurity; promulgating the new constitution with national consensus within stipulated time-frame; and accelerating economic growth by state restructuring and socio-economic transformation in planned manner are another political agenda of present Government .Beside, the above socio-political issues the Government has compelled to address the following economic and fiscal issue for the economically prosper Nepal.

IV.1 Sluggish Rate of Economic Growth

In fiscal year 2008/09, GDP growth rate is likely to register 3.8 % at basic price and 4.7% at produces' price in the current fiscal year. The GDP growth has declined owing to factors such as energy crisis, unfavourable weather, decline in capital expenditure, disturbed industrial sector, absence of elected local representatives and global economic crisis. This growth rate declares itself that it was very low in real terms, whereas its two neighbours 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 is not sufficient for poverty alleviation.

Government aimed to accelerate the current sluggish growth and lay foundation for the double-digit growth in the 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 hydropower 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 these development activities.

IV.2 Lack of Improvement in Investment Climate:

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.

IV.3 High Inflation:

It is a serious concern that Nepal is facing a double-digit inflation, although the price is declining all over the world, in the wake of global financial crisis for last few years. In addition, it has adversely affected disadvantaged communities by the sharp price increases of daily necessity items like lentils, rice, ghee, oil (edible), sugar and vegetables. Controlling inflation and bringing it to the minimum level has been another big challenge.

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.

IV.4 Weak Budget Implementation and Project Management:

It can be say by reviewing the past development efforts that people's credibility towards government has been declining because of the non-implementation of programs although policies and programs were well formulated. The cost overrun has been doubled in some big physical infrastructure projects due to time over run. In the absence of guaranteeing multi-year budget for infrastructure project that cannot be completed within a fiscal year, one third of annual time is being spent for contracting out. Likewise, either annually allocated or unspent amount are being freezed or demanding trends to transfer such amount to other low priority projects are increasing. On the one hand, quality of the completed projects are not being maintained, on the other hand, arrangement for maintenance has not been effective as well.

IV.5 Unemployment

Investment in non-agriculture sector shrinked from both the state as well as private sector due to conflict in the past and political instability during the latter period of transitional phase. Despite agriculture sector being a source of livelihood for about two third of the country's population, this sector has not been able to absorb the additional work force in this sector due to lack of modernization and commercialization. The employment opportunities available in the public sector are also passing through contraction. On the other hand, yearly about 400,000 workers have been added in the labour market of Nepal. Despite some relief in the employment problems of the country due to an increasing access of Nepali people in the labor market abroad, the number of youths who do not have access to employment opportunities is also large. In the latter period, the number of non-skilled youths as well as educated unemployed has also been increasing fast. Hence, effectively addressing the problem of unemployment has been another challenge.

IV.6 Physical, Financial Infrastructure and Energy Crisis

Modern road network, regular supply of energy, strong communication, skilled manpower, efficient financial sector and the capital market are essential for achieving commercialization of agriculture, beneficial use of renewable natural resources, industrialization and tourism development. Such physical and financial infrastructures have not been developed so far in our country. Day-to-day closures, strikes and criminal activities have been obstructing not only the utilization of the existing infrastructures but also the expansion of infrastructure. Electricity shortage has been a matter of another serious challenge in the context of moving the economy forward. Especially, during dry season, the whole society is disturbed due to load shedding of longer period. This has resulted in a big decline in the overall productivity of the country. This situation is an outcome of non-implementation of new power projects in a planned way for a long time due to conflict in the past. There is no possibility of additional electricity supply immediately as the completion of such projects takes longer period. Therefore, ensuring an uninterrupted supply of electricity has been a big challenge in order to make the economy dynamic.

IV.7 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 revenue GDP ratio 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 36 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.

It has been a challenging task making the revenue mobilization process dynamic, better, efficient and productive in a sustainable manner for the growth of revenue surplus mainly by meeting the recurrent expenditure and principal repayment expenditure in order to increase development activities through revenue mobilization in the days to come. Likewise, it is imperative to allocate best possible amount of resources for capital investment and take special care towards reducing non-prioritized and unproductive expenses. Such measures are expected to contribute to economic expansion and help create sustainable base for achieving the goal of economic development. The trend of revenue mobilization has remained satisfactory in recent years. To maintain this, there is a challenge to control tax leakages after identifying the possible leakage areas, and increase the revenue mobilization specially the VAT and income tax, which are the major instruments of tax revenue. Since, there is a need to enhance work efficiency, effectiveness and professionalism of revenue administration, a strong challenge has been there to make necessary arrangements for achieving desired results

IV.8 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 2 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 is 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 has 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 has 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 aid inflows. There seems a ray of hope by the end of current economic crisis in remittance and foreign aid. It is expected the minimization of 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.

IV.9 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 between centre and local level is a very important and difficult task. The challenge ahead is how to allocate the taxing power to the concern 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 different 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 are Standing and Where We Go?

At this moment, Nepal is in facing trouble of political turmoil. The issue of state restructuring, federalism, and economic development, equal and equitable distribution of development achievement and so on are hot issues of discussion. Even though there are bright rays of hope illuminating in political arena after a comprehensive peace agreement between Maoist rebel and the other political parties. Economic development regarded as a dependent on the vision of political leader. Hence, Nepal is not poor but it has poorly politicized its development achievement due to the poor management. Despite owning heavy natural resources, it is poor because of improper development policies of the past governments. In general, Nepal could never focus its endeavour 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.

Despite the recent political fragility and the global financial crisis, the macroeconomic situation in Nepal remains broadly stable. Real GDP growth in 2009/10 is expected to be resilient at 4 percent, slightly down from 4.7 percent in 2008/09 due to power shortages, difficult labour relations, and adverse weather conditions. Due to the continued growth of remittances, the current account and balance of payments remain in surplus and foreign exchange reserves have increased to a level sufficient to cover 8 months of imports. The 2008/09 budget deficit (after grants) was contained to 1.5 percent of GDP owing to strong revenue growth and under spending. Up to May 2009, M2 continued to grow by more than 20 percent on a year-on-year basis and credit growth, which in recent years has been particularly rapid to the real estate sector, rebounded compared to the first quarter of 2009. Inflation has remained high at about 13 percent for 2008/09, driven mostly by food prices increases as has been the case for India’s CPI, and has yet to decline.16

Nepal remained politically instable throughout its modern history. Neighbouring 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. In addition, 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. However, 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 neighbours 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 neighbours.

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 downtrend. As a result, export decreased continuously. On the other hand, the volume of imports increased sharply resulting in large trade deficit.

The domestic environment too became 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.

[16] www.imf.org, country report 2009.

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 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 that 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 labour force suitable for the development of agro-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 these, because of unique geography, climate, culture, people and diverse biodiversity, Nepal could be one of the popular tourist destinations in South Asia. Moreover, the 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 demanded 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. There is high potentiality to attract foreign direct investment in hydroelectricity sector which will be the back bone of Nepalese economic development.

After the declaration of republic, the government has taken the objective of accelerating sluggish economic growth rate and aimed 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 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.

Finally, Taking the post-conflict situation into account, priority will be given to allocation of resources for reconstruction, rehabilitation and inclusion. Resources will be provided to priority areas that will support broad-based, inclusive and sustainable development. Public investment will be concentrated more on effective delivery of services and infrastructure development. For instance, In agriculture development, special attention will be paid to agricultural roads, agricultural credit, research and dissemination of technology, irrigation, rural electrification and development of market infrastructure.

Backward geographical areas, ethnic groups, nationalities and communities will be included in the development process and will equitably share in the outcomes. Concrete contribution to poverty alleviation and economic growth will be made by emphasizing programs that raise income of the poor and marginalized communities, and empower them. Emphasis will be to increase the private sector investment in potential areas like electricity, communications, rural electrification and roads, where the government is currently engaged. Investment will be made in some big projects generate people's confidence towards the state and to generate opportunities for employment. At the local level, multiple projects that are identified and manageable by the communities if implemented will increase people's participation, ownership and employment.

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