ECONOMIC POLICY ASSESSMENT

NEPAL ECONOMIC, AGRICULTURE, AND TRADE ACTIVITY

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Nepal Economic Agriculture, and Trade Activity—Subsector Selection Report
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CONTENTS

EXECUTIVE SUMMARY

The purpose of this report is to review the economic policy framework in Nepal and to identify the key areas where NEAT can contribute to inclusive economic growth. The approach is to identify specific constraints to growth, to propose intervention activities that relieve these constraints, and to determine plausible baseline indicators that can be used evaluate the effectiveness of the intervention *ex-post*.

Economic Context. In the economic review, we describe an economy that is struggling to get by, where under-capitalized businesses compete on several fronts. But when asked about what forces threaten their business existence, most firms point to the government, rather than the competitors. They face an environment where compliance with the law is almost impossible, where underpaid civil servants leverage these laws in order to extract bribes, and where informal operators thrive by operating below the radar – untaxed, and undetected (for the most part) by the grabbing government hand.

There is no surprise that productivity is low, for industrial firms and agricultural farms alike. But the cause of lacking output is different between farms and firms. Most entrepreneurs are confronted with high energy costs (to run generators), a thicket of regulation and corresponding bribes, and a labor force that is low-skilled but strongly unionized. Farmers, on the other hand, are mostly low-skilled and unorganized family operations. They face uncertain crop prices, unclear land ownership, and obstacles to get their goods to market. Simply using more fertilizer and better seeds would increase output, but most farmers use neither. As a result, farm output is about half as high as in other countries.

The Nepalese government enacts a multitude of laws and regulations each year. The result is an entanglement of regulation that makes formal operation a challenge. In this environment, the large and organized multinational firms manage relatively easily, with full-time lawyers and strong lobbies. But small to medium local firms (SMEs) struggle to survive, as the regulatory burden eats up their time, and the taxes eat up their margins. Evasion and informality are attractive alternatives for SMEs.
In such a difficult environment, there is no silver-bullet cure that causes higher economic growth. Instead, the best course of action is to identify specific constraints to growth, and to propose specific solutions.

Component 1 Activities. Our recommendations, while ambitious, are focused. As described in Component 1 of the USAID task order, we foster an enabling environment by re-structuring the rules and regulations into something that is clear and streamlined. This means removing old and antiquated laws from the books, such as the 1961 "Essential Commodities Control" act, that limits internal movement of goods, while strengthening new laws that will stimulate investment activity. The new laws will ensure a more level playing field for honest business, by reducing incentives for bribery and informal activity.

The second activity under component 1 complements the legal strengthening activity above through business advocacy and private-sector facilitation. The goal is to empower business supporting entities, such as Trade Support Institutions (TSIs), or by informing targeted business groups about the new laws and simpler regulations. The government’s dream of a “one stop center” for forms and information will be made a reality. These activities will help to convert the government into an “enabling” organization, rather than a burdensome entity.

Component 4 Activities. On the revenue side, our activities focus upon operations, rather than pure policy. This decision was made because the tax policy reform has been done recently, with positive results in terms of revenues. The government now wishes to focus upon administration.

We aim to improve the “experience” of dealing with the government through modern technology. Together with the Inland Revenues Department (IRD), NEAT will develop a new “e-payment” system, where VAT, corporate taxes, and personal taxes can be paid at any bank branch, or over the internet. Currently, most businesses must visit the IRD in person 14-18 times per year to make tax payments. Further modernization will be targeted between the IRD and its sister agencies by linking their data systems. Through this link, the Registration office can automatically provide an IRD tax-id to new entities – eliminating a step in starting new business, and simultaneously closing a loophole for tax evasion. Similar links are envisioned for the license renewal office and other entities.

Similarly, the Customs Department will be streamlined and modernized. Previously, customs agents at the border held considerable authority and discretion over importers and exporters – placing these guards into a potentially lucrative situation. In an effort to shift the discretion away from remote ports and guards, and into the headquarter command center, the process has been computerized. Using a wide-area network, specialists can screen way-bills and import manifests in real-time, and decide whether to audit or pass certain containers.

The NEAT project will take this a step further, by installing high-definition IP-based video surveillance cameras into the three major import/export terminals. These cameras will be self-contained and separately powered, to monitor physical activity in real-time at the Customs HQ command center. It is hoped that this will further shift the control away from remote customs agents, and toward a few highly-trained center specialists.

Further enhancements include the development and integration of a “valuations” database for large-ticket items. This will quickly compute the taxable value of common import items such as used vehicles, reducing the incentive to haggle with customs agents over tax. NEAT will also bring experts on “risk management” (i.e, auditing and profiling), who can help the Department to balance the trade-off between improved compliance, and faster transit times. And the ancillary supporting businesses for import/export will be reviewed for potential improvements. Current practice is for restricted licensing of customs’ agents, who can expedite freight through the system, but who simultaneously extract monopolist type fees for the service. A new licensing system would encourage competition and lower pricing. These enhancements, together with streamlined protocols for traffic flow at the major terminals, will require new thinking among border guards and Customs agents. NEAT will train a subset of specialists (the “Trainers”) on the new practices and procedures.

Finally, international trade policy can be improved by enhancing capacity of the Trade Sector within the Department of Commerce and Supplies (MOCS). Deployment of a powerful data engine, coupled with an easy-to-use interface, will supply Nepalese negotiators with easy access to key international trade data, at the moment they need it. The Nepal Trade Institute and the MOCS Trade Analysis department will learn modern trade theory and modern trade modelling, in order to better understand the implications of complex bilateral and multilateral trade negotiations. This will help to shift the focus from maintaining Nepal's special interests, toward improving productivity and competitiveness for all Nepalese firms, and to lowering consumer costs for households. Trade in services will be an important new topic for Nepal's future.

Outcomes/Results. If successful, the NEAT project can lay claim to several major improvements in the daily lives of Nepali business. Importers and exporters will see faster transit times, and fewer hassles at the border. Intelligent auditing will weed out risky imports and exports, while simultaneously allowing free passage for low-risk shipments. By removing all discretion from border agents, over to anonymous central-office specialists, the incentives for corruption at the borders will fall significantly. Through improvements at Inland Revenue, small business will save 14-18 days per year by paying their taxes online, or at the local bank office, and the process of dealing with Inland Revenue will be more simplified. At the same time, the IRD office ability to monitor new businesses, to deal with sophisticated taxpayers, and to negotiate with large multinational agencies will be improved. All of this should improve the Nepalese revenue stream, and improve transparency and ease of taxation.

Measurements of success in the regulatory environment will focus upon simplifications – not additions – of laws and rules for business. Key legislation that facilitates business expansion, such as the Industrial Policy Act of 2010 will be strengthened to allow for legal contract farming, more competition and choice in shipping, and liberalization in the services sector, in order to attract FDI and new technology for business service providers. If done correctly, the outcomes will be more productive and competitive domestic firms, especially in the agriculture and industrial sectors.

Improvements in MOCS capacity for trade negotiation and trade policy is more difficult to measure. The main outcome will be a *pro-active* approach to trade liberalization, rather than a *re-active* response to foreign impetus. Perhaps one measure would be increased Foreign Direct Investment due to liberalized rules for FDI and service-sector competition. Things like lower end-use for communications and information services are also useful indicators of competition and productivity. Currently, the end-line price to call a mobile phone in Kathmandu is 37.5 cents per minute, compared to 2 cents per minute in the USA, or 9 cents per minute in Tashkent, Uzbekistan.

Caveats. Final selection of activities is subject to USAID approval. It is also a function of the availability of adequate project resources, which will be determined during the work plan process when we estimate the required resources for each activity. It is possible therefore that we may need to recommend to USAID cutting one or more activities even though included in this economic policy assessment and approved by USAID. As discussed in the USAID Task Order ("Windows of

Opportunity"), we will also reserve some resources for new and emerging business environment and fiscal and trade policy issues. For example, there may be compelling issues that arise in NEAT focus value chains.

SECTION I NEAT PROJECT OBJECTIVES

The USAID NEAT Activity task order lists five major goals for Nepal: (1) fostering a conducive business environment for private sector led growth; (2) encouraging competitiveness and exports in selected agricultural and non-agricultural commodities or services (3) enhancing food security, (4) improving trade and fiscal policies and practices to facilitate trade and increase revenues without distorting the economy, and (5) strengthening microfinance policy and institutions to increase the access of women, poor and the disadvantaged to financial services. This report will focus on two of these components, components 1 and 4.

Component 1: Fostering a conducive business environment for private sector led growth. Where the goal is to engage in policy-oriented analysis, dialogue, and partnerships that specifically address the business environment related to internal and international trade, domestic competitiveness, and the ability to invest and conduct business within Nepal.

Expected Outcomes include: improvements in the business environment, such as: improved legislation that discourages cartels, rent-seeking syndicates, and corrupt practices; an improvement to the flow of business, transport, and distribution of goods and services; simpler procedures and lower transaction costs for opening and closing a new business, as well as ease of operating and investing in business; and a stronger network of so-called “Trade Supporting Institutions” that can facilitate Nepalese enterprise development and growth.

Component 4: Improving trade and fiscal policies and practices to facilitate trade and increase revenues without distorting the economy. The main operative here is to streamline government procedures in order to reduce time-costs of dealing with the government for businesses and individuals. At the same time, the goal is to sustain the stream of government revenues, because they are used to fund education, health, and infrastructure – which are long-term constraints to growth. The project will work with the Ministry of Finance to improve fiscal policies and practices – including a streamlined customs process (where 52 percent of revenues are currently collected), improving the VAT and income tax collection methods, complying with WTO requirements.

Expected outcomes include: higher government revenue yields and faster deposits of revenue payments, easier payment methods for income tax, customs fees, VAT payments, and shorter transit times through customs. More predictable and transparent policies and procedures for collection and certification of duties and taxes at the border, as well as inland. Modernization of policies and procedures, especially with regard to electronic transactions, that reduce the level of government interference upon business.

There are many options for intervention, but the NEAT project would like to identify those options that will yield the highest return possible, subject to the conditions and constraints that exist in Nepalese reality. This report identifies Nepal’s growth potential, and also some of the most binding constraints that are hindering the growth potential.

SECTION II METHODOLOGY

The method for this Economic Policy Assessment Report began with review of the original USAID task order. In particular, Component 1: Private sector led growth; and Component 4: Improving Trade and Fiscal Policies. The objectives and discussion in the USAID task order describe improvements to the business environment through changes to the regulatory framework and business environment, policy reform related to taxation and international trade, and capacity building in terms of analytical ability at government and non-government institutions, and improved processes and procedures that foster business growth, while maintaining a steady stream of revenues.

As requested in the Task Order, the policy team used a *diagnostic* approach, where key constraints to growth are identified. Then, among the global set of constraints, a subset of constraints and possible solutions were found after a concerted review of the literature, meetings with private sector and public sector constituents, and also discussions with other donor agencies.

While it was easy to identify several symptoms that belie Nepal's weak economy, uncovering the *cause* was more difficult. The business community articulated several challenges to doing business – such as internal transport cartels, competing against illegal goods smugglers, and facing a "rent-seeking" attitude from government agents. The Economic Policy Assessment team reviewed the legal framework and evaluated the current business law. While we found the law lacking in several areas, we also noted that the *implementation* of the law was lacking as much as the framework itself. For example, there are stiff penalties for international smuggling in Nepal – yet any observer can see that this law is simply not enforced. The more relevant aspect of the legal framework appear to be the *rules and regulation* for business licensing and competition.

For example, licensing for Customs Agents, who can enter data and expedite customs transit, is restricted by law to a few agencies. While the initial restriction was designed to ensure that only qualified agents have permission to work with Custom's official data, the rule inadvertently created a *cartel* in this industry, leading to high fees, and a cozy relationship between the private agents and Customs guards. Changing these regulations to allow more competition could reduce time and cost of trading significantly.

In light of the Task Order directives to work on business environment, trade policy, and fiscal/tax policy and collection, we narrowed the targeted agencies to four: Ministry of Industry, Ministry of Commerce and Supplies, and two agencies within the Ministry of Finance: Customs, and Inland Revenue. Although we initially wanted to work with the Finance Ministry on the policy side, meetings with government suggested that efforts on the *administrative* side would be more productive at this time. Therefore, we targeted Customs and Inland Revenues.

Two separate sets of meetings were held with the targeted government agencies. A preliminary set of meetings explained the USAID NEAT project to them, and asked for their recommendations for intervention. Then, after a review and assessment of government's requests and our own understanding of the constraints to growth, a second set of meetings were held to seek consensus regarding the nature and depth of intervention within each agency.

These agencies have indicated a strong interest to collaborate with the NEAT project, and they have also outlined specific areas for collaboration that do not conflict with other donors' efforts. The Economic Policy Assessment project team held final meetings with government counterparts to select the assistance that is most likely to succeed and also that will have the highest impact.

The assessment team also discussed potential interventions among the donor community. Some areas were identified through a clearinghouse process, where a list of requested actions, and committing donors was cross-listed and committed by the NEAT program. Other potential intervention areas were discussed with donors – but the typical response was indifference, unless the area of intervention conflicted with specific activities at that particular donor agency. In general, the government agencies were more helpful to navigate the donor space than the donors themselves.

In the end, the Economic Policy Assessment team believes that a happy balance has been achieved, where several important constraints to economic growth and well-being are being targeted, yet these constraints lie within the set of feasibility for the NEAT program – that is, they can be accomplished within the 2.5 year time horizon, they are mutually-targeted by counterpart government and private agencies, and they are not already under the jurisdiction of any other donor parties. In addition, we believe that our targets are amenable to clear cause-and-effect, so that the Nepalese people can directly see improvements culminating from the efforts of USAID and the American people.

SECTION III ECONOMIC BACKGROUND

Nepal is among the poorest and least developed countries in the world. National GDP was $15.1 Billion in 2010. In per capita terms, GDP was just $522 using nominal exchange rates, or a slightly better $1,200 using a Purchasing Power Parity cost basis. The 2010 estimates show no improvement over 2009 and 2008 – in other words, the country is not growing. Nepal's per-capita GDP is lower than all South Asian countries except Afghanistan ($935/PPP).

Although domestic production is not growing, domestic consumption is growing. This is possible because a large share of Nepali residents' incomes are not from work, but rather from remittances. Emigration by young Nepali workers, mostly males, has been on the rise since Nepal's conflicts began, and it is complemented by a construction boom in the neighbouring Gulf states and India.

The cash remittances these workers send home has benefited the demand-side of the economy greatly in recent years by fuelling domestic consumption, but this benefit has also begun to generate inflationary pressures. As remittance receipts increased—from about $800 million in 2004 to $2.7 billion in 2009 (see External Sector)—private consumption swelled to about 79.2 percent of GDP in fiscal 2009 and continues to drive the economy from the demand side.

An obvious indicator of the weak production-side performance is lacking investment. Gross fixed investment has remained flat as far back as 2004, averaging about 21 percent of GDP, which is lower than the average for similar Asian countries, who have a median level of 28.1 percent. Most of the investment goes toward replacing depreciated capital, or toward asset creation, in areas such as real estate, and not toward "productive" investment in new business or factories.

In addition, these investments fail to push up Nepal's economy, because Nepal's investment efficiency is low. The Incremental Capital to Output Ratio (ICOR) indicator shows that in Nepal, $5.10 of capital investment must be spent in order to achieve one extra dollar of output, whereas the median ICOR for low-income countries in Asia is $4.20, then declining to $3.90 for Bangladesh, and $2.00 for Tajikistan. The depressed volume and inefficiency of investment—owing to Nepal's fragile political climate, poor infrastructure, and weak business, and regulatory environment—have created a vicious circle of slow growth undermining economic prospects, which then discourages investment and risk-taking and retards growth even further.

Several economic studies have already been conducted for Nepal, so we do not dwell upon standard economic indicators here. Instead, we focus upon specific constraints to growth, and we consider each of them as potential opportunities for intervention. For more in-depth analysis of the Nepalese economic situation, the July 2010 USAID "Nepal Economic Recovery Assessment" report provides a clear and concise description Nepal's economic situation, and also compares Nepal to regional its neighbors.

A LITANY OF CONSTRAINTS TO GROWTH

This subsection runs through a list of important impediments to economic growth. These "challenges" will become NEAT's "opportunities" for intervention and potential avenues to unlock key pockets of economic activity, thereby leading to private-sector led economic growth, and to improved quality and variety of goods and services available to the Nepalese people.

Long-term and Physical Constraints

There are several constraints to economic growth, many of which are long-term, structural constraints. These include very low human capital, as indicated by low literacy rates (59.7%) and limited university graduation, a social system that excludes broad segments of the potential work force, such as women, minorities, and lower caste members; a lack of natural resources for exploitation (oil, gas, metals and minerals); a remote geographic position making trade expensive: $1710 per container in Kathmandu vs. $970 in Dhaka, significant and recent political instability that increases the perceived risks related to investment and shortens investors' time horizon for a reasonable return on investment; and finally, systemic health problems including chronic digestive diseases, respiratory ailments, and high exposure to noxious fumes – all of which lead to lower cognitive abilities, increased sick leave, and a general lack of economic productivity.

These limitations are probably the most binding constraints to economic growth, but they require generations to change, or cannot be changed at all. Thus, we must work within these boundaries to find *feasible* improvements that can be undertaken in a shorter time frame.

Government Regulation and the Business Environment

Other constraints can be removed more readily. These types of constraints lie within the nexus of government policy and business practice. Many well-intentioned Nepalese government policies inadvertently cause disruptions to businesses, and cause distortions that lead to higher prices for consumers, unproductive economies and higher levels of unemployment. These rules are typically based upon frameworks that come from developed countries, where several key facets of society are different. By the time the new initiatives are deployed, many rules and regulations are diverted away from their original intention, and toward a source of rent-seeking or red-tape.

Two examples of costly government interference are paying taxes and business registration. Leaving the *rate* of taxation aside, we focus upon the *process* of actually filing business and personal taxes, the process of paying these taxes, and the process of getting a business registered. These costs are now quantified in the World Bank's "Doing Business Indicators," which are published annually. Nepal's 2011 overall doing business ranking is 116 out of 163 economies (IFC, 2011). Nepal is the most difficult country in the region to conduct business, ranking better than just one country -- Afghanistan.

The table below decomposes business costs into three areas: starting a business, paying taxes, and trading across the border. Starting a business and paying taxes in

Nepal is more costly, in terms of time, than any of the five countries, even Afghanistan. It takes 31 days to register a new business in Nepal[1], and approximately 338 hours to file and pay company taxes. Similarly, the cost of trading across the border is second highest, next to Afghanistan. Importing a container into Pakistan costs $680, compared with $2,095 for Nepal. Similarly, exporting a container costs $611 in Pakistan and $1,960 in Nepal. These costs can be changed, through improved government policy and through better information and communication technology (ICT).

Table 1: Comparative Ease of doing business in relation to some important regulatory meaures

Business Activity	Parameters	Nepal	Afghanistan	Bangladesh	India	Maldives	Pakistan
Starting Business	No. of Procedures	7	4	7	12	5	10
	Time (days)	31	7	19	29	9	21
	Cost (% of income per caita)	46.6	26.7	33.3	56.5	9.4	10.7
Paying Tax	Payments (no. pwer year)	34	8	21	56	3	47
	Time hours required/year	338	275	302	258	0	56
	% of tax rate	38.2	36.4	35.3	63.3	9.3	31.6
Trading across the border	**Export**						
	No. of Documents reuired	9	12	6	8	8	9
	Time to export (days)	41	74	25	17	21	21
	Cost of export (US$/container)	1960	3865	985	1055	1550	611
	Import						
	No. of Documents required	10	11	8	9	9	8
	Time to import (days)	35	77	31	20	22	18
	Cost of import (US$/container)	2095	3830	1390	1025	1520	680

Source: Doing Business in Nepal 2011 (IFC/the World Bank, 2011)

Similarly, it is almost impossible to comply with the Nepalese regulatory system. Nearly 80 legal mechanisms exist in the form of acts, regulations, and directives. This patchwork of rules is used at the leisure of the government bureaucrat, depending upon their need. Overlapping regulations exist for fiscal administration, trade, industry, investment, agriculture, and microfinance.

These Acts and Regulations are usually designed to enforce quality or fairness, but they are rarely designed to facilitate private sector led economic growth. Despite the well-intentioned design for many policies, the complexity and contradictory nature of the rules often provide opportunities for underpaid civil servants to solicit bribes and side-payments. So long as the side-payment is lower than the time-cost of compliance, competitive businesses will be compelled to pay. The next table details the set of Acts, Rules, Regulations, and Policies in Nepal.

[1] Similarly, it is difficult to *de-register* a business in the country. This leads to a large pool of inactive businesses lingering in government databases and regulatory logs.

Table 2: Regulatory Burden

Sector	Acts	Regulations/directives	Policies
Fiscal	6	4	?
Industry and Foreign Investment	5	1	2
Trade	5	1	1
Agriculture	5	5	9
Microfinace	3	1	2
Labour	3	2	1
SPS and TBT	8	5	
Cooperatives	2	1	
Others	9	2	1

Trade and Transportation Costs

Internal movement of goods. Nepal's mountains and valleys are inspiring, but also costly in terms of transport. Internal road connectivity is poor, with some districts still un-connected by paved road. These physical constraints deter the flow of essential materials and workers from one place to the other. On top of these physical barriers, lies the regulatory burden of internal trade. Internal trade, the trade of goods within Nepalese borders, requires a complex system of payments and approvals, because each district has its own separate regulations for the movement of goods.

Truck hiring, the process of using a vehicle to ship goods to the market -- is restricted by law to "syndicated drivers" only. This means that the producer has no control over the shipping. This process was developed by the Nepalese government in the 1960s, and it remains in place today. Despite the high costs for producers (and ultimately, consumers), the trucking syndicate (or cartel) remains intact. Other trade costs include the cost of bribing corrupt officials at each district border, the time-cost of inspections and quarantines between Nepalese district.

International trade. Better than internal trade, border crossing is simply a time-intensive, and complicated process of paperwork, inspection, and waiting in line. Often, importers/exporters prefer to pay to hire an agent who facilitates the process. But these fees are high, as the number of agents is currently restricted by Nepalese licensing rules. Together with import duties and payment of the VAT, these costs can make international trade prohibitive for all but the most essential goods and services.

A more subtle, possibly detrimental, aspect of these high trade costs is that it promotes informal trading and business activity. International border smuggling is rampant in Nepal, because the practice is profitable for smugglers and underpaid border-guards. The net savings in duties, VAT, and time-costs can be significant for some types of imports, making smuggling a highly-profitable business, with enough rents to share with willing border patrols and agents.

So long as this arbitrage condition remains, there will be a significant number of smugglers. In economic theory, this leads to an equilibrium with a few, powerful formal traders, and numerous illegal traders shuttling goods. This equilibrium precludes business expansion as the large firms block new entrants in the formal sector, and the small firms must remain small in order to avoid becoming "formalized".

The Informal Economy

According to H. DeSoto (1998), many informal activities are actually optimal responses to overly-burdensome government rules and regulations. They are also a response to overly corrupt government employees who aim to extract economic rents by "enforcing" pernicious government regulations. At some point, when the system becomes overly-burdensome, businesspeople will respond by circumventing the legal framework. They will find *informal* ways to provide alternate goods and services that consumers can afford. The more distorting the government policy becomes, the higher the profitability of innovative "informal" business alternatives.

In DeSoto's work, the effect of the informal economy is benevolent, where households enjoy a higher quality of life because goods and services that they want are supplied more readily than through informal channels. But at the same time, the presence of the informal economy presents significant obstacles to firm expansion and overall economic growth. For example, informal enterprises must remain small enough that they cannot be easily detected. Or if they can be detected, the perceived rents from official enforcement should appear small enough that government officials leave them alone. This dictates that informal business cannot expand, which implies that economies of scale cannot occur. The result is a chronic low level of productivity.

Productivity

Economic data confirms the effects of these constraints – productivity, measured in any way, is low. First, the data shows that industrial labor productivity is low and falling. Nepal's ranking among countries has slipped to 121 in 2009 from 111 in 2008, and it has the lowest labor productivity rank in the south Asia region. Similarly, non-farm labor productivity has declined by 14% over the past decade (from 1994 – 2004).

Agricultural productivity is also low. Crop yields for major cereals such as paddy are 2,700 kilograms per hectare, which is the lowest yield in South Asia (IFPRI, 2010). However, labor is not the only source of low productivity in agriculture. Nepal uses the least fertilizer in South Asia (19.1 kg/ha), and the worst type of seeds. The average seed replacement rate is around 5 to 7 percent which implies that 93-95 percent of cereal seed supplies are either informally-supplied, or self-sourced. The result is that Nepalese farmers must work harder per acre sown, but will see lower crop yields nonetheless.

Summary

The pessimistic view is that Nepal has little chance for improvement. We remain optimistic, in the sense that removing just one or two of these constraints should lead to significant improvements in economic conditions for Nepalese citizens. Section 5 presents some major potential areas for improvement.

SECTION IV THE DONOR/GOVERNMENT ENVIRONMENT

To this day, Nepalese government and business remain deeply intertwined. Most of the rules and regulations in the country were developed during the 1960's and 1970's, when government was perceived to be the only available catalyst for economic growth. As a result, the government is still considered to be the "caretaker" of business development, and formally-operating businesses must respect the legal policies outlined by the government, or be exposed to systemic hassling for fines, bribes, or both. This means that interventions – by donors and donor project such as NEAT - conducted outside the purview of the relevant government agency are risky, because they could be quickly undone – especially if the actions run counter to government agency's intentions. This means that project interventions have a higher likelihood of success if conducted as a collaboration between the respective government agency and donor or donor project.

There are many donors working within Nepal with various government ministries on a number of different policy, regulatory and business environment issues. The NEAT program respects other donors' efforts, and collaborates fully. Given the multitude of donors, the government environment, and NEAT's extensive discussions with the private sector, the NEAT policy program targets four major agencies: the Internal Revenue Department, the Ministry of Commerce, the Ministry of Industry, and the Customs Department. These agencies have indicated a strong interest to collaborate with the NEAT project, and they have also outlined specific areas for collaboration that do not conflict with other donors' efforts.

This section provides an overview of recent government initiatives, in order to better understand the Nepalese government's priorities. The next sub-section lists some key pre-existing donor interventions that have shaped our decisions about where to work.

THE GOVERNMENT VIEW: INITIATIVES AND PLANS

Despite the political turmoil, Nepal's government has been busily enacting and passing laws over the past half-decade. There are high hopes that new policies and initiatives will kick-start Nepal's economy, through some type of structural change.

Past Legislative Work

Among the several policies that have been formulated in the past, some of the notable ones are the Agriculture Policy, passed in 2004, the Agribusiness Promotion Policy, passed in 2006. More recent legislation is the Commerce Policy of 2009 and the Industrial Policy of 2010. The two most significant agricultural reforms include the National Agriculture Policy, 2061 from 2004, and the Agribusiness Promotion Policy of 2006. Each of these policies contains new directives for government, new sets of subsidies or benefits, new rules on taxation, and new laws that govern how business formation and competition. These policies attempt to elicit several types of changes -- with mixed results, for example:

- Guarantee the flow of agricultural credit.
- Develop large scale production programs for targeted agriculture products in order to capture economies of scale.

- Mobilize resources in a comprehensive way for these targeted agriculture sectors, by support agricultural roads, rural electrification, and irrigation.
- Introduce agriculture insurance
- Promote organic farming
- Promote cooperative-based agricultural industries
- Tax incentives for agriculture R&D
- Establish business promotion centers, such as special economic zones, commodity production areas, and agricultural product export areas
- Public-private partnerships for targeted export infrastructure

But like any program or initiative, the effectiveness depends upon the implementation. In this area, the government's track record is mixed. Less successful sectoral policies include the National Tea Policy (2000), Coffee Policy (2004), Dairy Policy (2007), and Seed Policy (1998).

New Three Year Plan (TYP). Nepal's National Planning Commission has now developed a new guiding document, called the "Three Year Plan" (TYP 2010-13). This document reiterates some of their previous initiatives, and it introduces new initiatives. Since the NEAT project lies completely within this time-frame, some of the highlights from this plan should be considered. A summary list is below.

TYP Agriculture Efforts:

- Improved seeds and breeds
- Value chain development
- Involvement of small and marginal farmers groups and cooperatives who produce in low volumes
- Crop and livestock insurance and concessional agricultural loans
- Organic farming
- Support cooperatives through loans, processing, and marketing programs
- Contract farming by private sector and cooperatives

TYP Industrial Efforts:

- More flexible labor policy
- Adoption of management alternatives like contract manufacturing, contract farming, franchising, and ancillary buy back
- Community based or cooperative MCSIs as industrial centers
- Upgrade targeted micro-enterprises through technology and value chain development
- Campaigns for entrepreneurial development of Nepal's youth
- Establishment and effective mobilization of Industrial Security Force

The Industrial Policy 2010 complements TYP Industrial activities. The private sector is keen to see several components of this Policy enacted, the main components of which are follows:

- Removal of the requirement of import licenses,
- Full convertibility of Nepalese Rupees,
- Service sector liberalization and FDI promotion in services,
- One Window Policy for foreign businesses,

- Simplification of procedures,
- Transparency in implementation

TYP Fiscal Policy

The main fiscal policy thrust is to increase revenue mobilization through efficient, information technology (IT)-based, transparent and reliable revenue administration. Current strategies and policies include:

- Modernize the customs valuation system, increasing transparency and improving efficiency, in compliance with the WTO principles.
- Attract foreign investment by entering into double taxation avoidance agreements (DDA) with foreign countries that are likely to bring capital and technologies into Nepal.
- Control revenue leakages by introducing more effective revenue policies and mechanisms.
- Ensure stability in tax rates and broaden the tax base.
- Phase out some tax exemption policies gradually and issue PANs to all persons and institutions involved in economic activities.
- Encourage tax payers to use an electronic payment technology system to reduce the cost of tax payments.

TYP Trade Policy

The trade policy focuses on creating a conducive environment for trade and making Nepali products and services competitive at the international level, thereby reducing the trade deficit through export growth. The main thrusts of the trade policy are:

- Implement value chain improvement programs for targeted export subsectors
- Improve infrastructure and develop or strengthen institutions required to facilitate export growth, import substitution and trade diversification.
- Introduce financial incentives that promote export growth.

It is unclear exactly how many of these policies will be passed and enacted, but they represent an encouraging view by the government to promote private-sector led growth. Most of the proposed activities under components 1 and 2 are in line with plans of the Government of Nepal.

THE DONOR VIEW: CURRENT AND FUTURE ACTIVITIES

Donors are active in Nepal, yet the NEAT staff has identified several important areas that could benefit greatly with assistance. This section presents a listing of donor activities that are either already active, or that have already been planned for implementation. Our project collaborates with some of these activities (such as the GIZ Inland Revenue IT Project), or has avoided intervention due to pre-existing plans (such as the ADB-financed ASYCUDA update program).

Ministry of Finance / Inland Revenue Department:

- GIZ "Revenue Administration Support Project (RAS). RAS is supporting Nepal's revenue administration in IT-Management/Software, Institutional Strengthening, and Taxpayer education. Completion Date: 2012.

- The IMF has a full-time supporting consultant sitting at the Inland Revenue Department, who is focusing upon VAT regulations and procedures. This person will stay until July 2011, but may be replaced with another 1-year appointment.

Ministry of Finance / Department of Customs:

- The Asian Development Bank (ADB) will begin a $2.0 million effort to upgrade the AYSCUADA computerized clearing system from 2012-2013.

- The IMF, under Japanese government funding, frequently provides short term consultants on specialized subjects.

Ministry of Commerce:

- The WTO, Enhanced Integrated Framework (EIF) is building the capacity of the National Implementation Unit of MOSC with a budget of US$ 900,000 for three years from 2010

- GIZ has started a new program from 2010 on "Supporting Nepal's WTO Accession (WTO-SP). In addition GIZ is taking a leading role in assisting with implementation of the Nepal Integrated Trade Strategy (NTIS), including coordinating other donor involvement.

- The European Commission is running Euro 2 million "Economic Cooperation and Capacity Building Project" (support to SMEs) and it is also undertaking program activities for creating an enabling environment for the private sector and for fostering improvement in labor productivity through regulatory streamlining and transparency.

Ministry of Industry:

- The European commission has two ongoing programs:
  - EC-WTO Technical Assistance Program for capacity enhancement of regulatory agencies involved in standards and laboratory testing (NBSM and DFTQC) for three years, 2008-2011
  - Economic Cooperation and Capacity Building (support to SMEs) to establish an enabling environment for the private sector and to foster improvement in labour productivity through regulatory streamlining and transparency (Euro 2 million)

- International Finance Corporation (IFC) is undertaking a project "Nepal Investment Climate Reform" which is assisting the Ministry of Industry with organizing public-private dialogue and regulatory reforms for business entry and operation. Works with and through the recently formed Nepal Business Forum (NBF). The IFC is also providing technical assistance for the establishment of Special Economic Zones.

- GIZ: Inclusive Development of Economy (GIZ/INCLUDE) started a three year program in 2008, which is soon coming to an end. They supported specific value chains (ginger, dairy, honey, NTFP, tourism), promoted local business environment and helped facilitated public private dialogues for policy and regulatory reforms.

Ministry of Agriculture:

- ADB has an ongoing long term (2008-2013) $18 million project called Commercial Agriculture Development Project (CADP) exclusively for the eastern development region of Nepal focused on market-linked crop diversification and commercialization of agriculture through establishment of high value agribusiness value chains. It recently started a similar project called "Raising Income for Small and Medium Farmers Project (RISMFP)" with grant and loan support of $33.54 million (loan +grant) for the Midwest and Far West development regions

- Last year the World Bank launched a long term project called "Commercialisation and Trade" (PACT) with loan and grant support of US $ 20.6 million. This project is designed to support agriculture commercialisation and trade facilitation through technology support and marketing grants and also for developing Sanitary and Phytosanitary (SPS) facilities and Food Quality Control.

- The Nepal Market Development Programme of DFID and the NEAT Activity of USAID/Nepal are the two programs underway or soon to be underway with components of business climate reforms. The DFID project is now working on finalizing the design of the project.

SECTION V PROPOSED NEAT ACTIVITIES

NEAT's selection of activities was guided by the NEAT project structure and timeline, Nepal's present economic environment, our discussions with the business community, the backdrop set by other donors, and the specific government requests we have received. In this report, we consider the "policy" components within the NEAT Task Order. They are defined as follows:

Component 1: Fostering a conducive business environment for private sector led growth.

Component 4: Improving trade and fiscal policies and practices to facilitate trade and increase revenues without distorting the economy.

COMPONENT 1: FOSTERING PRIVATE SECTOR LED GROWTH

Background The USAID Task Order for NEAT describes a "business enabling environment" where the government fosters private sector growth by ensuring that competition is fair, and through a competitive framework that rewards productive activity, and discourages unproductive activity. The government, through its economic laws and policies, provides the setting that determines incentives for enterprises. Thus, the focus of this Component will be to review and revise Nepal's legal framework, as it relates to business activity. The goal will be to eliminate discriminatory or nuisance laws that discourage business formation, and to strengthen those laws that will encourage investment and will reward entrepreneurs. The second activity under Component 1 is to enable the business community. In order to pass significant laws, the businesses community needs a stronger voice.

Unlike the United States, where businesses already have strong lobbies, Nepal's government often favors labor groups or certain "syndicates" (or unions) over privately owned business. While we agree that strong labor laws are important, overly draconian laws and regulations drive down business profits. Lower profits, in turn, discourages investment.

Additional activities to encourage private sector growth include the organization of so-called "one-stop-shops", where several agencies have representatives to help business complete their paperwork and regulatory compliance. One of these shops would be designed to help foreign entities register a new business, and another shop would help domestic industry to navigate the numerous quality controls and environmental impact assessments that are typically needed before breaking ground for new factories or offices.

Proposed NEAT Interventions

Activity 1.1: Provide a Legal Framework that Facilitates Business

Under this activity, NEAT proposes to amend **six** pieces of legislation. These changes will create a more *enabling* environment. The process includes reviewing existing legislation, organizing business dialogues to build consensus, and drafting amendments to the law. The entire process will be coordinated with the respective Ministry.

1.1.1: Amendments to sub-components of the "Industry Policy 2010"

The 2010 Industry Policy legislation is considered to be a step in the right direction. However, in order to ensure that the benefits of the 2010 Industrial Policy law are realized, some conflicting acts and regulations within this law must be amended. Specifically, the Industrial Enterprise Act, the Foreign Investment and Technology Transfer Act, and the Company Act. The first two Acts were originally written in 1992, and contain obsolete or conflicting ideas that contradict the motivation of the 2010 legislation.

Actions:

- The NEAT project will help re-draft key Acts within the 2010 Industrial Policy Laws. The result will be simple and clear operational requirements and procedures for several industries. This draft will be submitted to the Government of Nepal, Cabinet of Ministers, for approval.

1.1.2 Contract Farming Law

The current Contract Act, 1999 should be amended to address contract farming. Specifically, breach of contract issues must be addressed, and a provision for out of court mediation and arbitration should be included. Once a legal framework for contract farming is created, it will be easier to attract more agribusiness investors.

Actions:

- Review the existing Contract Act and contract & Lease farming systems in Nepal
- Consult with farmers and lawmakers to make recommendations for change
- Prepare a draft amendment for approval.

1.1.3 Agricultural Product Markets – Legal Management Authority

Nepal's major food markets are an essential part of the agribusiness value-chain, yet the ownership and management are organized using ad-hoc rules and regulations. This effort will review a previous draft Act, and if useful, re-draft the act as a way to enable creation of additional markets.

1.1.4 Agricultural Cooperatives Law

This activity will determine why cooperatives have developed in financing operations, but not in actual production activities. If scope exists to foster the development of production cooperatives, and to achieve economies of scale, the law may be reformed.

Actions:

- Identify provisions of Cooperative Act that discourage competitive producer cooperatives,
- Consult with cooperatives and related agencies (Nepal Cooperative Federation, National Cooperative Board Cooperative)
- Assist Nepal Cooperative Federation and National Cooperative Development Board to revise the existing law, in order to promote producer-led cooperative activity.

1.1.5 Competition Policy Laws

Help the Department of Commerce implement the Competition Promotion and Market Protection Act, 2063 (2007), beginning with the dispute on transport syndicates. Determine whether these syndicates are legally "anticompetitive". Streamline the process of Trademark and Copyright dispute, particularly through improved procedures and system development for approval and record keeping.

1.1.6 Redundant and Antiquated Laws

This activity assist the Ministry of Industry Support Ministry of Industry and Ministry of Environment, Science and Technology to simplify old and antiquated policies and procedures, for example: SMEs who are subject to the overly-burdensome environmental rules under the Environment Protection Rules, 2064 (2007).

- Review the Essential Commodities Control (Authorization) Act, 2017 (1961) (amended 1993).

Expected Outcomes of Activity 1.1

- Amendment of the existing major Acts governing establishment and operation of industries and foreign investment promotion and regulation.
- Investors will have better business atmosphere with higher security, and assured facilities.
- Additional Foreign Direct Investment (FDI) will be attracted; industrial employment and income will increase.
- Contract Act revised and special provision for contract farming included ensuring investors/operators of quick decisions in case of contractual disputes.
- New Agriculture Product Market Management Act introduced, ensuring safe investment by private sector in infrastructural development and management of agriculture markets for common use
- Essential Commodities Control Act and Export and Import Rules are revised

Activity 1.2: Facilitate Business Growth through Advocacy, Networking, and Distribution of Information

Activity 1.2 was developed to complement Activity 1.1. Legal and procedural reform is unlikely to occur without a cohesive and concerted effort by private sector groups. Conversely, when new laws and regulations are developed that facilitate private sector growth, they will be impotent without a strong network of enabling agencies to deploy the new methods, and to inform business about improvements in the rules of the game.

Activity 1.2.1: Organize public-private dialogue in order to collect business sector recommendations as to regulatory requirements needed and/or to promote awareness and get feedback on new business legislation underway. Potential link with Nepal Business Forum.

Activity 1.2.2: Provide a system of support for NEAT's focus value chains. Our NEAT Business Environment team will connect each of the different actors along the business value chain together. These actors include farmers, input providers, traders, food processors, exporters, and transporters, among others. This can be done by organizing round table meetings, conducting seminars, or by organizing "delegations" within a portion of the value-chain to meet with the government or other businesspeople. Together, value chain actors will be encouraged to identify constraints to growth/trade along the chain, recommend potential solutions, and develop action plans. NEAT will facilitate this process and assist with implementation of action plans as needed and appropriate.

Activity 1.2.3: Enhance the capacity of existing commodity associations and private-sector advocates through business dialogue, advocacy meetings, training, and study tours. Targeted organizations include: The Seed Entrepreneurs Association; The Himalayan Orthodox Tea Producers Association; FNCCI; CNI; Local chambers of Commerce and Industry; and the Agro Enterprise Centre (AEC).

Activity 1.2.4: Deploy a simplified method for Food Quality Standards
In this activity, the NEAT project will assist the Ministry of Agriculture to develop a streamlined approach to Good Agricultural Practices (GAP)and food standards and quality control. These standards include "Good Hygienic Practices", and the "Hazard Analysis / Critical Control Point" (HACCP) systems. The project will then help farmers, traders, and processors to utilize these standards in order to comply with international export requirements. NEAT will initially target one or more of its focus value chains, tea perhaps.

Activity 1.2.5: Deploy simplified regulations that are passed by government
This activity serves to implement the simplified procedures that result from the legislation. The staff within the Ministry of Industry and the Company Registrar Office must be trained on how to implement the new simplified procedures for regulatory compliance and setting up new businesses. Part of this activity includes preparation of operations manuals or procedure guidebooks for the Ministries, or for businesses. The same type of capacity development and training will be deployed at the Trademark and Copyright offices, in order to help them adop new, streamlined methods for record keeping and Trademark/Copyright verification.

Activity 1.2.6: Establish an "information point" targeted to potential foreign investors. The office would provide all of the pertinent policies and procedures related to establishing a foreign-owned entity in Nepal. The office can be located within a pre-existing investment office, such as the CNI. Currently, there does not exist an information aggregation center that helps to facilitate foreign direct investment.

Expected Outcomes of Activity 1.2

- Advocacy capacity of commodity associations and private sector enhanced.
- Working relationship between value chain actors improved.
- Staff of Department of Industry/Department of Cottage and Small industry and Company Registrar office trained for adopting simplified procedures and operation of One Stop service Centre
- Staff of trademarks and copyright offices trained for record keeping and trade mark and copy right verifications.

Activity 1.3: Develop a "One-stop-Shops" for New Business Registration and Regulation

In 1992, the government enacted laws to allow for so-called "one stop shops" designed to facilitate business registration, licensing, and documentation. But the actual *implementation* of these shops has not begun. This activity intervenes to kick-start the process of deploying these one stop shops as "One Stop Service Centres". Subject to a firm government budgetary commitment (for their on-going operation), NEAT will help convert the government's plans into a physical, working, embodiment of the legal vision for these shops. Next, the NEAT project will draw upon international experience to develop winning policies and procedures for this "One Stop Service Centre", in order to maximize the likelihood that it will be utilized by Nepalese businesses. For example, the project will help prepare the operation manuals that simplify the decision making process for industrial registration business license renewal, exit purposes, and for providing facilities and incentives stipulated by the Industrial Policy, 2010.

***Expected Outcomes for Activity 1.3*:**

- Faster and easier registration or renewals of business licenses
- A more transparent and clear decision making processes for business registration and license renewals in selected industrial areas.
- We expect an increase in small to medium sized businesses to register formally, or to renew their licenses and begin paying taxes as soon as the process is revealed to be simple and transparent. This will increase formal business activity, and potentially increase tax revenues as more firms enter the formal sector and leave the informal sector.

Activity 1.4: Business Research Reports

This activity will produce a series of analytical or informational reports, covering the topics of Industry and Investment environment. Particular attention will be paid to agri-business policy, business regulation, administrative reforms, and "inclusive growth." The NEAT project will commission a series of studies that will help to understand why Nepal's business environment is not conducive to growth. Specific examples of these studies are the following:

- Produce a "Literature Review" of Business Environment studies conducted for Nepal. This will be the starting point for many of the research initiatives below.

- Undertake a concerted research effort in order to better identify and rank the most serious constraints to economic growth – both “in general”, and for the priority sub-sectors that NEAT has targeted for promotion.
- Research Nepal’s labor market, especially how new worker skills are (or are not) matched to employers. Identify gaps in the current labor market and draw upon international experience to prescribe ways to better match worker skills to business needs.

The NEAT project will distribute the findings of these efforts to government agencies, to business groups, to university directors, and to other donors in order to crystallize the key barriers facing Nepalese businesses today.

COMPONENT 4: IMPROVING TRADE AND FISCAL POLICIES AND PRACTICES TO FACILITATE TRADE AND INCREASE REVENUES WITHOUT DISTORTING THE ECONOMY

As described in the Task Order, one of the key objectives of this component is to increase revenues in a non-distorting manner so that the government can fund essential public services, such as education, health, infrastructure and other social services. Much of this work will be connected with the Ministry of Finance, the Ministry of Commerce and Supply, the Inland Revenue Department, and the Department of Customs.

Analysis: Government’s Impact upon Business Environment

The business of dealing with government agencies in Nepal could be easier. We know this because the trend over the past five years has shown that business and government can find creative ways to communicate and transact with their customers. More convenient methods for bill payment, for contract certification, and for locational services using GPS have lowered costs for business and lowered the hassles of interaction for clients and consumers alike. This trend has only just begun in Nepal. Because a large segment of government activity still revolves around the pen and paper, significant time and effort is spent for recordkeeping, recording of information, error-checking, and transportation of physical papers between business and the government, as well as within the government itself. By utilizing Information and Communication Technology (ICT), many of these transactional costs can be significantly reduced. The benefits of lowering transactions costs accrue to both parties – the government and the corresponding business or individual. With this in mind, many of the activities we have designed under the NEAT project are targeted to utilize ICT in order to significantly reduce transactions costs when dealing with the government.

Numerous opportunities exist in this segment of government activity. The largest potential gains exist in payment facilitation, and in cross-agency data linking. Most small and medium firms must make VAT, excise, and income tax payments on a monthly, quarterly, or annual basis, leading to 4-14 payments per year. Except for the largest taxpayers, the department of Inland Revenue only accepts payments in person, and only in cash or check. An e-payment system using the internet would reduce time and transaction expenses considerably for businesses and individuals, thereby increasing willful compliance and automating back-office work. It would also facilitate faster receipt of funds for the government.

Another opportunity lies in the area of cross-departmental data-sharing and connection. In general, each government agency is a "pillar", which maintains their own database and has no electronic connection to other agencies. This disconnected situation leads to losses for the government, and time-costs for business. The time-loss for business is clear – they must personally visit each government office (separately), and complete redundant sets of paperwork in order to comply with the law. A second, perhaps more important issue is that disconnected agencies make law-enforcement and monitoring almost impossible, leaving wide holes of opportunity for more devious businesses and individuals. See Box A for an example.

> **Box A: Easy Tax Evasion through Agency Separation**
>
> It's easy – and legal – to evade Nepalese taxes, if you know how. Here is one example:
>
> A new business must go to the "Company Registrar's Office" to register. After the business is registered, the new entity must then proceed to the IRD office to obtain a PAN (Payment account number) for tax payment. But by law, the business has 1 year to register their PAN.
>
> Since the Registrar's Office and the IRD are separate agencies, companies can simply register a new business, but then skip the PAN registration step, and then close the business within a year, never registering or paying any tax. The IRD has no way of knowing that the new business ever existed in the first place.

Additional motivation for this type of intervention (process intervention) is that it is less risky than pure policy intervention. We believe that administrative and procedural areas currently show a higher likelihood of success than pure policy work, such as facilitating comprehensive tax reform. One reason for this is that tax-reform has recently been implemented, and the government is now more interested in implementation than policy reform in this area.

Capacity Development

More traditional constraints to economic growth is the lack of skills necessary to design effective institutions and rules. The area of trade negotiation is an example. When the Ministry of Commerce negotiates trade agreements and laws for international trade, they often *focus upon the past* – thereby missing the most salient aspects of an agreement *for the future*. Like other small countries, they lack the specific skills to understand subtle, but very important, issues and impacts of trade agreements. For example, Nepal negotiators may be focused upon free access of basic commodities into India during the negotiation, since the loudest existing voices are from basic crops traders. These negotiators would then miss far more important areas of trade, such as trade in services – which drives 60 percent of intermediate input costs for all Nepalese businesses. As a result, the Nepalese may win free access for certain basic commodities, but then miss potential benefits from sharing key technology in business services, logistics, communications, and even management – because the negotiators don't understand those issues, and because those issues may only become important in the *future*. Our proposed intervention activities aim to remove some of these significant costs and barriers to economic growth, either by reducing the transactions cost, by increasing business intelligence of the government, or by improving the capacity to develop and deploy sound economic and trade policy.

Proposed Interventions

Four activities are outlined in this section. The first activity targets transaction costs during revenue collection and tax registration, the second activity facilitates improved procedures and functions at the border (with customs), and the third activity strengthens the capacity of the Ministry of Commerce and Supplies with regard to international trade policy.

Activity 4.1: Streamline Tax Collections and Modernize Inland Revenue Administration

An antiquated tax-collection system and lacking procedures have created significant tax leakage, leading to a large gap between potential tax revenues and collected tax revenues on the Inland Revenue side of the tax net.[2] The modernization process has begun at Inland Revenue, as indicated by a new "e-file" system that allows for online, electronic submission of tax returns. The IRD is currently conducting an upgrade of existing IT technology (assisted by the GIZ). And the VAT collection scheme is under review and revision with the support of the IMF.

These improvements are still minor compared to what could be achieved. Although tax returns can now be filed on-line (in theory), payment is still required in person. An e-pay system would reduce the burden of taxation significantly for all taxpayers, and it would speed up the timing of tax receipts, creating a rare "win-win" between public and private entities. Now is the perfect time to deploy this system, as the IRD has indicated they are eager to move toward a completely electronic process of tax filling and payment, but still lack the crucial area of payments. The process of replacing civil servants with computers which lowers costs for the IRD and allows them to shift resources into enforcement and to focus upon new trends in taxation.

Several new trends in taxation have emerged together with multinationals and globalization. Multinationals, with their subsidiaries located across several regions, can minimize their tax burden by shifting profits between regions with different tax rates or different levels of enforcement. Transfer pricing has become an emerging issue, even in Nepal, as multinationals – especially Indian firms – game the tax system in order to avoid tax payment. Along the same lines, individual workers are more international, and are subject to taxation across multiple countries. This has led to more demand for international tax treaties, an area where IRD is lacking.

Finally, the IRD has increasingly had troubles dealing with sophisticated taxpayers. Large, long-term construction and service contracts have previously escaped Nepalese taxation altogether, but now the IRD wishes to identify more clearly what is taxable and what is not under current local and international rules. Similarly, they have faced the issue of "permanent entities" – where sophisticated taxpayers will game the system by claiming to be non-permanent, and therefore not subject to taxation. The IRD would like to develop clear and consistent procedures when dealing with these

[2] The border currently collects 52% of all tax revenues, and has a much higher collection efficiency. Enforcement at the border is much easier and straightforward because the goods and the taxpayers are all simultaneously present.

sophisticated taxpayers. After discussions with the Director of Inland Revenues, this activity (4.1) was separated into two "major" sub-tasks, and a set of "minor" tasks.

Activity 4.1.1: Deploy an "E-Pay" system for tax revenue collections. The electronic payment system will permit individuals and businesses to pay their taxes at a nearby bank office, or online. The system will be similar to existing payment systems for electricity bills and public utilities.

The activity can be broken down into phases, if required. The exact deployment of this activity depends upon findings from a brief exploratory analysis. Example phase deployment may be:

- Phase I: Arrange for Inland Revenue payments to be made using specific bank branches for interested banks. In other words, deploy a "pilot system" using selected banks.

- Phase II: Deploy an "Internet payment system", where payments can be made online based in any bank where tax payers are required to open separate special account for revenue payment.

- Phase III: Deploy an "E-payment system", where payments can be made online directly to the government.

Activity 4.1.2: Develop data linkages between IRD and other business related government agencies. While several agencies are deploying IT solutions to make business easier, they have not yet linked certain steps together. This task would link processes between IRD and other government entities.

The activity should begin with a targeted subset of related government agencies. For example, based upon a pre-activity study, the agent may decide to first target the Business Registration Office. The targeted agencies must have "something to gain" from this data-collaboration. The Business Registration office stands to gain, because it is one step closer to becoming the "one-stop-shop" for businesses.

Challenges/Risks:

The validity of payment certification has been mentioned as a potential hurdle, but several government agencies have already overcome this hurdle, and the agent who implements this activity should be able find a feasible certification option. For example, the Customs Department already allows payment through banks, and this payment has already been legitimized by the General Auditor of Nepal. Similar methods can be adopted for Inland Revenue.

Bank transaction fees can pose a risk if banks choose to raise these fees over time. This risk cannot be mitigated using rules, but it can be mitigated through competition, if all banks have access to the same payment system. This way, if enough banks are included, then rates should remain reasonable as customers choose their bank based upon the cost of this convenience.

The “data-connection” activity between agencies will probably only work if corresponding agencies have something to gain from the collaboration. Those agencies who stand to lose power or credibility from data-linking with Inland Revenue are unlikely candidates for intervention.

Other “Minor” Tasks:

The Inland Revenue Department has requested four separate, specific interventions that are both urgent and important. These interventions are intended to modernize the practices and procedures at Inland Revenue as new business innovation changes the rules of taxation. Some of these issues are advanced business practices that require above-average human capital.

Activity 4.1.3 Long Term Contracts (LTC): Establish new guidelines and procedures in the area of Long Term Contract (LTC) taxation. LTC examples are large infrastructure construction projects, long-term service contracts between public and private agencies, or stability agreements for mine development and resource extraction.

Activity 4.1.4   Transfer Pricing: Establish guidelines and procedures related to Transfer Pricing that best fit Nepal’s unique situation. As multinational firms extend into Nepal, the IRD must contend with clever manipulation of profits between subsidiaries. Depending upon income tax rates (or enforcement), profits are shifted between a multinational company’s subsidiaries in order to avoid paying tax. For example, cigarette companies can sell cartons at one dollar to distribution subsidiaries in Nepal, if profits are tax exempt or not enforced. Transfer pricing guidelines and laws deal with these issues.

Activity 4.1.5   Permanent Establishment (PE): Prepare guidelines that more clearly and consistently define what is a “Permanent Establishment” under Nepalese Law. Determine the best-practice set of rules and procedures for Nepal’s unique situation. These procedures are not necessarily the same as first-world “best practice.”

Activity 4.1.6   Double Taxation Agreements (DTA): Provide training and support to IRD from an expert who understands how to construct and maintain DTA treaties of international taxation in a country like Nepal. Produce a manual that explains the pros and cons of different options when choosing tax treaty design. Often, poorly designed tax treaties leave large loopholes for wealthy Nepalese and Internationals to legally avoid tax payment. These methods include offshore banking, surrogate residency in tax havens, and other sophisticated methods of tax avoidance.

Activity 4.1.7   Improve existing tools for revenue forecasting and forecast reporting.[3] Together with Ministry of Finance Revenue Division, improve the capacity of IRD specialists to forecast inland revenues for budgeting purposes. These improvements should be manifested in the economic technology used (i.e., the statistical models used to forecast revenues), but also the technology used to *deliver* the results to the

[3] If desired, this activity could be extended to Revenue Impact Modeling – that is, the economic and revenue impact of tax reforms and revisions. Typically, impact models are CGE models, and the model designed for Trade Policy Analysis can be recycled / adapted for use by the Ministry of Finance.

consumers – i.e., the budgeting office. The expert should identify when forecast information is typically needed, and what format best suits the consumer, and then design a delivery system that fits these needs. Often, the largest bottleneck for data analysis is the poor method of delivery, which then confuses the one who needs the information.

<u>Expected outcomes for Activity 4.1:</u>

Increase in volume of inland revenues, reduced tax revenue leakage, and a reduction in the time and hassles to prepare and pay income tax, excise tax, and VAT for business and individuals in Nepal. Reduced errors and mistakes as human writing and transcribing is avoided. Lower civil-servant budget for IRD as fewer officers are needed to man collection posts – or shifted resources toward high-return positions such as risk-auditing and tax-servicing.

- Reduced time-cost of dealing with the government for business and individuals.
- One less step to open a business in Nepal if the Registration Office and IRD tax-registration computers are linked. Business registration and tax registration would occur simultaneously at the Business Registration office. At the same time, the newly registered company details would immediately be available to the IRD.
- Reduced tax evasion from firms who Register a new business, but who surreptitiously choose not to obtain an IRD Tax ID number (called a PAN – personal account number).
- Elimination of redundant procedures for firms, such as re-entering business information at the IRD. This will lead to improved data accuracy and higher rates of tax-compliance.
- Enhanced clarity for multinational firms regarding Transfer Pricing, Long Term Contracts, Permanent Establishment, and International Cross-Taxation.
- Strengthened capacity of tax officials regarding emerging taxation issues, and streamlined policies and procedures for grey-area taxation.

Counterpart Agency: Ministry of Finance (MOF), Inland Revenue Department

Activity 4.2: Modernize and Strengthen Customs Practices

Extended delays and uncertainty at the Nepalese border are detrimental to private-sector led growth. Major bottlenecks identified include the Customs department and the NTB. In addition, there exist significant opportunities for rent-seeking and corruption at the border. In order to mitigate the incentive for bribery and corruption, increased automation is recommended. The Department of Customs has started implementing their 4-year "Customs Reform and Modernization Action Plan (2009/10 – 2012/13)". The Plan aims to reduce wait-times and improve service levels in order to encourage legitimate trade (rather than illegal trade) without mitigating revenue collections.

A major thrust of this effort is to automate and simplify customs activities at the border points, and to shift the more sophisticated activities into the Headquarters building (HQ). This strategy allows Customs to hire relatively low-skilled workers at the border, and to focus the high-skilled tasks of evaluation, auditing, and risk-management upon a smaller subset of workers at HQ. By doing so, the Customs department lowers their payroll bill, and simultaneously raises the level of performance, and reduces corruption. Automation and ICT are key facilitators of this transition.

The Asian Development Bank has already committed to a major replacement of the Customs department ASYCUDA data system. This system automates most tasks related to entering and cross-checking the importer or exporter waybill. But mere existence of the ASYCUDA system does not equal compliance. Border agents can currently choose not to use the system at all, or they can choose their own system of priorities and procedures, outside of the ASYCUDA system. Our planned activities aim to achieve two goals: a) to work within the Customs departments plans so that our intervention will be utilized within the new ASYCUDA system, and b) to facilitate the transition of control from border stations to HQ.

NEAT will solicit a high-caliber IT solutions contractor to undertake, or to help facilitate, the targeted interventions below. The nature of the contract, whether it is a single, large IT company, or a “consortium” of smaller companies and sub-contractors, will be determined at a later date.

Activity 4.2.1 Valuation database: Develop a database for the valuation of difficult-to-assess items, such as used vehicles, heavy machinery, and other large-ticket items where invoicing may be surreptitious. The database should be delivered in a manner that will ensure consistent valuation for all customs entry points. The database will be integrated into the existing and future versions of the ASYCUDA system, as possible. If not possible, then priority should be upon integration with the *future* ADB-financed system.

Activity 4.2.2 Install IP-based surveillance cameras into 2-3 major Customs offices. Currently, HQ based experts can monitor customs forms electronically, in real time -- for risk-based audits and inspection. But they cannot see the physical goods moving through customs or the flow of customs traffic. A recorded camera system will allow HQ experts to better examine and audit physical goods flowing through the Customs checkpoints. This is the approach taken in all first-world countries.
A high-definition camera may require increased internet bandwidth between the customs’ checkpoints and the HQ office. Under this task, the IT support contractor should ensure a sustainable level of bandwidth, and also a “backup” system that will record activities even when local electricity is unavailable.

Activity 4.2.3 Customs Broker Licensing: As presently designed, the licensing process creates an oligopoly for Customs Brokers that raises prices for consumers and costs for import/exporters. Review the licensing arrangements for customs brokers, and determine a new system that increases transparency and allows for new entrants. Deploy the new system.

Activity 4.2.4 Update the software for Customs Brokers and provide training to new or existing broker firms. Encourage broader use of this software for brokers. The broker software is designed to pre-process and submit all customs forms electronically. Such systems have dramatically improved customs processes in other countries, such as China, and may be useful here.

<u>*Activity 4.2.5*</u> Strengthen Risk Management and Profiling: Faster transit through customs means using statistical techniques to target “high risk” items and clients, while allowing low-risk clients to quickly pass. Using local and/or international expertise, review the process for risk-based scoring and targeting, propose a new system that fits the context of the Nepalese context, and help Customs deploy the new risk-management and profiling system.

<u>*Activity 4.2.6*</u> Training of Trainers – With new technology, comes a new way of doing business. The high-level Customs agents should receive training about how the new technology changes their work style, and how business should be done after new technology is installed.

<u>***Expected Outcomes for Activity 4.2:***</u>
These activities are targeted to improved business environment through trade facilitation. Specific indicators are:

- Shorter processing and wait time for imports and exports
- Improved clarity and consistency of rules and regulations for importers and customs agents
- Reduced paperwork for business entities dealing with international trade
- Improved data-tracking and data-retrieval for customs related information. This information will be used in other areas of the project.
- Higher revenue collections, as leakages are closed, and as corruption is dissuaded through centralization of customs decisions.
- NEAT activity support will result in increase in customs revenue by 10 per cent.

Counterpart Agency: Ministry of Finance, Department of Customs

Activity # 4.3: Strengthen Capacity for Trade Policy Analysis and Communication Management

Nepalese trade negotiators are frequently placed at a disadvantage during negotiations particularly with larger countries, despite both parties’ intent to improve the well-being of Nepalese people. The most common problem is that negotiators don’t have timely access to basic trade statistics, or to properly analyzed research findings. Perhaps more significantly, they often miss the key issues *pertinent to the future* because when they are negotiating certain chapters of an agreement, these negotiators are only informed by industry lobbyists, who *focus upon issues that existed in the past*. While these lobbyists are useful to understand some of Nepal’s priorities, they often skew the emphasis toward specific industries, rather than toward improved well-being of the Nepali people in general. For example, special interests may push negotiators to limit access of key service providers or key intermediate inputs in order to maintain a domestic monopoly and higher rents. In order to improve negotiator facility with basic trade statistics, and to foster a sound understanding of the benefits and costs surrounding bilateral, regional and multilateral free trade agreements, the following activities are proposed:

Activity 4.3.1 Develop a Trade Analytical Wing (TAW) and a Trade Consultative Committee (TCC) within the MOCS. The TAW assumes study, research, and analysis pertinent to trade policy and trade negotiation issues. The Consultative Committee will support with frequent technical recommendations for trade policy formulations and trade negotiations of the MOCS. The Trade Consultative Committee (TCC) will be represented by the concerned government bodies and the private sector organizations. The TAW will back up the TCC with analytical data and findings of the studies and researches. The TAW will also help MOCS in formulation of strategies and supportive policies for selected sub-sectors. Some project activities that will support to the TAW and TCC are identified below.

Activity 4.3.2 Develop and deploy tools for quick and easy access to basic trade statistics, at the aggregated and disaggregate levels, as far down as tariff lines and even to 8-digit or 10-digit HS code lines. The tools should provide fast and easy access to a number of relevant and recent trade statistics for Nepal and trading partners.

The delivery method can include a web-based system, but it should be deployed in a way that it can be used online or offline, if negotiators do not have internet access. One example is a database or data aggregator with a web-browser interface. Where the whole package can be transferred onto an individual laptop, and where the system is automatically updated periodically. The data-system could also be enhanced to include specific issues raised by Nepalese stakeholders, so that negotiators can make requests at the right time of the negotiations.

Activity 4.3.3 Introduce analytical tools and concepts for modern trade policy. Some emphasis may be placed upon the role of *services* in trade agreements. Service sector liberalization has been found to generate significant gains in domestic productivity. This activity should include specific case-study examples designed for Nepal with respect to key trade partners.

The Ministry of Commerce and Supplies has shown considerable interest in the use of economic impact models for trade policy. The most common type of model is a Computable General Equilibrium (CGE) model. These models can be used to understand the overall economic impact of different trade regimes upon the welfare of Nepalese households.

Activity 4.3.4 Organize training programs on business diplomacy, negotiation skill, trade analyzing models, trade research methodologies, etc.

Risks. Experience has shown that deployment of a model alone is not a sustainable solution. Often, the best technical experts use government jobs as a stepping-stone to the private or international sector. They leave the government and take the human capital with them. The model and training must be deployed in a way that the human capital is maintained for several years. One approach is to finance a quiver of trade-policy studies, each one related to a different aspect (or chapter) of trade agreements. The set of studies will require use of the CGE modeling system, and each study will be pre-financed under the project. This means that a portfolio of experts will know how to utilize the CGE model to undertake policy analysis. And the results will be accessible for future trade negotiators to build upon.

Expected Outcomes of Activity 4.3:

- A more coherent decision making process that yields improved trade-related economic outcomes, such as increased variety of services, higher quality of service, and more innovative service supply channels, increased export volumes for Nepalese goods and services, and lower import costs for Nepalese consumers.
- A more "inclusive" negotiating process that allows less-informed, less-educated interest groups have a voice before and during the negotiations.
- Government officials have stronger skills and capabilities when negotiating international, and when determining internal trade policy.
- Stronger skillset among the stakeholder community in the areas of trade policy formulation and trade negotiations.

Partner: Ministry of Commerce and Supply (MOCS)

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27	World Bank/ IFC	Enterprise Survey 2009-Featured snapshot			2009
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ANNEX B REFERENCE INTERVIEWS

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29	2/6/2011	Mr.K.P.Pandey	Assistant Director	FNCCI	Teku, Kathmandu	4262061/ 4262218		kp.pandey@fncci.org
30	2/8/2011	Mr. Shyam Dahal	Director,	Dept of Customs	Tripureswor	4259763/4259942	9841313251	sdahalnp@gmail.com

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