4 Nepal

Shiva Sharma

I. Introduction

Nepal is a small beautiful country situated in South Asia, land locked by China in north and India in south, east and west. It extends from 80^0 4’ E to 88^0 12’ E longitude and 26^0 22’ N to 30^0 27’ N Latitude with 147141 sq. km. total area from 60 meter above the sea level in south to 8848 m. (Mt. Everest) in North. It is roughly rectangular in shape, and the land extends approx. 885 km. east west and 193 km. north south. Kathmandu is the capital city of the country, located in the central part of Nepal at an altitude of 1336 m above the sea level. Nepal is the youngest republic country in the world. She is in ferment striving for socio-politico-economic transformation by early promulgating an inclusive, democratic, and federal constitution.

I.1 Geography and Climate

Ecologically, the land mass is divided into three geographical zones running from East to West, namely; Plain (Terai) Region, Hill Region and Mountain Region. Plain Region, commonly known as Terai, lies on the southern part of the country with the altitude ranges from 60 meters to 610 meters above the sea level. This region is low, flat and fertile. It covers 23 percent of the total area of the country out of which 40 percent is under cultivation. It is also known as the “grain basket” of Nepal. Highly populated and industrial cities such as Biratnagar, Birgunj and Bhairahawa, and Lumbini (the birth place of lord Budddha) are situated in this region. The hill region lies between the altitudes of 610 meters to 4,877 meters altitude from the sea level. This region accounts the largest share (42 percent) of the total land area of the country with several gorgeous mountains, high peaks, hills, lakes, basins and valleys such as Kathmandu, Pokhara, Dang, and Surkhet. These valleys, especially the Kathmandu valley, support relatively high percentage of the hill population. The mountain region lies on the northern part of the country covering mountainous area. The altitude ranges from 4877 meters to 8848 meters above the sea level. There are more than 250 peaks in this region with more than 6000 meters in height (8 mountains among the highest 10 mountains in the world with Mt. Everest). In this region the snow line lies above 5000 meters and there is no human settlement above this line. This region covers 35 percent area of the country but only 2 percent of the land is suitable for cultivation. Since this region is mostly steep, rugged and cold, it is the most sparsely populated region of the country.

Nepal experiences four seasons of climate spring, summer, autumn and winter. 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 25^0 -27^0 C. 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.

I.2 Natural Resource

Forest resource is another major natural resource of the country, almost 20% land area of the country is covered by forest which is habitat for wildlife as well as source of flora fauna and herbs and also it provides fodder to the livestock. Many industries are depending on forest resources as raw materials but misuse of the resource is major problem of this resource.

Nepal is very rich in natural resources especially in water resource with 2.27% of world water resource; Forest and Minerals are other major natural resources. Although Nepal has huge source of natural resources the country has not able to cash the opportunity due to lack of proper utilization. The major sources of water are snowmelt from Himalayas, glaciers, rain fall and ground water. There are around 6000 rivers (including rivulets and tributaries) having about 45000 km. length. Koshi, Gandaki and Karnali are the main river systems flowing in a high speed from north to south with a high potential of hydroelectricity generating which is highly underused.

Other than water resources and forest resources, Nepal contains mineral resources as well, though they are not excavated substantially. Studies indicate that iron, copper, gold, lead, zinc, limestone, slate, oil and gas, coal, sulfur etc are available which are almost unused. In overall, major problems of Natural resource are Under use, misuse and unused.

I.3 People and culture

Total population of Nepal has been continuously increasing over time. According to an estimation of Central Bureau of Statistics Nepal, total population is estimated to be 28.4 million in 2010. It ranked 40th position with 0.41% of world population in 2010. There is regular census in Nepal in every ten years and the last census was conducted in 2001. According to that census, population of Nepal was 23.1 million. Out of total population the share of male and female was 49.96 and 50.04 percent respectively. Annual average growth rate during 1991 to 2001 was 2.25. Similarly, population density was 157 square kilometer. Majority of people live in rural areas. Geographically, 48.4 percent people live in Plain followed by 44.3 percent in Hill and only 7.3 percent people in Mountain. .The literacy rate and life expectancy at birth were 54.1 and 60.4 percent respectively.

The composition of Nepalese society is diversified with multilingual, multicultural and multiethnic country. People of different race and religion live there and practice their own culture tradition and customs, among those, 80.62 % Hindus followed by Buddhists 10.74 %, Islam 4.2%, Kirat 3.6%, Christians 0.45 % and 0.39 %others. 102 ethnic groups live harmoniously with more than 100 languages, Nepali is the national official language and about 49 percent people speak Nepali followed by Maithili 12.3, Bhojpuri 7.53, Tharu 5.86, Tamang 5.9, Newar 3.63 percent etc.

I.4 History and Political Structure

Nepal enjoys the distinction of having always been an independent country, it has never colonized. Nepal has its long ancient and medieval history various dynasties namely Gupta (4th Century), Lichhavis (5th Century), and Malla (13th Century ruled over the long period of history, the modern history dates back from the second half of the 18th century. Prithivi Narayan Shah, king of Gorkha State, resumed unification movement to consolidate a strong nation by merging various small states. Since that time Kathmandu has been the capital of the country and ruled by Shah Dynesty. Jung Bahadur Rana declared himself Prime minister of Nepal and started autocratic Rana Regime after the Kot Parba1846 (a massacre) leaving monarchy with only nominal power and Nepal was ruled by the Rana Families by isolating the country by the rest of the world for 104 years. Popular movement of 1950 overthrew the Rana regime and Nepal entered multiparty democratic system and first democratic election held in 1959 for parliament and a democratic government formed as per the constitution, however, it lasted for short period. In 1960 King Mahendra declared democracy a failure and dismissed the elected government and issued new autocratic constitution. King Mahendra imposed autocratic Panchayat System and banned on running political parties.

Another popular movement 1990 leaded by major political parties Nepali Congress and Bam Morcha multiparty democratic system and issued a new constitution ensuring the sovereignty of the people, constitutional monarchy and multi-party elections held in 1991 to elect a truly democratic government under a constitutional monarchy. Under this system Nepal faced political instability by the frequent change of government, at the mean time Maoist insurgency started which destroyed Nepal’s overall internal security system. After the Royal massacre Gyanendra Shah became the King and he started to rule country autocratically avoiding the political parties, which created unified revolution by the CPN Maoist and other leading parties in 2006. The success of popular movement of April 2006 brought the decade-long insurgency to an end. After election of the new constitutional assembly, the first meeting of the Constitutional Assembly historically declared Nepal as Federal Democratic Republic in May 28, 2008. The process of making new constitution under federal republic political system is going on and so Nepal is now in political transitional phase.

I.5 International Relation

Constitutionally Nepalese foreign policy is guided by “the principles of the *United Nations Charter*, nonalignment, Panchasheel (five principles of peaceful coexistence), *international law* and the value of world peace.” The fundamental objective of the foreign policy is to enhance the dignity of Nepal in the international arena by maintaining the sovereignty, integrity and independence of the country. Before 1951, Nepal’s foreign relation was limited with four countries; namely – India, United Kingdom, USA and France. After membership of the United Nations in 1955, extension of diplomatic relations with various countries of the world increased considerably, with the diplomatic relationship to 118 countries around the world up to 2010. Membership and active participation on regional and international forums and organizations such as SAARC, BIMSTEC, WTO, World Bank, Asian Development Bank and UN Agencies is making Nepalese foreign relation effective and broad.

II. Overview of Macroeconomic Activity and Fiscal Position

II.1 Macroeconomic Activity

Nepal has been adopting periodic plan approach of development as a part of mixed economic development after 1950. Since that period 11 periodic plans has been completed for over development activities of the countries. Although, poverty alleviation through economic development became direct or indirect objectives of every development plans slow pace of economic development has became one of the biggest challenge of economic development. Low level of economic growth, low per capita income, increasing trade deficit, high rate of inflation, huge fiscal deficit, heavy dependency in foreign aid are major current features of Nepalese economy. Table 1 shows the summary of microeconomic indicators of last10 years of Nepalese economy. Detail sector wise analysis is included in this chapter.

Table 1: Summary of Macroeconomic Indicators

(NRs.10 Millions)

Description	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Percapita GDP (NRs)	19071	19410	20340	21694	23300	25290	27525	30171	35865	41851
Percapita GNI (NRs)	19144	19385	20312	21626	23365	25482	27806	30465	36290	42291
Percapita GNDI (NRs)	21978	22265	23433	25056	27227	30359	32684	37227	45316	52340
Percapita GDP at constant price	19071	18682	18990	19467	19754	20043	20332	21108	21416	21905
Percapita GNI at constant price	19144	18658	18964	19406	19809	20194	20540	21313	21924	22417
Percapita GNDI at constant price	21978	21431	21878	22485	23083	24060	24139	25290	26718	26718
Annual Change in nominal percapita GDP (%)	.	1.78	4.79	6.66	7.41	8.54	8.84	9.61	18.87	16.69
Annual change in real percapita GDP(%)	.	-2.04	1.65	2.51	1.47	1.46	1.44	3.81	1.46	2.29
Percapita GDP (USD)	259	255	261	293	328	350	390	464	467	562
Percapita GNI in (USD)	260	254	261	292	329	352	394	469	472	568
Gross domestic saving as percentage of GDP	11.66	9.49	8.56	11.75	11.56	8.98	9.82	9.83	9.71	9.36
Gross national saving as percentage of GDP	26.91	24.20	23.77	27.25	28.41	29.03	28.56	33.22	36.07	34.43
Exports of goods and services as percentage of GDP	22.56	17.74	15.70	16.68	14.58	13.45	12.86	12.78	12.38	9.23
Imports of goods and services as percentage of GDP	33.24	28.49	28.55	29.46	29.48	31.32	31.72	33.26	34.55	38.07
Resource Gap as percentage of GDP (+/-)	4.56	3.95	2.36	2.72	1.96	2.17	-0.12	2.90	4.18	-3.77
Gross Fixed Capital Formation as percentage of GDP	19.20	19.56	19.92	20.34	19.94	20.72	21.07	21.88	21.29	21.25

Source; Economic survey 2009/10, Ministry of Finance, Nepal.

II.1.1 International Environment

a. International Trade

With a trade to GDP ratio of about 38 percent, an average tariff of 11 percent, and virtually no quantitative restrictions, Nepal is among South Asia's most open and trade-dependent country. Nepal has been adopting an open and market oriented trade policy for the last two decades with expectations that such policy generates positive impacts on the resource mobilization, economic development and poverty alleviation.

However, Nepal has not been able to realize the benefits of trade liberalization due to difficulties in accessing capital, technology and market, and the unequal economic levels existing among the various countries. In spite of extension of market access due to the entry into the World Trade Organization and regional trading arrangements of SAFTA and BIMSTEC, Nepalese exports could not be enhanced mainly due to the deficiencies in creating synergies and positive interplay in the production emanating from the topographical, climatic and vegetation diversities with application of appropriate technologies, skilled human resources and investments

Nepal has been facing trade deficit from history to the present time. The country-wise and product-wise area of export trade of Nepal seems narrow. The main foreign trade partners of Nepal are India, China, USA, Germany, 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 2009/10 the volume of total foreign trade reached to NRs. 439.92 billions. The share of foreign trade with India is 59% whereas the share with other countries is 41%.

Nepal never experienced trade balance. More dependency on import is resulting increasing trend of trade deficit. Trade diversification is still remaining in far behind. The major exportable Nepalese goods are readymade garments, woolen carpet, cement; noodles, pashmina, big cardamom, lentils, herbal product, tea and handicrafts.

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.

Like many other developing countries, Nepal has adopted the liberal economic and trade policies under the auspices of multilateral, regional and bilateral free trade agreements. Nepal has also pursued the open economic policies since mid 1980s which was accelerated in 1990s. Realizing the importance of trade and its multiplier effects in the economic development process, the Government of Nepal, introduced ‘Trade Policy’ in 1992 with a view to optimize the benefits from trade liberalization, as an important part of economic liberalization. The policy provided overall direction towards further liberalization and diversification of the trading regimes and at the same time ushered Nepal’s trade to integrate at international level. In addition, it provided impetus to private sector for their active participation in the areas of trade and investment.

Table:2 Direction of International Trade

(Rs. in Millions)

Description	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Export F.O.B.	53910.7	58705.7	60234.1	59383.1	59266.5	67697.5	61126.8
India	30777.1	38916.9	40714.7	41728.8	38555.7	41005.9	40114.9
Other Countries	23133.6	19788.8	19519.4	17654.3	20710.8	26691.6	21011.9
Import C.I.F.	136277.1	149473.6	173780.3	194694.6	221937.7	284469.6	378795.6
India	78739.5	88675.5	107143.1	115872.3	142376.5	162437.6	217960.4
Other Countries	57537.6	60798.1	66637.2	78822.3	79561.2	122032.0	160835.2
Trade Balance	-82366.4	-90767.9	-113546.2	-135311.5	-162671.2	-216772.1	-317668.8
India	-47962.4	-49758.6	-66428.4	-74143.5	-103820.8	-121431.7	-177845.5
Other Countries	-34404.0	-41009.3	-47117.8	-61168.0	58850.4	-95340.4	-139823.3
Total Volume of Trade	190187.8	208179.3	234014.4	254077.7	281204.2	352167.1	439922.4
India	109516.6	127592.4	147857.8	157601.1	108932.2	203443.5	258075.3
Other Countries	80671.2	80586.9	86156.6	96476.6	100272.0	148723.6	181847.1
% Share in Total Trade	1000.0	1000.0	1000.0	1000.0	1000	1000	1000
India	575.8	612.9	631.8	620.3	643	578	587
Other Countries	424.2	387.1	368.2	379.7	357	422	413

Source; Nepal Rastra Bank

Table 2 shows the composition as well as trend of International trade of Nepal. Total volume of trade has been more than doubled from 2003/04 to 2009/10 with total volume of trade of NRs. 439922.4 Millions in F. Y. 2009/10. Growth on Export is negligible but import has been almost tripled during the Period. This trend shows that even after membership of WTO in 2004 Nepal could not able to catch the opportunities to enhance export.

Figure 1: Foreign Trade

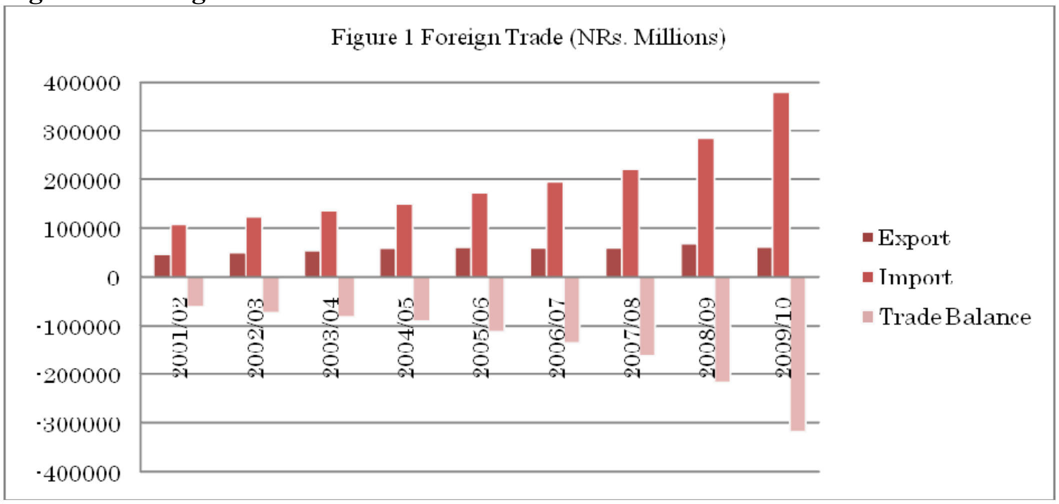
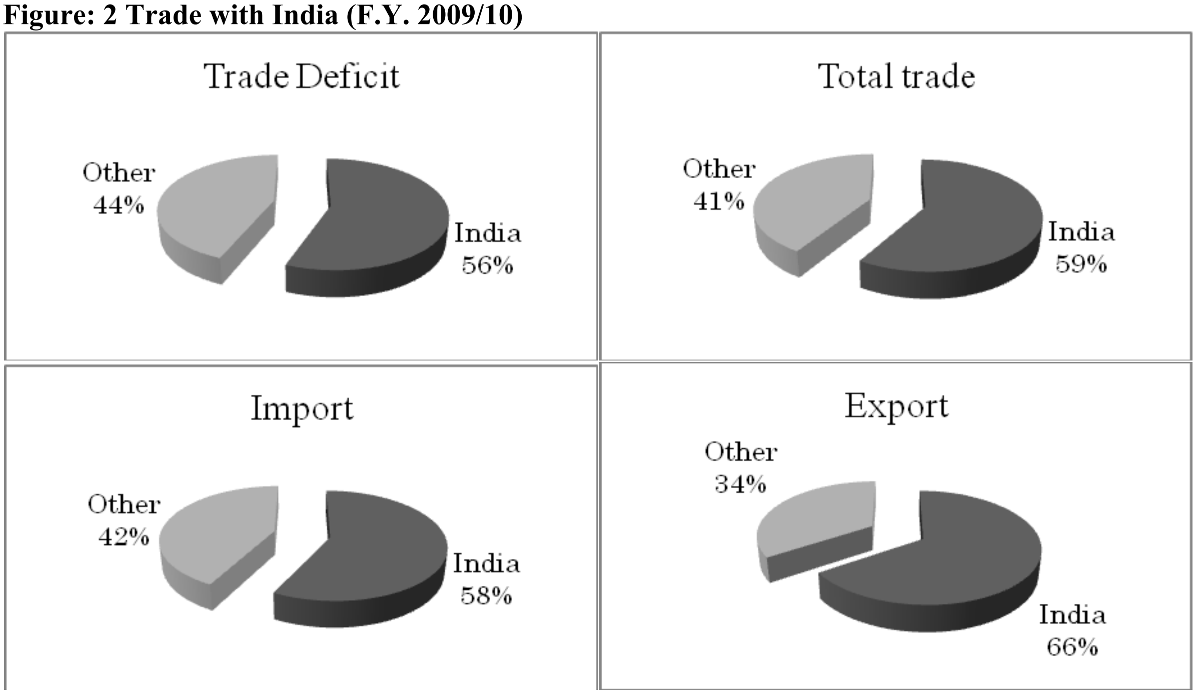


Figure 1 shows the increasing trend of trade deficit which is increased 4 times in 8 years after 2001 and total deficit reached NRs.317668.8Millions in 2009/10. Trade deficit has been accelerating from F.Y. 2006/07 due to rapid growth of export. Increasing consumption habit and change on food habit of middle class people due to remittance income, and lack of internal production and industrialization are the main reasons behind it.

Figure 2 shows the trade dependency with India. Nepalese International trade has been dependent with India historically due to Geo-Political as well cultural relation with India. In F.Y. 2009/10 total trade with India was 59%, with 66% export and 58% import and share of trade deficit of 56%. Lack of trade diversification, landlockness, non-tariff barriers from the Indian side are the main reasons behind this situation.

Figure: 2 Trade with India (F.Y. 2009/10)



b. Balance of payment

The current account and overall Balance of Payment is in deficit position in F.Y. 2009/10. Increasing trade deficit has been biggest challenge to maintain the current account balance. The only big supporting sector for current account has been remittance but the decreasing growth rate of remittances indicates further challenge. Although the capital account is in surplus, overall balance of payment is entering vulnerable stage.

Table: 3 Balance of Payment Summary

(NRs. in Millions)

Particular	Fiscal Year			Percentage Change	
	2007/08	2008/09	2009/10	200809	2009/10
A. Current Account	23679.6	41437.3	-32347.8	75.0	-178.1
Goods : Exports F.O.B.	61971.1	69906.8	63488.1	12.8	-9.2
Goods : Imports F.O.B.	-217962.8	-279227.8	-370757.3	28.1	32.8
Balance on Goods	-155991.7	-209321.0	-307269.2	34.2	46.8
Services Net	-11092.0	-10478.0	-16843.7	-5.5	60.8
Services : Credit	42236.1	52830.1	51120.5	25.1	-3.2
Services : Debit	-53328.1	-63308.1	-67964.2	18.7	7.4
Balance on Goods and services	-167083.7	-219799.0	-324112.9	31.6	47.5
Income : Net	7946.8	11749.5	9117.4	47.9	-22.4
Income credit	13447.7	16506.6	14917.9	22.7	-9.6
Income debit	-5500.9	-4757.1	-5800.5	-13.5	21.9
Balance on Goods, Services and Income	-159136.9	-208049.5	-314995.5	30.7	51.4
Current Transfer Net	182816.5	249486.8	282647.7	36.5	13.3
Current Transfer : Credit	185462.9	257461.3	287770.6	38.8	11.8
Grants	20993.2	26796.2	26673.6	27.6	-0.5
Workers' Remittances	142682.7	209698.5	231725.3	47.0	10.5
Pensions	18789.9	17755.4	25850.7	-5.5	45.6
Other	2997.1	3211.2	3521.0	7.1	9.6
Current Transfer : Debit	-2646.4	-7974.5	-5122.9	201.3	-35.8
B. Capital Account(Capital Transfer)	7912.5	6231.0	12578.3	-21.3	101.9
Total (Group A plus B)	31592.1	47668.3	-19769.5	50.9	-141.5
C. Financial Account (exclu.group E)	11032.6	21201.7	-3695.3	92.2	-117.4
Total (Group A through C)	42624.7	68870.0	-23464.8	61.6	-134.1
D.Miscellaneous Items, Net	-6690.3	-3719.6	14516.9	-44.4	-490.3
Total (Group A through D)	35934.4	65150.4	-8947.9	81.3	-113.7
E. Reserves and related items	-35934.4	-65150.4	8947.9	81.3	-113.7
Reserve assets	-37002.0	-65069.7	5649.1	75.9	-108.7
Nepal Rastra Bank	-29636.8	-45751.3	4398.2	54.4	-109.6
Deposit Money Banks	-7365.2	-19318.4	1250.9	162.3	-106.5
Use of Fund credit and loans	1067.6	-80.7	3298.8	-107.6	-
Change in Net Foreign Assets (- Surplus)	-29674.7	-44758.4	2619.1	50.8	-105.9

Source: Nepal Rastra Bank

Table 3 shows the current scenario of the Balance of Payment in detail. The balance of payments posted a loss of Rs. 2.62 billion in 2009/10 as against a surplus of Rs. 44.76 billion last year. The current account also registered a deficit of Rs. 32.35 billion as against a surplus of Rs. 41.44 billion last year. The large deficit in goods and services trade led to such a huge current account deficit. Despite a huge current account deficit, a rise in the capital account surplus coupled with a rise in trade credit liabilities largely contributed in bringing down the BOP deficit.

The capital account registered a surplus of Rs.12.58 billion in 2009/10 compared to a surplus of Rs. 6.23 billion in the previous year. Financial account, however, registered a deficit of Rs. 3.70 billion in the review year in contrary to a surplus of Rs. 21.20 billion in the previous year. The foreign direct investment grew by Rs. 2.85 billion compared to Rs. 1.83 billion of the previous year. The trade credit liabilities remained at Rs. 21.97 billion in the review year compared to the amount of Rs. 19.55 billion in the previous year.

c. Exchange Rate and Foreign Exchange Reserve

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 and since not changed yet.

Figure 3 reflects the trend of exchange rate of Nepalese currency with US$. Nepalese rupees continuously depreciated with US$ from 1970 to 2001.after that it was slightly appreciated and remained almost stable between NRs70 to 80 against US$ 1. Generally, the commercial banks in Nepal use similar exchange rates, though there have been some instances of different rates being used by different banks. The commercial banks have established an association called Foreign Exchange Dealers Association (FEDAN) with a view to sharing information and avoiding unhealthy competition in foreign exchange transactions. FEDAN works as a bridge between all member banks and Central Bank. All the commercial banks are the member of the FEDAN. FEDAN collects the daily exchange rates from its members and sends to Central bank. Central bank uses this information of exchange rate to determine the exchange rate for US dollar for the next day. After computing the exchange rate of the US dollar, the exchange rates for other convertible currencies are calculated on the basis of the cross rates with the US dollar in the international market.

Figure 3: Exchange Rate of NRs. To US $1

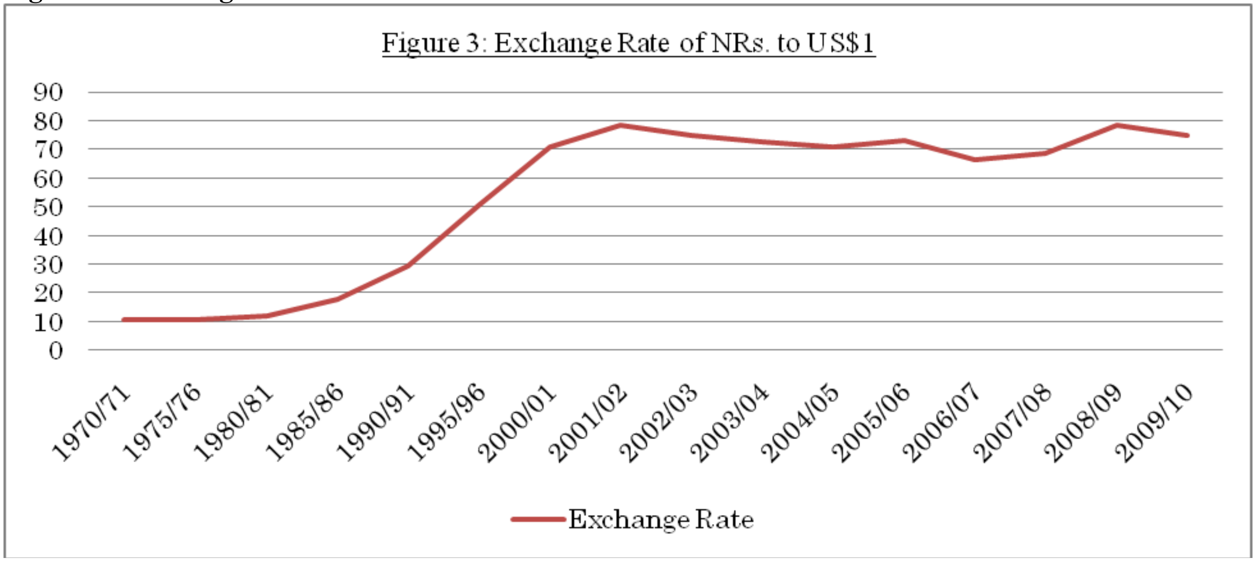


Table 4 presents the situation of foreign exchange reserve from 2007 to 2010. Although the total reserve increased by more than 1000 million US $during the period but there is significant decrease in 2010 with more than 100 million US $. The gross foreign exchange reserves dropped by 7.0 percent to Rs. 266.57 billion in mid-July 2010 from a level of Rs. 286.54 billion as at mid-July 2009. Such reserves had grown by 34.8 percent last year. Out of total reserve, NRB's reserve declined by 8.4 percent to Rs. 205.37 billion in mid-July 2010 from a level of Rs. 224.19 billion a year earlier. The gross foreign exchange reserves in dollar terms declined by 2.5 percent to US$ 3.58 billion in mid-July 2010 as against a growth of 18.3 percent last year. The widening of the current account deficit resulted in the depletion of foreign exchange reserves in the review year. Based on the trend of import in the twelve months of the review year, the current level of reserves is sufficient for financing merchandise imports of 8.6 months and merchandise and service imports of 7.3 months.

Table 4: Foreign Exchange Reserve

(US $ Million)

F.Y.	2007	2008	2009	2010
Nepal Rastra Bank	1998.9	2477.1	2872.4	2758.9
Convertible	1908.3	2085.4	2585.0	2229.9
Inconvertible	90.5	391.7	287.4	529.0
Commercial Bank	547.4	626.9	798.8	822.1
Convertible	488.5	566.8	752.7	750.7
Inconvertible	58.9	60.0	46.1	71.4
Total Reserve	2546.3	3104.0	3671.2	3581.0
Convertible	2396.9	2652.2	3337.7	2980.6
Inconvertible	149.4	451.8	333.5	600.4

Source: Nepal Rastra Bank

d. Foreign Direct investment

Nepal has opened foreign direct investment as a part of liberalization from the early 90's. It is believed that foreign direct investment is a supplement to the domestic private investment through foreign capital inflow, transfer of technology, enhancement of managerial skills, productivity and to get into the global market. Government of Nepal has begun carrying out policy and regulatory changes in industry, trade, finance and the Stock Exchange beginning in 1992 in order to promote foreign investment and technology transfer in the country. Single door policy has been carried out to simplify the process of granting necessary approval and providing services to the foreign investment through a single place.Although Nepal is the most liberalized country in South Asia, and adopting various policies to attract the FDI, Nepal become one of the least FDI attracting country among developing countries. Many foreign investors in Nepal are individuals rather than corporate entities. Most of the FDI projects are of small size 72%, medium-sized 16.5% and large-sized industries 11.5%. Lack of infrastructure for industrialization, international security problem, landluckness and high transportation cost are the main reasons behind it.

Much of the FDI inflow is for joint ventures because of non-commercial risks by offering shares to local partners. Most of the FDI in Nepal is Greenfield-type investment rather than acquisition. FDI is highly concentrated in the manufacturing sector, which accounted for slightly more than 45% of approved FDI projects. Within the manufacturing sector, the textile and garment industry accounts for 28% of total foreign investment, followed by the chemical and plastic industries at 25.3%. Tourism is second, accounting for almost 25% of total FDI projects, followed by the service sector with 20% ofFDI projects. Although the electricity, water and gas sector has just a few FDI projects, it ranks fourth highest in terms of the size of FDI inflow.

Table 5 shows the trend of FDI in Nepal. To attract foreign investment through adoption of relevant, practical, and liberal policy, more than 1,800 industries are granted permission until FY 2009/10. Fixed capital of those industries stands at Rs. 113.0 billion with their total project cost of Rs. 136 billion. A total of Rs.53.0 billion as foreign investment in these industries has been recorded. Once in operation, these industries are expected to generate employment for 140,953 Nepalese citizens. The commitment for foreign direct investment in theF.Y.2009/10 increased as a consequence of the gradual improvement in the peace and security situation of the country. In this fiscal year, the Department of Industry has given approval for the incorporation of 171 joint venture projects with foreign investment equivalent to Rs. 9.1 billion. In the previous year, the number of such approval accounted to 230 with a total foreign capital of Rs. 6.3 billion. Out of total joint venture investment, 50 are related to tourism, 72 are related to services, 37 are related to manufacturing, 1 is related to construction, 2 are related to agriculture, 5 are related to energy and the remaining 4 are related to mining. Of the total approved foreign investment projects, manufacturing sector witnessed the highest growth of 121.1%, as against at most reduction of 96.7% in the agricultural sector compared to the previous year. From all the approved projects, 7,848 people are expected to get employment. In 2009/10, 34 countries were given approval for foreign investment. Country-wise analysis shows that the investment commitment from India secures the topmost position followed by Mauritius, Canada and China.

Table 5: Foreign direct Investment

(NRs in Millions)

Fiscal year	Number of industries	Foreign investment	% of GDP	Total number of employment
1989/90	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	230	6245.0	---	11068
2009/10	171	9100	---	7848

Source: Ministry of Industry, Nepal.

e. Foreign Aid

Nepal has been a recipient of foreign assistance since 1952 when it joined the Colombo Plan for Cooperative, Economic, and Social Development in Asia and the Pacific (Colombo Plan). During the 1950s, many Nepalese received scholarships through the Colombo Plan to go to different countries for studies in technical and professional areas. Also during that time, all other aid was in the form of grants. The bulk of assistance was directed toward developing agriculture, transportation infrastructure, and power generation. Beginning in the 1960s, some bilateral assistance was in the form of loans. The loan share of foreign aid increased from under 4 percent between 1965 and 1970 to more than 25 percent by the 1985-88 period. In the 1970s, multilateral assistance programs started to play an important role in development planning and accounted for more than 70 percent of funding for development planning. By the end of the 1980s, the great majority of foreign aid was in the form of multilateral assistance programs. The major sources of borrowing or grants for these programs were the International Development Association of the World Bank and the Asian Development Bank. Most of these loans could be characterized as soft loan.

Sources of foreign aid are numerous. UN agencies, multilateral lending agencies (such as the World Bank), bilateral countries and some private agencies have been participating in aid program in Nepal. Under the auspices of World Bank, the Nepal Aid Group was created in 1976. By 1987 sixteen countries and six international agencies participated in the group.

Table 6: Foreign Aid

(NRs. In 10 millions)

F.Y.	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
A.Commitment										
1. Bilateral	1129.34	1749.59	1843.87	1531.24	822.36	2122.54	1475.55	1770.61	1310.64	2719.65
Grant	1129.34	1404.60	1729.22	1518.31	822.36	2122.54	1475.55	1770.61	562.09	2365.50
Loan	-	344.99	114.65	12.93	0.00	0.00	0.00	0.00	748.55	354.15
2. Multilateral	915.46	1379.10	1478.90	2789.03	1551.44	1692.69	616.87	1931.68	3607.98	2077.88
Grant	156.68	24.30	604.80	1217.45	73.34	416.73	350.88	1315.41	3544.33	1944.08
Loan	758.78	1354.80	874.10	1571.58	1478.10	1275.96	265.99	616.27	63.65	133.80
3. Total	2044.80	3128.70	3322.77	4320.27	2373.80	3815.23	2092.42	3702.29	4918.62	4797.53
Grant	1286.02	1428.91	2334.02	2735.76	895.70	2539.27	1826.43	3086.02	4106.42	4309.57
Loan	758.78	1699.79	988.75	1584.51	1478.10	1275.96	265.99	616.27	812.20	487.95
B. Disbursement										
1. Bilateral	492.91	277.12	467.53	1004.44	901.32	923.08	765.84	1640.64	1020.77	933.31
Grant	417.12	218.45	458.83	938.72	894.72	910.43	761.78	740.18	957.56	872.02
Loan	75.79	58.67	8.70	65.72	6.60	12.65	4.06	900.46	63.21	61.29
2. Multilateral	1259.48	1602.62	970.95	584.11	989.92	1442.65	1438.34	944.79	1909.29	2701.86
Grant	154.05	456.89	209.79	195.19	233.62	528.69	620.97	839.90	1074.51	1766.26
Loan	1105.43	1145.73	761.16	388.92	756.30	913.96	817.37	104.89	834.78	935.60
3. Total	1752.39	1879.74	1438.48	1588.55	1891.24	2365.73	2204.18	2585.44	2930.06	3635.17
Grant	571.17	675.34	668.62	1133.91	1128.34	1439.12	1382.75	1580.08	2032.07	2638.28
Loan	1181.22	1204.40	769.86	454.64	762.90	926.61	821.43	1005.35	897.99	996.89

Source: Economic Survey, Ministry of Finance, Nepal.

Foreign aid has significant role to fulfill the revenue gap of government of Nepal. Despite of more than half decade history of foreign aid adoption, development stage of Nepal is far behind, more than 25% people are on absolute poverty and country ranked as one of the least developed country. One the other hand revenue collection is not sufficient to fulfill the government expenditure. This kind of situation raised the question that, whether Aid is effective or not, is Nepal in debt trap or aid addiction.

Table 6 gives the detailed information about amount and composition of foreign aid in Nepal. Total amount of foreign aid has been doubled in past 10 years and reached to NRs.36351 millions in F.Y. 2008/09.The share of loan in slight decrease trend but share of grant increase significantly during the period. Composition of multilateral and bilateral assistance is almost similar, multilateral assistance is almost 75% and bilateral assistance is 25%. Total aid has been increasing significantly after 2006. Figure 4 shows the trend and composition of foreign aid.

Figure 4: Foreign Aid Disbursment

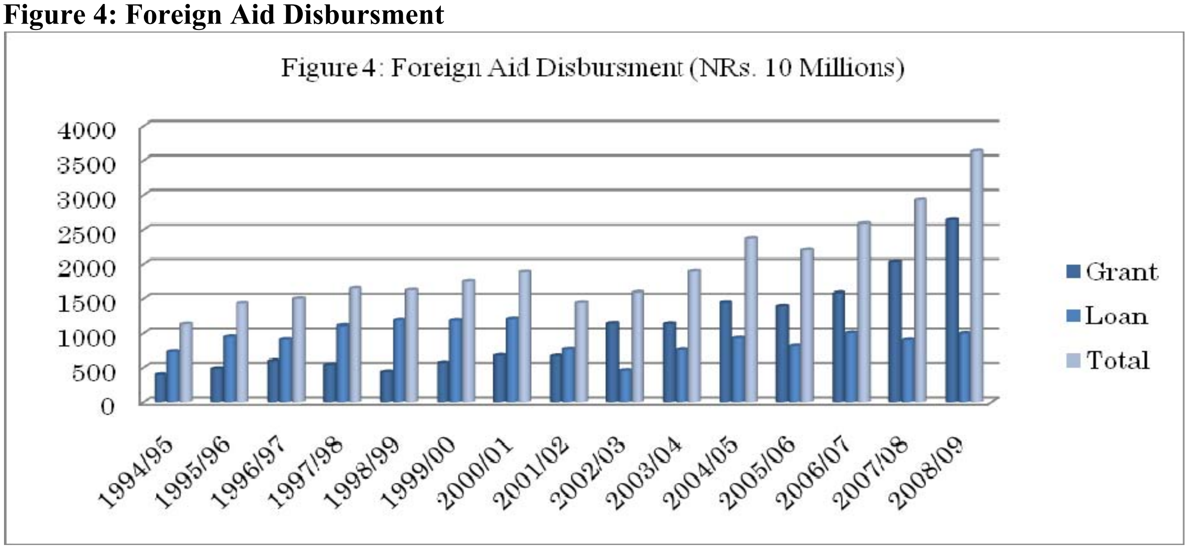
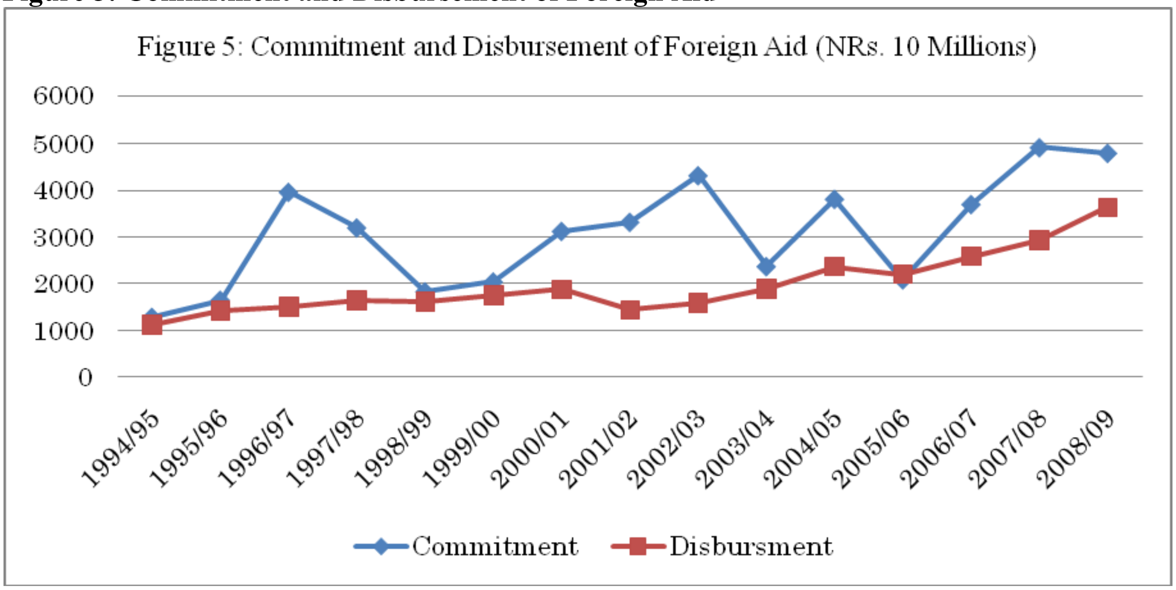


Figure 5 shows the gap between commitment and disbursement of Foreign Aid. Lack of effective aid management, lack of expensing capacity of government mechanism and various difficult conditions of donor agencies are the main reasons behind it. There is huge gap between commitment and disbursement in average only 60% of the total commitment amount has disbursed.

Figure 5: Commitment and Disbursement of Foreign Aid



II.1.2 Domestic Environment

a. Economic Growth Rate

Although every development plan set achieving economic growth as an objective of the plan, growth achievement is one of the biggest lacking of the Nepalese economic development history. When two immediate neighboring countries India and China achieving almost double digit growth in recent years at the same time, Nepal is in still in less than 5%.

Table 7: Sector wise economic Growth Rate

(%)

F.Y.	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Agriculture	3.1	3.3	4.8	3.5	1.8	1.0	5.8	3.0	1.1
Agriculture and Forestry	3.0	3.3	4.7	3.4	1.7	0.9	5.8	3.0	1.1
Fishery	8.7	4.0	12.2	7.1	9.9	3.0	7.3	5.7	5.3
Non-Agriculture	-1.1	3.5	5.3	3.2	5.3	4.4	5.9	4.7	5.1
Industry	0.9	3.1	1.4	3.0	4.5	3.9	1.7	-0.2	3.9
Mining and Quarrying	8.8	3.2	-0.4	6.8	8.3	1.5	5.5	0.7	4.2
Manufacturing	-5.3	0.0	2.2	2.6	2.0	2.6	-0.9	-1.0	2.6
Electricity Gas and Water	11.4	19.0	4.1	4.0	4.0		1.1	-0.9	0.5
Construction	6.4	2.1	-0.3	2.9	7.7	2.5	5.1	0.9	6.6
Service	-1.8	3.7	6.8	3.3	5.6	4.5	7.3	6.3	5.5
Wholesale and Retail Trade	-11.6	2.3	10.8	-6.2	3.7		4.2	5.9	5.6
Hotels and Restaurant	-18.2	2.0	12.7	-5.4	6.3	3.5	6.9	3.0	8.5
Transport, Storage and Communications	8.4	5.2	7.5	6.4	2.5	5.0	9.4	7.6	6.5
Financial Intermediation	3.8	1.7	6.2	24.3			9.2	1.5	1.6
Real Estate, Renting and Business Activities	-4.9	-4.0	-2.1	10.0	6.3		10.4	1.8	4.9
Public Administration and Defence	36.8	11.5	-0.6	6.6	6.9	1.3	0.6	7.3	4.2
Education	21.1	13.7	5.1	9.8	3.7	7.3	6.4	11.3	6.5
Health and Social Work	7.4	15.3	6.1	11.3	5.9	6.5	8.5	11.2	5.6
Other Community, Social and Personal Service	-8.6	4.4	13.4	-3.4	3.3		9.4	13.0	6.1
Total GVA including FISIM	0.5	3.4	5.1	3.3	4.0	3.1	5.9	4.1	3.7
Financial intermediation indirectly measured	10.7	-6.6	30.1	6.2			7.3	7.2	7.2
GDP at basic prices	0.2	3.8	4.4	3.2	3.7	2.8	5.8	3.9	3.5
Taxes less subsidies on products	-0.5	6.6	8.6	6.9			10.1	16.0	16.2
GDP at producers price	0.1	3.9	4.7	3.5	3.4	3.4	6.1	4.9	4.6

Source: Central Bureau of Statistics , Nepal.

Table 7 reflects the composition and trend of economic growth rate. Nepal's economic growth rate in the current FY 2009/10 is estimated to decline. In comparison to 4.0 percent GDP growth achieved at producers price in FY2008/09, is estimated to grow in this fiscal year only by 3.5percent. Major factors attributable to slower growth in GDP are the decline in production mainly of monsoon (summer) crops due to adverse weather situation and the expansion of economic activities under non-agriculture sector remaining not so favorable. Such performance of the economy below the expectation is mainly attributable to *bandhs*, strikes, labor problem, electricity supply problem and contraction in external market. Non-agriculture sectors of the economy that recorded expansion inFY2009/10 in comparison to the previous fiscal year have been, mining and quarrying (from 0.7 percent to 4.2 percent); industry (from -1.0 percent to 2.6 percent); electricity, gas and water (from -0.9 percent to 0.5 percent); construction (from 0.9 percent to 6.6 percent); hotel and restaurant (from 3.0 percent to 8.5 percent); financial intermediation (from 1.5 percent to 1.6 percent); and real estate, rent, professional services (1.7 percent to 4.8percent).

Table 8: Composition of Gross Domestic Product by ISIC Division

Industries	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Agriculture and forestry	36.15	36.92	36.03	35.45	34.71	33.09	32.05	31.22	32.10	33.03
Fishing	0.43	0.49	0.46	0.48	0.47	0.49	0.47	0.50	0.55	0.52
Mining and quarrying	0.43	0.48	0.49	0.48	0.49	0.50	0.49	0.56	0.54	0.52
Manufacturing	9.03	8.50	8.20	8.05	7.92	7.59	7.48	7.34	6.83	6.25
Electricty gas and water	1.82	2.06	2.42	2.31	2.26	2.09	2.13	1.95	1.61	1.49
Construction	6.01	6.49	6.54	6.42	6.47	6.50	6.47	6.95	6.78	6.64
Wholesale and retail trade	16.44	14.59	14.51	15.29	14.09	14.31	13.29	13.51	13.40	13.97
Hotels and restaurants	1.99	1.61	1.59	1.73	1.57	1.49	1.44	1.48	1.49	1.67
Transport, storage and communications	7.39	7.87	8.31	8.94	9.06	9.72	9.97	9.86	9.93	9.76
Financial intermediation	2.69	2.75	2.72	2.65	3.06	3.49	4.08	4.30	4.10	4.07
Real estate, renting and business activities	8.29	8.23	8.08	7.72	8.69	9.53	10.15	9.45	8.79	8.26
Public administration and defence	1.24	1.63	1.70	1.55	1.69	1.74	1.75	1.84	1.97	1.99
Education	4.08	4.69	5.19	5.08	5.59	5.55	5.87	6.25	6.69	6.67
Health and social work	0.98	1.04	1.14	1.12	1.24	1.24	1.23	1.41	1.49	1.46
Other community, social and personal service activities	3.03	2.66	2.63	2.73	2.69	2.67	3.12	3.40	3.74	3.70

Source: Central Bureau of statistics, Nepal.

Table 8 presents the sector wise growth rate from fiscal year 2001/02 to 2009/10. Observation of the sector-wise structure of GDP according to the ISIC classification shows, the shares of different sectors are, agriculture and forestry 33.0 percent, fisheries 0.5 percent, wholesale and retail trade 14.0 percent, transport, communication, and warehousing 9.8 percent, real estate and professional services 8.3 percent, education 6.7 percent, construction 6.6 percent and industry 6.3 percent. Likewise, the shares of the other remaining sectors to total GDP are, financial intermediation 4.1 percent, other community, social and personal services 3.7 percent, public administration and defense 2.0 percent, hotel and restaurant 1.7 percent, electricity, gas and water 1.5 percent, health and social works 1.5 percent and , mines and explorations 0.5 percent.

In recent years, there has been a steady growth in the tertiary sector with its increasing contribution to the Nepalese economy. This sector, which contributed 51.6 percent to the GDP in FY 2008/09, is not expected to change much with a share of 51.5 percent in FY2009/10. Likewise, primary sector in FY2009/10 is estimated to contribute 34.1 percent to total GDP compared to that of 33.2 percent in the previous year and secondary sector with a 15.2 percent share in the previous year is expected to be contained 14.4 percent. Tertiary sector, primary sector, and secondary sector are expected to grow by 5.5, 1.2, and 3.9 percent respectively in FY2009/10. In the last fiscal year 2008/09, tertiary sector increased by 6.3 percent and primary sector by 3.0 percent whereas secondary sector recorded a negative growth rate of 0.3 percent.

b. Structure of inflation

High rate of inflation has been a serious issue for Nepalese economy in last two decades, and it became more serious in last two years due to double digit rate of inflation. The country is facing the tragic co-incidence of having two digits price increase in the backdrop of stagnant pace of development process with low economic growth rate. Adverse impact on purchasing capacity in the living standard of the people has posed a big question mark in the overall macroeconomic management efficiency. 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.

Table 9: Change in Urban price Index

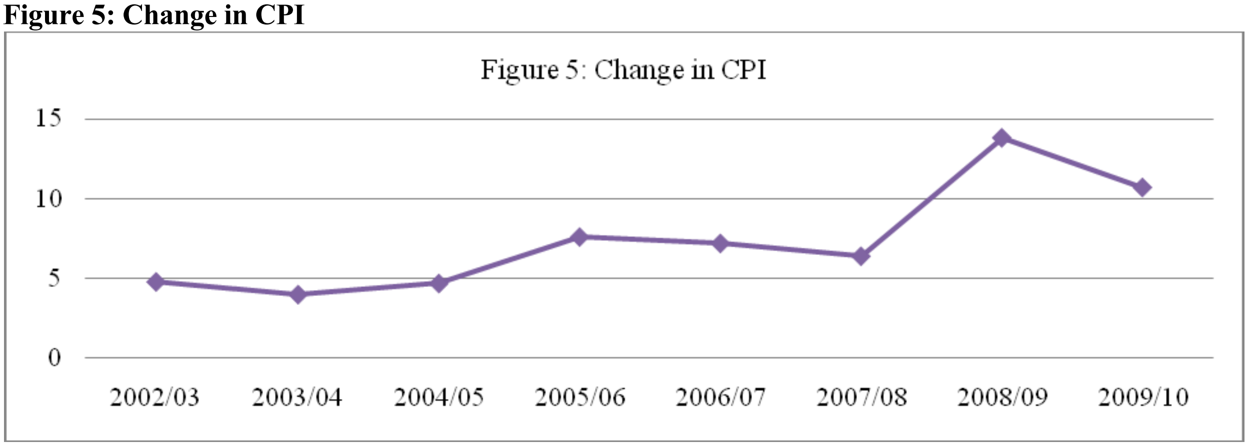
F.Y	2005/06	2006/07	2007/08	2008/09	2009/10
Kathmandu Vally	6.1	6.7	5.9	14.8	9.9
Hilly Region	8.4	7	6.2	13.3	10.9
Terai Region	8.3	7.6	6.7	13.4	11.1
National Average	7.6	7.2	6.4	13.8	10.7

Source: Nepal Rastra Bank

Figure 5 reflects the trend of consumer price index in recent years. The annual average consumer price inflation moderated to 10.5 percent in 2009/10compared to an increase of 13.2 percent in 2008/09. Despite a substantial rise of 15.4 percent in the prices of food and beverages group, the annual average consumer price inflation moderated on account of a low increment by 4.7 percent in the prices of non-food and services group. The index of food and beverages and non-food and services had increased by 16.7 percent and 9.5 percent respectively in 2008/09. The y-o-y consumer price index rose by 10.1 percent in Mid-July 2010, as against a rise of 11.4 percent in the previous year.

Region-wise, annual average price indices of Kathmandu Valley, Terai and Hills in the review year increased by 9.7 percent, 10.7 percent and 11.2 percent respectively. In the last year, such indices had risen by 14.3 percent, 12.8 percent and 12.7 percent respectively. The annual average core inflation in the review year rose by 11.7 percent in 2009/10 compared to a 12.6 percent rise in the previous year. The y-o-y core inflation went up by11.2 percent in Mid-July 2010 compared to a 12.5 percent rise in the previous year. Table 9 shows the region wise inflation rate.

Figure 5: Change in CPI



c. Consumption Saving and Investment

Consumption is increasing even amidst low economic growth rate thereby causing contraction in domestic saving. Therefore, another challenge of the economy is to create encouraging environment for saving. Millions of Nepalese youths are going overseas for employment due to very low employment opportunities in the country. They are sending remarkable amount of remittances for the livelihood of their relatives in the country, which comes out to almost 21 percent of GDP. The large chunk of such remittance, however, is spent in consumption of imported consumer goods and real-estate purchases. As such, the inward remittance could not be mobilized as financial savings. Table 10 shows the composition of intermediate consumption by industrial division.

Table 10: Intermediate Consumption by Industrial Division

(NRs. In Millions)

Industries	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Agriculture and forestry	55268	56689	59656	62323	65591	69465	75849	86078	103747	124496
Fishing	477	478	480	489	499	501	503	505	573	586
Mining and quarrying	466	554	596	649	708	810	879	1133	1313	1495
Manufacturing	100963	97434	100063	107267	115301	123035	134324	146922	164107	184079
Electricty gas and water	4963	6343	6009	7587	8338	9465	10265	11199	14506	16290
Construction	25538	29343	31461	33677	37521	42195	46647	57505	67452	78127
Wholesale and retail trade	13279	12342	13093	14936	15222	17151	17677	20096	24015	29583
Hotels and restaurants	17027	15574	16321	18679	19156	20079	22379	26034	31367	33857
Transport, storage and communications	25708	27869	30718	34986	38992	46099	52244	56307	67187	75760
Financial intermediation	3707	4582	5135	5639	5697	5960	8430	10369	11678	13152
Real estate, renting and business activities	12256	12917	13975	15000	18448	25656	29784	34252	37334	42911
Public administration and defence	1476	2072	2461	2663	3296	3321	4297	4872	5474	6679
Education	4539	5529	7023	7662	9471	9983	12389	14541	17849	21125
Health and social work	1588	1774	2084	2338	2808	3088	4084	4394	5231	6225
Other community, social and personal service activities	4916	4371	4960	5794	6460	6840	9185	10953	14335	16745
Intermediate Consumption at purchasers' prices	272,172	277,872	294,036	319,689	347,509	383,647	428,936	485,159	566,168	651,110

Source: Central Bureau of statistics. Nepal.

Table 11: Annual Consumption at current price

(NRs in 10 Millions)

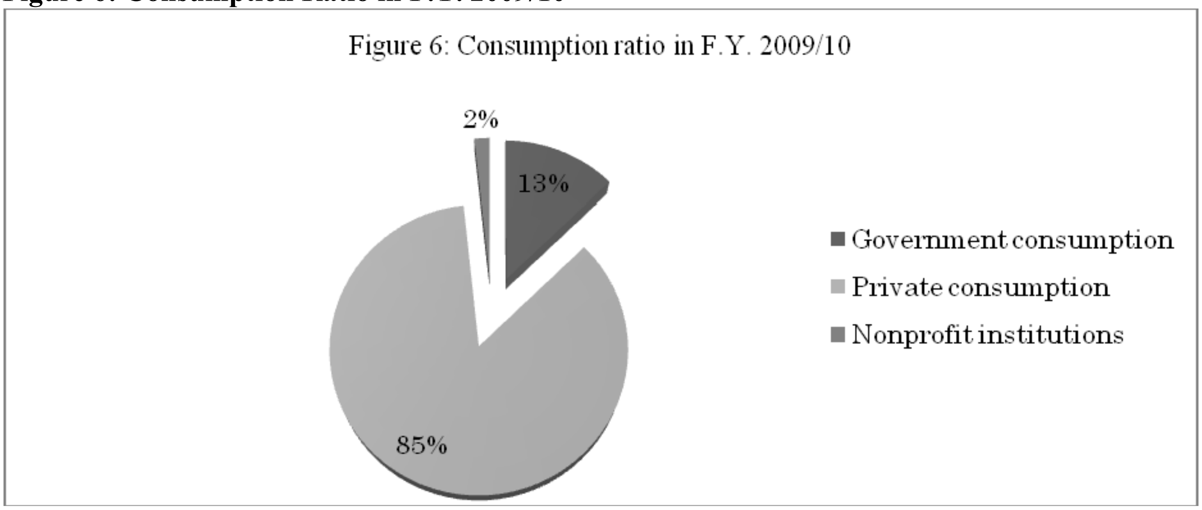
F.Y.	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Total consumption	39001.7	41584.3	45009.0	47368.5	52130.1	59532.7	65637.4	73547.0	89501.8	107192.9
Government consumption	3578.5	3858.6	4265.2	4639.7	5245.3	5679.4	6694.9	8066.3	10650.3	13657.4
Collective Consumption	2537.6	2785.7	3137.5	3396.0	3462.5	3710.5	4373.9	5499.6	6982.2	8588.1
Individual Consumption	1040.9	1072.9	1127.7	1243.7	1782.8	1968.9	2321.0	2566.7	3668.1	5069.3
Private consumption	34898.9	37140.2	40046.8	41929.0	45953.0	52781.4	57691.1	64108.5	77276.2	91706.6
Food	20590.4	21912.7	23627.6	24738.1	27112.3	31141.0	34037.7	38503.7	48455.2	57715.0
Non-food	10016.0	10659.2	11493.4	12033.6	13188.5	15148.3	16557.3	17999.9	20323.2	24097.5
services	4292.6	4568.2	4925.8	5157.3	5652.2	6492.1	7096.0	7604.9	8497.8	9894.1
Nonprofit institutions	524.3	585.5	697.0	799.8	931.9	1071.9	1251.5	1372.1	1575.3	1828.9
Actual final consumption expenditure of household	36464.1	38798.6	41871.5	43972.5	48667.6	55822.3	61263.5	68047.4	82519.6	98604.8

Source: Central Bureau of Statistics, Nepal.

Table 11 shows the annual consumption composition from F.Y. 2000/01 to 2009/10. In the fiscal year 2009/10 total consumption is estimated to increase by 8.4%. In comparison with the GDP, this amount accounts for 91.5% of the gross domestic production of the country. In the fiscal year 2008/09, total consumption was 88.3% of the GDP. In the fiscal year 2009/10 government is estimated to consume 11.5% of GDP, which was 11.0% in the previous year. Out of the total consumption of the private sector, looking at the structure of GDP consumed by the private sector in the fiscal year 2009/10, 57.4 % went to food consumption, 29.9% on non-food, and 12.6 % on services. Similarly, of the total private sector consumption of 59.5% of GDP in the previous year, share of food grains, non-food items and services was 59.5%, 28.4% and 12.1% respectively. It shows that there has been no noticeable change in the consumption structure of the private sector with food items occupying major share in total consumption. Considering the consumption dynamics, total consumption has increased by 8.4% in the fiscal year 2009/10 of which the private sector's consumption is estimated to have increased by 7.8% and that of the government by 13.1%. In the previous fiscal year, respective growth rates of the private and public consumption was 5.7% and 9.7% respectively. The increased public consumption is due to the excessive growth in recurrent expenditure. The ratio of gross consumption to GDP increased by 0.3% and reached to 90.6% in 2009/10.

In the current fiscal year 2009/10, the gross domestic savings in current prices has reached Rs 110.75 billion with a growth of 15.0 percent in comparison to 20.1 percent in the previous year. Despite the increase in both consumption and saving, it is estimated that saving will be limited to 9.4 percent with slight decline from 9.8 percent in the previous year. During the last decade (2000/01 – 2009/10) the domestic saving has declined by 2.30 percentage points from the earlier 11.7 percent of GDP.

Figure 6: Consumption Ratio in F.Y. 2009/10



The ratio of gross consumption to GDP increased by 0.3 percentage point to 90.6 percent in 2009/10, thereby pushing the ratio of gross domestic savings to GDP reached to 9.4 percent. The ratio of Gross capital formation to GDP recorded 38.2 percent in 2009/10, as against 31.9 percent in the previous year. The ratio of gross fixed capital formation to GDP stood at 21.3 percent in the review year, this is at par with the ratio of the previous year. The ratio of domestic savings to GDP at current prices, which stood at 9.7percent in FY2008/09, slightly declined to 9.4 percent in FY2009/10 as compared to 11.2 percent in FY2007/08. Similarly, the ratio of national saving decelerated from 36.1 percent in FY2008/09 to 34.4 percent in FY 2009/10. The ratio of investment to GDP is expected to be 38.2 percent in FY 2009/10 as against that of 31.9 percent in the previous year. Ratio of net exports of goods and services to GDP, which remained negative by 18.9 percent in the previous year, is estimated to be excessively negative by 28.4 percent during this period.

d. Capital Stock

Gross capital formation in constant price is estimated at Rs. 228.14 billion in the fiscal year 2009/10, which is 36.9 percent of GDP. Gross capital formation is estimated to grow by 26.0 percent as compared to the previous year. In the previous year gross capital formation stood at 30.6 percent of GDP with a growth of 9.7 percent. In the current fiscal year, the share of fixed assets and change in stock in gross capital formation was 50.5 percent and 49.5 percent respectively. It was 60.5 percent and 39.5 percent respectively in the previous year. Out of the gross fixed capital formation in the fiscal year 2009/10, the estimated share of public sector is 21.8 percent and that of the private sector is 78.2 percent. In the previous year the share of public sector was 20.2 percent while that of the private sector was 79.8 percent.

The figure suggests that the share of fixed capital formation in the public sector has increased whereas that of the private sector participation has decreased.

e. Money Supply

Table 12 shows the major factors affecting money supply from F.Y.2005/06 to 2009/10. According to the table in F.Y. 2009/10 net foreign assets has declined significantly than previous year, on the other hand net domestic assets almost doubled in comparison with previous year. Both narrow and broad money decreased significantly and balanced on 43191 million and 8992 million respectively.

Table 12: Factors Affecting Money Supply

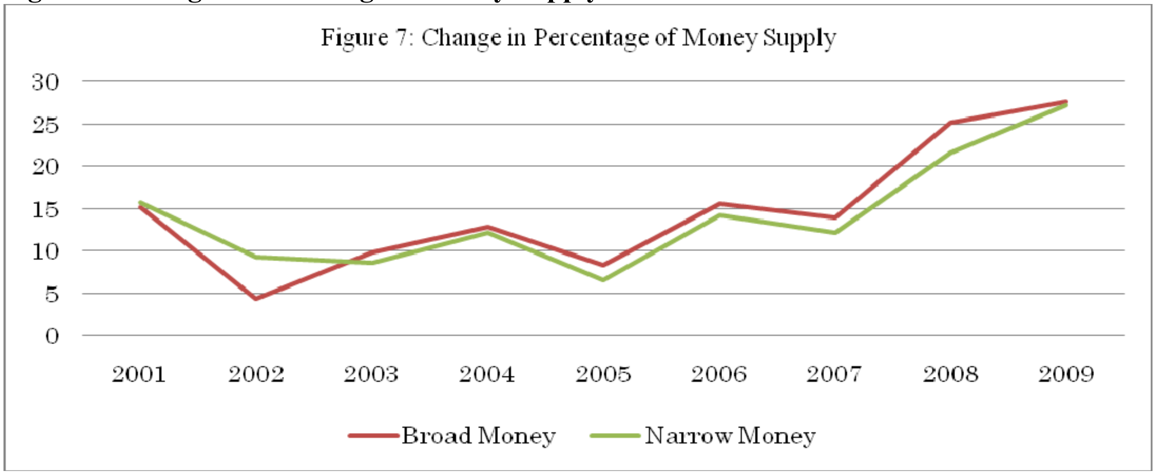
(NRs. In 10 Millions)

F.Y.	2005/06	2006/07	2007/08	2008/09	2007/08	2008/09	2009/10
Net Foreign Assets	2559.76	590.42	2967.47	4127.97	1363.30	3481.02	-2353.47
Net Domestic Assets	2138.40	4278.99	7018.43	9608.84	3945.10	3283.39	6672.59
Domestic Credit	2182.95	3787.43	7671.17	11636.27	4773.53	3260.13	5656.93
Domestic Credit	3287.61	5389.81					
Net Claims on Government	667.35	737.30	873.60	1778.81	-53.73	-2011.87	-1371.52
a. Claims on Government	667.35	1049.56	955.99	1384.17	380.53	245.65	-1289.21
b. Govt. Deposits	0.00	312.25	82.39	-394.64	434.26	2257.52	82.31
Claims on Govt. Enterprises	-217.6	45.9	48.9	-84.8	-61.3	6.6	22.7
a.Financial	-7.0	-9.5	-4.3	-29.4	-10.0	-23.1	6.7
b. Non Financial	-210.5	55.4	53.2	-55.4	-51.3	29.8	16.0
Claims on Non-Financial Govt.Enter	2.7	13.6	113.0	314.4	210.2	213.2	-181.1
Claims on Private Sector	1730.4	2990.7	6635.7	9627.9	4678.3	5052.2	7186.9
Claims on Private Sector	2835.1	4593.1					
Net-Non Monetary Liabilites	44.5	-491.6	652.7	2027.4	828.4	-23.3	-1015.7
Net-Non Monetary Liabilites	1149.2	1110.8					
Broad Money,	4698.2	4869.4	9985.9	13736.8	5308.4	6764.4	4319.1
Narrow Money,	1418.3	1382.7	2745.6	4211.7	1432.8	1830.7	899.2
a. Currency	914.2	577.3	1662.2	2558.5	1160.8	2190.7	1430.0
b. Demand Deposits	504.1	805.4	1083.4	1653.2	272.0	-360.0	-530.9
Time and Saving Deposits	3279.9	3486.7	7240.3	9525.1	3875.6	4933.7	3420.0
Exchange Valuation gian(+)/Loss(-)	609.9	-1343.4	987.1	834.8	142.2	1047.1	-988.0

Source: Nepal Rastra Bank

Broad money expanded by 14.5 percent in 2009/10. Broad money had expanded by 27.1 percent in the previous year. Narrow money, which had grown by 27.3percent in 2008/09, grew by 11.2 percent in the review year. A deceleration in the net domestic assets and decline in net foreign assets accounted for such a lower growth of monetary aggregates in F.Y.2009/10. Of the components of narrow money, currency in circulation increased by 13.0 percent compared to an increase of 25.5 percent in the previous year. Demand deposits increased by 7.9 percent compared to a growth of 30.5 percent a year ago. Similarly, time deposits increased by 16.1 percent in 2009/10 compared to a growth of 27.0 percent in the previous year. Net foreign assets(NFA), after adjusting foreign exchange valuation gain/loss, declined by Rs. 2.6 billion in 2009/10 in contrast to an increase of Rs. 44.8 billion in the previous year. An acceleration of trade deficits contributed to such a decline in net foreign assets. Figure 7 shows the trend of change in percentage of money supply.

Figure 7: Change in Percentage of Money Supply



f. Employment

The workforce of 400,000 entering annually in the labor market is compelled to seek foreign employment due to lack of employment opportunities amidst imbalance between the demand and supply of skill labor again in the country. The need of the day is to promote employment opportunities at domestic and foreign markets by equipping domestic workforce with new technology, qualitative knowledge, and skills.

Findings of Nepal Labor Force Survey 2008 (NLFS) conducted by the Central Bureau of Statistics, shows that labor force participation rate is 83.0 percent; rate of employment is 97.9 percent or 83 percent economically active with 17 percent remaining inactive; 2.1 percent unemployed, and annual employment growth rate is 2.45 percent. As compared to the NLFS I (1999/2000) decline in labor participation ratio is observed meaning the dependent population is in rise with obligations and liabilities of economically active population, is increasing. Likewise, out of the employed total, 16.9 percent are engaged in formal salaried/wage earning activities, while the remaining 83.1 percent are dependent on self-employment. Of the total employed in the age category of 15 years of age and above, 73.9 percent are employed in the agriculture sector, with the remaining 26.1 percent in the non-agriculture sector. The number of full-employment is 66.8 percent. Under-used employment rate is 30.0 percent, and wage discrepancy between male and female workers persists.

Table 14: Total No. of foreign Employment (Up to F.Y.)

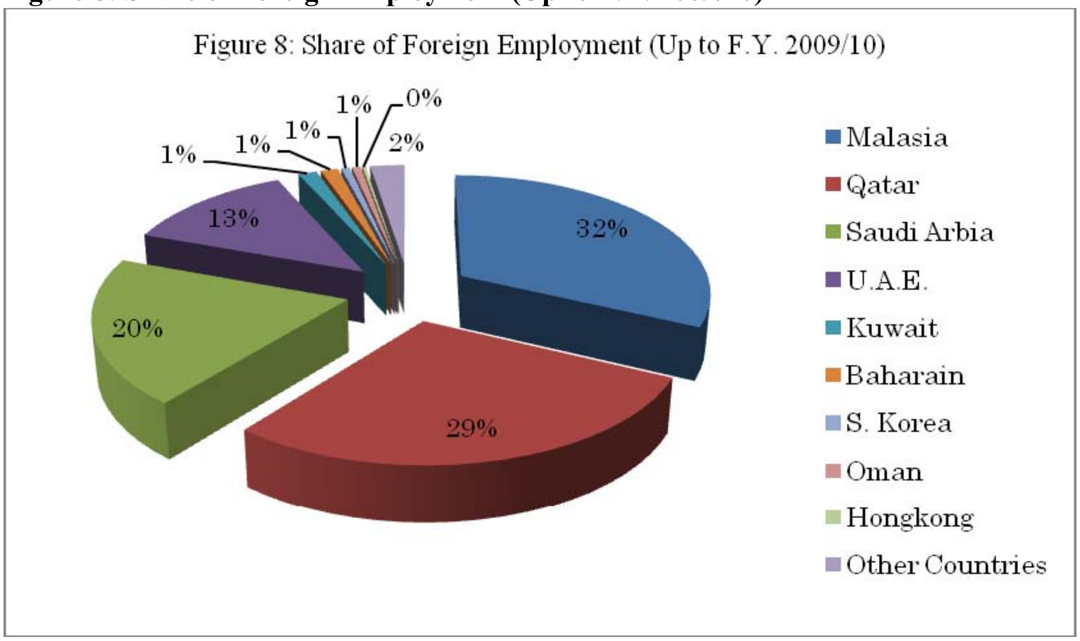
F.Y.	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Malasia	64643	108455	154215	220505	304667	378696	429240	464310	519145
Qatar	55222	82072	106200	148152	206385	266094	351536	427711	465289
Saudi Arbia	83459	101449	118324	131683	151190	190469	232863	281612	321063
U.A.E.	25672	38322	51082	63585	80769	105941	151283	182971	205537
Kuwait	2973	3880	7074	8760	9498	11939	13906	16197	22376
Baharain	3171	3989	4595	4853	5383	6583	11682	18042	20934
S. Korea	3119	3831	5155	5480	5676	6441	6587	9475	10461
Oman	0	380	453	758	835	1344	3970	8217	10456
Hongkong	1753	2317	2989	3167	3343	3704	3903	3968	4050
Other Countries	1993	2367	3635	4457	5846	6914	22196	34628	41059
Total	242005	347062	453722	591400	773592	978125	1227166	1447131	1620370

Source: Ministry of Labor and Transportation, GON

As per the details available from the Foreign Employment Department, 1,227,166 people had gone to different countries for foreign employment by the end of fiscal year 2007/08. By the first eight months of fiscal year 2009/10 such number reached 1,620,370 with addition of 219,965 and 173,239 in FY 2008/09 and 2009/10 respectively. Although statistics on the number of people visiting abroad through unauthorized means taking undue advantage of open border with India is unavailable, such number is assumed to be significant. It is however, estimated that the number of overseas employment seekers travelling without labor authorization is estimated to be equal to those authorized.

Figure 8 shows the composition of foreign employment up to F.Y.2009/10. According to the figure the main destinations for Nepalese labor are Malaysia and Middle East countries specially Qatar, KSA, and UAE.

Figure 8: Share of Foreign Employment (Up to F.Y. 2009/10)



II.2 Fiscal Position

a. Government Expenditure

The government expenditure, on cash basis, increased by 20.2 percent to Rs.248.37 billion in 2009/10 compared to an increase of 37.8 percent to Rs. 206.69 billion in the previous year. Growth in recurrent as well as capital expenditure accounted for such an increase in the government expenditure.

Table 15 shows the composition of government expenditure and source of financing. In fiscal year2009/10, the government's recurrent expenditure rose by 20.7 percent to Rs.144.38 billion compared to an increase of 35.4 percent in the previous year. An upward revision in the salary and allowances of the civil servants and teachers by the Government of Nepal mainly attributed to such a rise in the recurrent expenditure. Likewise, increasing expenditure on special security plan, growing amount of subsidies to public schools and increment in the distribution of economic assistance accounted for such a rise in the recurrent expenditure. In 2009/10, the capital expenditure went up by 20% to Rs 75.38 billion compared to an increase of 45% t in the previous year. However, such amount of capital expenditure accounted for only 71% of the annual budget estimate. Delay in the budget approval, lingering in the contract process, lower presence of employee in the local bodies as well as less than expected improvement in the peace and security situation mainly attributed to the lower performance of capital expenditure in the review year.

Table 15: Government Expenditure & Sources of Finance

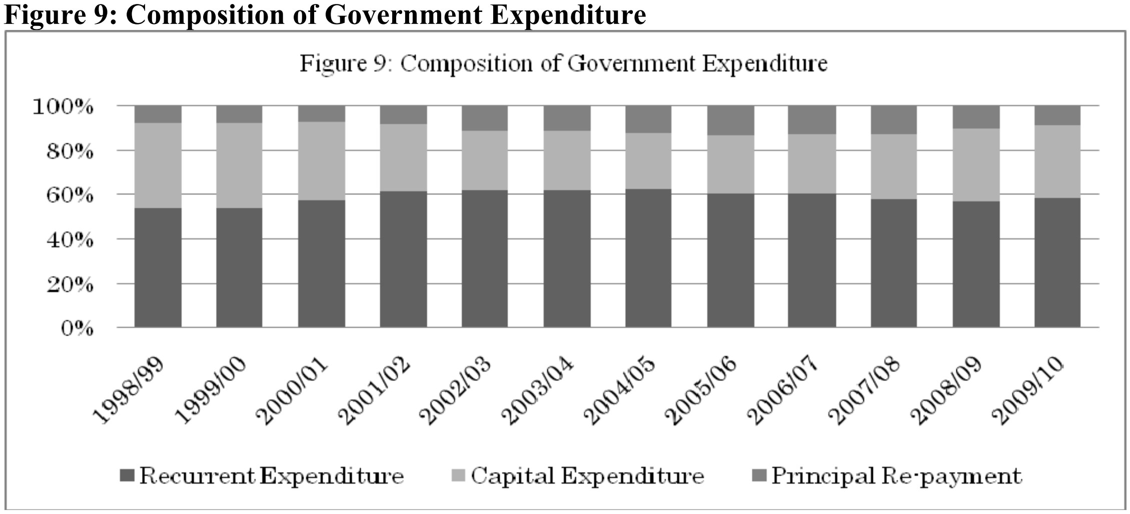
(Rs. in 10 Millions)

F.Y.	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Expenditure	7983.51	8007.22	8400.61	8400.61	8944.26	10256.04	11088.92	13,360.46	16,134.99	21,966.19
Recurrent Expenditure	4583.73	4886.39	5209.05	5209.05	5555.21	6168.64	6701.78	7712.24	9144.69	12773.89
Capital Expenditure	2830.72	2477.24	2235.61	2235.61	2309.56	2734.07	2960.66	3972.99	5351.61	7308.89
Principal Re-payment	569.06	643.49	955.95	955.95	1079.49	1353.33	1426.48	1675.23	1638.69	1883.41
Receipts	5564.70	5713.16	6756.89	6756.89	7361.44	8451.39	8610.96	10351.29	12794.32	16985.73
Revenue	4889.36	5044.55	5622.98	5622.98	6233.10	7012.27	7228.21	8771.21	10762.25	14347.45
Foreign Grants	675.34	668.61	1133.91	1133.91	1128.34	1439.12	1382.75	1580.08	2032.07	2638.28
Overall Surplus (+) Deficit (-)	-2418.81	- 2294.06	- 1643.72	- 1643.72	- 1582.82	-1804.65	-2477.96	-3009.17	-3340.67	-4980.46
Sources of Financing Deficits										
Foreign Loan	1204.40	769.87	454.64	454.64	762.90	926.61	821.43	1005.35	897.99	996.89
Internal Loan	700.00	800.00	888.00	888.00	560.78	893.81	1183.42	1789.23	2049.64	1841.71
Cash Balance (-)Surplus	514.41	724.19	301.08	301.08	259.14	-15.77	473.11	214.59	393.04	2141.86

Source: Economic Survey, Ministry of Finance, Nepal.

Figure 9 reflects the trend of government expenditure composition. From fiscal year 1998/99 to 2009/10 the average ratio of recurrent, capital and principle repayment expenditure is almost 60%, 30% and 10% respectively. Although the Government policies and periodic plans always focus on the more investment on developing activities, government has not been able to increase capital expenditure, which has been remaining only half of the recurrent expenditure.

Figure 9: Composition of Government Expenditure



The main sources of government financing have been revenue foreign aid (loan and grant) and internal borrowings. Figure 10 presents the trend of government source of financing from F.Y.1998/99 to 2009/10. Contribution of revenue collection has been almost 60% during the period. Foreign grant is another largest source which has been increasing significantly in last few years and increased from 5% to almost 15%, on the other side, share of foreign loan decreasing significantly from 20% to almost 7% of total government expenditure. Share of internal borrowing is almost 105 of the total expenditure.

Figure 10: Source of Financing

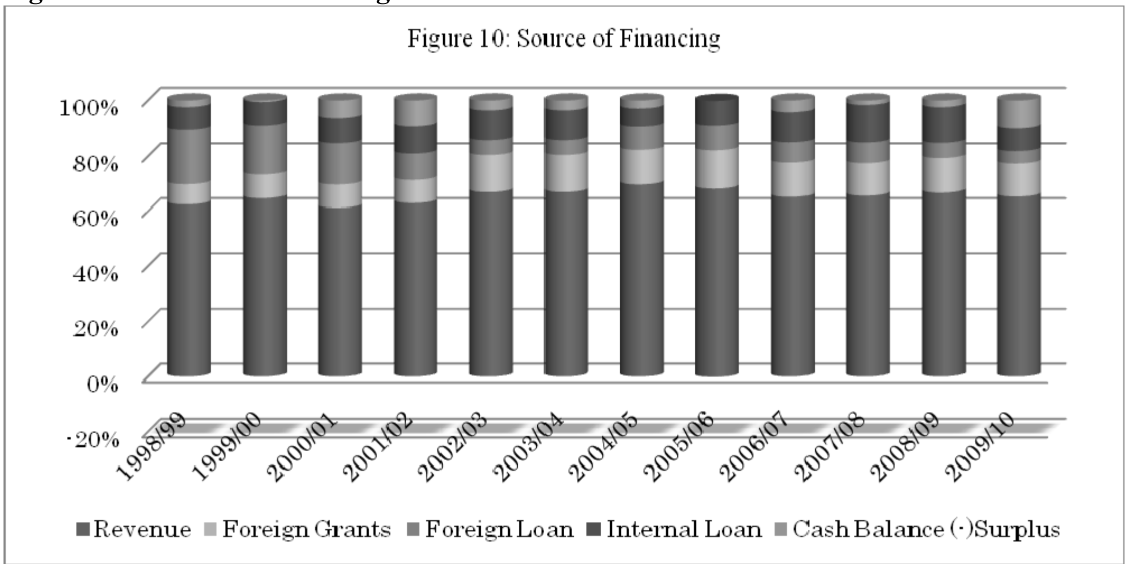
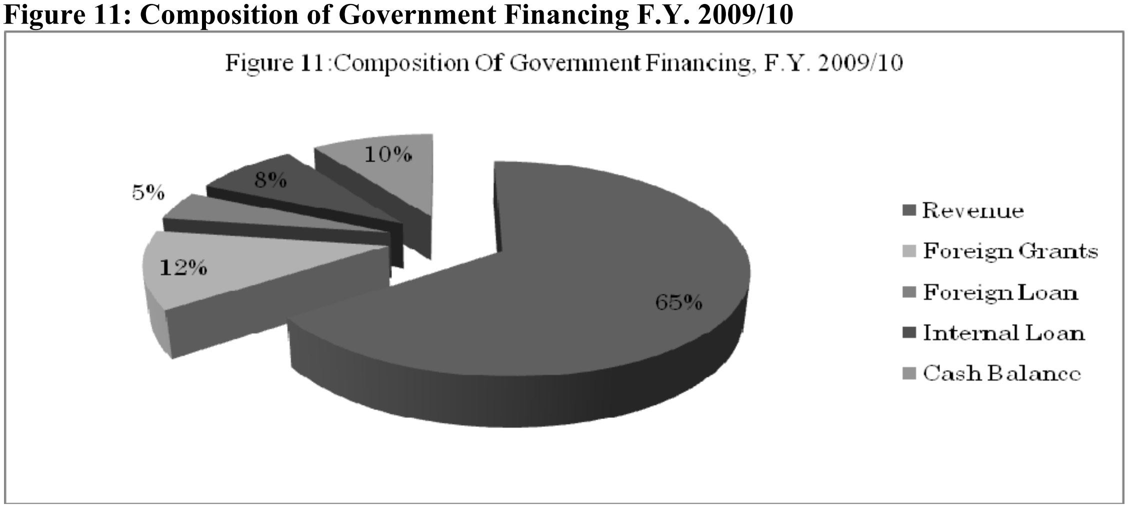


Figure 11 shows the composition of government financing in F.Y. 2009/10. Total contribution of the revenue in total expenditure is 65%, which is followed by foreign grants with 12% contribution. The main sources of deficit financing are internal loan and foreign loan which have 10% and 8% share of total government expenditure.

Figure 11: Composition of Government Financing F.Y. 2009/10



b. Public Borrowings

Public borrowing has been important source of deficit financing of Government of Nepal. Table 16 shows the ownership pattern of public borrowings. Up to fiscal year 2009/10 total outstanding was 124451 millions. Out of the total outstanding ownership of commercial banks was the highest with almost 50%, which was followed by Nepal Rastra Bank (the Central Bank) with 27% and other institutions and general public have share of 23%. Total outstanding internal loan has been increased by 120% in last 10 years.

Table 16: Ownership Pattern of Government Bonds and Treasury Bills

(NRs. In 10 Millions)

F.Y.	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Nepal Rastra Bank	2036.27	1739.97	2368.57	1913.88	1744.58	1580.50	2010.19	2368.58	2888.33	3449.93
Commercial Banks	1817.66	2539.29	3946.93	4379.63	4855.07	5886.14	6583.64	7214.06	7129.20	6169.91
Others	1581.77	1725.11	2149.03	2319.86	2156.77	2004.44	1783.78	2021.31	2549.88	2825.29
Total	5435.70	6004.37	8464.53	8613.37	8756.42	9471.08	10377.60	11603.95	12567.41	12445.12

Source: Economic Survey, Ministry of Finance, Nepal.

In 2009/10, the domestic financing of the budget deficit through the issuance of securities amounted to Rs. 29.91 billion, and it accounted for 2.5 percent of GDP. After deducting the principal repayment of Rs.7.93 billion from gross domestic borrowings, net domestic borrowings (including overdraft of Rs 6.16 billion from the NRB)stood at Rs 28.15 billion. The ratio of net domestic borrowing to GDP stood at 2.4 percent in the review year. Consequently, the Government total outstanding domestic debt increased to Rs.157.86billion. This amount also includes the government's last year's overdraft of Rs. 8.83 billion and an overdraft of Rs. 6.16 billion in the review year. The total external cash borrowing of the government increased by 14.5 percent to Rs 4.27 billion in 2009/10 compared to Rs 3.73 billion in the previous year

Figure 12: Share of Internal Loan

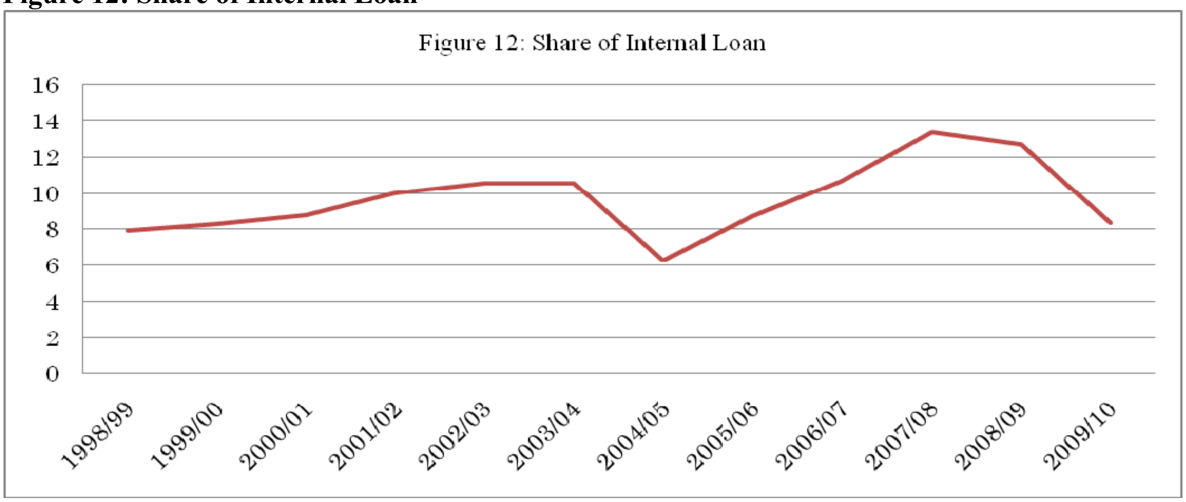


Figure 12 shows the trend of share of internal loan on total government expenditure from F.Y. 1998to 2009/10. The average share of internal loan to total government expenditure has been almost 10%. From 1998 to 2003 it was increased gradually from 8% to 10.5%, and dropped sharply in 2004 with only 6%. After 2004 it started to fast increase and reached on peak with 13.5% in 2007/08 and after that dropped significantly and balanced on 8% on F.Y. 2009/10.

c. Fiscal Deficit

Table 17 shows the trend of fiscal deficit of government of Nepal from F.Y. 2000/01 to 2oo9/10. During last 10 years, total amount of fiscal deficit has been doubled. From 200/01 to 2004/05 it was decreased gradually after that it started to increase and reached to 49804 millions in F.Y. 2009/10. In terms of GDP ratio, it was 5.5% of total GDP in 2000/01which was decreased gradually up to 2003/04 and started to increase after that and reached 4.65 of total GDP in F.Y. 2009/10.

Table 17: Fiscal Deficit

(Rs. in 10 Millions)

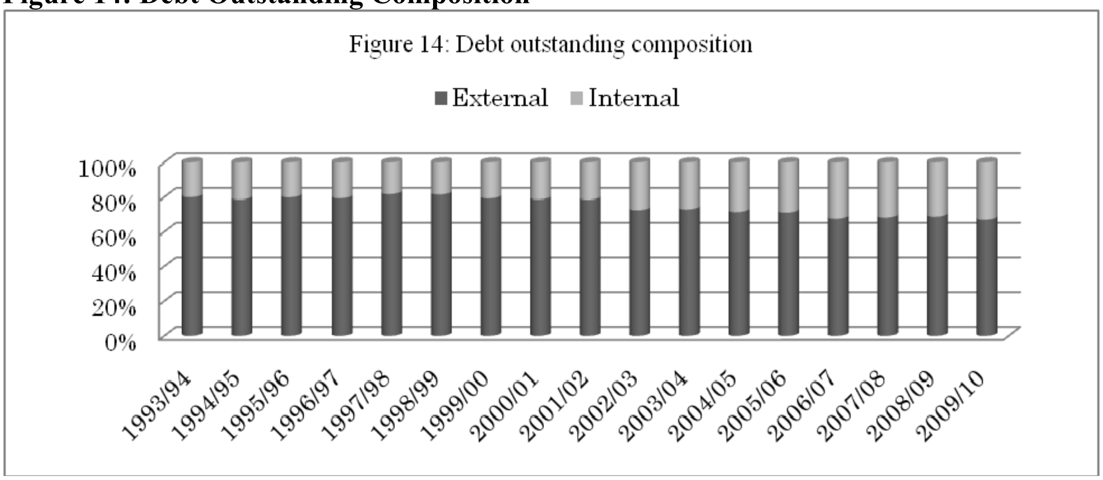
Fiscal Year	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Fiscal deficit	2418.81	2294.06	1643.72	1643.72	1582.82	1804.65	2477.96	3009.17	3340.67	4980.46
% of GDP	5.5	5	3.3	2.9	3.1	3.8	4.1	4.1	3.7	4.6

Source: Economic Survey, Ministry of Finance, Nepal.

d. Outstanding debt Liability

Total outstanding debt liability of government of Nepal has been increased by almost 50% in last 10 years and reached NRs.399756 Millions in fiscal year 2009/10. Ratio of External and internal loan as composition of total outstanding changing gradually from 75% and 25% in 1994 to 62% 38% in 2009/10. Figure 14 and Table 18 shows the trend and composition of debt outstanding of government of Nepal.

Figure 14: Debt Outstanding Composition



Both the domestic and foreign debts are increasing due to widening gap between the expenditure and income. Though, the ratio of outstanding debt to GDP has declined in the review period. The total outstanding debt, which stood at 37.4 percent during the first eight months of FY2008/09, has come down to 33.8 percent during the same period of FY2009/10. Both the external as well as domestic debt to total GDP ratios declined in this period. The ratio of foreign debt declined from 25.3 percent in the previous year to 23.3 this year and domestic debt to total GDP ratio remained at 10.5 percent in this period as compared to 12.1 percent last year. In terms of outstanding debt in amount, it was 370.697 billion in mid-March 2009, comprising of Rs. 250.71 billion foreign and Rs. 119.98 billion internal, which grew by 7.8 percent (9.8 percent foreign and 3.7 percent domestic) totaling Rs. 399.75 billion comprising of Rs.275.30 billion foreign and Rs.124.45 billion domestic.

Table 18: Total Debt Outstanding

(NRs. 10 Millions)

F.Y.	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
External	20155.06	22012.56	22343.32	23277.93	21964.19	23396.86	21662.89	24996.54	27704.04	27530.52
Internal	5435.70	6004.37	8464.53	8613.37	8756.42	9471.08	10377.60	11603.95	12567.41	12445.12
Total	25590.76	28016.93	30807.85	31891.3	30720.61	32867.94	32040.49	36600.49	40271.45	39975.64

Source: Economic Survey, Ministry of Finance, Nepal.

e. Revenue

In 2009/10, revenue mobilization of the government increased significantly by 25.4 percent to Rs. 179.95 billion, which accounted to 101.9 percent of annual budget estimate. The revenue had risen by 33.3 percent to Rs. 143.47 billion in 2008/09. Consequently, the revenue to GDP ratio moved up to

15.2 percent in 2009/10 from that of 14.5 percent in 2008/09. A positive impact of "Tax Compliance year", increase in PAN number holders, mobilization of tax volunteers, growth in imports, control in revenue leakages and tax administration reforms mainly contributed to such an increase in the revenue mobilization.

Table 19: Source of Revenue

(Rs. in 10 millions)

F.Y.	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Tax Revenue	3886.5	3933.06	4089.6	4817.3	5410.47	5743.04	7112.67	8515.55	11705.19	15466.77
Customs	1255.21	1265	1278.32	1555.48	1570.16	1534.4	1670.76	1981.1	2662.0	3502.8
Excise	377.12	380.7	377.12	622.67	644.59	650.76	934.32	1118.96	1623.74	2431.5
Value Added Tax	1238.24	1226.73	1345.97	1447.89	1888.54	2161.07	2609.56	3115.5	3960.4	5346.4
Icome Tax	954.65	946.57	1027.41	1021.51	1127.26	1178.7	1672.68	1909.4	2748.0	3364.8
Land Revenue and Registration	61.29	113.18	60.78	169.75	179.92	218.11	225.35	340.3	524.8	550.0
Non Tax revenue	1002.88	1111.6	1364.29	1415.8	1601.8	1485.16	1658.55	2142.6	2642.5	2527.8
Total	4889.38	5044.66	5453.89	6233.1	7012.27	7228.2	8771.22	10762.25	14347.45	17994.03

Source: Economic Survey, Ministry of Finance, Nepal.

Of the total revenue mobilization, VAT revenue grew by 35.0 percent to Rs 53.46 billion in 2009/10. Such revenue had increased by 27.1 percent in the previous year. The increase in VAT revenue was on account of growing imports and consumption induced by an increase in the inflow of remittances and reforms in VAT administration. In 2009/10, customs revenue rose by 31.6 percent to Rs. 35.3 billion compared to an increase of 34.4 percent in the previous year. Reforms in custom administration increase in imports of high tax yielding vehicles and spare parts and increase in the amount of Indian excise refund contributed to such a high growth of customs revenue.

Income tax revenue increased by 22.4 percent to Rs. 33.65 billion in 2009/10 compared to an increase of 43.9 percent in the previous year. A positive impact of tax compliance year and increase in PAN number holders accounted for such an increase in the income tax revenue mobilization. In the review year, excise revenue increased by 49.6 percent to Rs. 24.31 billion compared to an increase of 44.9 percent in the previous year. Reforms in excise administration and increase in the imports of high excise tax yielding light vehicles accounted for such a growth of excise revenue in the review year.

Table 20: Revenue Composition and Growth

(NRs. In 10 Millions)

Tax Heading	2005/06	2006/07	2007/08	2008/09	2009/10
Income Tax	1094	1573	1908	2724	3365
Growth %	5	44	21	43	24
VAT	2161	2610	2982	3970	5346
Growth %	14	21	14	33	35
Excise	651	934	1119	1632	2449
Growth %	1	43	20	46	50
Customs	1534	1670	2106	2679	3503
Growth %	-2	9	26	27	31
Others Tax	301	325	401	707	803
Growth %	15	8	23	76	14
Total Tax Revenue	5741	7112	8516	11712	15466
Growth %	6	24	20	38	32
Non Tax Revenue	1485	1659	2247	2642	2528
Growth %	_	12	35	18	-4
Total Revenue	7226	8771	10763	4354	17994
Growth %	3	21	23	33	25

Source: Economic Survey, Ministry of Finance, Nepal.

Amongst the components of revenue in 2009/10, VAT constituted a share of 29.7 percent followed by income tax (18.7 percent), customs duties (19.5 percent), and excise duties (13.5 percent). In the previous year, such compositions were 27.6 percent, 19.2 percent, 18.6percent and 11.3 percent respectively. In the review year, non-tax revenue decreased by 4.3 percent to Rs. 25.28 billion compared to an increase of 23.3 percent in the previous year. A decline in the receipts of the Nepal Government from principal, interest and dividend accounted for such a decrease in the non-tax revenue.

Figure 15: Composition of Revenue

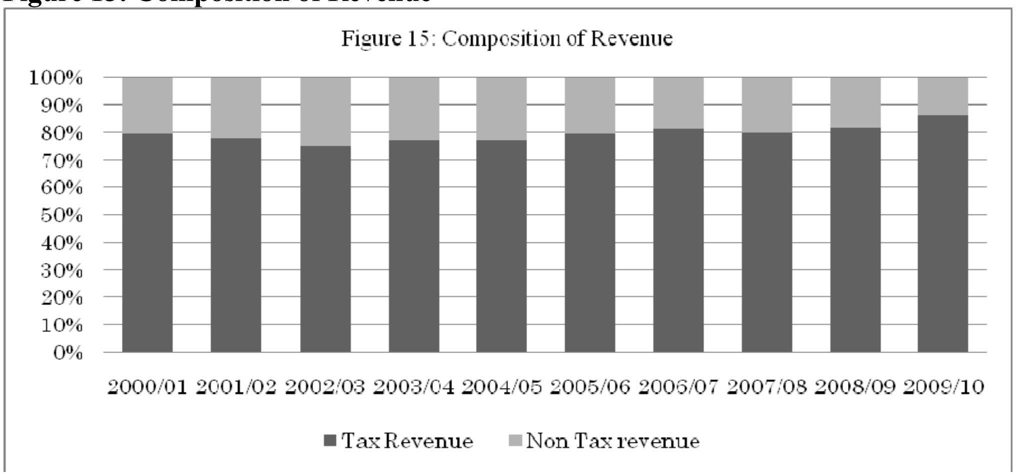
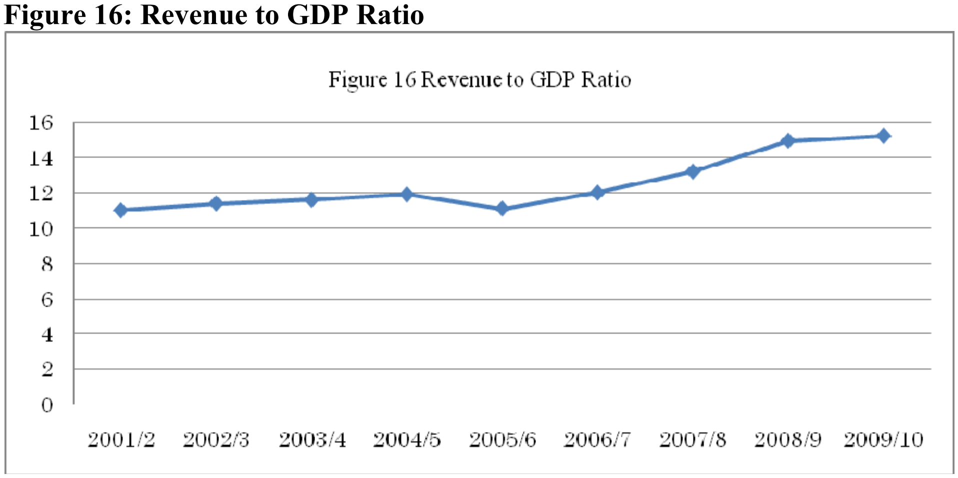


Figure 15 shows the composition of government revenue. The share of tax revenue was 78% in F.Y.200/01 which decreased to 74% on 2002/03, after that year it has been increasing gradually and reached up to 85% on F.Y.2009/10. Still there is significant share of non tax revenue on total revenue about 15%.

Significant increment of revenue collection in past 3 years GDP Revenue ratio reached on more than 15% in F.Y. 2009/10, which was only 11% on F.Y. 2001/02 and remained stable up to F.Y. 2005/06. Hence Revenue GDP increased by more than 4% in last 4 years. Figure 16 shows the trend.

Figure 16: Revenue to GDP Ratio

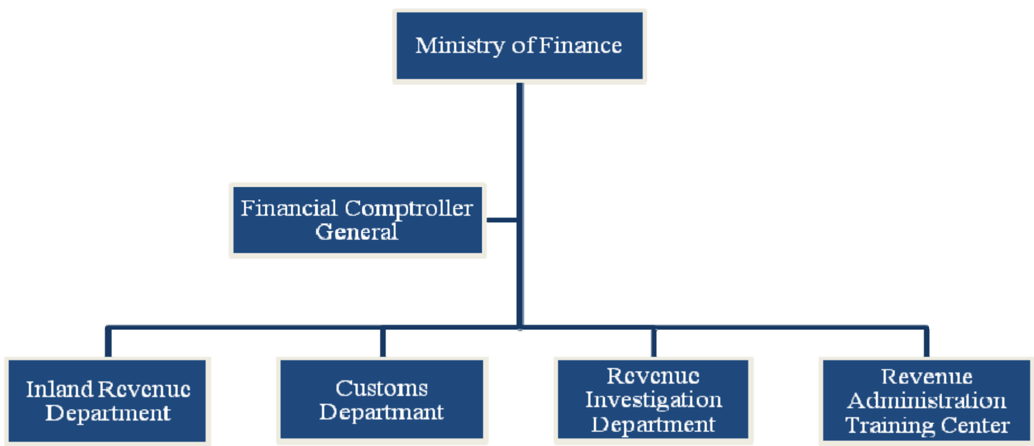


III. Tax Structure: Institutions and the Reality

III. 1. Organizational Structure of Revenue Administration

The Ministry of Finance (MOF) is the apex authority of the Revenue Administration. There are four Departments under the Ministry of Finance, namely, Inland Revenue Department (IRD), Customs Department, Revenue Investigation Department and Revenue Administration Training Center. MOF supports to maintain fiscal framework and focus on macroeconomic stabilization and promote and monitor the macroeconomic indicators. 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 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. The organizational structure is as follows;

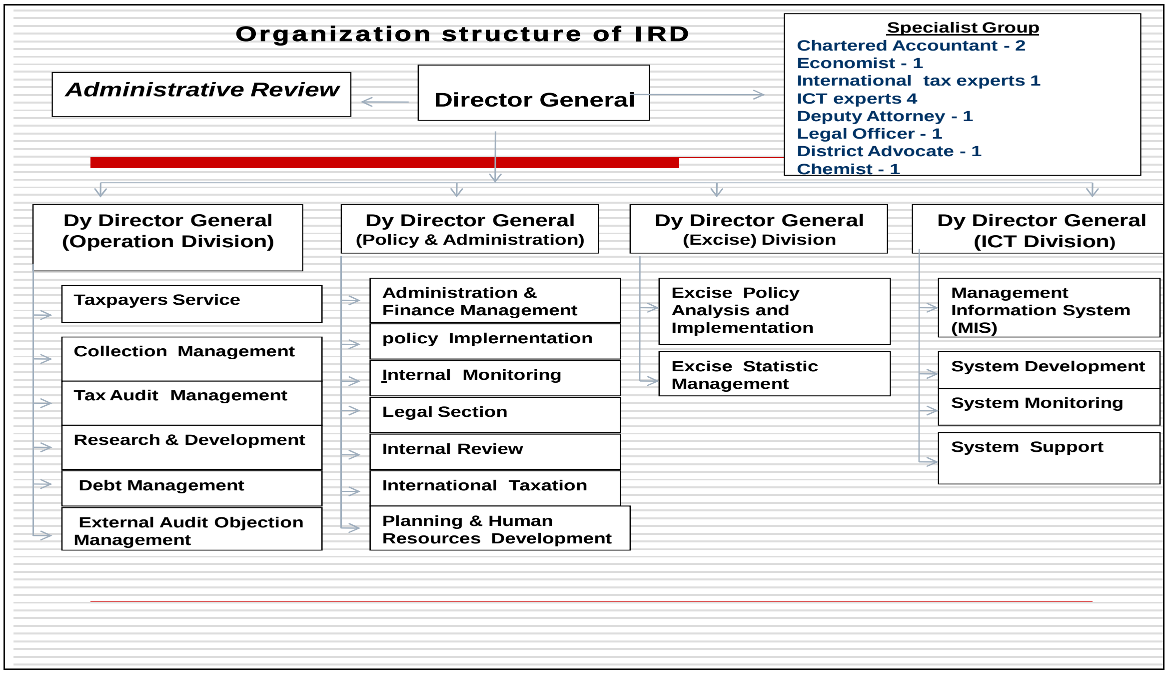
Organization Structure of Ministry of Finance



III.1.1 Inland Revenue Department

Inland Revenue Department (IRD) is responsible for administering Income Tax, Value Added Tax (VAT), Excise Duty, Health Service Tax, and educational Service Fees. The IRD is also responsible for the monitoring of Non –tax revenue, throughout the country. To implement and enforce respective laws, one Large Taxpayer Office (LTO), twenty two Inland Revenue Offices (IROs), and twenty six Taxpayer Service Offices (TSOs) are running across the country under the IRD.

IRD has been focusing on prompt and qualitative service, taxpayer and consumer awareness, internal data discipline, strong and unbiased enforcement, effective monitoring and mass media campaigning for marketing of its accomplishments. To support and facilitate implementation, e-PAN, (e-registration) e-TDS, e-filing, e-RAS accounting, risk base audit and investigation selection from risk engine, e-monitoring system has been introduced along with organizational restructuring and reengineering. Performance Based Incentive System (PBIS) has been introduced to improve employee motivation. Performance based placement and transfer policy is being applied to develop professionalism in IRD. IRD and its functionaries are organized in a relatively flat and functional orientation. LTO, IROs, and TSOs are designed in line with taxpayer service, tax collection, and audit and investigation.



III.1.2 Taxpayers Right

Taxpayers' right is very important aspect of modern taxation. After implementation of new Income tax act it became a part of taxation on legal base and also Inland Revenue Department has declared taxpayers right. Income Tax Act has mentioned the following points as the rights of taxpayers on its clause 74:

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

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

In addition to the specific rights and assurances provided in the concerned Acts, Inland Revenue Department has declared Taxpayers Rights in general with assurance of following rights. These assurances will be strictly adhered to. The Taxpayers rights, among others, include:

- Each taxpayer is treated with due respect and honor.
- Each taxpayer will get an immediate receipt of return submission whilst a receipt of other correspondences is to be provided in one hour.
- Each taxpayer willing to seek an advance ruling may apply either in the Department or through concerned Inland Revenue Office. There is a legal provision that a decision should be made within 45 days after the request is made.
- Each taxpayer can represent or make any correspondence by an authorized person including legal assistants and the accounts specialist or auditors just in case if he/she is unable to represent or make any correspondence.
- Each taxpayer is to get copies of the documents related with him/her or submitted to the 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.1.3 Reform and Modernization of Tax system

Nepalese revenue administration has achieved significant reform in last decade. Major reform and modernization activities can be mentioned as follows:

- Effective implementation of VAT with replacement of various sales and service taxes.
- New income tax act issued as a modern income tax act with provisions of self assessment system, international taxation and broad coverage of income.
- Establishment of Inland Revenue Department with integration of income tax department and VAT Department as a unified institution for internal revenue mobilization on fully functional basis.
- Establishment of Large Taxpayers' Office for big taxpayers.
- New customs act issued with modern approach of customs such as WTO valuation, PCA and selectivity model of good clearance.
- Use of ICT for simplification and modernization of tax administration such as e-PAN and Personal e-PAN (for taxpayer registration), e- return (for return filing of VAT and Income tax), e-TDS (for TDS return and verification).
- Performance based Incentive System in Revenue Administration.

III. 2. Tax Specific Analysis

III.2.1 Income Tax

Income Tax was introduced in Nepal by the first Parliamentary Government in 1959. Income Tax Act 1962 was enacted in 1962 replacing business, Profit and Remuneration Tax Act of 1959. The Income Tax Act, 1962 was replaced by Income Tax Act, 1974, which was amended for eight times and existed for a period of 28 years. The Income Tax Act, 1974 and all the income tax related provisions made under other special enactment have been repealed and the existing Income Tax Act, 2002 became effective since1st April 2002. The Act governs all income tax matters and is applicable throughout the country. It is also applicable to residents residing wherever outside Nepal. This act covers individual as well as corporate income tax. 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.

a. Income Heads

The Act imposes tax on those activities contributing toward the creation of wealth. Wealth is created with the help of labor, capital and capital-labor mix activities that generate income from employment, investment and business respectively. The Act makes broad classification of income encompassing almost all income-earning activities. They are:

A. Employment (an individual`s remuneration income from an employment for an income year)
B. Investment (profits and gains of a person from conducting an investment for an income year)
C. Business (profits and gains of a person from conducting a business for an income year)

b. 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 residing in Nepal, and, or incorporated under the laws of Nepal or has its 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.

c. Income Year

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

d. Tax rate

The normal corporate tax rate for the entity is 25%, but financial institutions and some specific business tax rate is 30%. The presumptive tax for individuals conducting small businesses (who have a turnover up to Rs.2 million or an income of Rs.200, 000) in the Metropolitan or Sub-Metropolitans, Municipalities and anywhere else in Nepal Tax 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%. Income tax for resident individual is as follows:

Table 20: Income Tax Rate for Resident Individual

S. No.	Taxable Income for Single	Taxable income for Couple	Tax Rate
1	Up to Rs.160,000	Up to Rs. 200,000	1%
2	From Rs.160,000, to Rs.260,000	From 200000 to Rs.300000	15%
3	Above Rs. 260,000	Above 300000	25%

Source: Income Tax Act, 2002, Nepal.

e. Withholding Tax Rate

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 below.

Table 21: 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, Nepal.

f. Capital Gain Tax

The Income Tax Act, 2002 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 years 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.

g. Taxpayers Registration

Every taxpayer who is liable to pay income tax should be registered as soon as possible. Nobody can operate his/her business without registrations in Income tax. IRO provides Permanent Account Number (PAN), a unique 9 digit number, randomly generated, as a taxpayer registration number, 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. From the fiscal Year 2009/10 department introduced personal e-PAN registration system for the individuals who does not have any formal individual business firm but earns through employment or providing professional service individually. Under this system taxpayers can register through internet using the official website of the department. More than 98000 taxpayers have been registered in F.Y. 2009/10 through this system.

Table 22: Number of Taxpayers Registration

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
2008/09	353902	69753

Source : Annual Report Inland Revenue Department , 2010

h. 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.

According to the Income tax of Nepal, global income of resident and source income of the non-resident is taxable source of income. For the definition of the residents in case of individual the person whose normal place of abode is Nepal and who is present in Nepal for 183 days or more in 365 consecutive days of any fiscal year is defined as resident. For the purpose of the entity, an entity which is established under the laws of Nepal, effective management in Nepal and foreign permanent establishment which is situated in Nepal is defined as resident entity. The income tax act has clear definition of Permanent establishment, Controlled foreign entity and other international taxation related terminologies. The act is adopting modern tools and methods to control tax avoidance in the field of international taxation, such as general Anti avoidance Rule, Transfer pricing and Income Splitting.

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 below.

Table 23: List of the countries having DTA

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 2010, Inland Revenue Department, Nepal.

Some basic features of DTA conducted by Nepal can be mentioned as follows:

- Use of Ordinary Tax Credit Method.
- Generally followed UN Model, some cases OECD model.
- DTA with Norway conducted in respect of income and capital, other countries in respect of Income only.
- Capital gain also included in all agreement except with India.
- Resident principle adopted for Shipping and Air Transport Business.

- Source Principle adopted for Players and Artist.

i. Tax collection

Figure 17 shows the total collection trend of Income Tax. There was slow increment in tax collection from F.Y. 1999/00 to 2005/06 After that tax collection has been growing rapidly and reached 33 billion in F.Y. 2009/10. In last 4 years amount of Income tax has been increased significantly with almost triple. The share of Income tax in total revenue is 19% and share of tax revenue is 22% in F.Y. 2009/10.

Figure 17: Income Tax Collection (NRs in 10 millions)

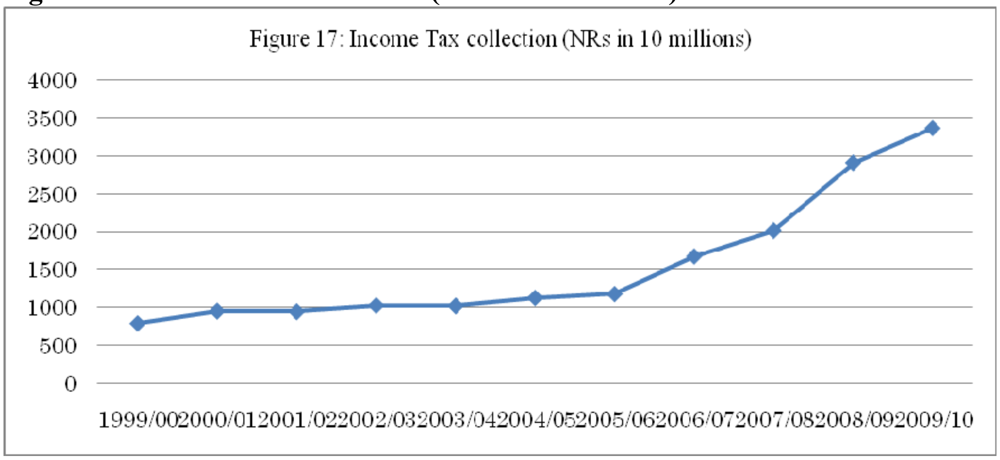


Table 24 shows the composition of income Tax from F.Y. 2000/01 to 2008/09. The major sources of Income tax are corporate firms, individual firms, and individuals. Income tax by the Individual firms was 9877 Millions which was followed by private corporations and remuneration with 9425 millions and 3196 Millions respectively in F.Y. 2008/09. Tax on interest payment, vehicle tax and public enterprises are other contributing sectors for Income tax. Share of public enterprises has been decreasing significantly in recent years.

Table 24: Composition of income Tax

(NRs. 10 Millions)

F.Y.	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Income Tax from Public Enterprises	292.8	176.93	292.8	205.66	133.24	19.57	101.97	20.46	95.91
Income Tax from Private Corporate Bodies	192.43	141.2	192.43	153.13	246.78	340.43	571.71	718.65	942.51
Income Tax from Individuals	320.05	441.91	336.22	353.34	392.63	423.47	523.44	638.12	987.75
Income Tax from Remunerations	59.73	83.56	59.73	139.12	167.59	176.41	200.79	245.1	319.56
Urban House and Land Tax	0.29	0.23	0.29	0	0	0	0	0	0
Vehicle Tax	42.96	55.97	42.96	70.06	80.65	84.76	99.5	106.92	185
Tax on Interest	46.39	46.77	86.4	73.34	75.7	77.49	105.49	108.79	168.51
Other Taxes	0	0	16.58	26.86	30.67	56.57	69.78	176.66	210.5
Total	954.65	946.57	1027.41	1021.51	1127.26	1178.7	1672.7	2014.7	2909.74

Source: Economic survey, Ministry of Finance, Nepal.

III.2.2 Value Added Tax

Replacing the then four taxes, namely, Sales Tax, Contract Tax, Entertainment Tax, and Hotel Tax, the VAT at a first time, was introduced in November 16, 1997 with the objectives of increasing revenue mobilization by broadening the tax base, and by instilling neutrality, efficiency, fairness, and transparency in tax administration. Value Added Tax Act was promulgated in 1995 and enacted from 1997 to administer

VAT. The standard rate of VAT was 10 percent at the time of its inception and subsequently increased to 13 from 2005.

Nepal has embraced destination principle in VAT system that imposes tax on the taxable transaction within the jurisdiction of Nepal. All Imports are taxed and exports are zero-rated in order to lend support for export of domestically produced goods and services through its tax credit and tax refund mechanism. The vendors who deal with exempt goods and services are not subjected to register its business in VAT and hence are not required to fulfill the formalities that are applicable to other registered taxpayers. The registration of taxpayers is guided by the nature of transaction, place of supply, and annual turnover. The VAT Act has set a limit of annual taxable transaction beyond which the taxpayers are supposed to be registered. The threshold is fixed at annual turnover worth Rs. 2 million for goods and Rs. 1 million (Rs 72 for 1 US dollar) for services within the jurisdiction of Nepal, and volunteer registration under the threshold also allowed

III.2.2 a. Features of Nepalese VAT

A. Broad based tax

Nepal has adopted a broad-based consumption type VAT, using the credit method. Under this system tax is levied on all types goods and services, both imported and domestically produced except exemption by the law. It is extended up to retail level, levied on the value added by each firm at each stage of the production and distribution process. VAT is levied on the goods and services where the place of supply is in Nepal and import of goods and services in to Nepal, this means tax base is domestic consumption of goods and services.

B. Big list of exemption

Although VAT is broad based coverage but also it has comparatively big list of exempted goods and services which are listed in Schedule 1 of value Added Tax Act, which can be mentioned briefly as follows:

- Basic Agro products such as paddy, rice, wheat, fresh vegetables, fresh fruits, eggs, unprocessed cereals, unprocessed foods excluding foods of hotel and restaurant etc.
- Goods of basic need such as piped water, electricity and kerosene.
- Live animals and fresh animal products such as milk and raw meat.
- Agriculture inputs such as seeds, fertilizer, manure, agricultural hand appliances and pesticides.
- Medicine, medical and health services.
- Formal education services, books and news papers.
- Artistic and cultural goods services.
- Transportation services.
- Other goods and services such as public postal service, financial service, bank notes and check books, gold and silver, land and building etc.

C. Invoiced based VAT

Nepal is adopting invoice based VAT. Under this system each registrant is require to issue a tax invoice or an abbreviated tax invoice, which should be in a prescribed format and should contain specific information such as PAN No, Invoice No., name and address of seller and buyer, transaction detail, amount, VAT etc. Abbreviated tax invoice is especially for retail level where they can mention value of the sales or services mentioned including VAT for simplification for VAT calculation. Minimum of three copies of tax invoice must be prepared, 1st for buyer, 2nd copy to record for vender which should made available when tax administration ask to show during the inspection. Therefore tax invoice is also important tools for tax base as well as controlling.

D. Single rate of tax

Nepal is adopting single rate VAT from the beginning. At the beginning tax rate was 10% for every taxable goods or services and from the Jan. 2006 tax rate was increased to 13% but export is zero rated. Therefore calculation of VAT is easy and similar treatment for each taxable goods and services so it is easy to understand to general public and consumers. Now there is some debate about multiple tax rate because of demand by business community, and sometime also single rate is creating obstacle for the government for preferential treatment for specific goods and services.

E. Tax Credit System

Tax credit is an important element of VAT. Under this system, VAT registrant making taxable supplies including the zero rated are entitled to claim input tax credit. It is necessary to meet following conditions for the entitlement of input tax credit;

- The goods or services supplied to the VAT registrant must be solely for use in his business of making taxable sales.
- The registrant must hold and be able to produce a valid tax invoice for the goods or services for which credit is claimed.
- The claim for deduction must be made within one year of the date of invoice.
- For the mixed transaction, input tax credit is claimable only the purchase related to taxable sales.
- For some goods which can be used personal as well as business purpose are allowed for partial credit, such as 40% tax credit for automobile.
- Some goods and services which are mostly used for personal use such as liquor and entertainment are not allowed for input tax credit.

F. Provision of threshold

There is certain level of threshold of registration for small business of taxable transaction, which can be mentioned briefly as follows:

- NRs 2 million of yearly taxable turn over for goods transaction.
- NRs 1 million for yearly taxable turnover for service transaction.
- NRs 10000 for taxable import at a time for business purpose.
- No threshold for certain business in specific area, such as Hardware, Electronic goods, Furniture and furnishing business in municipalities.

G. Tax Refund system

Tax refund is an important feature of VAT, which is generally happens in the case of zero rated supplies such as export. Tax refund may arise in other situation also if there is the condition that, input tax is higher than output tax.

- For export, VAT act provides immediate refund on monthly basis, when total percentage of export is more than 50% during the month.
- For non export, taxpayer can apply for refund if there is excess credit for a continuous period of six month.
- For Diplomats, refund provided to the accredited diplomats on a reciprocal basis, first they have to pay VAT for domestic consumption they can claim VAT refund from Inland Revenue Department.

H. Provision of Zero rate

Export and some goods and services are zero rated according to VAT act, Schedule 2. The main aim of zero rating is to provide full input tax credit to ensure absolute exemption in specific goods and services. These supplies are zero rated now:

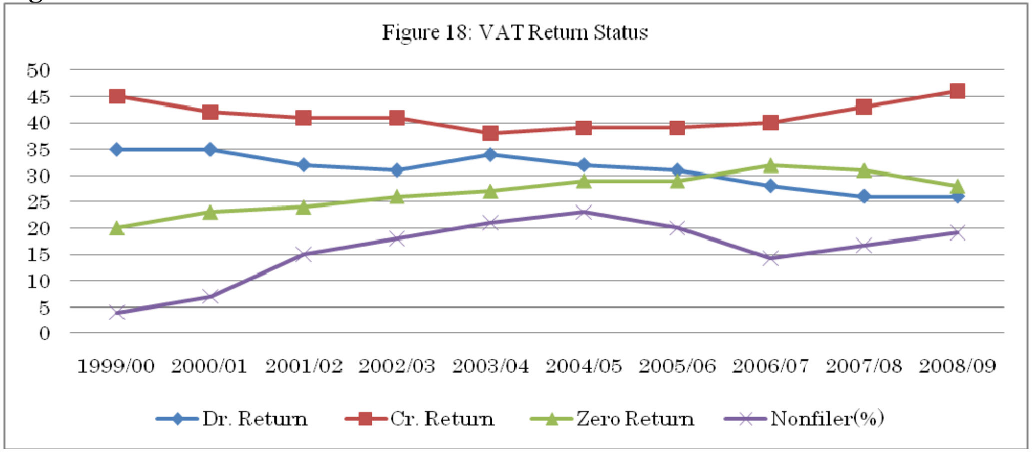
- Export of goods
- Imports of goods and services by accredited diplomats.

- Medicine industries can request for zero rate facility.

III.2.2.b VAT Return status

Quality of VAT return has been worsening in recent years. In fiscal year 2008/09 among the total submitted VAT returns, only 26% are debit returns, 47% are credit returns and 27% are zero returns.19% taxpayers are the non filer of VAT return which has been increasing significantly in recent years. Increasing trend of non-filer and zero return, huge percentage of credit returns and decreasing trend of debit returns shows the increasing challenge to achieve effective compliance. Figure 18 shows the trend.

Figure 18: VAT Return Status



III.2.2.c. Tax Collection

Table 25 and figure 19 shows the total collection and growth trend of VAT from F.Y.2000/01 to 2009/10. Total collection of VAT has been increasing significantly in last decade and reached total amount of 53464 millions in F.Y. 2009/10. Although the total collection amount has been increasing significantly, the share of VAT in tax revenue is almost stable between 305 to 35% in last decade.

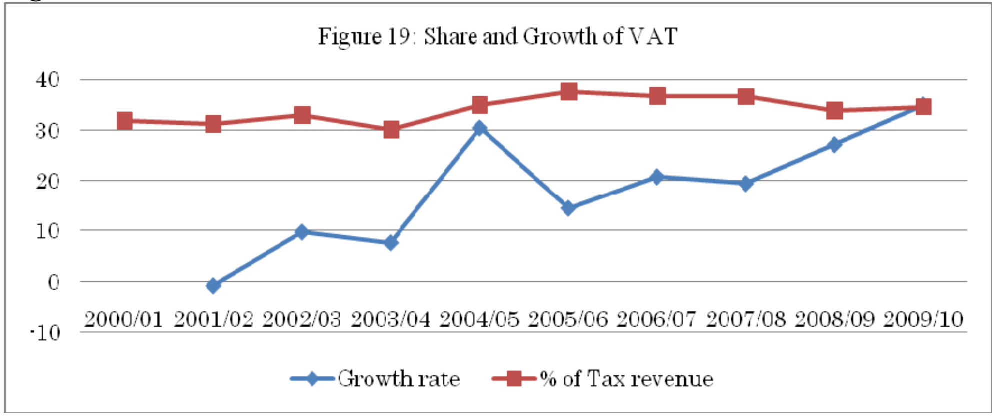
Table 25 VAT Collection and Growth

(NRs. 10 millions)

F.Y.	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Tax collection	1238.2	1227	1346	1447.9	1889	2161	2609.6	3116	3960	5346.4
Growth rate		-0.93	9.72	7.57	30.43	14.43	20.75	19.39	27.12	35.00
% of Tax revenue	31.86	31.19	32.91	30.06	34.91	37.63	36.69	36.59	33.83	34.57

Source: Economic Survey, Ministry of Finance, Nepal.

Figure 19: Share and Growth of VAT



III.2.3 Excise Duty

Another important contributor for internal revenue is Excise Duty, which is one of the oldest taxes, started with custom duty. 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) during 1990. 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, flavored soft drinks, cement and plastic goods. 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. Another important objective of the excise duty is to help to control the consumption which is regarded as lacking merit or as likely to cause negative externalities.

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 2001, Excise Regulation 2002, and Alcohol Regulation 1976. As provisioned in the law, the excise 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.

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. Producers of excisable goods are allowed to claim input tax credit for excise duty paid on raw materials used for providing excisable goods/services. Export is exempted from Excise.

Tax Collection

Table 26and Figure 20 shows the total revenue collection and growth trend of excise duty from Fiscal year 2000/01 to 2009/10. Although the total tax collection from excise has been increasing significantly, the growth rate is much more unstable due to frequent change on list of excisable goods and items. Total excise collection for fiscal year 2009/10 was 24315 millions, which is 15.72% of total tax revenue. Share of excise on total tax revenue also increasing gradually in last decade from 9.7% to almost 16%.

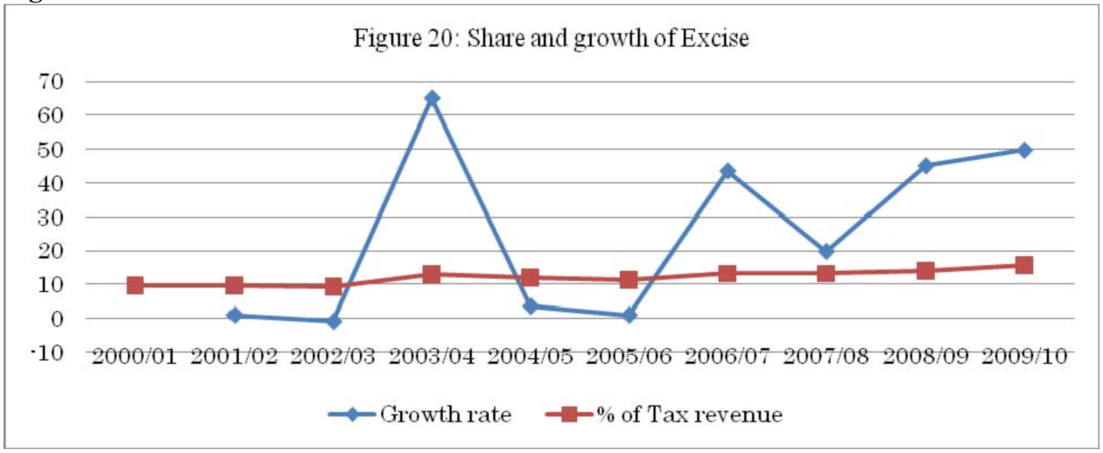
Table 26 Excise Collection and Growth

(NRs. 10 millions)

F.Y.	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Tax Collection	377.12	380.7	377.12	622.67	644.6	650.8	934.32	1119	1624	2431.5
Growth rate		0.95	-0.94	65.11	3.52	0.96	43.57	19.76	45.11	49.75
% of Tax revenue	9.70	9.68	9.22	12.93	11.91	11.33	13.14	13.14	13.87	15.72

Source: Economic Survey, Ministry of Finance, Nepal.

Figure 20: Share and Growth of Exercise



III.2.4 Customs 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.

Table 27: Custom Duty Collection and Growth

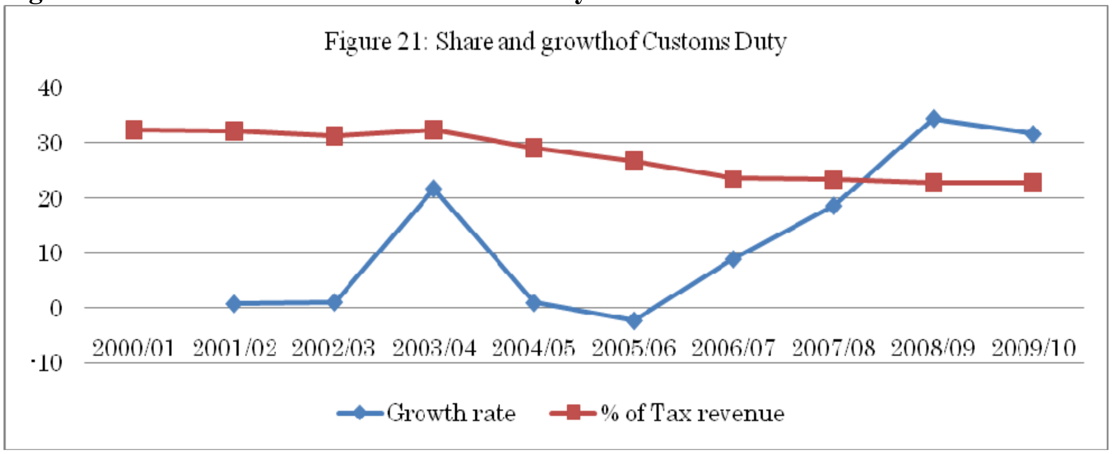
(NRs 10 millions)

F.Y.	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Tax collection	1255.2	1265	1278.3	1555.5	1570.2	1534.4	1670.76	1981	2662	3502.8
Growth rate		0.78	1.05	21.68	0.94	-2.28	8.89	18.57	34.37	31.59
% of Tax revenue	32.30	32.16	31.26	32.29	29.02	26.72	23.49	23.26	22.74	22.65

Source: Economic survey, Ministry of Finance, Nepal.

Table27 and figure 21 shows the total revenue collection by custom tariff and growth trend of it from 200/01 to 2009/10. Although, total tax collection from custom tariff has been increasing the growth rate is not stable. Total tax collection from custom tariff in F.Y. 2009/10 was NRs.35028 millions which is 22.65% of total tax revenue. Share of custom tariff in total tax revenue has been decreasing gradually from 32% in 2000/01 to 22.65% in 2009/10. Gradual reduction on custom tariff after membership of WTO and regional trade agreements (SAFTA and BIMSTEC) has been effect on total collection of custom duty.

Figure 21: Share and Growth of Customs Duty



IV. Country Specific Fiscal Issues

Nepal is a developing country having numerous natural as well as human resources as potentiality for its economic development. Political instability and conflict, lack of investment friendly environment, lack of infrastructure development are the main reasons behind slow pace of economic development. Landlockness, energy crisis, high transportation cost, lack of competitiveness and unfavorable geo-political conditions are major obstacles to catch the opportunities from liberalized economy and membership of WTO, and some regional trade arrangements. In recent years, developing economy of Asia have been performing very well(specially two immediate neighbors, India and China), at the same time Nepalese economy entering on vulnerable stage. Major current fiscal as well as economic issues are mentioned below.

IV.1 Balance of Payment Deterioration

The current account and overall Balance of Payment is in deficit position in F.Y. 2009/10. Increasing trade deficit has been biggest challenge to maintain the current account balance. The only big supporting sector for current account has been remittance but the decreasing growth rate of remittances indicates further challenge. Although the capital account is in surplus, overall balance of payment is entering vulnerable stage. The balance of payments posted a loss of Rs. 2.62 billion in 2009/10 as against a surplus of Rs. 44.76 billion last year. The current account also registered a deficit of Rs. 32.35 billion as against a surplus of Rs. 41.44 billion last year. The large deficit in goods and services trade led to such a huge current account deficit. Balance of Payment deterioration is the biggest challenge for current macroeconomic condition of the country.

IV.2 Huge Trade Deficit

Nepal has been facing trade deficit from history to the present time. The country-wise and product-wise area of export trade of Nepal seems narrow. Nepal never experienced trade balance. More dependency on import resulted the increasing trend of trade deficit. Trade diversification is still remaining in far behind. Nepalese foreign trade is bouncing around the Indian market. In Fiscal Year 2009/10 the volume of total foreign trade reached to NRs. 439.92 billions. The share of foreign trade with India is 59%of the total trade. The trade balance has been much worsening in recent years. Nepal's merchandise exports declined by 9.7 percent to Rs. 61.13 billion in 2009/10.Such exports had grown by 14.2 percent to Rs. 67.70 billion a year ago. The merchandise imports, on the other hand, grew by 33.2 percent to Rs. 378.80 billion in 2009/10. Such imports had grown by 28.2 percent to Rs. 284.47 billion last year. Total trade deficit in 2009/10 expanded by 46.5 percent to Rs. 317.67 billion. Trade deficit had risen by 33.3 percent to Rs. 216.77 billion last year. Trade diversification, promotion of comparative advantage goods, promotion of service sector, investment friendly environment should be focused by the trade policy to move toward trade balance.

IV.3 Remittance Deceleration and Sustainability

Nepal is heavily dependent on remittances constituting over 20 percent of GDP. Owing to the global crisis the outflow of Nepali workers abroad decreased by 12 percent during 2009. As a result of fewer Nepalese leaving to work abroad, the growth of remittances halved to 9.6 percent year-on-year in the first nine month from an average of 34 percent in 2005–08. Workers’ remittances in 2008/09 aggregated Rs. 209.70 billion, a rise by 47.0 per cent compared to 2007/08. Similarly, the remittances to GDP ratio increased from 17.4 per cent in 2007/08 and further to 21.8 per cent in 2008/09. As a matter of fact, Nepal was one of the top ten recipients in terms of share of remittances in GDP in 2008/09. These figures clearly demonstrate that any sharp decline in receipts from remittances could disturb the structure of the economy from the macro level, which has been reflected as balance of payment deficit in F.Y.2009/10. Although the share of remittance is increasing on balance of payment a question emerged whether it can be sustainable or not. To get the benefit for economic development through remittance, policy should be focused on, skill development and facilitation to the workers, invest of remittance in productive sector rather than daily consumption. In long run economic policy should focus on use of the human resources to enhance domestic production and industrialization for the economic development of the nation.

IV.4 Economic Growth Slowdown

Despite of focus of economic policies as well as periodic plans on economic growth, slow pace of economic growth has been a biggest challenge in Nepalese development history. Overall development cannot be achieved without economic growth. Economic growth rate was less than 5% in every year of the last decade. When two immediate neighbors, India and China achieving almost double digit growth rate, at the same time Nepal is suffering less than 5% growth rate. Based on the Preliminary estimate of the Central Bureau of Statistics, the gross domestic product (GDP) has witnessed a growth of 3.5 percent at basic price and 4.6 percent at producer's price in 2009/10.Such growth rates were 3.9 percent and 4.9 percent respectively in 2008/09.The agriculture and non-agriculture sectors are estimated to grow at 1.1 percent and 5.1percent respectively in 2009/10. Such growth rates were 3.0 percent and 4.7 percent respectively in the previous year.

IV.5 Price Stability

High rate of inflation has been a serious issue for Nepalese economy in last two decades, and it became more serious in last two years due to double digit rate of inflation. The country is facing the tragic co-incidence of having two digits price increase in the backdrop of stagnant pace of development process with low economic growth rate. Adverse impact on purchasing capacity in the living standard of the people has posed a big question mark in the overall macroeconomic management efficiency. The annual average consumer price inflation moderated to 10.5 percent in 2009/10compared to an increase of 13.2 percent in 2008/09. Nepalese monetary authority, Nepal Rastra Bank should review Nepalese monetary policy for price stability which has been one of the biggest lapses of Nepalese Monetary Policy.

IV.6 Revenue Growth Sustainability

Revenue growth rate has been one of the biggest achievements of Nepalese economy in last 4 years. Significant increment (more than 20% per year) of revenue collection in past 4 years GDP Revenue ratio reached on more than 15% in F.Y. 2009/10, (which was only 11% on F.Y. 2001/02 and remained stable up to F.Y. 2005/06) which is still low than other developing economies. To fulfill the huge gap between government revenue and expenditure, there is no way than increment of revenue. In this situation, achieving sustainable revenue growth is one of the biggest challenges for economic development. Broadening tax base through lowering the exemption and exploring the emerging new sectors, effective enforcement through efficient administration, enhancement of taxpayer compliance through taxpayer education and procedural simplification should be on focus of revenue policy.

IV.7 Fiscal Federalism

Nepal is now in politically transitional as well as state restructuration period. Nepal has been declared as federal republic. Only political federalism cannot achieve the objectives of state restructuration to fulfill the expectation of the citizens without fiscal federalism. Adoption of effective and suitable model of fiscal federalism on long term prospective of the overall development of the nation is necessary at this moment.

V. Conclusion: Where we are standing and Where to Go?

Nepal is one of the developing countries with very low per capita income ranked in 138th position in UNDP Human Development Index with 0.428 HDI in 2010. Poverty alleviation has been one of the biggest challenges of Nepalese modern development history. More than 30% people are still on absolute poverty. More than 70% people involving in agriculture sector which contributes one third of the total GDP and based on traditional subsistence farming with monsoon dependency, due to lack of sufficient irrigation, adequate technology and commercialization. Huge percentage of active population working abroad especially in gulf countries due to unemployment and lack of opportunities within the country, which has made remittance one of the biggest source (more than 20% of GDP) of middle and low middle income people.

Nepal has never enjoyed political stability in its modern history. Frequent change of government as well as political system especially internal conflict of last 15 years pushed issue of economic development in shadow. Although every periodic plan focused to achieve economic growth for poverty alleviation, economic growth has been biggest challenge for economic development. When developing Asia achieving almost double digit growth (especially two immediate neighbors India and china) in recent year, at the same time Nepal has been suffering less than 4% economic growth in last two decades which pushed Nepal far behind than same economic status with East Asian countries in 1970's.

Despite of above gloomy conditions Nepal has huge potentiality of development and economic growth. Nepal is enriched with water resource (more than 6000 rivers), which gives lots of potentiality of hydro electricity which is very important in current world energy crisis and also there is big market potentiality in neighboring countries. Natural as well as geographical diversity (70 m. to 8848m.altitude from sea level), long Himalayan range (8 top mountains out of 10 including Mt. Everest), world heritage sites (including Lumbini, the birth place of Lord Buddha) and national parks are potentialities for tourism development. Huge percentage of active population ensures the supply of the human resource for developing activities.

Overall development cannot be achieved without economic growth. Nepal already liberalized its economic policy since 1990, and especially after the membership of WTO, Nepal has opportunities as well as challenges for economic development. Huge trade deficit, low flow of FDI, lack of invest friendly environment are the biggest challenges of the Nepalese economy. Export promotional policies with special focus on comparative advantage goods and services, and focus on trade diversity is necessary to achieve trade balance. Infrastructure development for industries and strengthening security situation especially industrial security are crucial for FDI attraction. Government should focus to promote investment on potential areas of development especially in hydro electricity and tourism development. When more than 70% population is involving in agriculture sector, poverty alleviation cannot be achieved without reform on agriculture sector. Commercialization and injection of modern technology in agriculture sector is necessary for agriculture sector development, which will be helpful to shift the dependency of people to other industry and service sector from agriculture sector.

Despite of political instability and conflict rapid growth of revenue in last few years, become helpful to minimize the fiscal deficit, modernization of tax system and reform on revenue administration are the main reasons behind it. Still there is huge gap between government revenue and expenditure, revenue covers only 65% of total expenditure. Large agriculture sector and many other sectors are still out of coverage of Income Tax as well as VAT. Revenue policy should focus on expansion of tax base and modernization of tax policy as well as tax administration, to achieve sustainable revenue growth for fulfillment of fiscal gap.

References:

Central Bureau of Statistics, Government of Nepal, official website: www.cbs.gov.np
Department of Customs, Government of Nepal official website: www.customs.gov.np
Excise Act (2002), Government of Nepal, Kathmandu, Nepal.
Income Tax Act 2002, Government of Nepal, Kathmandu, Nepal.
Inland Revenue Department,(2010), *Annual Report*, Government of Nepal, Kathmandu, Nepal.
Inland Revenue Department, Government of Nepal official website; www.ird.gov.np
International Monetary Fund Official website: www.imf.org
Keio University,(2009), International Comparison of taxation in Developing Countries, Faculty of Business and Commerce, Tokyo, Japan
Ministry of Finance, Government of Nepal, official website: www.mof.gov.np
Ministry of Finance, *Budget speech (various issues),* Government of Nepal, Kathmandu, Nepal
Ministry of Finance, *Economic Survey (various issues),* Government of Nepal, Kathmandu, Nepal
Ministry of Industries, Government of Nepal, official website: www.moi.gov.np
Ministry of Commarce and supply official website: www.mocs.gov.np
Nepal Rastra Bank official website: www.nrb.org.np
National Planning Commission, Government of nepal, official website: www.npc.gov.np
Revenue Administration Training Centre, *Rajaswa- Biannual Journal of Revenue and Economic Development, (various issues),* Government of Nepal, Lalitpur,
Security Board Nepal, official website: www.sebonp.com
United Nations Development program, official website: www.undp.org
Value Added Tax (1995), Government of Nepal, Kathmandu, Nepal.
World Bank, official website: www.worldbank.org