5 Nepal

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I. Introduction

Nepal is a small landlocked country located in South Asia. It is bordered to the east, west and south by India and north by China. It is also recognized as country of Himalayas where eight of world's ten tallest mountains including highest Pick Mt. Everest are situated in the northern side. It is located between latitudes 26° 22' and 30° 27' north and longitudes 80° 4'and 88°12' east with an area of 147,181 km2 and population of approximately 27 million. It is roughly rectangular in shape, and the land extends approx. 885 km. from east to west and 193 km from north to south. It covers 0.03% area of the world and 0.3% area of Asia. Kathmandu is the capital city of Nepal. Modern Nepal was created in the latter half of the 18th century when Prithvi Narayan Shah, the ruler of the small principality of Gorkha, unified many small states. Nepal was never colonized and always remained independent during the whole of its history. Nepal has been categorizing as developing country where 24% of its people are living below the poverty line and earning less than one dollar per day. The birth place of Lord Buddha proponent of Buddhism, 'Lumbini' is also situated in Nepal. Nepal is very wealthy in cultural and natural variety. It has more than 61 ethnic group and more than 70 spoken languages whereas Nepali is an official language. Nepal is the secure habitat of thousands of flora and fauna because of its natural diversity.

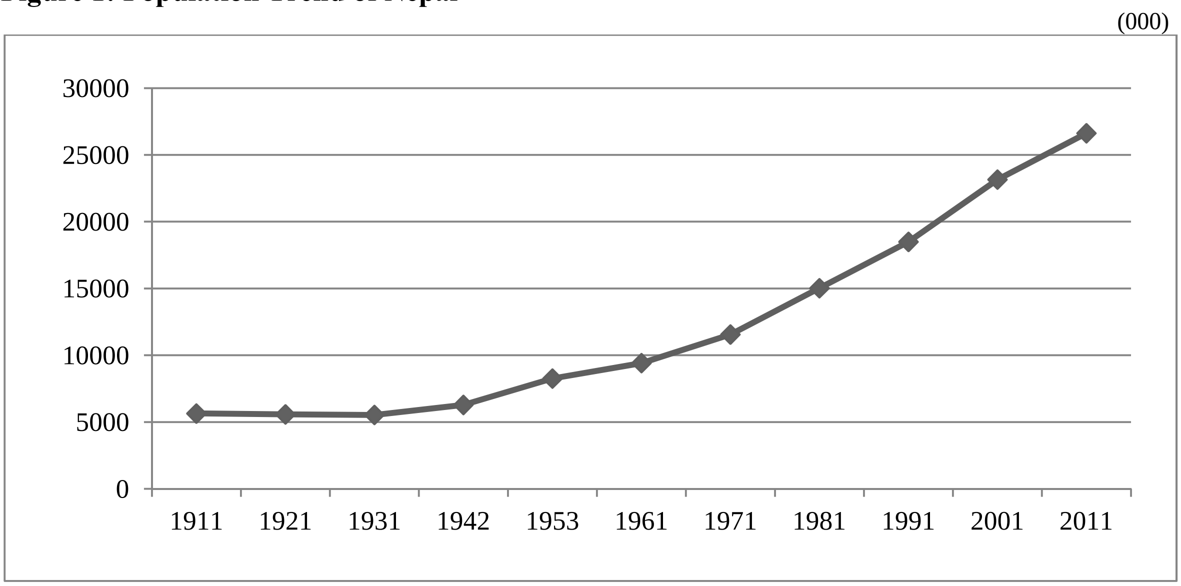
Nepal is mainly divided into three broad geographical regions extending from east to west and parallel to each other; Plain (Terai), the Hill and Mountain .The Plain (Terai) area is connected with India and it is very important for crops because it is low, fertile and flat. This area is fed by three big rivers which are originated from Himalaya: the Koshi,The Gandaki and the Karnali and some other small rivers. This region has a subtropical to tropical climate. The altitude of this region is ranged from 60 miters to 600 miters above the sea level. It has covered 17% area of the total geography. It is highly populated. It is also known as the "grain basket" of Nepal. Moreover, it has key share in the economy not only because of agricultural region but also because of industrial region. The main industrial cities of the country, Biratnagar, Birgunj, Bhairahawa and Nepalgunj are located in this region.The hill region is located in middle part of the country between the altitudes of 600 meters to 4000 meters altitude from the sea level. It has big coverage with 68% of the total geography. It is very important for livestock because of the large quantity of jungle. There are beautiful valleys located in this region including capital city Kathmandu; Pokhara, Dang,and Surkhet. Land is quite stepper in this region besides some valleys. It is very important for tourism because of its geographical beauty. Pokhara is major destination for tourist. Moreover, horticulture also has big potentiality in this region due to good climate. The Mountain region is located in the northern part of the country between the altitudes of 4000 meters to 8848 meters connected with Tibet region of china. It has series of mountain including highest pick Mount. Everest. It has covered 16% of its geography. It is less populated region due to geographical difficulties. In this region the snow line lies above5000 meters and there is no human settlement above this line. This region is mostly steep, rugged and cold and only 2% of the land is suitable for cultivation.

Nepal has great deal of variation in climate and tropical and subtropical climate exists in the Terai region. However, there is completely different climate in other region. The main cause of this diversity is due to the enormous range of altitude within short north south distance. Because of this diversified altitude, annul patterns of rainfall is also unique. Up to about 3000 meters, annual rainfall increase as the altitude increase. But thereafter, annual rainfall diminishes with increasing altitude and latitude. Annual rainfall in eastern Nepal is approximately 25,00 millimeters, but in Kathmandu and western Nepal is approximately 1420 millimeter and 1000 millimeter respectively. Nepal has four major seasons, namely, winter: December to February, spring: March to May, summer: June to August and autumn: September to November. In addition, there are seasonal variations in the amount of rainfall depending on the monsoon cycle. The pre monsoon seasons normally occurs during April and May which is characterized by highest temperature reaching 40° C during the day in the Tarai Region and other lowlands. However, the hills and mountains remain cool. The arrival of the summer monsoon can vary by as much as a month, in Nepal it generally arrives in early June. The post monsoon season begins with a slow withdrawal of the monsoon and last until about December. The days are mild or even warm, except on the higher mountains, and sunshine averages from six to nine hours a day. Much colder temperatures prevail at higher elevations. The temperature in Kathmandu Valley ranges from 19-27ºC (67-81ºF) in summer and 2-20ºC in winter, hence pleasant. There are some dangers of floods and landslides during the heaviest rain falls, the climate of Nepal is rarely hazardous and on average is very pleasant. Some indication of variation and irregularities are being noticed in recent years due to global warming.

Nepal does not have plenty of natural resources in terms of valuable minerals and petroleum. Though there are some potentiality of iron, copper, gold, zinc, limestone, slate, oil and gas, coal, sulphar, quartz, cobalt etc which are not substantially excavated. Nepal is rich in terms of natural diversity, scenic beauty, water resources and forest. There is a serious of mountain in the northern part of the country with snow which is very attractive for tourist. It has roughly 6000 rivers flowing throughout the year round form mountains to the plain. It can make as a backbone of economy by producing and trading electricity through hydropower which is cost effective due to the Stepper Rivers. It is estimated that all these rivers have potential of generating 83,000 MW of hydroelectricity out of which 40,000 MW is said to be feasible. It is said that Nepal is the second rich country in terms of water resources after Brazil. The main rivers of Nepal are Mechi, Koshi, Narayani, Gandaki, Karnali and Mahakali. These rivers have several tributaries. Besides rivers, glaciers, lakes, rain fall and ground water are also the source of water. Forest is one of the important natural resources in Nepal. Different types of forests are found in different regions of Nepal. It occupies about 37% of the total land of Nepal. Forest is the source of all wood-based industries. Industries like paper, furniture and timber are based on the forest. Forests are rich in herbs. The herbs have medicinal values. Many medicines are made from these herbs. Timber and herbs are valuable natural resources. The value of timber and herbs is very high in the world market. There are many kinds of animals in the forests of Nepal. Forests provide food and shelter for these animals. Animals and birds add to the natural beauty of the country. People from many countries come to Nepal to see these beautiful birds and exotic wildlife. Many types of fruit and grasses grow in forests. People depend on them for their living and also to rear their livestock. Forests support agriculture. It also causes rainfall. It keeps the soil tight. So, forests help control soil erosion, landslides and floods. Nepal government is trying to preserve forests. It has established many National Parks and Wildlife Reserves. Green forest is the wealth of Nepal. Forest is the free gift of nature to human beings. Forest is a very important resource of Nepal. Forest provides wood, fuel, herbs etc. we get raw materials for fuel, raw materials for furniture, matches and paper. It influences climates, causes rain, stops flood, soil erosion and landslide. Forest is the habitat of wild animals. Tourists come to see wild animals and thus we can earn foreign currencies. Forest regulates the temperature of the surrounding areas. It is pleasant to live near forest. Villagers graze their cattle in the forests and they also get fodders for their cattle. We should preserve our forest and use it wisely.Land is the other natural resource of Nepal. In Nepal most people depend on land. They do farming and earn their living from land. Land includes soil and minerals. The cultivable land in Nepal is about 17%. Soil is an important factor for agriculture. It is not possible for people and animals to live on earth without soil. The land in Terai is very fertile. It is good for agriculture. So, the productivity of Terai is very high. The terai region is the storehouse of food grains. It is called the green belt of Nepal. There are many hills and mountains in Nepal. The surface is rugged and sloppy in the hills. When rainfall is heavy the top soil of the hills is washed away. Then it causes landslides. So, the trees should be planted and conserved to protect soil in the hills. Plants are the only means to hold the soil tightly and to stop erosion. Nepal is one of the richest countries in the world in terms of bio-diversity with unique geographical position and latitudinal variation. The elevation of the country ranges from 70m above sea level to the highest point on the earth, Mt Everest at 8,848m, within a distance of 150 km. Climate range from subtropical to arctic. This wild variation fosters an incredible variety of ecosystems.

Nepal's population has continuously increased over time. According to the preliminary national census report of Nepal 2011, it is 26.62 million. It ranked 45 th position in the world in 2011. Nepal has been conducting national census in every ten years. Average exponential growth rate in last 10 years is 1.40 % whereas this average growth rate from 1991 to 2001 is 2.25%.Out of total population the share of male and female was 48.56 and 51.44 percent respectively. Similarly, population density was 181 square kilometer. Majority of people live in rural areas with 83 percent. Geographically, 50.2 percent people live in Plain followed by 43.1 percent in Hill and only 6.7 percent people in Mountain. Crude birth rate, crude death rate, infant mortality and child mortality rate was 28.4, 9.9, 48 and 61 (per 1000) respectively. Similarly, total fertility rate, maternal mortality rate is 3.1 and 281 per 100,000 live births respectively in the same period. The literacy rate and life expectancy at birth were 53.7 and 61 percent respectively. Figure 1 shows the population trend of Nepal since 1991.

Figure 1: Population Trend of Nepal



Source: Central Bureau of Statistics, Nepal (2011)

Nepal is a 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 Maithili12.3, Bhojpuri 7.53, Tharu 5.86, Tamang 5.9, Newar 3.63 percent etc.

Like all other countries of the world, Nepal has also its pre-historic period. It was taken to mean only the valley of Kathmandu, Swayambhu Puran and Nepal Mahatmya have it to say that to begin with, Nepal was a lake with no outlet of water whatsoever. The valley of Kathmandu remained under water till Manjushree,a Bodhisatwa (potential Buddha) who came from China on pilgrimage sometime in Tretayuga to pay unreserved homage to Swayambhu which appeared on the lotus that grew out of the seed thrown in the lake by Bipasvi Buddha who came to Nepal sometime in the golden age, cut a rock through which the water of the lake flowed out, making the valley habitable. Many dynasties ruled Nepal in different time periods such as Kirati, Lichhavi, Malla and Shah. Nepal kept its sovereignty intact throughout its history, though Nepal had to fight many wars in which Nepalese people displayed intense courage and bravery.

The political situation in Nepal was very instable and there were conspiracies against each other are those in power. Kota Massacre happened in 1846 slaughtering many people and it paved the way for 104 year long family rule called "Rana autocracy" in Nepal. Lastly, democracy was established in the country in 1950. Democracy was restored in 1990 after nearly 30 years of autocratic rule of Shah Kings in the name of people's democracy. Nepal faced Maoist insurgency for a decade from 1996 to 2006. In 2001, there was Royal massacre killing the then king Birendra with his whole family. The success of popular movement of April 2006 brought the decade-long insurgency to an end. The first meeting of the Constitutional Assembly historically declared Nepal as Federal Democratic Republic in May 28, 2008. But, due to the lack of experience of political parties, constitutional assembly failed to make new constitution and dissolved without completing its task. It has clearly seen that still Nepal is facing political transition and it might take time to established permanent political stability and to forward the smooth development process.

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 geographical situation of Nepal is a constant in the determination of Nepal’s foreign policy. 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 a 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

Nepal has been adopting period development plan since 1956 except 1960, 1990 and 1991.11 periodic plans have already implemented within 5 decades and one interim plan is now running. After the restoration of democracy in 1991, liberalization and privatization policy was implemented rapidly. Previous plans focused on infrastructure development, social development, integrated rural development and public necessities as priority sector. However, from the 8th five years plan, private sector development and poverty alleviation have been taken as main concern area. Despite its long planned development efforts, Nepal still remained low –income developing country in the world. GDP per capita based on purchasing power parity as World Bank's data is $1256 in 2007 and at 157th position on the Human Development Index (HDI) in 2011 both were the lowest among the SAARC countries. Still 25.2 percent people live below the poverty line-earning less than a dollar per day. The Gini coefficient which measures the extent of inequality has increased from 0.34 in 1995/96 to 0.41 in 2003/04. Annual growth rate of Nepal in 2011 is to be estimated 4.3% which is slightly improved figure compared to last 3 years. The below table 1 shows the summary of macroeconomic indicators of last 8 years and detailed sector wise analysis also has been done in this chapter.

Table 1: Summary of Macroeconomic Indicators

Description	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12*
Per capita GDP (NRs)	23292	25279	28905	31946	38172	45469	51444	57726
Per capita GNI (NRs)	23357	25471	29200	32257	38626	45817	51727	58274
Per capita GNDI (NRs)	27218	30346	34323	39417	48262	56583	63292	73123
Per capita GDP at constant Price (NRS)	19670	19884	21129	21110	22793	23561	24138	24908
Per capita GNI at constant Price (NRs)	19802	20186	21569	22567	23301	24170	24585	25393
Annual Change in nominal per capita GDP (%)	7.39	8.53	14.34	10.52	19.49	19.12	13.14	12.21
Annual change in real per capita GDP(%)	1.2	1.09	6.26	-0.09	7.97	3.37	2.45	3.19
Per capita GDP (USD)	323	350	410	491	496	610	712	727
Per capita GNI in (USD)	324	352	414	496	502	615	715	734
Gross domestic saving as percentage of GDP	11.6	9	9.8	9.8	9.4	11.5	8.6	10
Gross national saving as percentage of GDP	28.4	29	28.6	33.2	35.9	36	31.6	36.7
Exports of goods and services as percentage of GDP	10	9.2	8.2	7.3	6.9	5.1	4.7	4.7
Imports of goods and services as percentage of GDP	25.4	26.6	26.8	27.2	28.8	31.4	28.9	29.2
Gap between domestic saving and investment percentage of GDP (+/-)	-14.9	-17.9	-18.9	-20.5	-22.2	-26.8	-23.9	-22.8

*estimated.
Source: Ministry of Finance (2011)

Above table 1 depicts the low per capita growth rate of last 8 years. Similarly, it shows the poor situation of saving ratio compared to GDP which is very important for capital accumulation. Gross national saving is quite high then domestic saving because of the increasing share of remittance in the economy. Substantial gap of export and import is another serious issue for stabilizing the economy

A. International Environment

II.A.1 Trade Balance

International trade is one major component of external sector of the economy. Nepal has been doing trade with its neighboring countries India and China for a long time. Nepal has never experienced trade balance. Despite some policies and institutional reforms, the commercial sector of Nepal has not been developed as expected. Still, Nepali goods and services have not been able to become competitive in the international market. The given table 2 shows the international trade situation .The main reason of this continuous trade deficit is Nepal is exporting low value products like garments and handicrafts but importing high value products including machinery and petroleum products. The niche product and niche market have not been identified. Sustainability in trade sector has not been ensured due to the development of trade based on imported raw materials rather than on the domestic raw materials. Due to supply side constraints, remarkable benefit from the export trade could not be achieved.

Nepal has adopted liberal trade policy and removed quantitative restrictions on import. It became the member of World Trade Organization (WTO) in 2004. Moreover, Nepal signed on two regional arrangements SAFTA and BIMSTEC. It has newly introduced new trade policy in 2008 by replacing the former trade policy addressing new issues and challenges seen in the commercial sector. Indeed, some products have been identified as priority sector having comparative advantage for international trade. New trade policy has three objectives; To enhance the opportunities of income and employment by promoting domestic and international trade; to get maximum benefits from goods and service trade by identifying comparatively new beneficial goods and services with the participation of private and government sector by making price and quality more competitive in internal and external market; to alleviate poverty by promoting exports of local raw material goods using more resources and skills, and to expand the benefits from the activities of commercial sector up to the rural level.

Table 2: Trend of International Trade

(NRs in Millions)

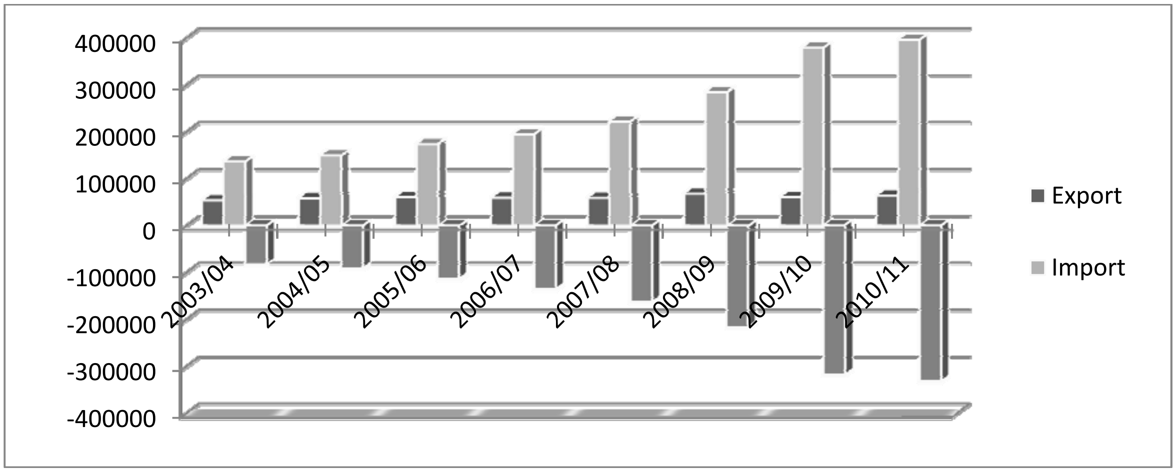
Description	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Export F.O.B.	**58706**	**60234.1**	**59383**	**59266.5**	**67698**	**61126.8**	**64338.5**
India	38917	40714.7	41729	38555.7	41006	40114.9	43360.4
Other Countries	19789	19519.4	17654	20710.8	26692	21011.9	20978.1
Import C.I.F.	**149474**	**173780**	**194695**	**221937.7**	**284470**	**378796**	**396175.5**
India	88676	107143	115872	142376.5	162438	217960	261925.2
Other Countries	60798	66637.2	78822	79561.2	122032	160835	134250.3
Trade Balance	**-90768**	**-113546**	**-135312**	**-162671.2**	**-216772**	**-317669**	**-331837**
India	-49759	-66428	-74144	-103820.8	-121432	-177846	-218565
Other Countries	-41009	-47118	-61168	58850.4	-95340	-139823	-113272
Total Volume of Trade	**208179**	**234014**	**254078**	**281204.2**	**352167**	**439922**	**46051.4**
India	127592	147858	157601	108932.2	203444	258075	305285.6
Other Countries	80587	86156.6	96477	100272	148724	181847	155228.4

Source: Nepal Rastra Bank

According to the table 2, total export is fluctuating in given period. It slightly dropped in 2006/07 and in 2009/10. But it has again raised in 2010/11 from 61126.8 million NRs in 2009/10 to 64338.5 million NRs in 2010/11. On the other hand import amount is rising continuously throughout the last 8 years and it is three times more in 2010/11 than 2003/04. Total volume of import in 2010/11 was 396175.5 million NRs whereas it was 378796 million NRs in 2009/10.

Figure 2: Trade Balance

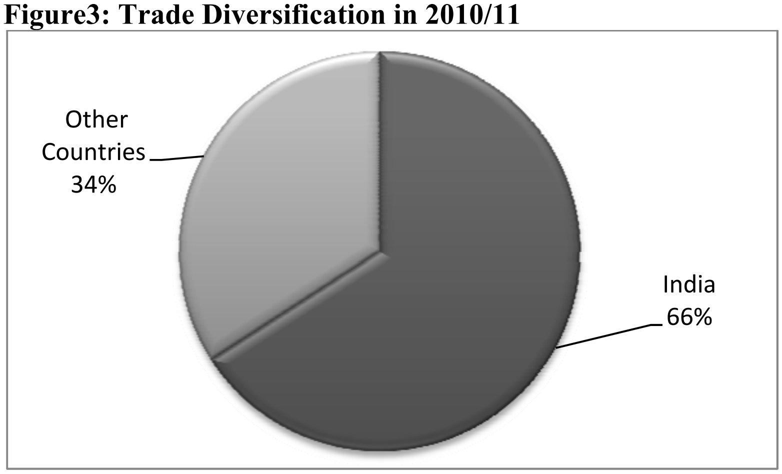
NRs in Millions



Source: Nepal Rastra Bank

Figure 2 shows the increasing trend of trade deficit which is increased more than 4 times in 8 years after 2003 and total deficit reached NRs. 331837 Millions in 2010/11. 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.

Figure3: Trade Diversification in 2010/11



Source: Nepal Rastra Bank

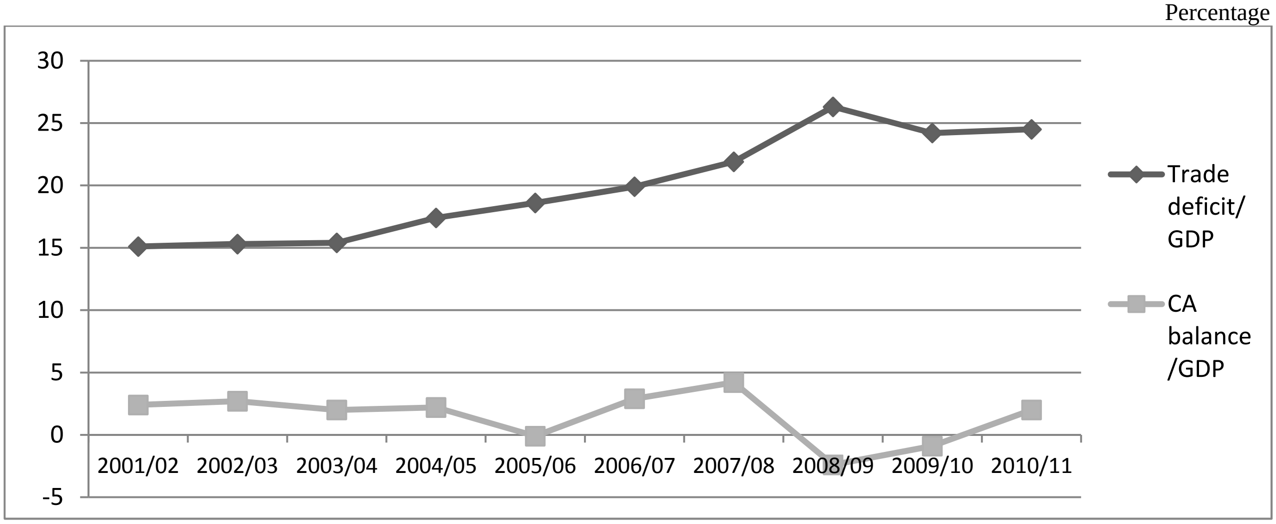
One remarkable issue we can obtain form this figure 3 is lack of trade diversification in Nepal and majority of the trade is with India. Except India, other trade partners are USA, Germany, Belgium, France, Japan, Bangladesh, Republic of China, Italy and Singapore. India occupies more than 98 percent of trade share (export as well as import) of Nepal in SAARC countries. India has 66% share in total international trade volume in 2010/11 whereas other countries have only 34%. Moreover, India has 67.39% share in total export and 66.11% share in import. Obviously, Nepal has largest trade deficit with India with 66% of total trade deficit due to the key trading partner of Nepal..

Figure 4 given below depicts the increasing trend of trade deficit ratio with GDP. This ratio was 15% in 2001/02 but it was approximately 25% in 2010/11. The main reason of this increasing trend of deficit is Internal conflict, political instability and industrial insecurity along with renewal of 1991 treaty in 2002 created regressive impacts on Nepalese export to India. India reintroduced the concept of value addition and other non-tariff barriers to Nepalese export. India imposed quantitative restrictions on Nepal's export of vegetable fat, acrylic yarn, copper and zinc oxide to India. Nepalese export to India was also subjected to countervailing duty. Moreover, many multinational companies were established in India after India took the policy of liberalization in 1991. As a result, Nepal started to import many third country products from India. Similarly, the import share of petroleum product has increased to around 31 percent in 2006 from 24 percent in 2001/02. Nepal imports around 99 percent of petroleum products from India. The increasing price of petroleum products in recent years has sharply increased the trade volume and trade deficit with India. In 2006/07, imports volume was three times larger than that of exports.

Even though Nepal is an agriculture country, it is not self sufficient in agriculture products. Nepal has to some extent substitute imports with domestic products and at the same time has to diversify its export goods and services according to competitive advantages. Government has to play a catalyst role to encourage private sector to produce quality exportable goods and services and explore new export markets to diversify the export destination. Attempts must be done to attract foreign Direct Investment in manufacturing, agriculture, tourism, and hydro-power and infrastructure development by creating business environment and proper policy incentives. Indeed, figure 5 also shows the ratio of current account and GDP. Current account is slightly surplus during last 10 years except 2008/09 and 2009/10. Current account surplus is due to because of the substantial increase in remittance income. Current account itself is not bad for the economy unless country getting capital inflow smoothly. However, foreign investment is also not very noticeable in Nepal. In this context, CA surplus should be necessary for the country to safeguard from the capital flight.

Figure 4: Trade Deficit and Current Account Balance Trend

Percentage



Source: Nepal Rastra Bank

II.A.2 Balance of Payment

Nepal is following the 5th Balance of Payment (BOP) manual of the IMF to compile the BOP statistics since mid-April 2003. Nepal has experienced Balance of Payment deficit due to the huge trade deficit in 2010/11. However, it had BOP surplus in 2009/10. Nepal traditionally faces large trade deficits, which is offset by equally large service, transfer and capital account surpluses. Nepal's overall balance of payments in 2010/11 recorded a deficit of NRs 2182.7 million. In FY 2009/2010, Nepal had recorded a balance of payments surplus of NRs 2619.1 million, which declined to 183 percent in FY 2010/2011 due to an increased trade deficit and service deficit. Import growth rate is only 6% and Export growth rate is 9% in 2010/11 whereas import and export growth ware 32.8% and -9.2% in 2009/10 respectively. Balance of goods and services also declined and deficit was increased with 5%. Grants increased by only 3% in 2010/11 and remittance growth rate were also shrink in 2010/11 with 9% growth which was 47% and 10.5% in 2008/09 and 2009/10 respectively. Similarly, continued increase in trend visiting Nepalese abroad has also increased travel payment resulting negative balance on service. Services net registered negative balance in 2007/08 and continued to increase further onwards.

The current account registered surplus though decreasing over time mainly pushed by foreign grants and worker's remittance. Worker's remittance in 2007/08 was 142683 million NRs which is 253551.6 in 2010/11 which shows the substantial increase of remittance within 4 years. Remittance's growth rate was slightly dropped in 2010/11 because of impact of global economic crisis. Remittance and pensions have become the main source of earning foreign currency for Nepalese economy. Nepal needs proper foreign employment policy to promote development of foreign employment and channelize it through banking sector so as to make it sustainable. Remittance is still not completely captured by banking sector; it mostly depends on informal sector. Capital account recorded surplus fluctuating during the period of seven years. It decreased up to year 2004/05 and began to increase afterwards. Financial account was highly unfavorable up to year 2004/05. There is some progress in financial accounts afterwards.

The main problem of Nepal's balance of payment is increasing trade deficit and negligible flow of foreign investment. To maintain favorable balance of payment for Nepal is a challenge. Nepal has to expand its foreign earning resources by extending service-oriented industries e.g. tourism, hydroelectricity etc. Attracting foreign direct investment, investment form Non-Resident Nepalese could be a better way to achieve this for resource-constraint country. Balance of Payments statistic of four years from 2007/08 to 2010/11 has been presented in table 3.

Table 3: Balance of Payment

Description	Fiscal year (NRs in Millions)				Percentage change		
	2007/08	2008/09	2009/10	2010/11	2008/09	2009/10	2010/11
A. Current Account	**23679.6**	**41437.3**	**-28135.2**	**-12936.4**	**75**	**-178.1**	**54**
Goods : Exports F.O.B.	61971.1	69906.8	63177.5	68701.5	12.8	-9.2	9
Goods : Imports F.O.B.	-217963	-279228	-366693	-388371	28.1	32.8	6
Balance on Goods	-155992	-209321	-303515	-319670	34.2	46.8	5
Services Net	-11092	-10478	-16385.3	-8674.6	-5.5	60.8	47
Services : Credit	42236.1	52830.1	51120.5	53012.5	25.1	-3.2	4
Services : Debit	-53328	-63308.1	-67505.8	-61687.1	18.7	7.4	9
Balance on Goods and services	-167084	-219799	-319900	-328345	31.6	47.5	3
Income : Net	7946.8	11749.5	9117.4	7549.4	47.9	-22.4	-17
Income credit	13447.7	16506.6	14917.9	17504	22.7	-9.6	17
Income debit	-5500.9	-4757.1	-5800.5	-9954.6	-13.5	21.9	72
Balance on Goods, Services and Income	-159137	-208050	-314996	-320795	30.7	51.4	2
Current Transfer Net	182817	249486.8	282647.7	307858.7	36.5	13.3	9
Current Transfer : Credit	185463	257461.3	287770.6	311156.7	38.8	11.8	8
Grants	20993.2	26796.2	26673.6	25780	27.6	-0.5	3
Workers' Remittances	142683	209698.5	231725.3	253551.6	47	10.5	9
Pensions	18789.9	17755.4	25850.7	28993.4	-5.5	45.6	12
Other	2997.1	3211.2	3521	2831.7	7.1	9.6	-20
Current Transfer : Debit	-2646.4	-7974.5	-5122.9	-3298	201.3	-35.8	36
B. Capital Account(Capital Transfer)	**7912.5**	**6231**	**12578.3**	**15906.1**	**-21.3**	**101.9**	**26**
Total (Group A plus B)	31592.1	47668.3	-19769.5	2669.7	50.9	-141.5	114
C. Financial Account (exclu.group E)	11032.6	21201.7	-3695.3	3212.5	92.2	-117.4	187
Total (Group A through C)	42624.7	68870	-23464.8	6182.2	61.6	-134.1	126
D.Miscellaneous Items, Net	-6690.3	-3719.6	14516.9	2767.8	-44.4	-490.3	-81
Total (Group A through D)	35934.4	65150.4	-8947.9	3414.4	81.3	-113.7	138
E. Reserves and related items	-35934	-65150.4	8947.9	-3414.4	81.3	-113.7	138
Reserve assets	-37002	-65069.7	5649.1	-3011.7	75.9	-108.7	-153
Nepal Rastra Bank	-29637	-45751.3	4398.2	-7531.4	54.4	-109.6	-271
Deposit Money Banks	-7365.2	-19318.4	1250.9	4519.7	162.3	-106.5	261
Use of Fund credit and loans	1067.6	-80.7	3298.8	-402.7	-107.6	-	-112
Change in Net Foreign Assets (-Surplus)	**-29675**	**-44758.4**	**2619.1**	**-2182.7**	**50.8**	**-105.9**	**-183**

Source: Nepal Rastra Bank

II.A.3 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 not by the return of the financial investment but by trade. India is the single largest trade partner. It is also influenced by cultural proximity and open border with India. The peg of NPR-INR has worked as the anchor for price stability in Nepal. The present NPR-INR was fixed in 1993. Since then, it has not been adjusted

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

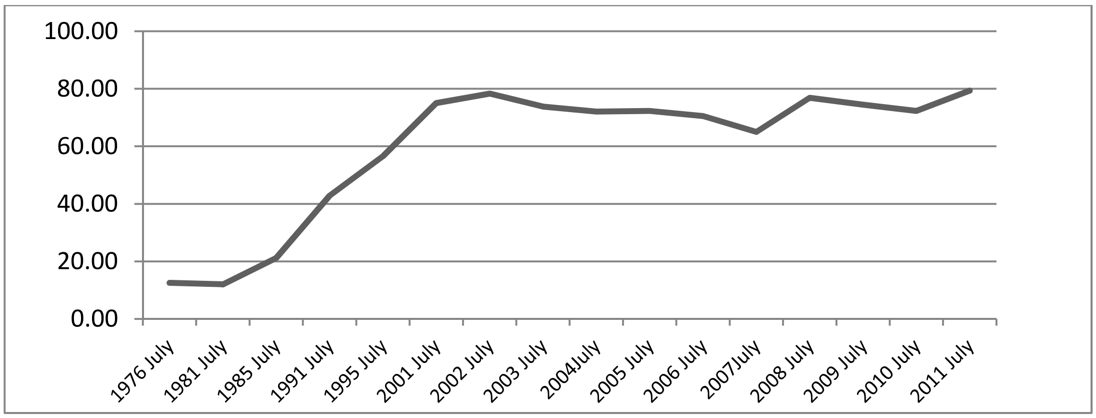
Many reforms were initiated in the area of foreign exchange management from early 1990s. Freedom to determine the exchange rate of the foreign currencies, except the Indian rupee, to the market; relaxations of rules and regulations for providing foreign exchange facilities; opening foreign currency account in local banks, amendment in foreign exchange management laws, permission to import selected goods from India in convertible currencies etc. are some of the important reform measures adopted over the period. Despite these reforms, there still remain restrictions in current account transactions. Nepal has not yet opened its capital account so far, but is in the process of opening it on different phases.

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

Figure 5 illustrates the exchange rate of Nepalese currency with US dollar since 1976. Nepalese currency has depreciated substantially against US dollar. It was somewhat stable from 2001/02 to 2007/08. Afterwards, exchange rate is significantly increasing till now. The depreciation of Nepalese currency is mainly due to the rising oil prices and the volatility in the international currency market i.e. sliding Euro against Dollar, and the Euro zone debt crisis in Italy, Greece and Spain. This continuing devaluation process is not because of Nepalese inflation rates, interest rates or increase in Nepal’s GNP, rather, it is simply because Nepalese rupee is pegged to the Indian currency. Exchange depreciation tends to cheapen domestic goods and services for non-residents and to make imports costlier. The currency of each country has a geographical limitation within which it can function as a legal tender. But, trade does not always take place within these geographical limitations. In a least developed country like Nepal, the various measures aimed at correcting unfavorable balance of payments are noted as stagflation, devaluation, and exchange rate controls. These measures are monetary in nature. In Nepal, the Nepal Rastra Bank (NRB) has come up with more than six monetary policies in the last couple of years. Before that also the NRB used to monitor the monetary policy of the country. A quick review of the history indicates that the Nepalese rupees are non-convertible currency.

Figure 5: Exchange rate of NRs with US dollar (Mid rate)

NRs/1 US dollar



Source: Nepal Rastra Bank

Table 4 illustrates the last four years foreign exchange reserve of Nepal. Although the total reserve increased by more than 60000 million US $during the period but there is significant decrease in 2010. Total foreign assets of the banking sector increased with NRs. 272153.1 million in mid July 2011 which was only 268907.1 million in mid July 2010. Similarly, the reserve with Nepal Rastra Bank slightly increased with 213095.1 million in 2011 July compared to previous same period with 205371.3 million. However, the Reserve with Commercial Banks has also collapsed with 59058 million compared to 63535.8 million in 2010 July. Based on the trend of imports for the first eight months of the current fiscal year 2010/11, the that foreign exchange reserve is sufficient to cover 10.1 months of goods imports and 9.0 months of goods and services imports.

Table 4: Foreign Exchange Reserve

(NRs million)

	2008 July	2009 July	2010 July	2011 July
Nepal Rastra Bank	169683.6	224190.3	205371.3	213095.1
Convertible	142848.8	201756	165992.7	165257.5
Inconvertible	26834.8	22434.3	39378.6	47837.6
Commercial Bank	42939.9	62345.2	63535.8	59058
Convertible	38827.1	58750.3	58222.2	55503.3
Inconvertible	4112.8	3594.9	5313.6	3554.7
Total Reserve	212623.5	286535.5	268907.1	272153.1
Convertible	181675.9	260506.3	224214.9	220760.8
Inconvertible	30947.6	26029.2	44692.2	51392.3

Source: Nepal Rastra Bank

II.A.4 Foreign Direct Investment

Nepal has been adopting market oriented economic policy since mid 1980s. Different policy initiatives have been introducing in Nepal to welcome the FDI. The industrial Policy and Industrial Enterprises Act were promulgated in 1987 which were the first attempts to provide legal framework for the foreign investors to invest in large and medium size industries. Moreover, some incentives including tax holidays were also introduced at that period. After changing in political regime in 1990, Reform process was continuously forwarded by the government through introducing new Industrial Policy, Industrial Enterprises Act, The Foreign Investment and Technology Transfer Act. Government opened the all sectors for foreign investment except some limited number of negative list. Tax holiday period was extended and provided guarantee for repatriation of equity, dividends and payment of principal and interest on foreign loans in convertible currencies. Furthermore, approval and licensing system was developed as much as simple; one window committee was formulated to facilitate the investors; some double taxation avoidance agreement was signed with some countries. Foreign Investment and Technology Transfer Act was amended many times to make environment more friendly, straightforward, transparent and encouraging for foreign investment. It has provided some tax incentives, concessional rate of custom duties and excise duty to import machinery, duty draw back system, bonded warehouse facilities, opening foreign exchange account and VISA arrangement. Industrial Policy 1992 was replaced by new industrial policy in 2010 which has ambitious objective to develop Nepal as a hot spot for foreign investment. This new policy simplifies the exit process, focuses on infrastructure up to factory sites for priority industries. Recently, government of Nepal has established Investment Board with the aim to create investor friendly environment. The chairman of this board is Prime Minister and some private sectors representatives are also member of this board. This board has authority to make long term strategies for investment and provide one window solution to resolve the investment issues.

Despite of these various kinds of institutional arrangements in Nepal, Foreign direct investment is not flowing significantly and almost lowest in south Asia. Following tables shows this underperformance. To attract foreign investment through adoption of relevant, practical, and liberal policy, more than 2108 industries are granted permission until FY 2010/11. Fixed capital of those industries stands at NRs. 129116.29 million with their total project cost of NRs. 152181.75 million. A total of NRs 68049.97 million as foreign investment in these industries has been recorded. Once in operation, these industries are expected to generate employment for 155432 Nepalese citizens. The main attractions to invest Nepal are manufacturing, service and tourism sector. In terms of foreign investment amount, energy sector is in second largest sector which indicates that energy sector will be main attraction in future because of the high potentiality of hydropower in Nepal. There was some attraction in manufacturing sector when Nepal got some quota for export carpets and garments. After ending this quota system, manufacture sector is not attractive now days due to higher transit cost for export. Almost 70% foreign investment based industries are located in Kathmandu valley and 15 % are established in Terai region. Only 15 % industries are located in whole hilly and mountain. This variation is mainly because of the condition of infrastructure and geographical location. Table 6 shows the FDI inflow amount in 2010/11 was significantly increased from NRs 9100 million in 2009/10 to 10050.71. In terms of GDP/FDI ratio, the FDI amount is still tiny amount. Nepal has varieties of reasons which are hindering the FDI inflow in Nepal. According to south Asia economic report of Asian Development Bank (ADB), the poor business climate, poor infrastructure, restrictive labor policy and labor unrest, political uncertainties and civil conflicts, weak regulatory systems, and rampant corruption are some identified bottlenecks that hinder FDI not only in Nepal but all in south Asia. Overall investment climate in Nepal is not conducive for investment. Particularly, Institutional bottlenecks are major factors to hinder its performance. Geographical situation is beyond the control but tourism sector has lots of potentiality in hilly and mountain area. Nepal is in between two large emerging countries China and India and there is huge potential to attract FDI from these two countries. Table 5 and table 6 show the current situation of foreign direct investment in Nepal.

Table 5: Number of Industries approved for foreign investment up to 2010/2011

Category	No. of Industries	Total Project Cost (in NRS Millions)	Total Fixed Cost (in NRS Millions)	Foreign Investment (in NRS Millions)	Total No. of Employment
Agriculture	60	1674.42	1095.61	893.29	3497
Construction	42	3605.34	2683.1	2762.81	3016
Energy Based	47	40759.24	40381.02	14518.77	7947
Manufacturing	712	54611.18	40355.5	25595.87	78409
Mineral	36	5162.62	4223.6	2090.24	5574
Service	650	29955.4	21220.18	12974.65	32127
Tourism	561	20413.55	19257.38	8400.34	24862
Total	2108	152181.75	129116.39	68049.97	155432

Source: Department of Industry.

Table 6: Foreign Direct Investment

Fiscal year	Number of industries	Foreign investment (NRs million)	% 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	0.94	10677
2008/09	230	6245	0.63	11068
2009/10	171	9100	0.76	7848
2010/11	209	10050.71	0.73	10887

Source: Department of Industry.

II.A.5 Foreign Aid

Foreign aid plays an important role in Nepal's socioeconomic development, representing 26 percent of the national budget. The main sectors receiving external support are education, local development, health, roads followed by drinking water, energy, agriculture, and peace and rehabilitation. Various economic and financial reform programs also receive significant external support. Nepal receives official development assistance from over 40 donors, including 35 resident agencies. The Ministry of Finance is mandated for the overall coordination of foreign aid in Nepal, including its allocation in line with national priorities. The Foreign Aid Coordination Division (FACD) of the Ministry of Finance is empowered, among others, to oversee the Government's activities in the area of aid coordination, harmonization and alignment.

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 the1950s, 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 periods. 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.

According to current three years interim plan, Unable to spend foreign aid in desired amount for the promotion of regional balance and in the sectors which help to make inclusive and equitable society, lack of investment environment in high return providing projects, weak receiving and utilization capacity of foreign aid, lack of increment in the mobilization of foreign aid in mega physical infrastructure construction in expected manner, lack of adequate preparation before making projects and programs contracts, unable to include all types of foreign aid into national budgetary system, unable to mobilize the assistance received through international non-government organization in national priority sectors in transparent and accountable manner, are the problems seen in the foreign aid mobilization.

Table 7: Foreign Aid

(NRs Million)

F.Y.	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
A. Commitment								
1. Bilateral	8223.6	21225.4	14755.5	17706.1	13106.4	27196.5	36900	31824
Grant	8223.6	21225.4	14755.5	17706.1	5620.9	23655	36900	24824
Loan	0	0	0	0	7485.5	3541.5	0	7000
2. Multilateral	15514.4	16926.9	6168.7	19316.8	36079.8	20778.8	59709	74276.7
Grant	733.4	4167.3	3508.8	13154.1	35443.3	19440.8	33357.8	39913.8
Loan	14781	12759.6	2659.9	6162.7	636.5	1338	26351.2	34362.9
3. Total	23738	38152.3	20924.2	37022.9	49186.2	47975.3	96609	106100.7
Grant	8957	25392.7	18264.3	30860.2	41064.2	43095.7	70257.8	64737.8
Loan	14781	12759.6	2659.9	6162.7	8122	4879.5	26351.2	41362.9
B. Disbursement								
1. Bilateral	9013.2	9230.8	7658.4	16406.4	10207.7	9333.1	22901.5	25850.4
Grant	8947.2	9104.3	7617.8	7401.8	9575.6	8720.2	18350.9	21738
Loan	66	126.5	40.6	9004.6	632.1	612.9	4550.6	4112.4
2. Multilateral	9899.2	14426.5	14383.4	9447.9	19092.9	27018.6	26867.9	32147.3
Grant	2336.2	5286.9	6209.7	8399	10745.1	17662.6	20195.1	24184.1
Loan	7563	9139.6	8173.7	1048.9	8347.8	9356	6672.8	7963.2
3. Total	18912.4	23657.3	22041.8	25854.4	29300.6	36351.7	49769.4	57997.7
Grant	11283.4	14391.2	13827.5	15800.8	20320.7	26382.8	38546	45922.1
Loan	7629	9266.1	8214.3	10053.5	8979.9	9968.9	11223.4	12075.6

Source: Ministry of Finance

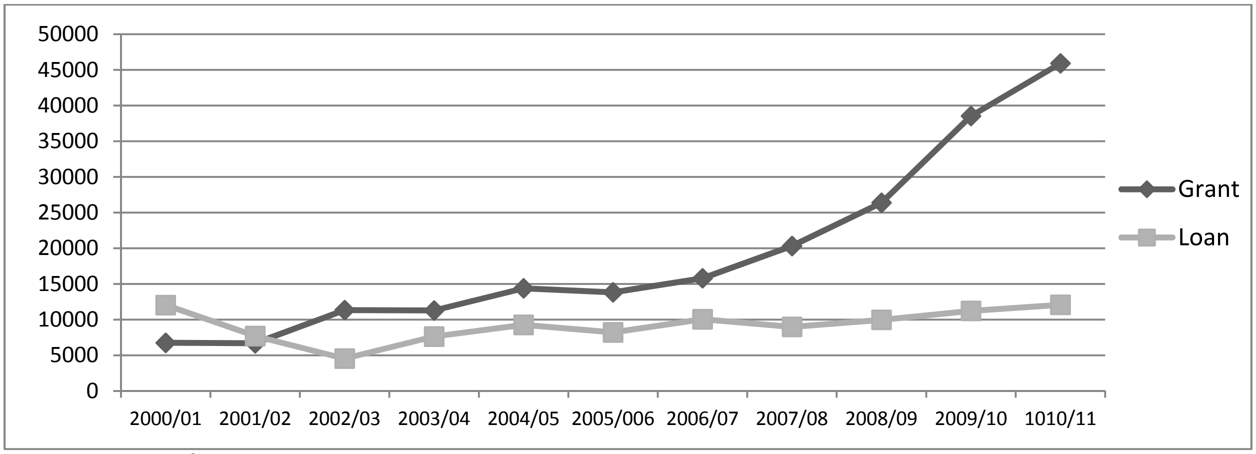
Above table 7 illustrates the 8 years foreign aid commitment and disbursement trend through multilateral and bilateral donor agencies. If we compare the disbursement trend, bilateral aid disbursement was increased around 3 times during this 8 years period. Only NRs 9013.2 million was disbursed in 2003/04 whereas NRs 25850 million was disbursed in 2010/11.Grants is increasing quickly than loan in bilateral aid disbursement during the given period. Similarly, multilateral aid has also risen smoothly and reached almost three times in 2010/11 compared to 2003/04. Multilateral loan amount has been dropping compared to previous years. Multilateral loan disbursement in 2003/04 was NRs 7563.3 million whereas it was NRs 32147.3 million in 2010/11. However, multilateral grants were dropped in the previous year but it has significantly increased later years. In total foreign aid, 44.57 % aid has been covered by bilateral sector and 55.43% foreign aid has been covered by multilateral sector in 2010/11. In total aid disbursement, 79.17% share has been covered by grants in 2010/11 whereas its coverage in

2003/04 was only 35.92. In contrast, loan had only 20.83% coverage in 2010/11 whereas it covered almost two third shares in 2003/04. These figures show the dramatic structural change in foreign aid within 8 years.

Figure 6 shows the composition of foreign aid disbursement. Foreign aid disbursement has been increasing. At the same time grant also has been increasing simultaneously but loan is almost remain stable.

Figure 6: Foreign Aid Disbursement

NRs in Millions

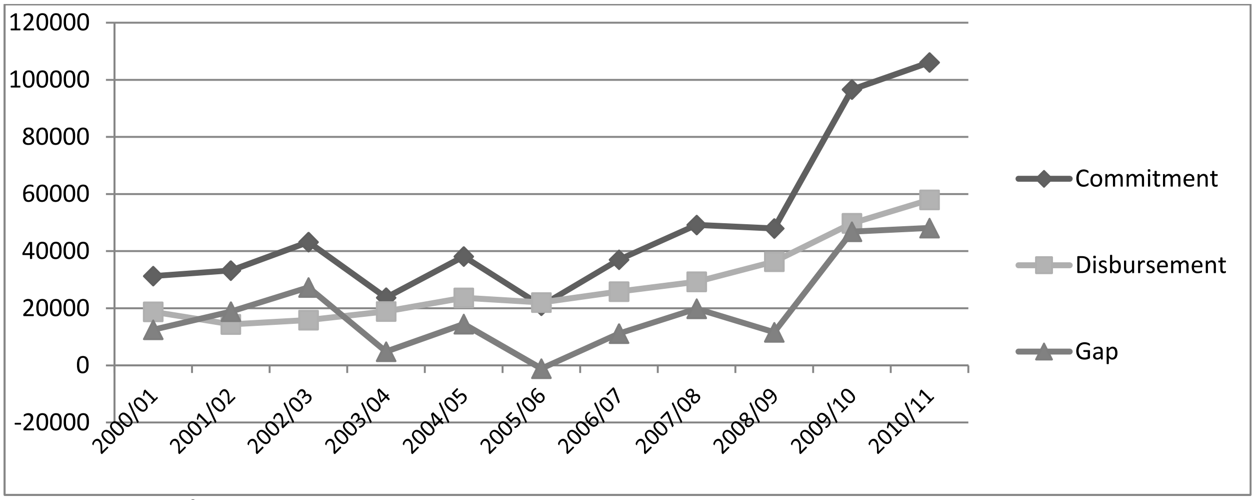


Source: Ministry of Finance

Figure 7 depicts the gap between foreign aid commitment and disbursement in Nepal during last 10 years. The gap is fluctuating but remains significantly and it rose last 2 years noticeably. Nepal has been taken one action policy to narrow down the gap in her foreign aid policy. However, it has not materialized due to the country's low absorptive capacity. Nepal received foreign aid commitment of NRs 106100.7 million in 2010/11 but this fiscal year witnessed a disbursement of NRs 57957.7 million which is only 54.62% of commitment. The donors and the government have some differences and reservations concerning foreign aid management in Nepal. The donors are not very happy with the foreign aid management in Nepal. They have their perspectives such as lack of ownership, lack of leadership and direction by the recipient, leakage and misuse of resources, a poor top down planning, lack of accountability and transparency and proliferation of projects are major concerns of donor's side. The government has also reservations with management of aid and with donor's perspectives. Such as mismatch of development priorities, lack of project planning, use of inappropriate technology and conditionality, gap between commitment and disbursement, channeling of aid through INGOs, rising debts, low absorption capacity, internal security problem, and shortcomings in institutional capacity are major concerns from the government side.

Figure 7: Foreign Aid Commitment and Disbursement

NRs in Millions



Source: Ministry of Finance.

B. Domestic Environment

II.B.1 Economic Growth Rate:

Economic growth rate is indispensable to expand the size of economy in every country. However, Nepal is facing low economic growth rate for a long time. Table 8 shows the economic growth rate trend of last 8 years in which economic growth rate is less than 5 % except 2007/08. Average growth rate of South Asian countries that was 7.3 percent in 2010 and Nepal is below than the average south Asian growth rate. Maldives, Sri Lanka, India and China have achieved double digit growth rate in 2010.

Agriculture sector has still remarkable contribution to the GDP in Nepal with 35% but its growth rate was very poor in last nine years. Nepalese agriculture sector is mostly depends upon rain fed water without proper irrigation. If there is enough rain in rainy season, agriculture sector contributes more and vise versa. On the other hand, due to long internal political conflicts and huge energy crisis, non agriculture sector has also not been contributing as expectation. In 2010/11, non agriculture sector's growth rate was 3.40% which is lower than previous year 2009/10.In non agriculture sector, hotel and restaurant sector has remarkable growth rate due to the improvement of tourism sector after the political movement. Transportation and communication and financial sector are also attending growth rate satisfactorily. Electricity and water sector has poor situation with in last 4 years and country has been facing serious energy crisis. Manufacturing sector has also not attending normal growth rate in which growth rate was 2.6 and 2.29 respectively.

Table 8: Sector wise economic Growth Rate

Percentage

F.Y.	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Agriculture	4.8	3.5	1.8	1	5.8	3	1.1	4.51
Agriculture and Forestry	4.7	3.4	1.7	0.9	5.8	3	1.1	4.47
Fishery	12.2	7.1	9.9	3	7.3	5.7	5.3	6.87
Non-Agriculture	5.3	3.2	5.3	4.4	5.9	4.7	5.1	3.40
Mining and Quarrying	-0.4	6.8	8.3	1.5	5.5	0.7	4.2	2.01
Manufacturing	2.2	2.6	2	2.6	-0.9	-1	2.6	2.29
Electricity Gas and water	4.1	4	4		1.1	-0.9	0.5	-0.46
Construction	-0.3	2.9	7.7	2.5	5.1	0.9	6.6	4.79
Service	6.8	3.3	5.6	4.5	7.3	6.3	5.5	
Wholesale and Retail Trade	10.8	-6.2	3.7		4.2	5.9	5.6	1.17
Hotels and Restaurant	12.7	-5.4	6.3	3.5	6.9	3	8.5	7.39
Transport, Storage and Communication	7.5	6.4	2.5	5	9.4	7.6	6.5	5.67
Financial Intermediation	6.2	24.3			9.2	1.5	1.6	3.30
Real Estate, Renting and Business Activities	-2.1	10	6.3		10.4	1.8	4.9	2.25
Public Administration and defence	-0.6	6.6	6.9	1.3	0.6	7.3	4.2	3.84
Education	5.1	9.8	3.7	7.3	6.4	11.3	6.5	2.97
Health and Social Work	6.1	11.3	5.9	6.5	8.5	11.2	5.6	5.29
Other Community,Social and Personal Service	13.4	-3.4	3.3		9.4	13	6.1	8.01
Total GVA including FISIM	5.1	3.3	4	3.1	5.9	4.1	3.7	3.78
Financial intermediation indirectly measured	30.1	6.2			7.3	7.2	7.2	3.05
GDP at basic prices	4.4	3.2	3.7	2.8	5.8	3.9	3.5	3.81
Taxes less subsidies on Products	8.6	6.9			10.1	16	16.2	4.64
GDP at producers price	4.7	3.5	3.4	3.4	6.1	4.9	4.6	3.88

Source: Central Bureau of Statistics

Table 9 shows the sector wise composition of GDP during last 8 years. Agriculture and forestry is the main source of GDP with 36.5% followed by the wholesale and retail market with 14.2 % in 2010/11.Transfromation of economy from primary sector to secondary sector has not been materialized because agricultural sector had 35.45 % contribution in 2003/04 and it slightly decreased from 2003/04 to 2009/10 but again increased in 2010/11. One very noticeable issue here is manufacturing sector is losing its contribution from 8.05% in 2003/04 to 6.2% in 2010/11. Electricity, water and gas sector has also same trend as manufacturing sector. Some sectors have more or less same contribution throughout the decade which is wholesale and retail trade, hotel and restaurant and construction and so on. Only financial intermediation sector has increased its contribution from 2.65 in 2003/04 to 4.7% in 2010/11.

Nepal is taking as strategy for attaining employment centric, broad-based economic growth, creating development infrastructures in its periodic plan. The agriculture sector growth is targeted at 3.9 percent on an annual average considering that the agriculture sector will be oriented towards commercialization with special attention given to agriculture sector, promoting co-operatives, irrigation, agriculture roads, agriculture credit, research and technology dissemination, rural electrification and development of market mechanism to increase production and productivity and the investment of the private sector. In the industrial sector, policy and procedural reforms will be carried out along with ensuring industrial security and institutional reforms to improve industrial climate. Special attention will be given to the development of industrial and commercial infrastructures and expansion of services, expansion and promotion of micro, small and medium-scale industries, ensuring industrial peace, focus on mining industry and creating environment for the full use of the actual capacities of the existing industries. With these emphases, the growth rate of this sector is estimated to be 5 percent.

Table 9: Composition of Gross Domestic Product by ISIC Division

Percentage

Industries	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Agriculture and Forestry	35.45	34.71	33.09	32.05	31.22	32.1	33.03	36.5
Fishing	0.48	0.47	0.49	0.47	0.5	0.55	0.52	0.3
Mining and quarrying	0.48	0.49	0.5	0.49	0.56	0.54	0.52	0.6
Manufacturing	8.05	7.92	7.59	7.48	7.34	6.83	6.25	6.2
Electricty gas and Water	2.31	2.26	2.09	2.13	1.95	1.61	1.49	1.1
Construction	6.42	6.47	6.5	6.47	6.95	6.78	6.64	6.7
Wholesale and retail trade	15.29	14.09	14.31	13.29	13.51	13.4	13.97	14.2
Hotels and restaurants	1.73	1.57	1.49	1.44	1.48	1.49	1.67	1.8
Transport, storage and communications	8.94	9.06	9.72	9.97	9.86	9.93	9.76	8.3
Financial intermediation	2.65	3.06	3.49	4.08	4.3	4.1	4.07	4.7
Real estate, renting and business activities	7.72	8.69	9.53	10.15	9.45	8.79	8.26	8.2
Public administration and defence	1.55	1.69	1.74	1.75	1.84	1.97	1.99	1.9
Education	5.08	5.59	5.55	5.87	6.25	6.69	6.67	4.9
Health and social work	1.12	1.24	1.24	1.23	1.41	1.49	1.46	1.3
Other community social and personal service activities	2.73	2.69	2.67	3.12	3.4	3.74	3.7	3.8

Source: Central Bureau of Statistics

II.B.2 Structure of Inflation:

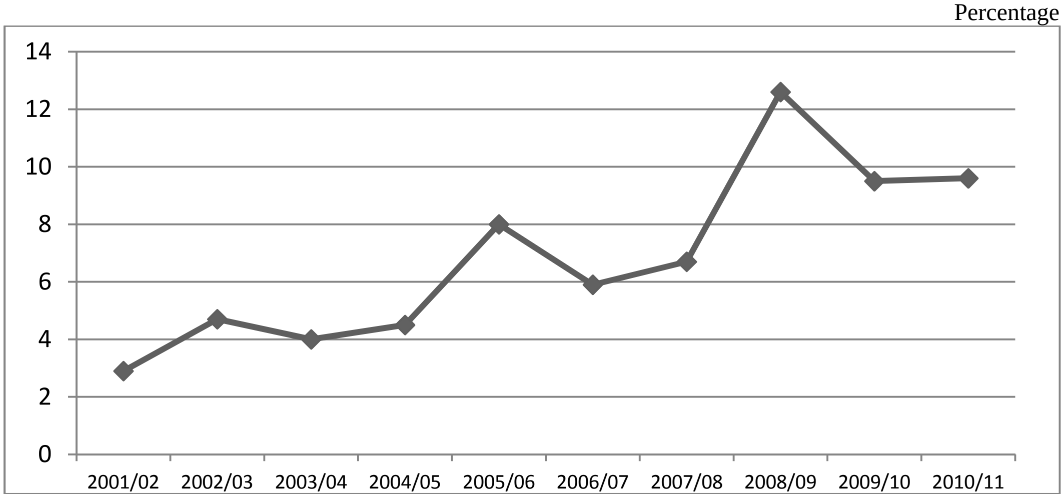
Some increases in the prices are required in the economy to encourage economic activities. Macroeconomic stability in the economy is necessary because high price rises affects the whole economy negatively. Price situation is affected by demand and cost as well as by supply aspect. The latest price situation in Nepal is impacted by cost and supply aspect and specially price oscillation of petroleum products in international markets and price situation in India rather than demand aspect. Although, the prime objective of the monetary policy is to maintain price stability, however, in recent years maintaining price stability by using the monetary instruments through banking system has been becoming more complicated. Weak administration has been seen as more responsible for price rises.

Increase in salary and wage rates, cartelling in price fixation, low growth rate of agriculture sector, increase in prices of pulses and food items due to effects in the supply system caused by control of food grains exports by India, and continuous increase in prices of sugar in the international market etc. are the causes behind the double digit inflation during the past 3 years.

Figure 8 show the consumer price index growth rate of last 10 years. It has clearly seen that inflation is in increasing trend and very high in last 3 years. It was more than 12% in 2008/09 followed by nearly 10% in 2009/10 and 2010/11. Inflation in 2010/11 was more than 4 times than 2001/02. Although, one major objective of monetary policy in Nepal is to maintain price stability, it has not been materialized properly in practice due to some non economic factors. Controlling inflation and maintaining favorable balance of payments on one hand and minimizing possible adverse impact from the shortage of monetary liquidity on economic growth and financial sector sustainability on the other are the standing challenges of monetary policy management at present. The continued pressure on inflation in spite of lower growth in money supply reflects that it is a structural problem rather than monetary. Inflation is driven especially by weak supply of food items. Increasing trend in labor export has pushed the cost of production of both agricultural and industrial production on the one hand and cost of fund has also increased on the other.The wage indices of agricultural and industrial labor increased which has created continued pressure on prices, therefore, was generated from lack of proportional increase in productivity and factor cost. Lingering political transition, weak labor relation, power crisis, inadequate physical infrastructure, lack of investment-friendly environment, lower capital expenditure by the government and structural bottlenecks of the economy are the sources of low productivity.

Figure 8: Growth rate of consumer price index

Percentage



Source: Central Bureau of Statistics

II.B.3 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	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Agriculture and forestry	62323	65591	69465	75849	86078	103747	124496	143622
Fishing	489	499	501	503	505	573	586	511
Mining and quarrying	649	708	810	879	1133	1313	1495	1795
Manufacturing	107267	115301	123035	134324	146922	164107	184079	204518
Electricty gas and water	7587	8338	9465	10265	11199	14506	16290	15818
Construction	33677	37521	42195	46647	57505	67452	78127	93258
Wholesale and retail trade	14936	15222	17151	17677	20096	24015	29583	36266
Hotels and restaurants	18679	19156	20079	22379	26034	31367	33857	49326
Transport, storage and communications	34986	38992	46099	52244	56307	67187	75760	76727
Financial intermediation	5639	5697	5960	8430	10369	11678	13152	15964
Real estate, renting and business activities	15000	18448	25656	29784	34252	37334	42911	50967
Public administration and defence	2663	3296	3321	4297	4872	5474	6679	8240
Education	7662	9471	9983	12389	14541	17849	21125	26313
Health and social work	2338	2808	3088	4084	4394	5231	6225	7694
Other community, social and personal service activities	5794	6460	6840	9185	10953	14335	16745	19439
Intermediate Consumption as purchasers price	319689	347509	383647	428936	485159	566168	651110	750459

Source: Nepal Rastra Bank

Table 11: Annual consumption at current price

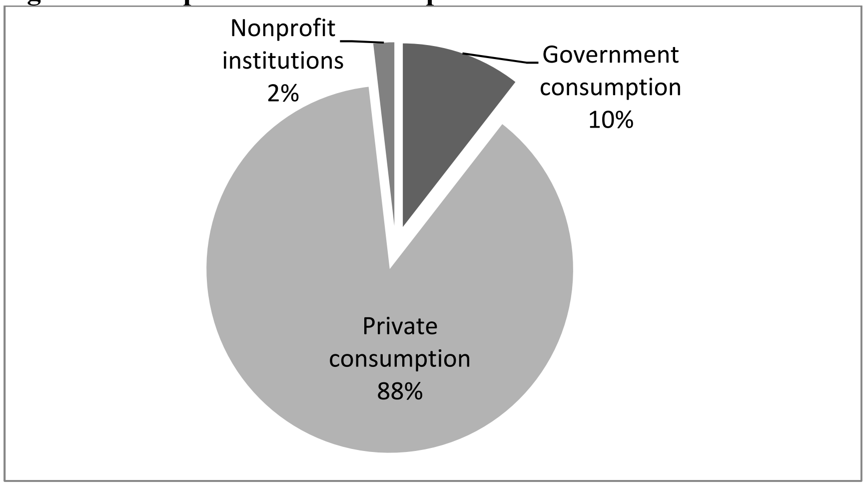
(NRs in Millions)

F.Y.	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Total consumption	473685	521301	595327	656374	735470	895018	1071929	1251421
Government consumption	46397	52453	56794	66949	80663	106503	136574	131664
Collective consumption	33960	34625	37105	43739	54996	69822	85881	88215
Individual Consumption	12437	17828	19689	23210	25667	36681	50693	43449
Private consumption	419290	459530	527814	576911	641085	772762	917066	1096653
Food	247381	271123	311410	340377	385037	484552	577150	687645
Non-food	120336	131885	151483	165573	179999	203232	240975	288414
services	51573	56522	64921	70960	76049	84978	98941	120595
Nonprofit institutions	7998	9319	10719	12515	13721	15753	18289	23104
Actual final consumption expenditure of household	439725	486676	558223	612635	680474	825196	986048	1163206

Source: Nepal Rastra Bank

Table 11 shows the annual consumption composition from F.Y. 2003/04 to 2010/11. In the fiscal year 2010/11 total consumption was increased by 16.74 %. In comparison with the GDP, this amount accounts for 91.38% of the gross domestic production of the country. In the fiscal year 2009/10, total consumption was 91..5% of the GDP. In the fiscal year 2010/11 government consumed 9.61% of GDP which was 8.92% 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 2010/11, 62.70% went to food consumption, 26.29% on non-food, and 11 % on services. Similarly, of the total private sector consumption of 76.82% of GDP in the previous year, share of food grains, non-food items and services was 62.93%, 26.27% and 10.78% 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 16.74 % in the fiscal year 2010/11 of which the private sector's consumption was increased by 19.58% and that of the government consumption was decreased by 1%. In the previous fiscal year, respective growth rates of the private and public consumption was 18.67% and 28.23% respectively. The increased public consumption is due to the excessive growth in recurrent expenditure. The ratio of gross consumption to GDP decreased by 0.12% and reached to 91.38% in 2010/11. In fiscal year 2010/11, the gross domestic savings in current prices has reached Rs 118008 million with decreased by 14 % compared to previous year. The growth of 47.47% was existed in 2009/10 compared to 2008/09. Despite the increase in consumption and decrease in saving, saving was 8.62% in 2010/11 slightly increased compared to 2009/10 with 8.5 percent. During the last decade (2001/02 – 2010/11) the ration of domestic saving with GDP has remained almost steady.

Figure 9: Composition of Consumption in 2010/11



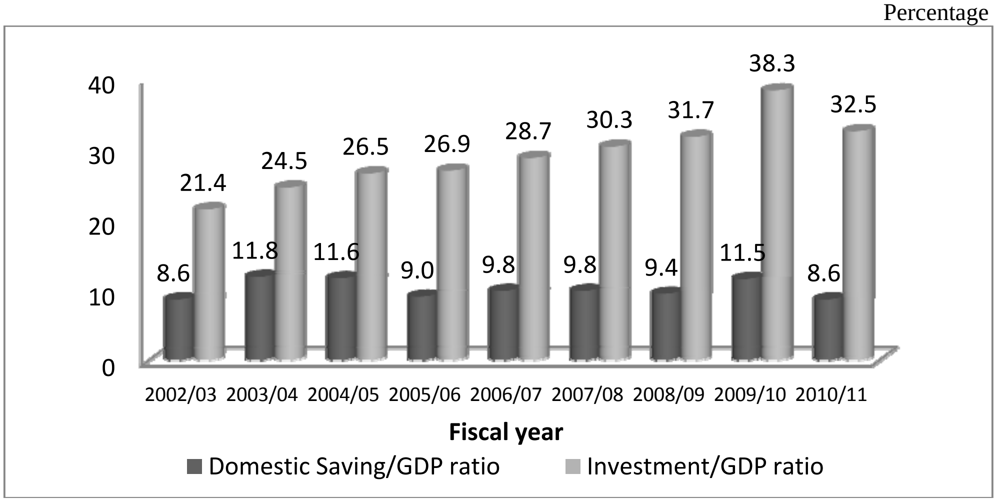
Source: Nepal Rastra Bank

According to the figure 9, the ratio of gross consumption to GDP decreased by 0.11 percentage point to 90.38 percent in 2010/11, thereby pushing the ratio of gross domestic savings to GDP reached to 8.62 percent. The ratio of Gross capital formation to GDP recorded 32.51percent in 2010/11, as against 38.3 percent in the previous year. The ratio of gross fixed capital formation to GDP stood at 21.22 percent in the 2010/11, which was 22.19% in previous year. The ratio of domestic savings to GDP at current prices, which stood at 8.5 percent in FY2009/10, slightly increased to 8.62 percent in FY2010/11. Similarly, the ratio of national saving decelerated from 38.31 percent in FY2009/10 to 31.64 percent in FY 2010/11. The ratio of investment to GDP was 32.5 percent in FY 2010/11 as against that of 38.3 percent in the previous year.

Nepal could not achieve the higher economic growth despite the five decades of planned development efforts. This is perhaps due to resource constraints. Political instability and armed conflict adversely affected the development efforts by deteriorating the internal and external investment environment. Frequent lock outs, obstruction, kidnapping, demand of excessive donation etc have increased the cost of economy, reduced competitive strength, and retarded the normal expansion of economic activities. Also, the dispute between laborers and industrialists has adversely affected the growth of industrial sector. The figure 10 shows the trend of Investment in Nepal for past nine years.

Figure 10: Saving Investment Gap

Percentage



Source: Nepal Rastra Bank

II.B.4 Capital Stock

Gross capital formation in constant price is estimated at Rs. 220062 million in the fiscal year 2010/11, which is 34.24 percent of GDP. Gross capital formation was dropped by 8.42 compared to the previous year. In the previous year gross capital formation stood at 39.12 percent of GDP with a growth of 34.43 percent. In fiscal year 2010/11, the share of fixed assets and change in stock in gross capital formation was 57.96 percent and 42.04 percent respectively. It was 52.98 percent and 47.02 percent respectively in the previous year. Out of the gross fixed capital formation in the fiscal year 2010/11, share of public sector was 21.60 percent and that of the private sector is 78.4 percent. In the previous year the share of public sector was 18.96 percent while that of the private sector was 81.04 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.

II.B.5 Money Supply

Money supply in Nepal has always been affected by its balance of payments. Around 42 percent of the Total money supply in Nepal during the 1980s was attributed to change in net foreign assets of the Banking system. An improvement in the balance of payments during the 1990s meant that the foreign assets of the banking system had an increased contribution. However, net domestic assets of the banking system had declined during the same period, effectively neutralizing the expansionary contribution of foreign assets. After a brief decline in the balance of payment conditions during 1995/96, the situation improved after 1997. Today, there is a balance of payment almost surplus and sometimes slightly deficit in Nepal. There were attempts made to neutralize the impact of balance of payment surplus on the money supply in the country. In order to do this, the NRB issued the NRB bills between 1991 and 1994. However, the NRB overdid the security instruments including the NRB bills, and as a result the interest rate on the NRB bills went up from 9.4 percent in 1992 to 11.1 percent in 1994. One of the reasons for this sterilization failure was the relatively inflexible exchange rate system in Nepal, mainly with regards to the Indian currency. If there were a rather flexible exchange rate system in Nepal, the effects would not have been so severe, and Nepal would not have experienced the high interest rates and excess monetary growth. However, if the NRB bills were not introduced, the money supply would have been even larger, even after accounting for inflation. The growth in the financial sector, attributed to the financial deregulation by the NRB on the IMF's insistence, has been miraculous in Nepal. The growth can be examined by looking at the money supplies in the economy. The growth in the ratio of broad money (M2) to GDP shows that the money supply has grown significantly, and this in turn shows the development of financial sectors in Nepal. The declining ratio of narrow money (currency) to broad money (M2) shows that use of currency has lowered significantly in Nepal, and this in turn, again, suggests the development of financial sectors in Nepal.

Table 12: Factors Affecting Money Supply

(NRs in Millions)

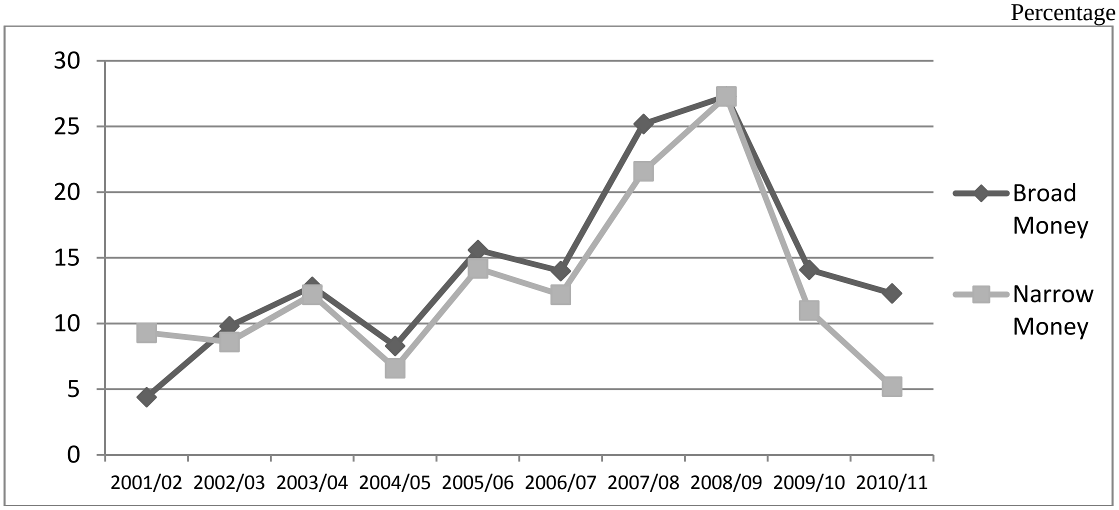
F.Y.	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Net Foreign Assets	25597.6	5904.2	29674.7	44758.4	-3631	2183
Net Domestic Assets	21384	42789.9	70184.3	90385.6	92708	98874
Domestic Credit	21829.5	37874.3	76711.7	118405.8	95307	115525
Domestic Credit	32876.1	53898.1				
Net Claims on Government	6673.5	7373	8736	17788.1	28261	26853
a. Claims on Government	6673.5	10495.6	9559.9	13841.7	28261	26853
b. Govt. Deposits		3122.5	823.9	-3966.4		
Claims on Govt. Enterprises	-2176	459	489	-848	1490	2912
a.Financial	-70	-95	-43	-294	1139	61
b. Non Financial	-2105	554	532	-554	351	2851
Claims on Non-Financial Govt.Enter	27	136	1130	2946	3260	-3012
Claims on Private Sector	17304	29907	66357	98520	62296	8877
Claims on Private Sector	28351	45931				
Net-Non Monetary Liabilites	445	-4916	6527	28020	2598	16651
Net-Non Monetary Liabilites	11492	11108				
Broad Money,	46982	48694	99859	135144	89078	101056
Narrow Money,	14183	13827	27456	42115	21700	6137
a. Currency	9142	5773	16622	25583	16356	2650
b. Demand Deposits	5041	8054	10834	16532	5344	3487
Time and Saving Deposits	32799	34867	72403	93029	67378	67378
Exchange Valuation gian(+)/Loss(-)	6099	-13434	9871	8348	-7985	651

Source: Nepal Rastra Bank

Table 12 shows the major factors affecting money supply from F.Y.2005/06 to 2010/11.According to the table in F.Y. 2010/11 net foreign assets has risen significantly than previous year. In previous year it was negative change. On the other hand net domestic assets increase slightly than previous year. Narrow money decreased significantly and balanced on 21700 million in 2010/11. In contrast, broad money increased significantly and reached on 101056 million in 2010/11. Broad money expanded by 12.3 percent in 2010/11 which expanded by 14.1 percent in the previous year. Narrow money, which had grown by 11 percent in 2009/10, grew by 5.2 percent in 2010/11. Of the components of narrow money, currency in circulation increased by 1.90 percent compared to an increase of 10.75 percent in the previous year. Demand deposits increased by 11.43 percent compared to a growth of 2.99 percent a year ago. Similarly, time deposits increased by 14.79 percent in 2010/11 compared to a growth of 40.27 percent in the previous year. Net foreign assets(NFA), after adjusting foreign exchange valuation gain/loss, increased by Rs. 651 million in 2010/11 in contrast to decrease of Rs. 7985 million in the previous year. An acceleration of trade deficits contributed to such a decline in net foreign assets. Figure 11 shows the trend of change in percentage of money supply.

Figure 11: Change in Percentage of Money Supply

Percentage



Source: Nepal Rastra Bank

II.B.6: Employment

It is the prime responsibility of state to promote employment opportunities by imparting knowledge and skills to national human resources in line with national and international labor market. To reduce unemployment, employers as well as workers and to create investment friendly environment, it is necessary to invest in labor management infrastructure. Currently, in Nepal, 2.5 million people of working age are unemployed and labor participation rate stands at 83.4 percent. Out of the total population, 30 percent is either unemployed or underemployed whereas four hundred thousand people are entering labor market every year. In this context, the emphasis of government would remain on increasing employment opportunities within the country; protecting the rights of workers; initiating reforms in labor law and administration to increase production and productivity; making foreign employment decent, safe and productive; increasing access of youth, women, indigenous people, people with disability, Madhesi, Dalits, conflict affected people as well as backward and poor people to productive employment; ensuring social security to workers and elimination of worst forms of child labor in accordance with international commitments. Findings of Nepal Labor Force Survey 2010 (NLFS) conducted by the Central Bureau of Statistics, shows that labor force participation rate is 80.1 percent; rate of employment is 97.8 percent or 79.1 percent economically active with 19.9 percent remaining inactive; 2.2 percent unemployed, and annual employment growth rate is 2.45 percent. As compared to the NLFS I (2003/2004) labor participation ratio increased. Likewise, agriculture sector covers 35% employment whereas 65% employed people is engage in non agriculture sector. With in non agriculture sector, construction sector has main contribution with 37% share followed by personal services and manufacturing with 25 and 17% respectively.

There are lots of issues which has to be addressed in employment sector. The absence of cordial industrial relations; lack of employment opportunities; inadequacy of the vocational and skill development training opportunities; inability to cater the needs of national and international labor markets for skilled human resources; failure in curbing frauds and abuses related to foreign employment; prevalence of child labor in formal and informal sectors; increasing number of child laborers due to conflict; and weak collaboration and coordination among national and international agencies constitute the main problems and challenges facing this sector.

Besides, foreign employment now is an alternative source of employment for Nepalese. The number of Nepalese going abroad for foreign employment has been increasing every year. The number was 35543 in 1999/00 and increased to 2108538 in 2010/11. The table below shows the trend of foreign employment. The data in table is official data. It is supposed the actual number is more than this because people use informal channels for foreign employment. Traditionally, India is the single largest source of foreign employment for Nepal, but it is not included here. The total number of people went for foreign employment up to year 2010/11 is presented in the follow table 13.

Table 13: Total Number of Foreign Employment

F.Y.	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Malasia	154215	220505	304667	378696	429240	464310	578292	684198
Qatar	106200	148152	206385	266094	351536	427711	483651	586617
Saudi Arbia	118324	131683	151190	190469	232863	296380	359780	430896
U.A.E.	51082	63585	80769	105941	151283	183441	216629	261093
Kuwait	7074	8760	9498	11939	13906	16197	24452	39639
Baharain	4595	4853	5383	6583	11682	15299	19533	24180
S. Korea	5155	5480	5676	6441	6587	9475	12007	15735
Oman	453	758	835	1344	3970	8217	11502	13944
Other Countries	6624	7624	9189	10618	26099	38596	47976	52236
Total	453722	591400	773592	978125	1227166	1447131	1753822	2108538

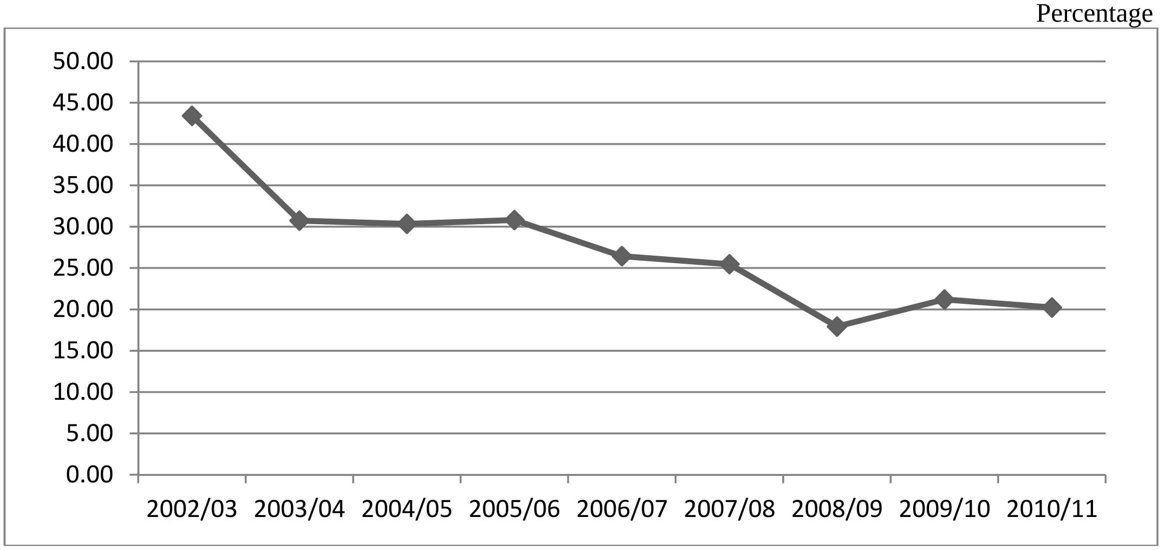
Source: Foreign Employment Department

Table 13 depicts the the number of people going abroad for foreign employment increased sharply from 453722 in 2003/04 to 2108538 in 2010/11. The number of people going to different countries in table 13 above has been presented in descending order. The most popular destination is Malaysia, followed by Qatar, Saudi Arabia, and UAE and so on in 2010/11. Out of total 2108538 persons, 32.44 percent people went to Malaysia, 27.82 percent to Qatar and 20.43 percent people to Saudi Arabia. Gulf countries are the major destinations of foreign employment. These countries occupy about 65 percent of foreign employment for Nepalese.

Below figure 12 shows the growth rate of foreign employment form Nepal which is in declining trend. Although total numbers of foreign employment is significantly increasing but growth rate is not in positive trend and it is almost steady since 2008/09 to afterwards. The main reason of this declining growth rate is decreasing trend of demand from abroad.

Figure 12: Growth rate of Foreign Employment

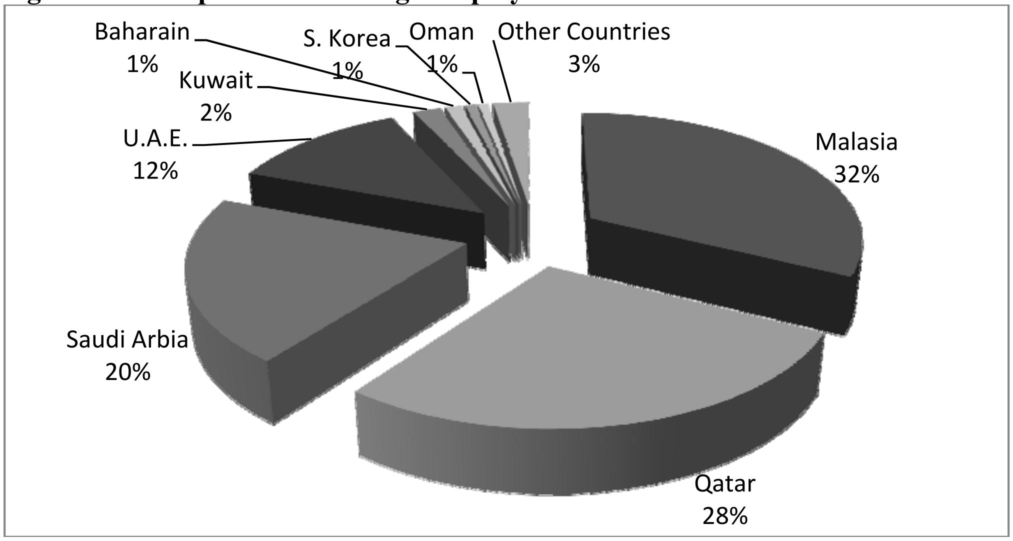
Percentage



Source: Foreign Employment Department

Figure 13 shows the composition of foreign employment in terms of different countries and numbers of employment.

Figure 13: Composition of foreign employment in 2010/11



Source: Foreign Employment Department

II.C Fiscal Position

II.C.1 Government Expenditure

It is the responsibility of the state to judiciously manage the public expenditure in productive sectors by maintaining balance between investment and savings. Although, there has been increase in the revenue collection in comparison to the past years, however, the current expenditure has been very high in relation to the projected targets whereas the proportion of the capital expenditure has been very low. The government expenditure, on cash basis, increased by 13.73 percent to Rs.295.36 billion in 2010/11 compared to an increase of 18.22 percent to Rs. 259.68 billion in the previous year. Growth in recurrent as well as capital expenditure accounted for such an increase in the government expenditure.

Table 14 shows the composition of government expenditure and source of financing. In fiscal year2010/11, the government's recurrent expenditure rose by 12.76 percent to Rs.170.29 billion compared to an increase of 18.22 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 2010/11, the capital expenditure went up by 19.51% to Rs 107.84 billion compared to an increase of 23.46% 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 2010/11

Table 14: Government Expenditure & Sources of Finance

(NRs in Millions)

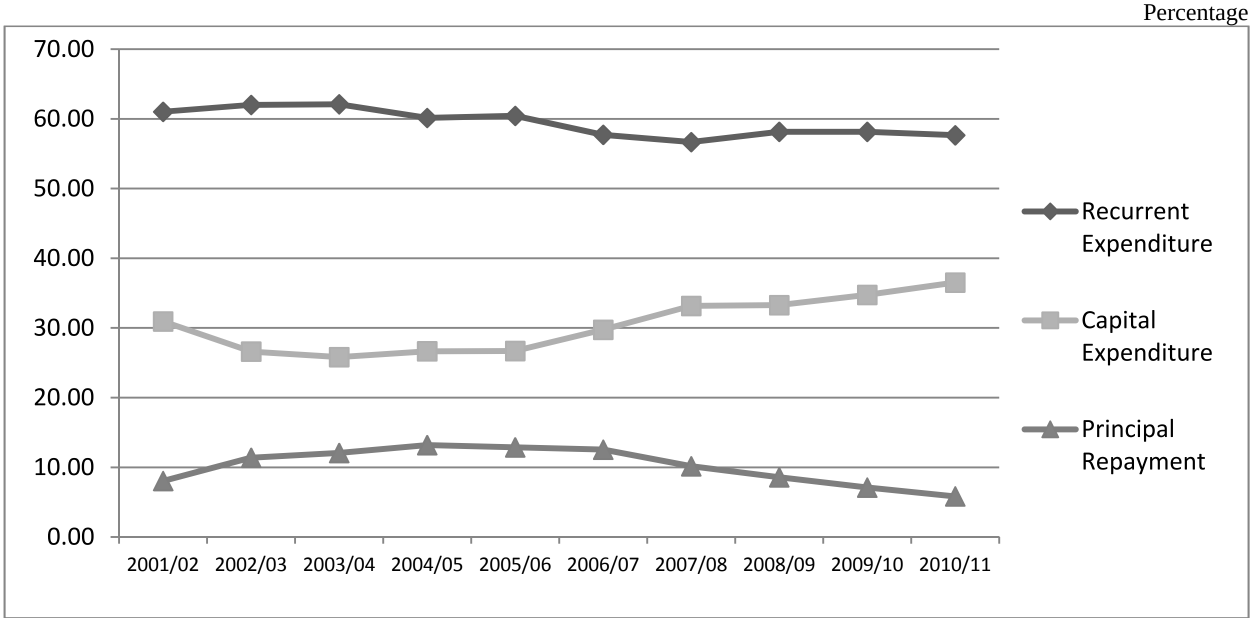
F.Y.	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Expenditure	89442.6	102560.4	110889.2	133604.6	161349.9	219661.9	259689	295363.4
Recurrent Expenditure	55552.1	61686.4	67017.8	77122.4	91446.9	127738.9	151019	170295.4
Capital Expenditure	23095.6	27340.7	29606.6	39729.9	53516.1	73088.9	90237.7	107847.5
Principal Repayment-	10794.9	13533.3	14264.8	16752.3	16386.9	18834.1	18432.3	17220.5
Receipts	73614.4	84513.9	86109.6	103512.9	127943.2	169857.3	218492	245741.2
Revenue	62331	70122.7	72282.1	87712.1	107622.5	143474.5	179946	199819
Foreign Grants	11283.4	14391.2	13827.5	15800.8	20320.7	26382.8	38545.9	45922.2
Overall Surplus(+) Deficit (-)	15828.2	-18046.5	-24779.6	-30091.7	-33406.7	-49804.6	-41197.4	-49622.2
Sources of Financing Deficits								
Foreign Loan	7629	9266.1	8214.3	10053.5	8979.9	9968.9	11223.4	12075.6
Internal Loan	5607.8	8938.1	11834.2	17892.3	20496.4	18417.1	29914	42515.8
Cash Balance (-)Surplus	2591.4	-157.7	4731.1	2145.9	3930.4	21418.6	60	-4969.1

Source: Financial Controller General Office.

Figure 14 reflects the trend of government expenditure composition. From fiscal year 2001/02 to 2010/11 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 14: Composition of Government Expenditure

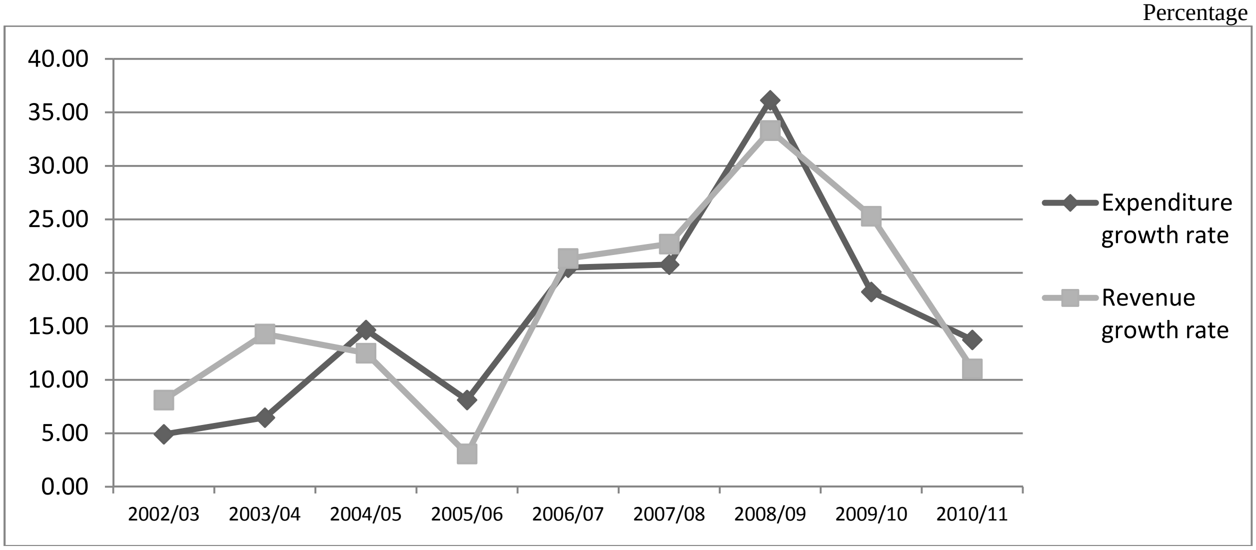
Percentage



Source: Financial Controller General Office

Figure 15: Growth rate of Expenditure and Revenue

Percentage



Source: Financial Controller General Office

The following figure 15 shows the trend of the growth rate of government revenue and expenditure for a period of nine years from 2002/03 to 2010/11. Up to 2003/04, revenue growth rate was high and since then the trend reversed and continued till 2006/07. The gap between revenue growth rate and expenditure growth rate was the highest in 2003/04. Revenue grew more rapidly than expenditure and the gap was about seven percent in that year. After 2006/07, revenue growth rate and expenditure growth rate ware almost equal up to 2008/09. Afterwards, Revenue growth rate was again high in 2009/10 but almost equal in 2010/11.

The main sources of government financing have been revenue, foreign aid (loan and grant) and internal borrowings. Table 15 presents the trend of government source of financing from F.Y.2003/04 to 2010/11. 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 15% of the total expenditure.

Table 15: Source of Financing

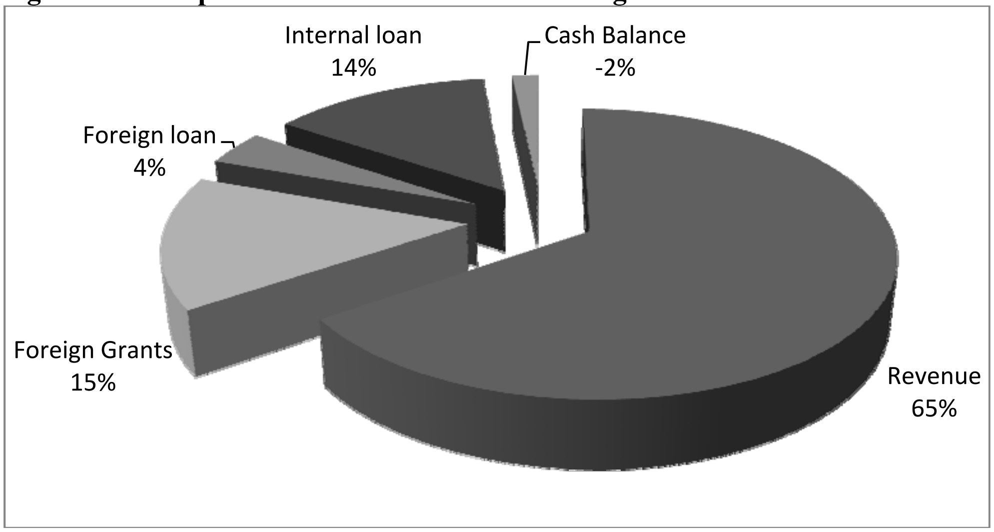
Percentage

Source	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Revenue	69.7	68.37	65.18	65.65	66.70	65.32	69.29	67.65
Foreign Grants	12.6	14.03	12.47	11.83	12.59	12.01	14.84	15.55
Foreign loan	8.5	9.03	7.41	7.52	5.57	4.54	4.32	4.09
Internal loan	6.3	8.71	10.67	13.39	12.70	8.38	11.52	14.39
Cash Balance	2.9	-0.15	4.27	1.61	2.44	9.75	0.02	-1.68

Source: Financial Controller General Office

Figure 16 shows the composition of government financing in F.Y. 2010/11. Total contribution of the revenue in total expenditure is 65%, which is followed by foreign grants with 15% contribution. The main sources of deficit financing are internal loan and foreign loan which have 14% and 4% share of total government expenditure.

Figure 16: Composition of Government Financing in 2010/11



Source: Financial Controller General Office

II.C.2 Public Borrowing

Nepal collects domestic loan from treasury bills, development bonds, national saving certificates, citizen saving certificates and special bonds. Among these, Treasury bill is the main source. Its share increased from 57.72 percent in 2001/02 to 65.32 percent in 2010/11. The share of development bonds and national saving certificates has reversed from 18.96 percent and 11.02 percent respectively in 2001/02 to 23.62 percent and 5.80 percent in 2007 respectively. Outstanding internal loan increased from Rs 60043 million in 2001 to Rs 184205.7 million in 2010/11. It increased by 24.41 percent as compared to the previous year 2009/10. The structure and ownership pattern of domestic borrowing instruments is presented in table 16 below.

Table 16: Ownership Pattern of Government Bonds and Treasury Bills

NRs in Millions

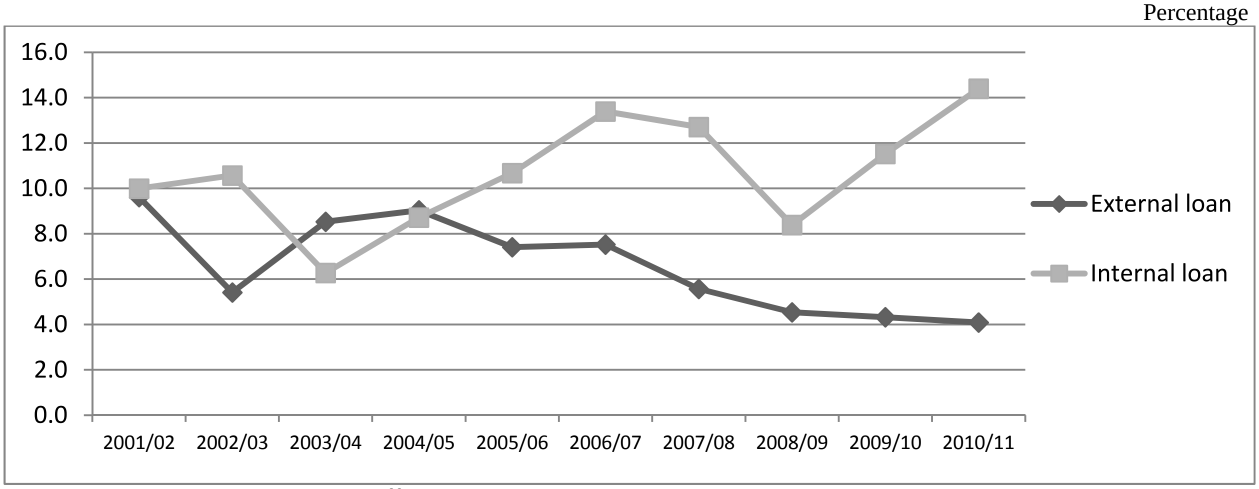
F.Y.	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Nepal Rastra Bank	19138.8	17445.8	15805	20101.9	23685.8	28883.3	38621.5	36541.3
Commercial Banks	43796.3	48550.7	58861.4	65836.4	72140.6	71292	82995.8	105940.9
Others	23198.6	21567.7	20044.4	17837.8	20213.1	25498.8	26442.5	41723.6
Total	86133.7	87564.2	94710.8	103776	116039.5	125674.1	148059.8	184205.8

Source: Nepal Rastra Bank

From the table 16, out of the total outstanding debt in 2010/11, Nepal Rastra Bank held Rs 36.54 billion (19.83 percent), commercial banks held Rs 105.94 billion (57.51 percent) and other non-bank institutions and private sector held Rs 41.72 billion (22.65 percent).

Figure 17: Share of Internal and External Loan on Total Expenditure

Percentage



Source: Financial Controller General Office

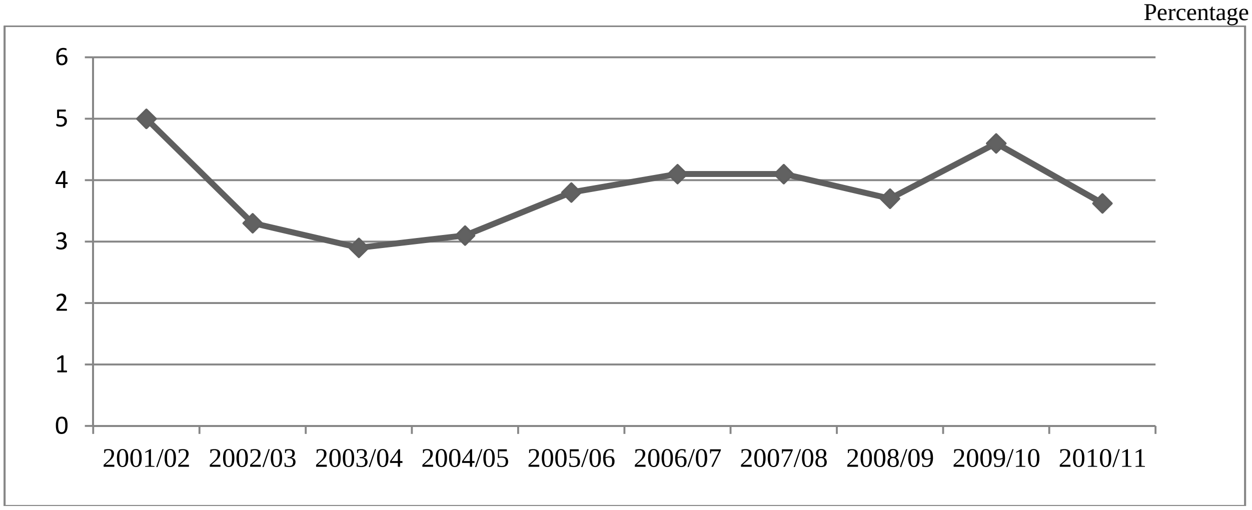
Figure 17 shows the trend of share of internal loan and external loan total government expenditure from F.Y.2001/02to 2010/11. The average share of internal loan and external loan to total government expenditure has been almost 14% and 4% respectively in 2010/11. In 2001/02, both has almost equal share with 10%. Afterwards, share of external loan has been continuously decreasing trend. However, internal loan has been expanding except in 2003/04 and 2008/09.

II.C.3 Fiscal Deficit

Deficit financing is one of the important phenomenons of fiscal position Nepal. Figure 18 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 2001/02 to 2010/11, it was decreased gradually after that it started to increase and reached to 49622.2 millions in F.Y. 2010/11. In terms of GDP ratio, it was 5% of total GDP in 2001/02 which was decreased gradually up to 2003/04 and started to increase after that and reached 4.6 of total GDP in F.Y. 2009/10 and again decreased in 2010/11 with 3.6% of GDP.

Figure 18: Fiscal Deficit (% of GDP)

Percentage



Source: Financial Controller General Office

II.C.4 Outstanding Debt Liability

Total outstanding debt liability of government of Nepal has been increased by 58.38% in last 8 years and reached NRs.443757.5 millions in fiscal year 2010/11. Ratio of External and internal loan as composition of total outstanding is changing gradually from 73% and 27% in 2003/04 to 58.5% and 41.5% in 2010/11. Table 17 shows the trend and composition of debt outstanding of government of Nepal.

Table 17: Total Debt Outstanding

(NRs in Millions)

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
External	232779.3	219641.9	233968.6	216628.9	249965.4	277040.4	256243.3	259551.8
Internal	86133.7	87564.2	94710.8	103776	116039.5	125674.1	148059.7	184205.7
Total	318913	307206.1	328679.4	320404.9	366004.9	402714.5	399756.4	443757.5

Source: Financial Controller General Office

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 33.48 percent in FY2009/10, came down to 32.4 percent during the same period of FY2010/11. External debt to total GDP ratios declined but domestic debt to total GDP ratio increased in this period. The ratio of foreign debt declined from 21.46 percent in the previous year to 18.95 in 2010/11 and domestic debt to total GDP ratio remained at 13.45 percent in this period as compared to 12.40 percent last year. In terms of outstanding debt in amount, it was 443.75 billion in 2010/11, comprising of Rs. 259.55billion foreign and Rs. 184.20billion internal, which grew by 11 percent (1.29 percent foreign and 24.41 percent domestic) .

III. Tax Structure: Institutions and the Reality

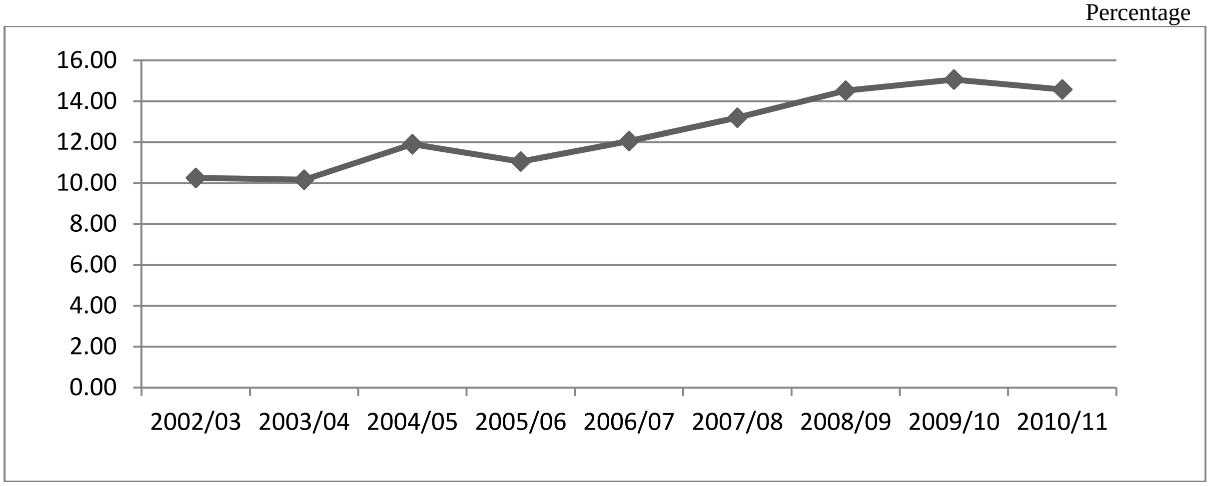
Taxation is a primary phenomenon of public finance. It has been recognized as a obligatory payment to the government irrespective of any benefits. There are particularly three roles of taxation; taxation is the key basis of revenue for financing various sorts of government activities, it has been used to safeguard equality in the society through income redistribution, and it can take part indispensable role to reallocate the resources through tax incentives to diminish the market distortion.

III.1 Revenue/GDP ratio

The ratio of revenue to Gross Domestic Product in Nepal is very low. Government in its three year interim plan (2010/11- 2012/13) has targeted to increase the ratio to 17.3 percent by the end of the plan.

Figure 19: Revenue/GDP ratio

Percentage



Source: Financial Controller General Office

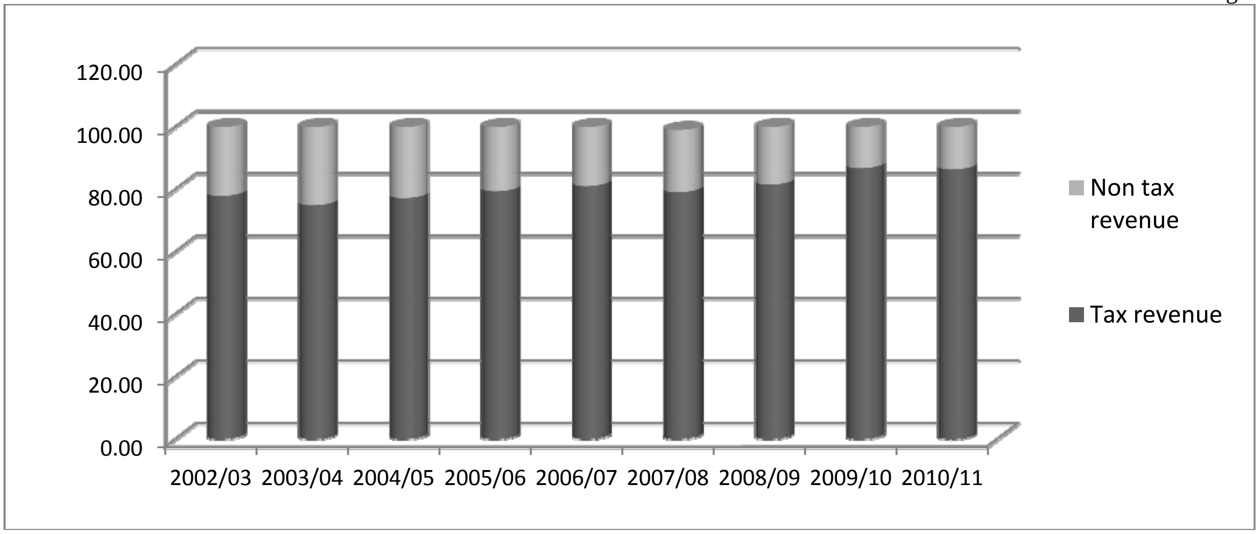
Figure 19 shows that the ratio of revenue to GDP continuously increased from 2002/03 and reached 14.5 percent in 2010/11 from 10.25 percent in 2002/03, but sharply decreased to 11.1 percent in 2005/06 compared to previous year. It gradually increased from 2006/07 to 2009/10 and sharply declined in 2010/11. It was 15.06% in 2009/10.

III.2 Tax Revenue and Non Tax Revenue

Government revenue in Nepal is divided into two parts- tax revenue and non-tax revenue. Tax is the main source of government revenue in Nepal. Government collects more than 80 percent of revenue from tax. The composition of tax revenue and non-tax revenue has been presented in the figure 20 below.

Figure 20: Composition of Tax revenue and Non tax revenue

Percentage

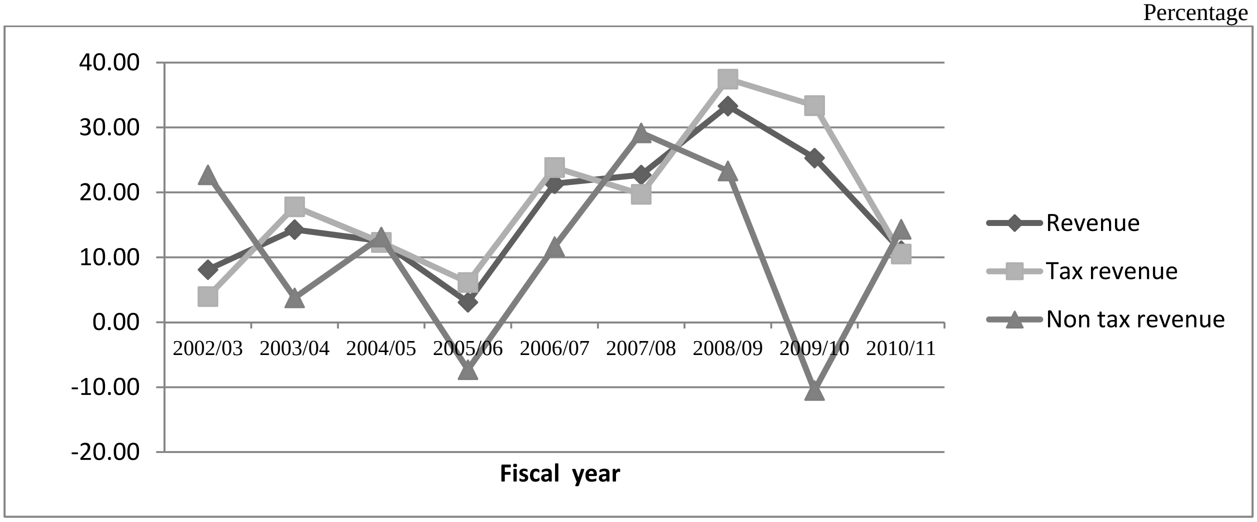


Source: Financial Controller General Office

The given figure 20 shows that contribution of non tax revenue has been slowly declining from approximately 22% in 2002/03 to 14% in 2010/11. One reason of this declining trend is poor situation of public enterprises which were the main source of royalty income. Because of the huge loss in almost 50% public enterprises, on tax revenue has been affected. Moreover, tax base has also been expanding with change in tax laws and procedure. The tax revenue contributed to Rs 39330 million and non-tax revenue contributed to Rs 11116 million in 2001/02 and both the components of revenue increased continuously over time and reached Rs 172573.2 million and Rs 27041.1 million in 2010/11.

Figure 21: Growth rate of Revenue

Percentage



Source: Financial Controller General Office

Figure 21 shows the growth rate of revenue, tax revenue and non tax revenue which are not following any particular trend. It depends upon policy and structural changes from the government. In 2008/09, revenue growth was around 33 % which is very remarkable. The reasons behind this are implementation of amnesty (Rebate) scheme in which taxpayer's can get some rebate if they want to pay their due amount with in the given period. At that time, government was able to reduce the significant amount of tax dues and to resolve the disputable cases. After that, it is not possible to maintain this significant percentage of growth rate for forever, it is declining. Non tax revenue is more fluctuating than tax revenue.

III.3 Composition of Tax Revenue

Tax revenue contributed around 86 percent in 2010/11. The share of tax revenue total national revenue has been increasing since after 2007/08. The composition of tax revenue has been presented in the table 18 below.

Table 18: Source of Revenue

(NRS in Millions)

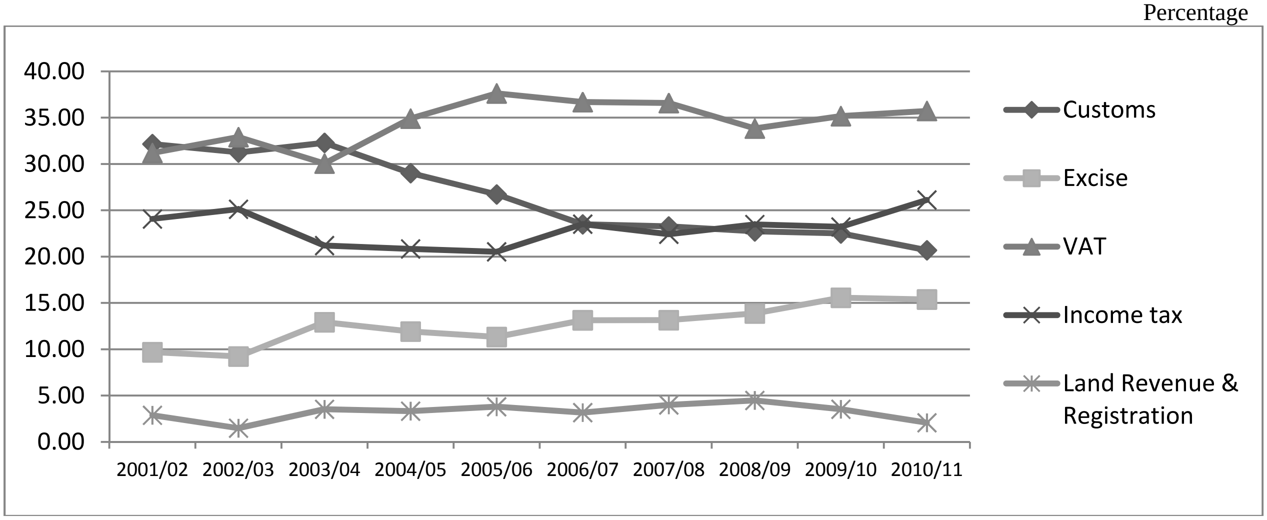
F.Y.	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Tax Revenue	48173	54104.7	57430.4	71126.7	85155.5	117051.9	156127.8	172573.2
Customs	15554.8	15701.6	15344	16707.6	19811	26620	35150.8	35711.6
Excise	6226.7	6445.9	6507.6	9343.2	11189.6	16237.4	24306.1	26542.9
Value Added Tax	14478.9	18885.4	21610.7	26095.6	31155	39604	54920.9	61663.6
Income Tax	10215.1	11272.6	11787	16726.8	19094	27480	36238.9	45082.6
Land Revenue and Registration	1697.5	1799.2	2181.1	2253.5	3403	5248	5511.1	3572.5
Non Tax Revenue	14158	16018	14851.6	16585.5	21426	26425	23650.9	27041.1
Total	62331	70122.7	72282	87712.2	107622.5	143474.5	179778.7	199614.3

Source: Financial Controller General Office

In the total tax revenue mobilization, VAT is the biggest source since 2003/04. The year 2003/04 was the turning point for VAT revenue and custom revenue. In this year the share of VAT continuously increased and vice versa for custom revenue. Income tax did well in later years and so was the excise revenue. The custom revenue decreased because of tariff reduction in line with commitments under WTO, SAFTA and BIMSTEC arrangements and it will further decrease in the future. On the contrary, since 2003/04 Value Added Tax continuously increased. Although custom revenue has continuously decreased from year 2003/04, the increase in revenue was boosted by the increase of its other components. This was partially increased by the increase of VAT rate from 10 to 13 percent in 2004/05 and government had tried to broaden its base so as to offset, to some extent, the loss of revenue from custom duties. This clearly indicates that VAT is going to be the major source of internal revenue for Nepal in the years to come. Similarly, excise revenue also increased during the period. It has become potential source of offsetting revenue loss from custom tariff reduction. VAT collection is almost four times more in 2010/11 than 2003/04 and reached NRs 61663.6 million. 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. Similarly, income tax collection has also same pattern of continuous increasing trend and reached NRs 45082.6 million in 2010/11. Customs duty has some fluctuations during this period but increased substantially from 15554.8 million in 2003/04 to NRs 35711.6 million in 2010/11. Besides, Excise has increased around 5 times more in this last 8 years from NRs 6226.7 million to NRs 26542.9 million in 2010/11. Land revenue has also increasing trend.

Figure 22: Composition of Tax Revenue

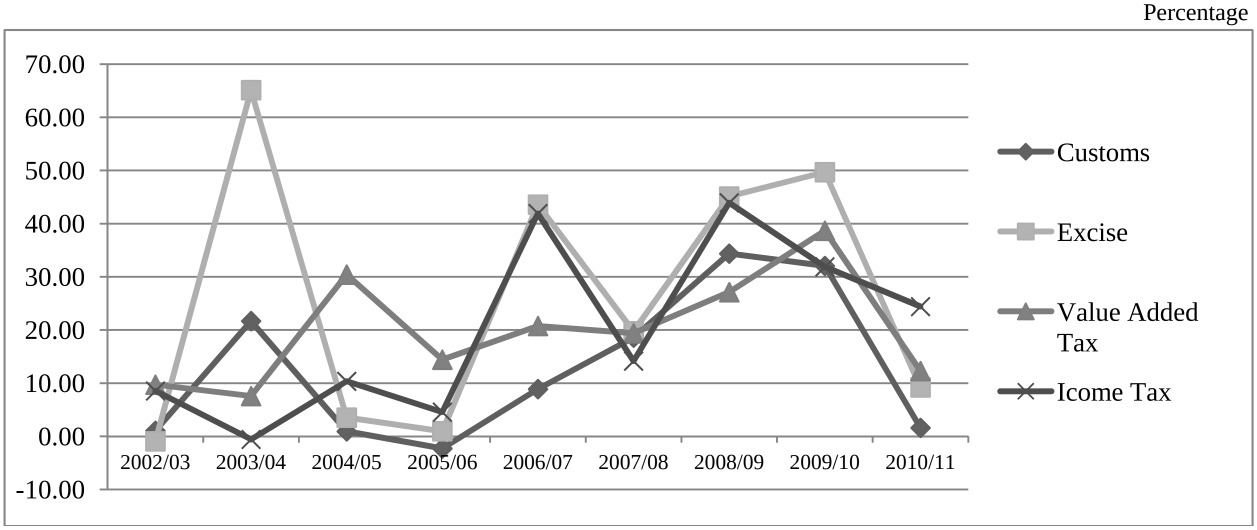
Percentage



Source: Financial Controller General Office

Figure 23: Growth rate of tax revenue

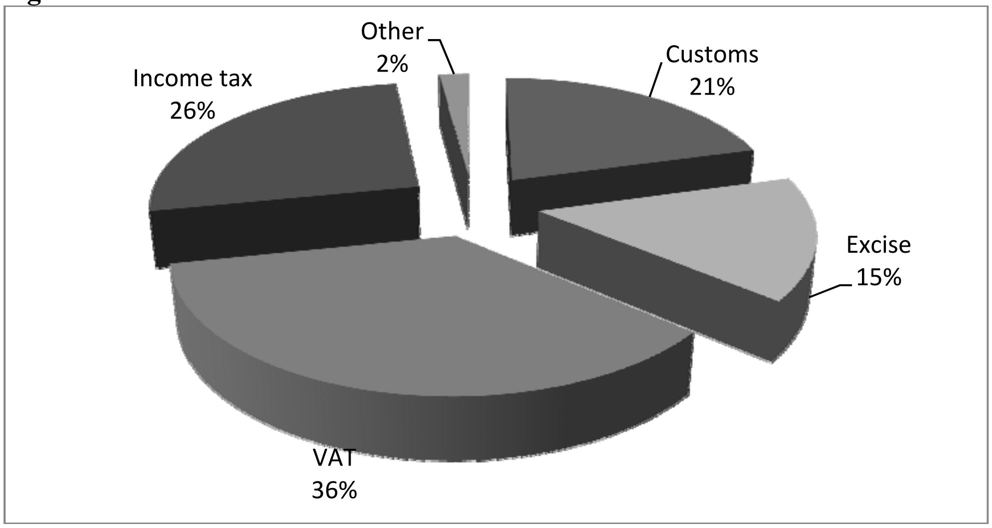
Percentage



Source: Financial Controller General Office

Figure 23 shows the growth rate of tax revenue during last nice years. All tax revenues have positive growth rate except customs in 2005/06 and 2006/07. Value added tax growth rate is very significant here. Particularly, VAT was revenue grew by12.28% in 2010/11 compared to previous which was 38% in 2009/10. In 2010/11, customs revenue rose by 1.60 percent to Rs. compared to previous year. In previous year this growth rate was 32%.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 in 2009/10.Income tax revenue increased by 24 percent in 2010/11 compared to an increase of 31.87 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 2010/11, excise revenue increased by 9% percent to an increase of 49 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 2010/11.

Figure 24: Tax Revenue in 2010/11

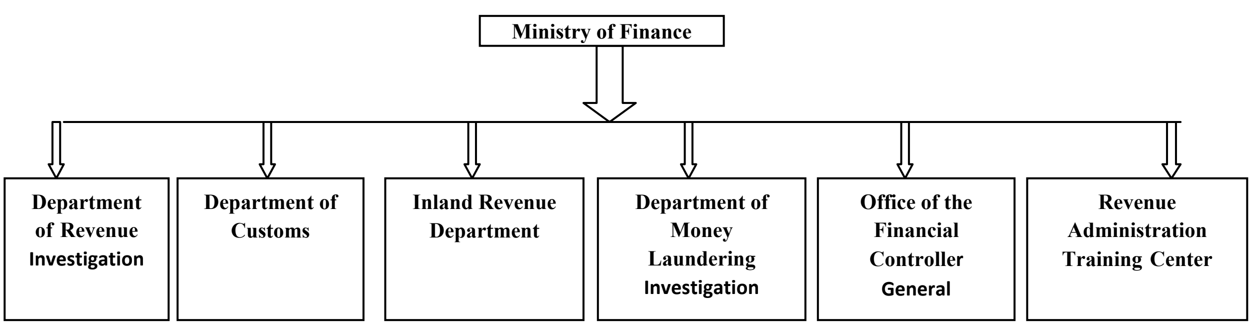


Source: Financial Controller General Office

Figure 24 shows the composition of tax revenue in 2010/11. It is clearly seen that VAT is the main source of tax revenue with 36% followed by income tax with 26% and customs duty with 21%. Excise duty has 15% share whereas others have 2% share in total tax revenue in 2010/11

III.4 Tax administration

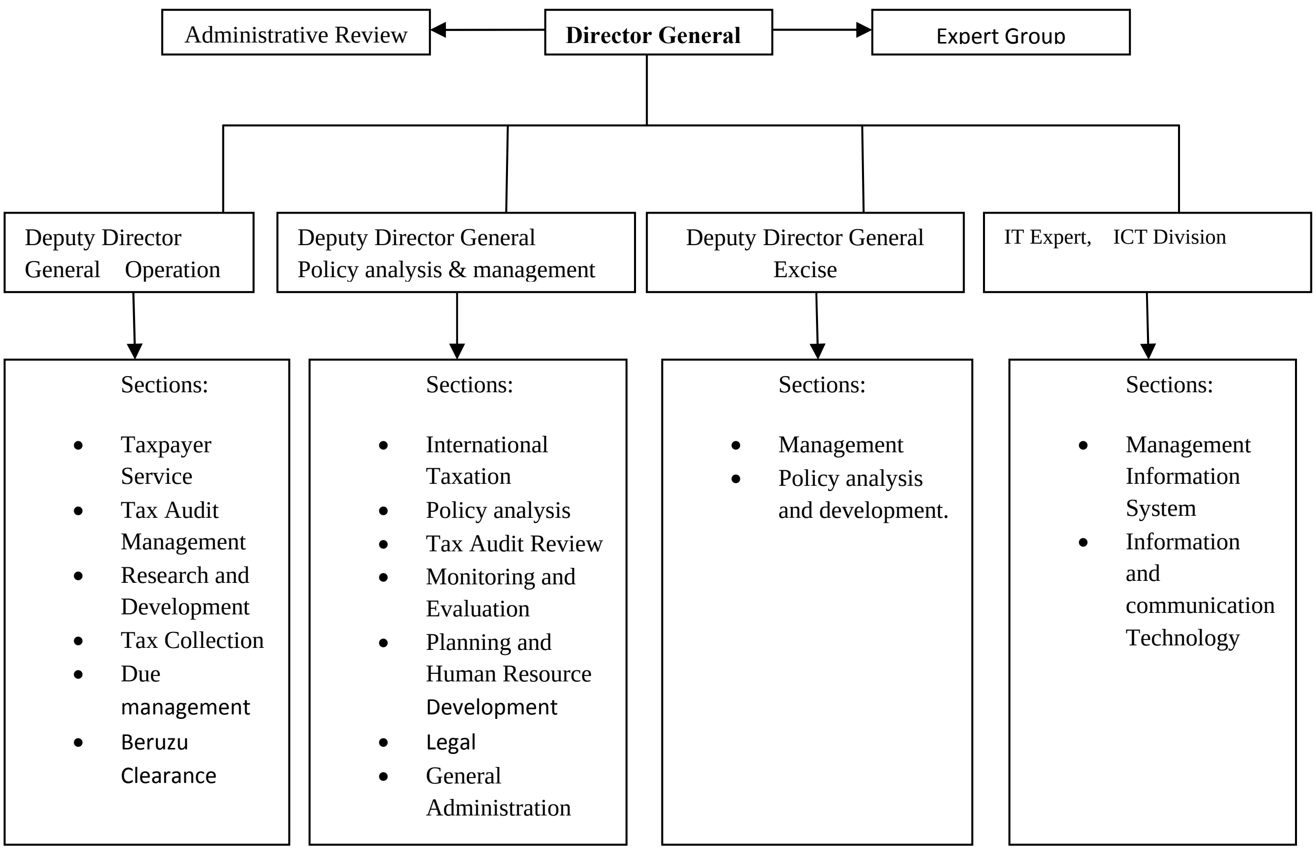
The Ministry of Finance (MOF) is the apex authority of the Revenue Administration. There are six Departments under the Ministry of Finance, namely, Inland Revenue Department (IRD), Customs Department, Revenue Investigation Department, Revenue Administration Training Center ,Department of Money Laundering Investigation, and Office of Financial Controller General. Revenue related former 4 departments have been introduced below. 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.



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. Organizational Structure of Inland Revenue Department has been given below;



Department of Customs

Nepalese Customs Administration collects Customs duty, Value Added Tax, Excise and other taxes at the border points. It accounts 42% of the total revenue and 50% of the total tax revenue. Customs duty alone contributes 22 % of the total tax revenue. Customs Administration is in the forefront in terms of internal revenue mobilization. This does not mean that the Customs role needs to be confined to internal revenue mobilization. It is equally important to enhance trade facilitation by adopting international convention, recommendation and best practices without compromising with the national security. There are 31 main Customs offices in all over the country (Including one at Tribhuvan International Airport) under the direct supervision of the department and 143 sub-customs offices under the supervision of main customs offices. Since Nepal is a land locked country, she does not have sea port customs. International Airport customs is headed by chief customs administrator of joint secretary level where as the other main customs offices are headed by either Chief Customs Officer of under-secretary level or Customs Officer and sub-customs offices by Customs Inspectors.

Department of Revenue Investigation

Revenue Investigation Division (RID) was established in the Ministry of Finance to take care of revenue leakage investigation and controlling economic crimes. At present, the DRI has four regional unit offices located at different Development Regions of the country. Controlling and investigation of revenue leakages, investigation and control of economic crimes and investigation are the clear mandate othis department given by the Government of Nepal.

Revenue Administration Training Center

Revenue Administration Training Centre another organizations under the Ministry of Finance for human resources development in the field of financial management, accounting and revenue administration for developing human capital in the concerned sector. has been conducting various activities like training needs assessment, curriculum and training modules development, teaching materials development and pre-service & in-service training organization in the field of revenue and financial administration over the years.

III.5 Tax Reform

Nepal has been adopting a variety of tax reform policies and programs for a long time period. We can segregate two period of Nepalese tax system.

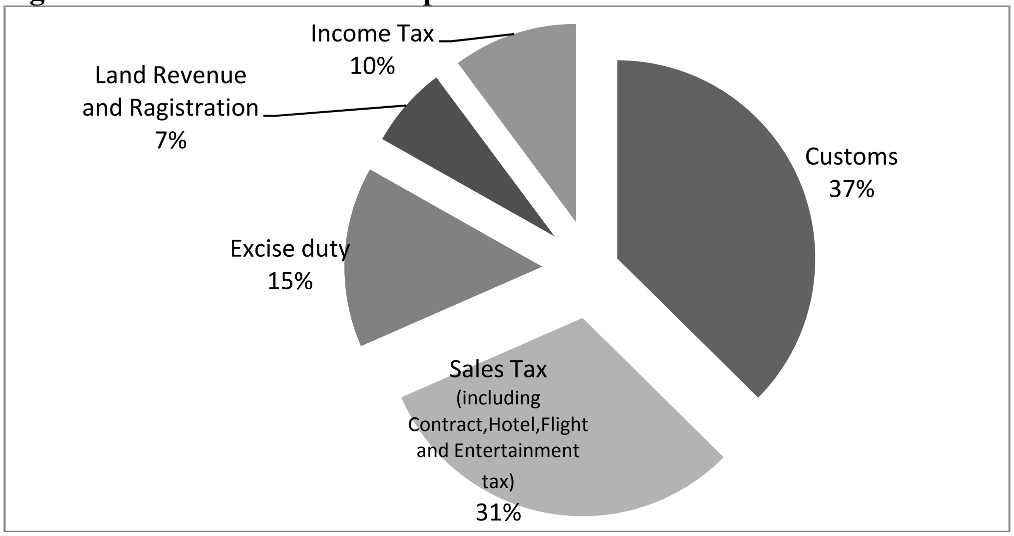
Before Middle 1990s

Policy: There was no clear cut revenue policy before middle 1990s. Government determined or revised the tax rates according to the revenue requirement. One objective of taxation was protection of domestic industries through laving higher import duties and income tax exemption. There were plenty of tax related acts to provide tax exemptions, tax reliefs and deductions which made tax law and procedures more complicated. The legal coverage of Income tax was also very narrow due to closed economy and enormous incentives.

Structure: Narrow based tax system with higher and multiple tax rates were the main characteristic of that system. Tax arrangement was quite traditional principally based on discretionary authority on tax administration. Income tax rate was maximum 40% of net income and forms were also complicated and redundant. All tax returns were assessed by tax officer based on their own judgment. Taxpayers were not smart to keep their account properly and to justify their tax liability. Tax officers had arbitrary tax assessment power to reject the taxpayer's financial statement and to re-assess the tax liability without any strong evidence which fostered to harass the honest taxpayer and ultimately promoted towards corruption. Tax administration never accepted loss in business and assessed tax liability as incremental basis.

There were 4 types of goods and services based taxation: sales tax, hotel tax, contract tax and entertainment tax with different tax rates (maximum 60%) and more than 500 goods were levied with different rate of excise duty. Custom duty had higher contribution of revenue where more than 300 types of duty rates (maximum 450%) were levied. The main objective of the custom administration was revenue mobilization. License was necessary for import. Custom administration had already prepared list of goods and value (set value) and importers were supposed to accept that value and paid custom duty.

Figure 25: Tax Structure of Nepal in 1990/91



Source: Financial Controller General Office

Figure 25 clearly indicates the situation of Nepalese tax structure before starting new tax reform policies where customs was the foremost position with 37% and share of income tax was very low with 10%.

After Middle 1990s (Modern reform with policy departure)

Policy Departure: When Nepal initiated to execute the structural adjustment program (SAP) since 1986, lowering the customs duties was one of the big steps to liberalize the economy. After restoration of democracy in 1990, economic liberalization policy was grown very rapidly. The main policy changes are mentioned below:

- Removing the concept 'protection of domestic industry through import duties' and maintaining the tax policy neutral to the economic growth.
- Lowering the custom duty rates and types gradually and reducing the dependency of custom duties to the tax revenue.
- Broadening the tax base and imposing few tax types with lower rate instead of higher tax rates and different types.
- Developing value added tax (VAT) as a main source of domestic resource mobilization.
- Developing fair and transparent tax system.

Structural Change: Self assessment system was introduced in income tax, VAT was adopted instead of hotel, entertainment, sales and contract tax, self declaration in customs etc. Tax system was made fully account based. Following points were the main elements of structural reform:

- **Broadening the tax base**: This was one major element of tax reform. There were lots of incentives, exemptions and deduction in old system which made tax base very narrow and complicated. Narrow based tax system promotes the high tax rate to the limited area for collecting adequate tax which affects the saving and investment. Indeed, higher tax rate helps to persuade taxpayers towards tax evasion. New income tax act was introduced in 2001 which fully adopted the account based and self assessment system. Income from business, employment, investment and capital gain were identified as income. All incentives, deduction and exemptions were suspended and only limited into the new act. Value added tax was implemented from 1997 which is modern tax system and already proved as a successful tax for broadening the tax base because it is levied in every stage of value addition to good and services.
- **Leveling the structure of tax rates**: Income tax rate and level were reduced and fixed two rate 15% and 25% instead of maximum 40% rate. Other South Asian countries India, Pakistan and Bangladesh also cut the income tax rate significantly. Only single tax rate 10% (now 13%) was

set up in VAT instead of maximum 60% sales tax rate. There were 300 tax rates with maximum 450% rate in custom. Custom rates were drastically reduced. Now there are only 6 rates and 80% maximum rate instead of 300 types and 450% duty rate.

- Simplifying tax system: One objective of the reform was simplifying the policies and procedure which promotes the tax compliance and ultimately enlarges the tax amount with low doing business cost. One single tax law VAT Act was enacted instead of sales, entertainment, contract and hotel tax law was the major steps to simplify the law and procedures. VAT was administered through fully computerized system, permanent account number (PAN) was introduced for identification of taxpayer and dismissed the annual renewal system of income tax registration certificate. In custom administration, licensing system for importing was removed and self declaration system, computerized declaration form were adopted to simplify the custom service.
- **Improving tax administration:** Administrative capacity with professional tax officials is one major prerequisite for good tax system. Considering this issue, separate revenue group was formed to develop high professionalism and expertise. One integrated administration (Value added tax department and Tax department were merged and Inland Revenue Department was established) was established to provide tax services from single door.

From that period, reform process has been continuously going ahead very rapidly. Current main reforms steps are given below;

- **Policy reform**: Broadening the tax base, reducing the compliance cost, promoting investment, enhancing voluntary compliance, developing taxpayer friendly tax administration are the main policy direction of current reform. Stability of tax policy is one foremost precondition for economic efficiency. Government has taken policy stability as one objective.
- **Functional Reform**: IT based tax administration (e-based tax governance) is one ambition of tax administration. E-VAT, E-TDS (tax deduction at source), E-PAN (Permanent Account Number), E- Return, E-installment return, E-based monitoring are some examples which has been implemented for modernizing the tax system. IT based system can contribute for reducing the cost of taxpayers as well as tax administration. It also helps to maintain transparency in tax procedures. Tax administration can hire some expert services such as Charter Accountant, Cost Engineer etc in contract for quality audit of tax returns. IT based risk engine has been developed to select the taxpayer for auditing.
- **Structural Reform**: Tax offices have been developed as functional organizations. Reducing the gap and enhancing the excess between tax offices and tax payers has been taken as one objective of tax administration. Recently both Inland Revenue Department and Customs Department have been restructured for cost effective and qualitative services.
- **Human Resource Development:** *'Functional indicators based incentive system'* [1] has been implemented in all revenue related unit offices to developed highly motivated, professional and well disciplined human resource.
- Tax incentives: Government has tried to facilitate foreign direct investment as well as domestic private investment through tax incentives. Tax credit system has been introduced where taxpayer can claim the foreign income tax paid as credit. Only 20% income tax rate is levied for export income instead of 25%. Flat rate income tax rate (5%) has been levied for repatriated income of foreign permanent establishment of nonresident person. Special provision of loss carries forward for big infrastructure investment and global long term contract have been established. Double tax avoidance treaty has been taken as a tax policy for promoting foreign investment. Zero rate system has been set up for export in VAT to promote export trade.

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[1] Functional indicators based incentive system has been implemented in all unit offices of Inland Revenue Department and Custom Department in which functional indicators for all sections have been prepared by the government. Corresponding department gives the section wise targets for monthly and annually, fix the standard and ties up with certain percentage of salary as allowance if they achieve or exceed the allocated target. The maximum limit of this allowance is 100% of basic salary.

Government of Nepal has taken following revenue reform objectives three years reform plan 2012/13 to 2014/15;

- Policy reform and enhancement of enforcement.
- Improving taxpayer service and education.
- Optimal use of modern technology.
- Revitalizing Inland Revenue Department's organizational structure and mobilization of competent human resources.

III.6 Legal Framework

Nepalese tax administration fully adopted the principle of "no taxation without representation" principle. It is clearly insured in constitution that without ratification from the parliament, government cannot impose new tax or cannot reduce or increase the rate and cannot remove the tax. Parliament make act and provide some mandate to the government to make regulation under the act. Government only can manage some operational matters based on the mandate provided by parliament. Parliament can change some tax policies through finance bill every year. Following acts are main tax related legal foundations currently.

- Income Tax act, 2000 and Regulations, 2002.
- Value Added Tax,1995, and Regulations,1996
- Excise Act,2000 and Regulations,2001
- Liquor Act,1973, and Regulations, 1975
- Customs Act,2007, Regulations,2008
- Revenue Leakage (Investigation and Control) Act,1995

III.7 Taxpayer's 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.8 Tax Specific Analysis

III.8.1 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.

Income Heads

The Act imposes tax on those activities contributing toward the creation of wealth. Wealth is reated 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:

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

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 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.

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).

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 3,500 Rs. 2,000 and Rs.1,250 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 19: Income Tax Rate for Resident Individual

S.N	Annual Taxable income for single	Annual Taxable income for couple	Tax Rate
1	Up to NRs 160,000	Upto NRs 2000,000	1%
2	From NRs 160,000 to NRs 260,000	From NRs 200,000 to NRs 300,000	15%
3	From NRs 260,000 to NRs 2,500,000	From NRs 260,000 to NRs 2,500,000	25%
4	Above NRs 2,500,000	Above NRs 2,500,000	35%

Source: Income Tax Act, 2000

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 20: Withholding Tax Rate

Withholding Agent	Payment	Tax Rate
I. Adjustable Withholding		
Employers	Remuneration	15- 35 %
Resident person	Natural resource payment; royalties; service fees etc	15%
Resident Bank or financial institution	Interest	15%
Resident person	Rent	15%
Resident person	Insurance premium for nonresident company	1.5%
Resident person	Payment against VAT invoice	1.5%
Resident person	Service contract	10%
Resident person	Other contracts	5%
Resident person	Gain from stock	15%
II. Final Withholding		
Resident company	Dividend	5%
Resident banks and financial institutions	Interest paid for non- business purpose	5%
Resident person	Rent for lease of land or building	10%
Retirement Fund	Retirement Benefit	5%
Resident employment company	Commission to non-resident	5%
Resident person	payment of Insurance premium	5%
Resident person	Insurance premium to non-resident company	1.5%

Source: Income Tax Act, 2000

Capital Gain Tax

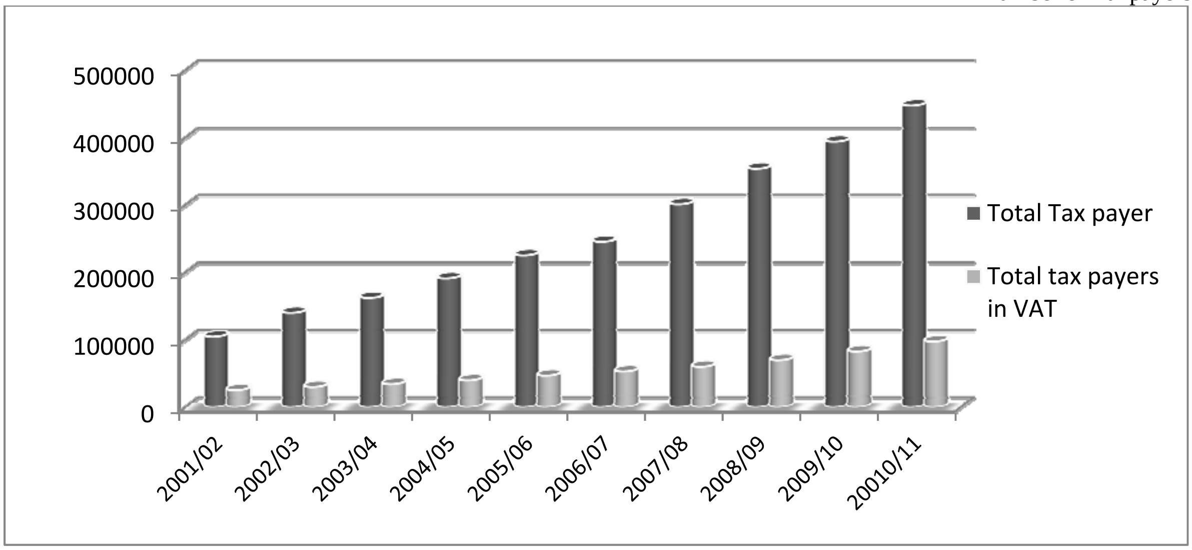
The Income Tax Act, 2002 has introduced capital gain tax. However, the Act does not cover all such gains i.e. only those gains, which are received from the disposal of business assets or liabilities and those from the disposal of non-business assets of an investment of a person, which are regarded as 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.

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..

Figure 26: Expansion of Tax Base

Number of Taxpayers



Source: Inland Revenue Department

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.

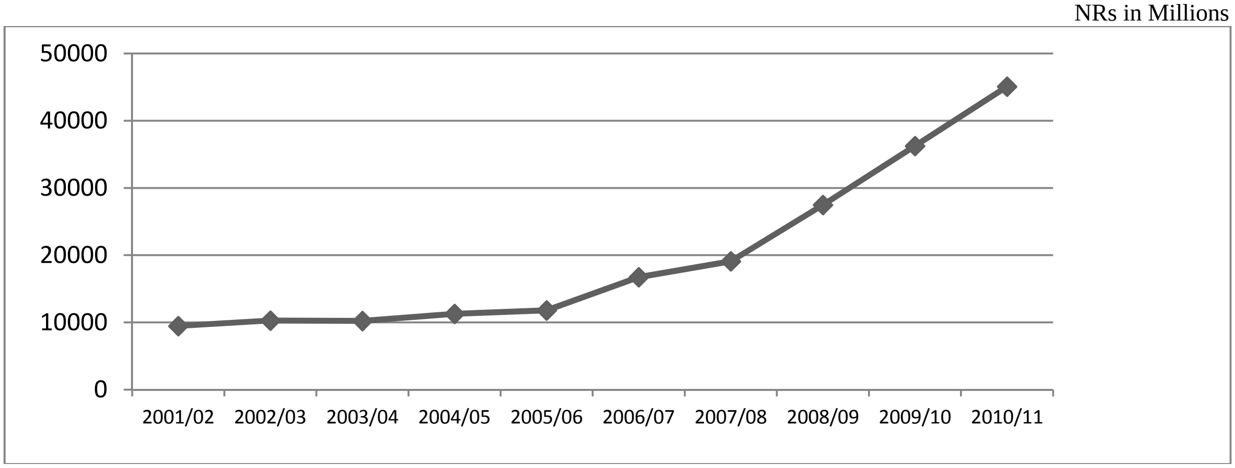
Table 21: List of Countries having DTAA

S.N	Country	Conclusion Date
1	Republic of India	27/11/2011 (New)
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: Inland Revenue Department

Figure 27: Collection of Income Tax

NRs in Millions



Source: Inland Revenue Department

Table 22: Composition of Income tax

NRs in Millions

F.Y.	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Income Tax from Public Enterprises	2056.6	1332.4	195.7	1019.7	204.6	959.1	1131.8	1281.8
Income Tax from Private Corporate bodies	1531.3	2467.8	3404.3	5717.1	7186.5	9425.1	12234.4	13965.5
Income Tax from Individuals	3533.4	3926.3	4234.7	5234.4	6381.2	9877.5	11039.9	13627.4
Income Tax from Remunerations	1391.2	1675.9	1764.1	2007.9	2451	3195.6	4413.1	5863.3
Urban House and Land Tax	0	0	0	0	0	0	0	0
Vehicle Tax	700.6	806.5	847.6	995	1069.2	1850	2417.9	3022.6
Tax on Interest	733.4	757	774.9	1054.9	1087.9	1685.1	2466.4	4130.5
Other Taxes	268.6	306.7	565.7	697.8	1766.6	2105	2535.4	3191.6
Total	10215.1	11272.6	11787	16727	20147	29097.4	36238.9	45082.7

Source: Inland Revenue Department

Table 22 shows the composition of income Tax from F.Y. 2003/04 to 2010/11. The major sources of Income tax are corporate firms, individual firms, and individuals. Income tax by the private corporate bodies was 13965.5 Millions which was followed by individual firms and remuneration with 13627 million and 5863.3 Million respectively in F.Y. 2010/11. 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.

III.8.2 Value Added Tax (VAT)

Introduction of VAT

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. Main features of VAT in Nepal has been described below;

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.

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.

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.

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 rates 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.

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.

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.

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.

Provision of Zero rates

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.

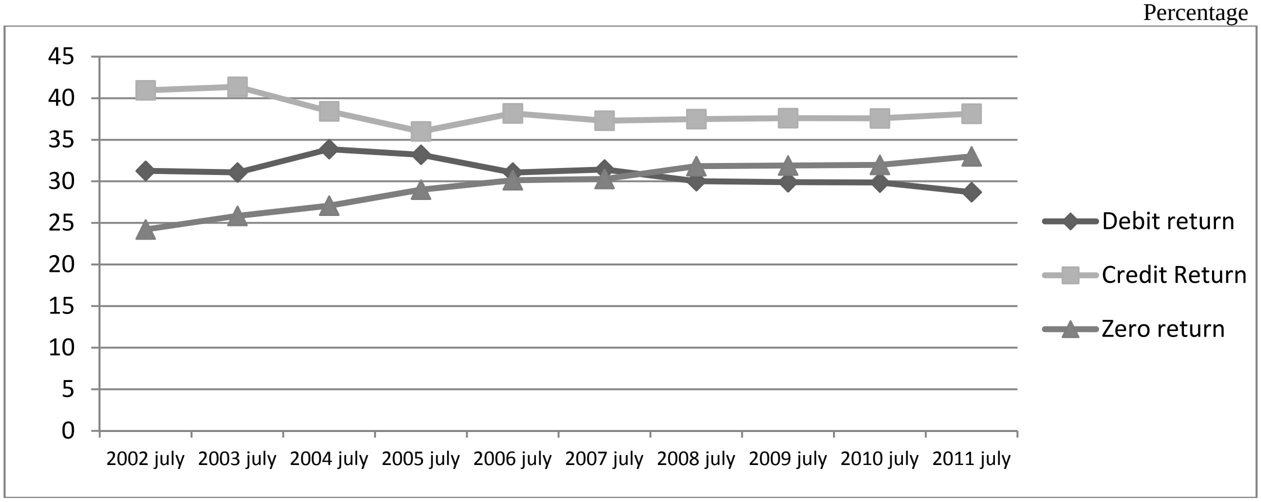
VAT Return status

VAT has been fully relied on self tax return in which taxpayers should submit their returns at tax offices. VAT returns are backbones of whole VAT system. Government not only gets tax revenue from tax returns but also updates information of taxpayers. Huge data base is developed through tax returns. Tax returns is not only important for collection but also it is a proof for tax administration that taxpayers are complying tax law or not. In other words, tax returns are the bridge between tax administration and tax offices.

Quality of VAT return has been worsening in recent years in Nepal. In 2011 July, among the total submitted VAT returns, only 28.7% are debit returns, 38.13% are credit returns and 33% are zero returns. Increasing trend of zero return, huge percentage of credit returns and decreasing trend of debit returns shows the increasing challenge to achieve effective compliance. Figure 28 shows the trend.

Figure28: Composition of VAT returns

Percentage

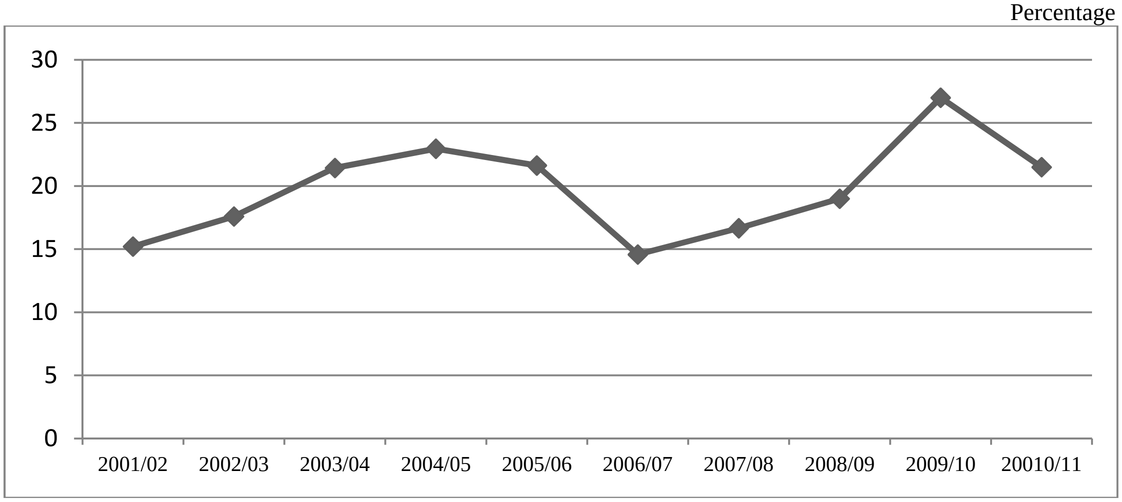


Source: Annual Reports, Inland Revenue Department

Figure 28 shows the degrading situation of whole VAT system and it clearly indicates the less compliance. Increasing zero returns means taxpayers are not doing taxable business and it is in increasing trend. One big question rises here that returns are really zero returns or these returns are fabricated. This increasing number of zero returns cancels out the increasing number of tax payers. Moreover, increasing number of zero returns also indicates that administration has failed to register potential taxpayers and enforcement mechanism also ineffective. Similarly, credit returns are increasing which means amount of output tax is lower than amount of input tax. Surprisingly, Numbers of debit return are down warding continuously which means taxpayers are not issuing invoices correctly. Increasing numbers of credit returns and decreasing number of debit returns are indicating serious problem of under billing in the market and fake accounting of their transactions. If this trend is continuously happen in the future, whole VAT system will be collapsed. Numbers of suspended returns are not showing very serious problem here.

Figure 29: Non-filers in VAT

Percentage



Source: Annual Reports, Inland Revenue Department

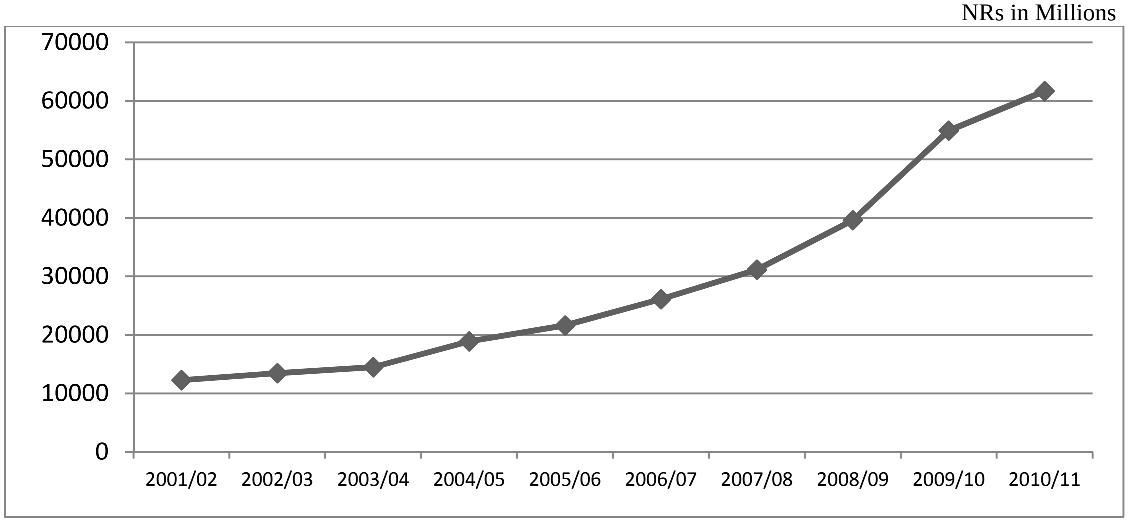
Figure 29 shows the very serious situation in VAT. Numbers of non filers are continuously increasing and 21.5% taxpayers are out of contact with tax administration in the end of 2011 July. It raises many questions to the tax administration: why taxpayers are missing? And why don't want to submit their tax returns? What is government doing? Can't tax administration collect their tax returns?

VAT Collection

Figure 30 shows the total collection and growth trend of VAT from F.Y.2001/02 to 2010/11. Total collection of VAT has been increasing significantly in last decade and reached total amount of 61663.6 millions in F.Y. 2010/11. Although the total collection amount has been increasing significantly, the share of VAT in tax revenue is almost stable between 30 to 36 % in last decade.

Figure 30: Collection trend of VAT

NRs in Millions



Source: Annual Reports, Inland Revenue Department

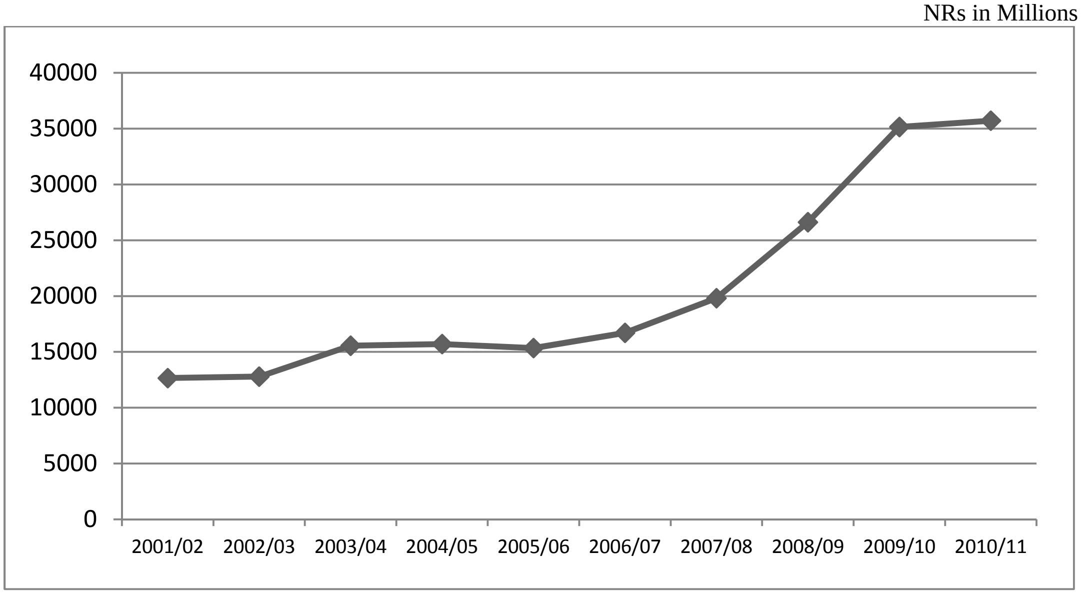
III.8.3 Customs Duty

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.

Customs duty had main contribution to the revenue before open the economy. But, its contribution is now in decreasing trend. Customs has adopted self declaration system in customs point. To make clearance system more smoothly and maintain uniformity, customs has implemented harmonized code system for goods classification. GATT valuation system has been adopted to value the goods. However, smuggling due to open broader and under evaluation of products are the main challenges of the customs.

Figure 31: Collection trend of customs

NRs in Millions



Source: Ministry of Finance

Figure 31 shows the collection trend of customs. Although, customs rates are now reducing according to the WTO, SAFTA and BIMESTEC agreement, it has still significant share to the revenue and it is in substantially increasing trend due to the high import of high value products.

III.8.4 Excise

Nepal has been imposing excise duty in different sorts of products for a long time. Civil Service Code 1854 provided the legal foundation to impose the excise duty at first on liquor, Iron, animal bones, hashish, cannabis, timber wood etc. The Excise Act 1959 and The Liquor Act 1975 authorized the tax on some domestic product and provide some legal basis to produce liquor. Now, Excise Act 2002 and Liquor Act 1975 have been implemented to levy the excise duty on around 50 products including liquor, beer, molasses, tobacco, cement, vehicle, television, soft drinks, plastic materials, irons, marbles, tiles, noodles, junk foods, bricks, paints production. Excise Act 2002 has also allowed to tax on service sector and imported products. There are two types of taxing excise on different products; Ad valorem and quantity basis. Fundamentally, liquor, beer and cigarettes are levied by quantity basis whereas automobiles are taxed on ad valorem basis.

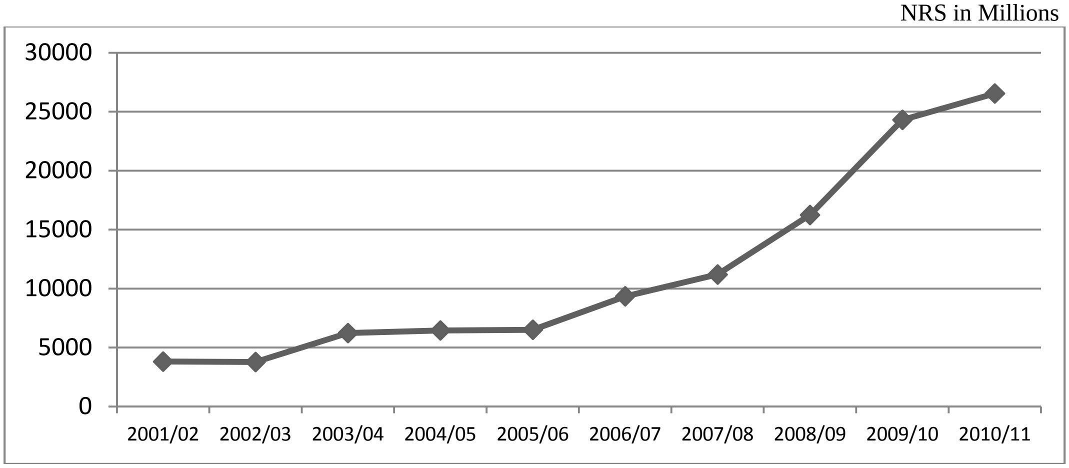
Fundamentally, Government of Nepal has mainly 4 objectives to impose the excise duty in different products. These objectives are given below;

- To mobilize the tax revenue.
- To discourage the consumption of health hazard products.
- To protect the domestic industries from unfair competition.
- To protect the environment.

The Excise Act 2002, Excise rules 2002 and Finance Acts every year are the main legal basis of excise duty regarding the excisable products, collection methods, and exemptions, deputation of excise inspectors, licensing process, regulation mechanism and penalty of the wrongdoers. Section 7 of the Excise Act has made provisions for the fixation of price for excise purposes. For products, it will be either sale price of the manufacturer or the Inland Revenue Department (IRD) may fix the price taking into consideration the production cost. In case of imported product, excise is levied on the sum of price fixed for customs purposes and the customs duty charged for the product. Excise rate is applied to mark up prices of the imported products. For the services, it is based on invoice. IRD has also the authority to revise the price or impose additional price for excise purposes. There are two system of controlling mechanism in excise- One is physical control system whereas excise inspector is inducted to closely monitor the production and sales process and all excise related books of account and godown of ram materials as well as semi finished and finished goods are controlled by excise inspector. Liquor, Beer and Tobacco industries are controlled through this physical control system which needs licensing from tax authority to produce or sales. On the other hand, self removal system is implemented to other excisable products where taxpayers can only report to the excise administration time to time about their raw materials, semi finished and finished goods.

Figure 32: Collection trend of Excise

NRS in Millions



Source: Annual Reports, Inland Revenue Department

Figure 32 shows the total excise collection trend of excise duty from Fiscal year 2001/02 to 2010/11. The total tax collection from excise has been increasing significantly. But, the growth rate is much more unstable due to frequent change on list of excisable goods and items. Total excise collection for fiscal year 2010/11 was 26542 millions, which is 15% of total tax revenue and 13.29% of total revenue.

IV. Country Specific Fiscal Issues

Nepal has been attempting to uplift the economy of the country through various development policy and programs. Government has been implementing periodic plans and prioritizing the development necessities. At the same time, It has been encouraging private sector and foreign investors to invest in the country. However, fiscal indicators show the underperformance of these attempts and country is still remain as low income country of the world. There are some fiscal issues which are very indispensible to address first to accelerate the economic progress of the country which has been described below.

Low economic Growth:

The economic growth rate of the country, a major indicator of economic development, has not been encouraging. High and sustainable growth only can expand the size of economy and create employment with in the country. Emerging economies of south East Asia and neighboring countries China and India are enjoying with high economic growth. However, Nepal is facing low economic growth for a long time. The economic growth rate of country that averaged 3.51 percent over a decade has registered growth of 3.8 percent in 2010/11. Achieving the double-digit economic growth rate and creating a platform so as to make the nation economically prosperous has been a major challenge.

Poverty

The poverty appears to be one of the country's major problems. Although, Nepal has been considering poverty alleviation as a main priority sector of the periodic plan, one fourth of its total population still lives below the national poverty line. Poverty itself is related to socio economic dimensions of the society. In this context, there lies a big challenge of reducing the poverty through poverty alleviation oriented programs to make the people economically and socially prosperous.

Underdeveloped Agriculture sector

The main contributing factor of the domestic economy is agriculture which has one third share to the economy and provide employment opportunities to two third of its population. However, agricultural production could not be increased as expected. Majority of the farmers are compelled to adopt subsistence agriculture. Majority of the farmers are adopting traditional technology in their production system because of the low investment capacity and lack of infrastructure and market opportunities. Attention needs to be paid towards land management, enhancement of irrigation facility, and easy availability of chemical fertilizers, agricultural tools and improved seeds and seedlings, extension of agriculture credit facility, and marketing of agricultural produces in order to ensure the availability of essentiality of agricultural inputs.

Poor Industrial Sector

The status of Industry sector has not been satisfactory. Though this sector was expected to grow in the post conflict situation, this could not be achieved due to lack of adequate investment, political transition and uneasy industrial relation. Hence, creating investment friendly environment for the industry sector by identifying both the domestic and foreign sources of investment and bringing policy, institutional and infrastructural improvements have been a challenge. Producing adequate human resource for this sector so as to facilitate the marketing of industrial outputs are also found to be equally important.

Low Foreign Investment and Poor Infrastructure Development

Foreign investments could not be attracted as desired despite appropriate policies in place. Though the country has entered into Bilateral Investment Promotion and Protection Agreement (BIPPA) and Double Taxation Avoidance Agreement (DTAA) with some countries for the promotion of investment, investment has not been made as projected. Even the private sector has not come forward openly for such investment. Hence, special effort has to be made to attract both the foreign as well as private sector investors. Proportionate development of physical infrastructures across the country could not be attained. All district headquarters are yet to have access to road transport facility. Other infrastructures are concentrated more on cities rather than on villages. Hence, it is necessary to put emphasis on the proportionate development of physical infrastructures.

Energy crisis

Energy has been the largest obstacle for country's economic development. Despite country's huge water resource, all the economic and social activities have shrunk due to unavailability of adequate energy required to carry out such activities. Hence, enhancing investment through expeditious identification of appropriate electricity generation projects and easing policies while removing other difficulties related to such projects have remained as another challenges.

Unemployment

The country has not been able to generate enough employment opportunities for the labor force entering the labor market every year. This has increased unemployment rate in the country on one hand, while millions of youth are flying oversees for foreign employment on the other. Hence, providing employment opportunities to the available human resource is a big challenge. The number of foreign employment seekers is surging up every year and the income from remittance is also growing at the same time. However, investment environment could not be created by converting such remitted amount into the capital. Therefore, it is necessary to make it a solid source of investment to mobilize in productive sectors.

Mismanagement in Expenditure

The expenditure capacity of government agencies has not increased. The synchronization between budget allocation and expenditures is lacking. Efforts on increasing capital expenditure have not been successful. Hence, there is an urgent need to increase capital expenditures to expedite development works. The task for prioritizing government expenditures has not been fully achieved. Though a number of projects/programs are in implementation, the consolidated and coordinated results from these projects could be obtained. Hence, urgency is sought to develop result oriented expenditure system by prioritizing the government expenditure and make public expenditure management effective.

Price Stability

Inflation rate is still high though its increasing trend could be curbed by a little. The pressure on price of imported goods was exerted due to the deflation of Nepalese currency against US Dollar during the current fiscal year. Containing the price within certain limit by raising export of domestically produced goods is another challenge. The price hike of petroleum products in international market has affected the domestic inflation of the country. Emphasis should be given to the energy management thereby reducing high dependence over such petroleum products. Likewise, attention should be paid to the imports and distribution of petroleum products.

Trade Deficit

Foreign trade deficit of Nepal is ever growing. Low production of export oriented goods and higher imports of consumable goods due to the rise in per capita income and change in consumption pattern of the people have been attributing factors to persistent trade deficit as such. To reduce this, production has to be increased while promotion of goods and services that are of comparative and competitive advantage should be emphasized. Though the entire Nepal possesses potential for tourist destination, the country has not been able to develop this sector properly as desired. Despite the increasing number of tourist influx as a result of marking the year 2011 as Nepal Tourism Year, contribution of this sector to GDP has not yet been appreciating. Hence, it is imperative to develop tourism infrastructures and increase the number of quality tourists. Managing the national flag carrier airline has remained another challenge.

Low productivity of Taxation

Effective revenue mobilization is only one key agenda of Inland Revenue Department. Revenue ratio with GDP is still low (15%) in comparison to developed countries. Huge informal sector is still not in tax net. Recurrent expenditure has been increasing and demand of capital expenditure is also growing every year. In this context, effective revenue mobilization is solely an alternative for the revenue administration.

Rampant Corruption

Corruption is one very serious issue in Nepal whereas not only government sector, private sector is also corrupt. Rule of law is only showing teeth in practice and every sector has badly suffered from malpractices and irresponsible behavior. To establish the good governance, corruption should be taken as zero tolerance issue and punish as much as maximum.

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

Nepal is known as a low income country of the world. Even though, Nepal is poor not because of scarcity of resources, It is poor because of the lack of suitable development polices and poor execution and review of the adopted policies. The key problem in Nepal is political volatility for a long period. There is an absence of common consensus among the political power. Development agendas are not getting continuity and always change for change because of this political stalemate. New constitution making process through constitutional assembly has been unsuccessful due to the lack of consensus among the major political parties. Potentialities have been already explored but politics is always in front for the advancement of country, which seems very immature currently. Today's world is running for rapid economic growth. Developing countries even in Asia like Vietnam, Korea, and Thailand are radically transform their economy with in very short period of time. Neighboring countries China and India are now hot cake from the global eyes due to attending high economic growth. There was little difference among China, India and Nepal in terms of development indicators in 1970s. However; Nepal is far behind from this movement. Protest, lock out, conflict between industrialist and workers, power cut and rampant insecurity deteriorated the investment environment. Many industries were shot down; many have run below the capacity which increased the production price. As a result, Nepalese products could not compete in the global market. The end of quota further aggravated the down trend. As a result, export decreased continuously. On the other hand, the volume of imports increased sharply resulting in large trade deficit. All these factors reduced the income level of general public increasing the unemployment rate. As there are less numbers of jobs available, potential labor force is compelled to go abroad in search of employment. Government targeted to reduce poverty and whole tenth plan and other latest three years interim plans were solely focused on poverty reduction, but due to many reasons as mentioned above hindered the path of development. The inequality between the poor and the richer has enlarged. Low growth rate, low level of income and adverse security had negative impact on the government revenue. Reduction in the import tariffs after the membership of World Trade Organization further decreased the percentage contribution of customs revenue in tax revenue. The government expenditure on development sector decreased, which also hindered the development and growth of the country. Destruction of physical capital during decade-long internal conflict has drastically reduced the physical infrastructure stock in the country. Social infrastructure such as health and education investment has also been affected by the conflict. Education system is only producing unemployed people and stimulating the youth to go abroad. Brain drain is one serious problem presently which will generate immense of negative impact to the near future.

The economic growth rate in Nepal was very low for the last decade, below 4 percent. To attending the high economic growth, Nepal must identify its competitiveness first and concentrate fully to trade this competitiveness in the world. Domestic market size is very small compared to its neighboring countries. Hence, Nepal can only get its prosperous through integrating it economy with the global world. In this context, these four sectors could be established as mainstreams of the economy.

Agriculture

Agriculture sector is backbone of the Nepalese economy. It cannot be neglected because of its high share to the economy. However, it is becoming worst due to improper policies and programs. Agriculture has some strength in Nepal to compete in the world economy. First, it has good prospect of livestock in the hilly region due to diversified climate and huge quantity of forest. Nepal can export meat instead of import of huge quantity of meat now. Second, Nepal can produce non pesticide agricultural products due to existing proper environment of livestock. Demand of non chemical food will be increased in near future from which Nepal can benefit through exporting non chemical agricultural products. In this context, agricultural transformation from subsistence agriculture to professional should be developed as key agenda of the development plan. Agriculture transformation will create employment to the non skilled labor with in the country. Hilly region of Nepal is very famous for different kind of herbs. Plants of medicinal values, herbs etc are found in different regions. Many new species of herbs can be cultivated here. If commercially farm the herbs, It would be one best item for export and drug companies can be opened with in the country. One noticeable issue here is agricultural transformation doesn't need huge amount of capital investment like industrialization. Agricultural transformation is implementable by this way. Government only should take initiatives to build infrastructure and to ensure market to the investors. Land reform is also very important issue to do this transformation.

Water Resources

Abundant water resource is second important sector for Nepalese economy. Nepal has altogether around 6000 rivers, rivulets and streams. However, Nepal is now facing energy crisis because of proper hydro policy. Unfortunately, less than 1 percent of total potential is produced so far and it is not sufficient to meet the domestic demand of electricity. There is huge potentiality of hydropower from the river and hydro projects are environment friendly and financially feasible. International big investors are ready to invest the hydro projects. There is huge demand of electricity in India and south Asia. Nepal can export electricity in low price compared to other source of energy. However, every hydro projects are now in political dispute so that investors want to ensure their investment. If there is common political and social consensus among the people about the utilities of water resources, country may enjoy a turning point in the pace of development.

Industrial Development

Capital intensive industrialization might not be appropriate in Nepal. However, Labor intensive and agro based manufacturing industries have some potentialities in Nepal. There is lack of capital and technology for domestic investment. Hence, conducive environment should be created to the foreign investors to meet the requirement of capital, technology and transparency culture.

Tourism

Tourism is one foremost sector of Nepal because of its natural diversity. Nepal has unique geography, climate, culture, people and diverse biodiversity. It is a good destination for expedition and tracking in the Himalaya including highest peak Mount Everest. Moreover, it is also indispensable for religious destination like Lumbini where Lord Buddha was born and some renowned temples for Hindus. Similarly, it is also important of bio diversity within the small place. Due to climatic variations from temperate to tropical, large number of flora and fauna are found in Nepal. Nepal has scope to expand it as the popular destination for adventure, sightseeing and religious touristic hub in the world. Tourism could be the sustainable source of foreign exchange earnings and generating employment opportunities. China and India are now welcoming huge quantity of tourist from the world. In this context, Nepal can attract these tourists to visit Nepal also. However, security situation, reliable international flight and international standard hotels and lodges are the concerning area for tourist which is very poor in Nepal. If Nepal can focus on this sector and provide enough facilities to the tourist, Nepal can get enormous quantity of tourist which will have remarkable share to the national economy.

To sum up, economic agenda are only in paper due to long political transition. Economic agendas are well presented in the documents but not materialized in practice. Government fiscal policy should direct the private sector but frequently change in government and opposition always protests to the initiation of ruler seems very bad political culture. Political power should make common consensus at least to some economic agenda so that fiscal rule can get continuity for some time. Reform and transformation takes some time but big push should be needed to some national projects immediately which give some lesson to the future development plan.

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