DOMESTIC RESOURCE MOBILIZATION CASE STUDY: NEPAL

Leadership in Public Financial Management II

(LPFM II)

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Acronyms

ADB	Asian Development Bank
ASYCUDA	Automated System for Customs Data
CAER	Consultancy Assistance for Economic Reform
CIT	corporate income tax
CRMSAP	Customs Reforms and Modernization Strategies and Action Plan
DOC	Department of Customs
DRM	Domestic Resource Mobilization
FAD	Fiscal Affairs Department
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit
GDP	gross domestic product
GON	Government of Nepal
HLTSRC	High Level Tax System Review Commission
IMF	International Monetary Fund
IRD	Inland Revenue Department
ITS	Integrated Tax System
LTO	Large Taxpayer Office
PAN	permanent account number
PIT	personal income tax
SDG	Sustainable Development Goals
VAT	value added tax
WTO	World Trade Organization
USAID	U.S. Agency for International Development

Executive Summary

Despite a prolonged period of domestic conflict and political turmoil, the government of Nepal (GON) has achieved a truly remarkable improvement in tax performance. Between fiscal year (FY) 1999/2000 and 2015/16, total domestic revenue (excluding grants) climbed from 11.3 percent of GDP to 21.6 percent, while tax receipts rose from 8.7 percent of GDP to18.7 percent. The biggest revenue gain accrued from the Value Added Tax (VAT), which more than doubled from 2.6 percent of GDP to 5.4 percent over that period.

The improvement in Nepal's tax performance is partly due to the natural responsiveness of VAT and income tax to economic growth, and partly due to the government's reform efforts, supported by international agencies such as the IMF, USAID, World Bank, Danida, and GIZ. A key factor has been a rapid increase in workers' remittances from 16 percent of GDP in 2006 to 30 percent in 2016. This fueled an expansion (relative to GDP) in imports and consumption expenditures, yielding revenue gains in VAT, excise duty, and trade tax. Beyond these underlying economic dynamics, GON has pursued a long-term program of reforms to tax policy and tax administration. The most important tax *policy* measures were implemented in the early 1990's, particularly the introduction of VAT in 1997 at a 10 percent tax rate. GON subsequently pursued a series of administration reforms, including development of ICT; functional reorganization; operational segmentation by taxpayer size; improvements in frontline taxpayer services; and improvements in risk management. Still, GON recognizes further reforms are needed, including implementing a Single Tax Code to consolidate legal framework for major taxes (underway during 2017); rationalizing tax incentives; and improving compliance.

The case of Nepal illustrates several basic lessons about DRM. First, and foremost, Nepal's performance demonstrates that *impressive gains in revenue performance are achievable, even in post-conflict conditions with prolonged periods of political turmoil*. Second, the cornerstones for strengthening revenue performance included the introduction of sound policy measures, supported by sensible administrative reforms. Third, tax reform is a long-term process: major reforms implemented in 1990s in Nepal paid off in recent years with remarkable improvements in revenue performance. Fourth, host country ownership is vital to success. Finally, in early stages of the DRM reform process, development partners played an essential catalytic role in triggering transformational changes; more recently their role has focused on supporting technical improvements, as GON has developed its own capacity to drive the reform program.

Domestic Resource Mobilization Case Study: Nepal

Programs to strengthen domestic resource mobilization (DRM) in developing countries are critically important not only to curtail reliance on donor funding, but more importantly to provide the governments with a dependable, steadily expanding source of domestic revenue for investing in development and delivering essential public goods and services. Effective DRM programs can also be a foundation for building good governance and enhancing accountability in public finance management. In addition, DRM programs can deliver major economic benefits by creating tax systems that foster more efficient private sector development.

The 2015 Addis Ababa Action Agenda on Financing for Development placed DRM front and center as a goal in its own right, and as the most viable mechanism for achieving the Sustainable Development Goals (SDG). To follow up on the Addis Agenda, the Addis Tax Initiative was established, underpinning the international community's commitment to help developing countries strengthen their DRM efforts.

In seeking to improve revenue performance, developing countries face enormous challenges, including weak administrative and enforcement capacity; an inherently narrow tax base owing to low incomes; a prevalence of informal sector activities; a culture of low tax compliance; and deep-seated problems with corrupt practices and politically driven tax favors.

Notwithstanding these challenges, many developing countries—including Nepal—have shown remarkable progress in strengthening DRM. This short case study tells the story of Nepal's successful efforts to enhance revenue performance and provide better services for the country's taxpayers.[1]

Nepal's Success in Mobilizing Domestic Revenue

Despite a prolonged period of domestic conflict and political turmoil, compounded by devastating earthquakes in 2015, Nepal sustained moderate GDP growth averaging 4 percent per year over the decade to 2016.[2] This growth has been driven mainly by the service sector, which expanded by 5.3 percent per year over this period, whereas growth in agriculture averaged only 2.9 percent and in manufacturing just 1.2 percent. A large share of economic activity is still concentrated in smallholder agriculture and micro-, small and medium enterprises, most of which operate in the informal sector. And yet, the share of the population living below the national poverty line has fallen sharply, from 42 percent in 1990 to 24 percent in 2013 (IMF 2017).[3] These trends have been fueled by a huge inflow of workers' remittances, reaching 29.7

[1] This paper focuses on central government revenues. Fiscal decentralization is also an important part of the Nepal DRM story—and one that is currently evolving.

[2] GDP growth and GDP structure statistics are from the World Development Indicators (World Bank), available at https://data.worldbank.org/data-catalog/world-development-indicators.

[3] Figures on the share of population living below the national poverty line differ across sources.

percent of GDP in 2016—one of the highest in the world. Remittances have also been a major source of foreign exchange to cover a large balance of trade deficit, with imports greatly exceeding exports.

Despite often difficult political conditions, the government of Nepal has achieved a truly remarkable improvement in tax performance (Figure 1). Between fiscal year (FY) 1999/2000 and 2015/16, total domestic revenue (excluding grants) climbed from 11.3 percent of GDP to 21.6 percent; this gain derived almost entirely from tax receipts, which rose from 8.7 percent of GDP to18.7 percent.[4] In comparison, the average tax-to-GDP ratio for South Asia increased less than three percentage points between 1999 and 2014, from 10.9 percent of GDP to 13.8 percent.[5]

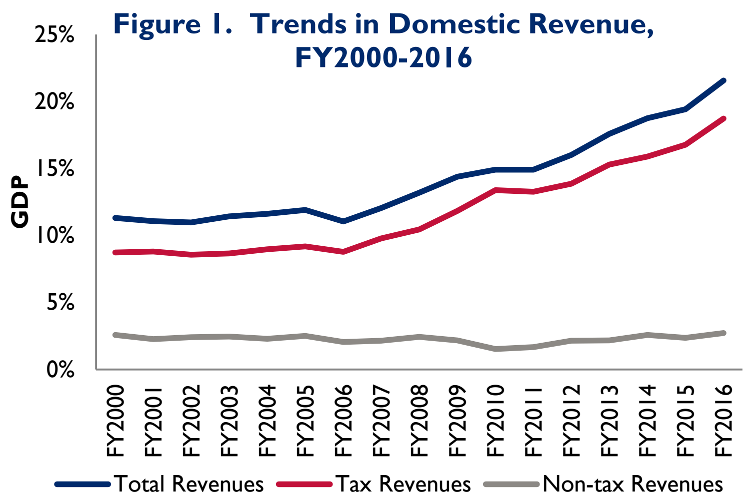

Figure 1. Trends in Domestic Revenue, FY2000-2016

Revenue performance in Nepal has improved for all major taxes, with the biggest gain accruing from the Value Added Tax (VAT). Between FY1999/2000 and 2015/2016, VAT revenue more than doubled from 2.6 percent of GDP to 5.4 percent (Figure 2). During this period, the VAT efficiency ratio showed steady improvement from 0.26 to 0.42.[6] Over the same period, income tax revenue (personal plus corporate) jumped to 4.5

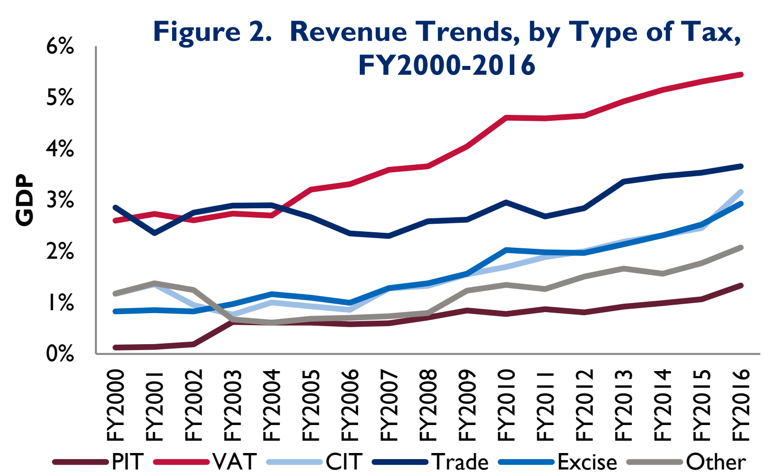

Figure 2. Revenue Trends, by Type of Tax, FY2000-2016

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[4] The IMF has suggested that improvements in Nepal's tax ratio might be somewhat overstated because of underestimation of GDP to an increasing extent over time, caused by the use of an increasingly outdated base year. See footnote to page 1 of Annex II in IMF (2017).

[5] Data for South Asian countries from the IMF World Revenue Longitudinal Data (WoRLD), available at http://data.imf.org/?sk=77413F1D-1525-450A-A23A-47AEED40FE78&sId=1390030341854

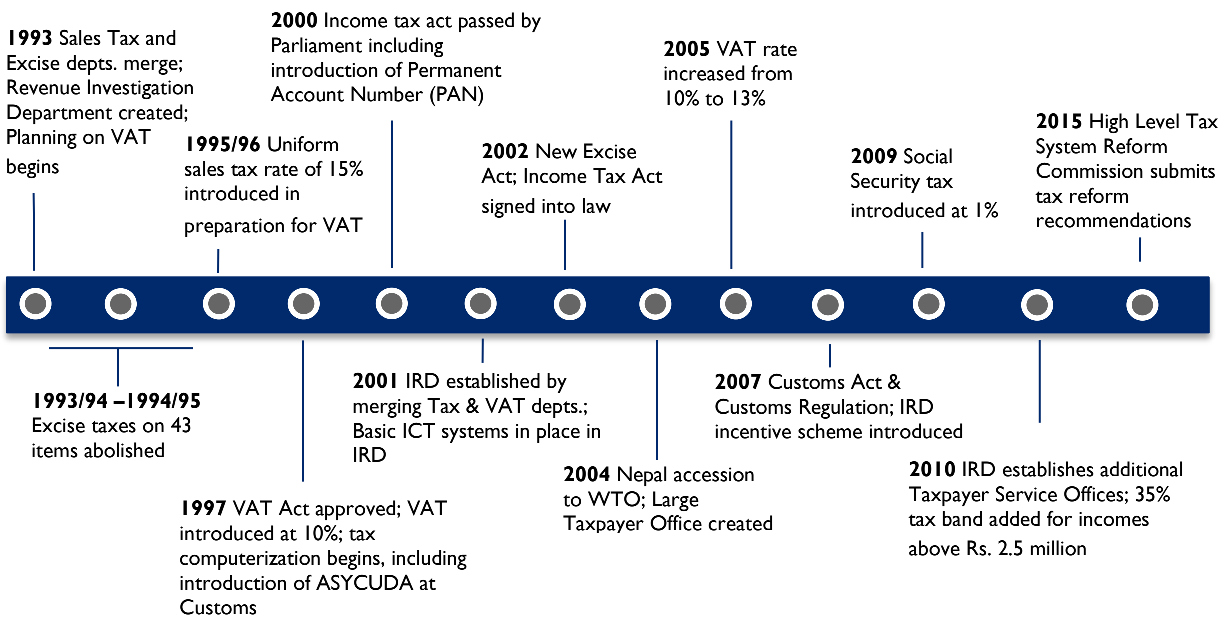
[6] The VAT efficiency ratio is the actual revenue from VAT as a percentage of the theoretical potential that would be derived from applying the standard VAT rate to all economic activity contributing to GDP. A higher ratio indicates a more productive VAT system with broader coverage, improved administration, or both.

percent of GDP, from 1.3 percent, while excise revenue climbed from 0.8 to 2.9 percent of GDP. Taxes on international trade rose less quickly, from 2.8 percent of GDP in FY1999/2000 to 3.7 percent in FY2015/16. As a result, trade taxes fell as a share of total revenue. In the future, trade taxes are likely to become even less important as Nepal pursues trade liberalization measures in compliance with its WTO accession in 2004 and regional trade agreements, such as the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation and the South Asian Association for Regional Cooperation.

How Did Nepal Achieve These Results?

The improvement in Nepal's tax performance is partly due to the natural response (or "elasticity") of VAT and income tax to economic growth, and partly due to the government's reform efforts (highlights of which are shown in Figure 3). The growth effect results when an expansion in the formal-sector share of GDP brings more taxpayers, more income, and more transactions into the tax net. Yet, experience of other countries shows that economic growth alone cannot explain more than a small fraction of the remarkable increase in tax revenue seen in Nepal.

Figure 3. Timeline of Major Tax and Customs Reforms in Nepal (1993–2015)



A more important factor has been a rapid increase in remittances from citizens working outside the country. Measured remittances jumped from 16 percent of GDP in 2006 to 30 percent in 2016. This fueled an expansion (relative to GDP) in both imports and consumption expenditures, yielding associated revenue gains, especially for VAT, excise duty, and trade tax. Between 2005 and 2016, imports of goods and services climbed from 29.5 percent of GDP to

39.4 percent — a rise of 10 percentage points. Over the same period, household consumption expenditure increased from an estimated 79.5 percent of GDP to 83.8 percent.[7]

Beyond these underlying economic dynamics, the Government of Nepal has pursued a long-term program of reforms to tax policy and tax administration (See Appendix A and B for details). The most important *policy* measures were implemented early in the process. Hence, the tax structure and most tax rates have been fairly stable over the past fifteen years. But the government has continued to implement a series of sensible, effective reforms to tax and customs administration, drawing on lessons from international experience.

Reforms to Tax Policy

Before 1959, Nepal had an archaic revenue system consisting of land tax, customs duties, and domestic excise duties. By 1990, the Nepal government had introduced an income tax and sales tax, and updated the legal framework for customs and excise duties, among other basic measures. Then in the 1990s—after the absolute monarchy ended and constitutional monarchy began—the government embarked on a series of reform initiatives, following recommendations from a special Task Force on Economic Policy.

Much of the work on tax policy in the 1990s focused on indirect taxes, especially transformation of the sales tax into a VAT. [8] Development of VAT began in 1993, with strong technical support from USAID's Consultancy Assistance for Economic Reform (CAER II) project. The VAT Act was drafted in 1994 and approved by Parliament in 1996. VAT regulations were approved by the cabinet in 1997. The VAT then into effect at a tax rate of 10 percent, with funding and technical assistance from Danida. It was recognized at the outset that the tax base for VAT would initially be very narrow, but would expand naturally over time as more businesses enter the formal sector and as registered businesses grow (Jenkins and Khadka 2000a).

The Value Added Tax

VAT was introduced in Nepal in FY1997/98 and quickly became the "backbone of the tax system," accounting for 2.7 percent of GDP in 2000/01 (when the total tax ratio was 8.8 percent of GDP). Since inception, roughly two-thirds of VAT revenue has been collected by the Department of Customs.

The next major policy reform was passage of a new Income Tax Act which took effect in 2002. The Act retained the prior marginal tax rates, at 0, 15, and 25 percent, while modernizing provisions for self-assessment, introducing Permanent Account Numbers (PANs), strengthening the presumptive tax on small businesses, and clarifying the treatment of different types of income, among other elements. Also in 2002 a new Excise Act extended the coverage of excise duties to imports, in line with international norms. There have also been frequent subsequent

[7] Household consumption expenditures may have increased more than shown in the national accounts because Nepal's Central Bureau of Statistics lacks a direct measure and estimates this figure as a function of gross national disposable income (Government of Nepal, CBS 2007, p. 25).

[8] Another reform in the 1990s focused on simplification and rationalization of the excise duty schedule, reducing coverage from 62 items to only 14 items. Subsequently, though, the excise schedule again became more complicated, involving a mix of specific and ad valorem duties on 50 categories of items (Government of Nepal 2011).

adjustments to excise rates and regulations, along with tightening of labeling rules for goods subject to excise.

In 2005 the government increased the standard VAT rate from 10 to 13 percent; surprisingly, this measure produced only a small increase in VAT revenue, relative to GDP. Then in 2007, a new Customs Act and accompanying regulations addressed requirements of Nepal's accession to the WTO (which took effect in 2004), including major simplification of customs documentation requirements. In 2009, the 40 percent band for customs duty was reduced to 30 percent, while other rates remained unchanged (at 5, 10, 15, 20, and 80 percent, with the latter applying to certain motor vehicles and weapons). Also in 2009, a one percent Social Security tax on income was introduced and a new Social Security Fund was established under the Ministry of Labor and Employment.

In 2010, a new 35-percent tax band was added to the personal income tax (PIT) structure for individuals with incomes in excess of Rs. 2.5 million. As with the 2005 increase in the VAT rate, this policy change did not yield a substantial jump in PIT revenue. The past decade has also seen intermittent modifications to the income tax bands and the threshold for VAT registration, as adjustments for inflation.

Overall, reforms to *tax policy* since 2000 do not appear to have been a major driver for boosting the revenue yield. The importance of tax policy for DRM stems mainly from the inherent long-term elasticity of VAT and income tax in response to economic development and the surge in remittance flows.

In fact, Nepal's strong tax performance has been achieved *despite* policies that bred a proliferation of costly tax incentives. The Nepal government has regularly granted ad hoc exemptions, rebates, and tax holidays to "promote industrial development" and "make the tax system more growth friendly" (Government of Nepal 2009; Sharma 2015). Beneficiaries include special manufacturing industries, IT industries, foreign investments, energy projects, and tourism-related industries, conditional on job creation, capital investment, or technology transfer. There have also been partial tax amnesties in several years. Tax expenditure budgeting has not been developed, but rough estimates by the Inland Revenue Department (IRD) indicate that the revenue loss from tax incentives may be as large as 5 percent of GDP (Sharma 2015). These incentives also distort investment decisions and complicate tax administration. Moreover, they are widely regarded as ineffective, as evidenced by the sluggish growth of favored sectors. Hence, the International Monetary Fund (IMF) has regularly proposed rationalization or elimination of these incentives, and similar recommendations were highlighted by the government's High Level Tax System Review Commission (HLTSRC) in 2015.

Reforms to Tax Administration

For the main story on DRM performance in Nepal, one must look to the cumulative effect of steady progress in reforming tax administration in line with international best practices. The IRD has been pursuing administrative reforms since it was formed in 2001 by combining the Department of Taxes and with the VAT Department. The IRD's first formal Strategic Plan was not produced, however, until 2012, covering the period through FY2016/17. This plan set strategic objectives and a matrix of measures in four broad areas: policy reform and enforcement, taxpayer service and education, ICT, and organizational and human resource revitalization. This was followed in 2015 by a three-year Reform Plan (FY2015/16–2017/18), which took stock of progress and specified a menu of further measures to strengthen tax administration.

The Department of Customs (DOC) has an even longer history of strategic planning. With guidance from the IMF and the World Bank, DOC developed its first Customs Reforms and Modernization Strategies and Action Plan (CRMSAP) in 2003. The process is now in its fifth phase covering the period FY2016/17–2020/21. In light of the government's declining reliance on custom revenues, the DOC strategies aim not only to improve the efficiency of revenue collection but also—and equally important—to facilitate trade.

Overall, three components of the reform program for tax administration have been most important and effective: (1) introduction of Information and Communication Technology (ICT), (2) institutional restructuring, and (3) improvement in taxpayer services.

Introduction of ICT. A comprehensive program for computerizing revenue administration has been ongoing since 1997, when the new VAT administration adopted computerized systems. With funding initially from Danida, and then jointly from Danida and GIZ,[9] the central VAT office was computerized first with modules for registration, refunds, returns, payments, audits, and other basic functions. Computerization then extended gradually to VAT field offices.[10] The IRD Strategic Plan indicates that a major portion of the ICT infrastructure for IRD was implemented in FY2000/01—evolving into a fully Integrated Tax System by 2017, with sustained support from GIZ. By FY2014/15, 98 percent of tax filings and nearly 100 percent of registrations were conducted online.

The Department of Customs (DOC) also embarked on computerization in 1997, with a seven-year program to introduce the Automated System for Customs Data (ASYCUDA). The program began at Tribhuvan International Airport, with funding from the Asian Development Bank (ADB), and was later rolled out across the country. DOC is currently introducing the latest version of this system, ASYCUDA World, with support from the ADB and UNCTAD. It is also planning an Internet-based National Single Window (with World Bank support), which should greatly simplify the border process for traders.

ICT and the IRD

Success with ICT has made IRD a leader in e-governance in Nepal. Although IRD has not yet completely eliminated paper processes, its ICT systems have improved administrative efficiency and simplified tax registration, tax filing, and tax payments. Computerization has also helped curb opportunities for corruption and negotiation between tax officers and taxpayers, and improved public perception of IRD as a more professional, transparent organization.

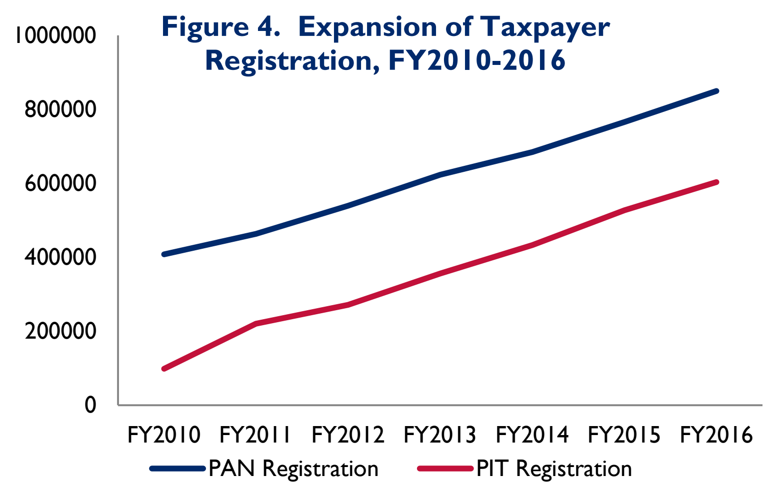
[9] Known previously as Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ).

[10] See Jenkins and Khadka (2000b) for more details on VAT computerization.

Institutional Restructuring. Institutional restructuring has been another critical element of the tax reform program since 2000. As noted earlier, IRD was created in 2001 by combining the VAT and Tax Departments. This amalgamation helped to consolidate the taxpayer registration database, facilitate the use of a common PAN, and reduce administrative costs. The consolidation was also essential in paving the way to modernize IRD's organizational structure by function, rather than by type of tax.

The single most important organizational reform was the creation of the Large Taxpayer Office in 2004, supported by the IMF; this began the process of reorienting IRD operations by taxpayer segment (defined by size), including the more recent establishment of taxpayer service offices focused on small taxpayers and the Inland Revenue Office focused on medium-size taxpayers. This segmentation allows the IRD to enhance efficiency by gearing resources and staff training to the special requirements and revenue potential for each type of taxpayer. Creation of the Large Taxpayer Office has been especially important because this segment accounted for 54 percent of total revenue in 2015/16 (Government of Nepal, IRD 2016a).

Taxpayer services improvements. A third major focus of the reform program has been to broaden the tax base and promote voluntary compliance through improved taxpayer services. Starting in 2010, IRD set up Taxpayer Service Offices (TSO), initially in areas of high-density taxpayer populations, to provide front office operations such as registration and filing. This network was then expanded to other geographic areas offering full services, such as audit, debt, and enforcement. IRD currently has 49 field offices, with 26 TSOs (13 within the Kathmandu district and 13 elsewhere), and 22 Inland Revenue Offices, in addition to the Large Taxpayer Office.



Strategic plans for both IRD and DOC highlight taxpayer education and outreach as a key pillar for their respective reform programs. Both departments also provide extensive taxpayer information on their websites, in Nepali. Outreach by the tax departments to business associations aims not only to establish dialogue on tax issues, but also to work jointly in providing tax training for their members. In addition, the Ministry of Commerce has established the Nepal Trade Information Portal through the Trade and Export Promotion Centre, as a one-stop portal for importers and exporters, with information including transit and tax-related information.[11]

Electronic innovations have improved taxpayer services and increased administrative efficiency

[11] See the Nepal Trade Information Portal, available at http://www.nepaltradeportal.gov.np/index.php?r=site/display&id=12

within IRD. As a notable example, with support from USAID, the Office of the Company Registrar has been linked electronically to the IRD, enabling new companies to receive their tax PANs immediately upon company registration, and allowing IRD to search for non-compliant companies. Similarly, and again with initial support from USAID, IRD implemented the Any Brank Banking System (ABBS) for large taxpayers, allowing them to pay their taxes monthly through any nationwide commercial bank.

The combination of outreach to taxpayers and simplification of tax compliance through e-registration and e-filing seems to be working well to broaden the tax net (Figure 4). Between FY2009/10 and 2015/16, PIT registrations increased from less than 100,000 to 603,581, while PAN registrations (including VAT) more than doubled to 849,236. Total VAT returns almost doubled from 487,191 in FY2010/11 to 914,270 in FY2014/15, while total income tax returns increased from less than 194,000 to more than 438,000 during the same period (Government of Nepal, IRD 2016a).

The strategic plans for IRD and DOC also emphasize professional integrity. Some improvement in this regard can be seen in the World Bank Groups's Enterprise Surveys data.[12] In 2013, 11.0 percent of Nepalese manufacturing firms reported that they expect to give gifts to tax officials, down from 17.3 percent in 2009. Similarly, 10.1 percent of service firms reported expecting to give gifts in 2013, an improvement from 14.0 percent in 2009. Those results are considerably better than the regional average response rate of 19.6 percent for South Asia. Even so, perceptions on the ground suggest that corrupt practices in the tax system are still widespread.

Other Administrative Reforms. Aside from the three areas highlighted above, another important administrative reform has been the adoption of modern risk management practices. IRD has introduced automated risk ratings for audits, including the Large Taxpayer Office.[13] Similarly, DOC has adopted some risk management systems for border operations, along with establishment of a Post-Clearance Audit Office. However, the effectiveness of these measures is limited by human resource constraints, compounded by frequent staff transfers within the government's fiscal service.

By some accounts, the improvement in tax yield may also have benefited from a special incentive scheme for revenue officers, introduced in FY2007/08. Some reports indicate that the incentive payments can be large enough to double the base pay for tax officers who meet collection, service, or other targets. However, the revenue data do not show a substantial impact from this measure when it was introduced. Moreover, such schemes may have adverse effects by creating incentives to low-ball revenue targets or to invite abusive tax practices that are antithetical to the goal of improving taxpayer services.

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[12] For more information on the Enterprise Surveys (World Bank), visit http://www.enterprisesurveys.org/.

[13] At the LTO, audit case work gets prioritized based on risk criteria. However, the LTO is also legally mandated to conduct a compulsory three-year audit of all its taxpayers. Removal of this requirement has been recommended by the international community.

Unfinished Business

Although Nepal has been pursuing reforms to the tax system for a quarter century, with impressive results, the reform agenda is still work in progress. Among the prominent issues on the Government of Nepal's reform agenda:

- Efforts to train and professionalize the revenue service have long been hampered by the practice of rotating revenue officers (even the director general) every 18-24 months, along with low civil-service pay, and lack of direct control over personnel decisions. Establishment of a semiautonomous Central Revenue Board could alleviate this problem if the Board were to have authority over conditions of service and control of hiring, retention, and staff rotation. Creation of the Board has been on the reform agenda for nearly a decade, and a bill to this effect has been drafted. But the prolonged delay suggests a lack of political will to move ahead on this measure.
- There is a pressing need to rationalize tax incentives and introduce tax expenditure budgeting. Ad-hoc tax breaks not only reduce revenue, but also create economic distortions and complicate tax administration.
- IRD still faces a very high incidence of non-filers and late filers. In FY2015/16, the non-filer rate was nearly 40 percent for personal income tax and 30 percent for VAT.
- Tax arrears increased sharply from Rs. 2.7 billion in FY2010/11 to Rs. 8.3 billion in FY2014/15 and reportedly remain very high, indicating a needed for greater emphasis on compliance and enforcement.
- IRD is moving to strengthen the effectiveness of headquarters operations to design, implement, and coordinate system wide procedures for all functions, including risk assessment and compliance improvement.
- The e-payment system is still under development for the majority of taxpayers, and some internal IT systems at IRD and DOC still need to be integrated.
- On the customs front, a framework for the National Single Window has been designed with ADB funding, and is scheduled for implementation with World Bank support.
- By 2020, DOC intends to implement the Trusted Trader program and Authorized Economic Operator program to simplify customs clearance procedures and reduce the time and cost of trading across borders.
- The Nepal government has drafted a Single Tax Code to consolidate the legal framework for major taxes (CIT, PIT, VAT, Excise). The Code, when passed, will help harmonize tax laws and reduce compliance costs.

Nepal continues to demonstrate strong political interest in improving its tax system and improving DRM, as evidenced by support for ongoing reform initiatives, as well as a decision in 2017 to join the Addis Tax Initiative.

Contribution of Donor Support

Donor support has been catalytic in some major areas of tax reform in Nepal, and highly supportive in others. A starting point was USAID's support for the design and introduction of VAT in the 1990s, setting the path for the effective, sustainable mobilization of domestic resources. Long-term support from Danida, GIZ, and ADB to computerize tax and customs operations was then instrumental in modernizing tax administration, as a cornerstone for broader e-governance reforms.

The IMF played a major role in helping IRD to implement the Large Taxpayer Office, among other technical assistance activities, with financing mainly from the government of Japan and support from the Tax Policy and Administration Topical Trust Fund.[14] Given the large share of revenue generated by large businesses, support for the Large Taxpayer Office was critical to enhancing efficiency and effectiveness in revenue mobilization by IRD. The IMF also worked extensively with DOC—along with the ADB, the World Bank, and other development organizations—to formalize its early reform strategies and operating plans, through which DOC achieved significant improvements in operational efficiency and trade facilitation.

Increasingly, the Nepal government has bolstered its capacity to take the lead in planning and implementing tax reforms. For instance, recommendations of the High-Level Tax System Review Commission in 2015 were fully home-grown, though broadly informed by earlier recommendations from the IMF and international best practices. Although IRD received support to develop its Strategic Plan and the first Reform Plan from the GIZ and IMF respectively, it developed the second Reform Plan 2015/16–2017/18 largely on its own initiative. Similarly, the DOC's most recent CRMSAP was also developed with minimal support from the international development community. The Nepal government has also taken the lead on many specific actions, as outlined in the IRD and DOC Strategic Plans, with ongoing GIZ support.

Lessons Learned

The case of Nepal illustrates several basic lessons about domestic resource mobilization. First, and foremost, Nepal's performance demonstrates that *impressive gains in revenue performance are achievable, even in post-conflict conditions with prolonged periods of political turmoil*.

Second, host country ownership is vital to success. Under successive and diverse governments, the Nepal government has not simply announced, but actually followed through on a wide range reforms to tax policy and tax administration. Political will has been weak, however, in resisting special interest pressures for granting costly and distortionary tax favors.

Third, the cornerstones for strengthening revenue performance included the introduction of VAT on the policy side, and three critical factors on the administrative side: (1) functional reorganization and operational segmentation by taxpayer size, especially for large taxpayers; (2) computerization throughout the tax system; and (3) a focus on taxpayer services to facilitate voluntary compliance.

Fourth, tax reform is a long-term process. This is particularly evident in Nepal, where major reforms have been ongoing since the 1990s. Although tax reforms of the 1990s may not have produced immediate impact, they have been paying off in recent years in remarkable improvements in revenue performance, strengthened by a series of sensible administrative

[14] Funded by Belgium, the European Union, Germany, the Republic of Korea, Kuwait, Luxembourg, the Netherlands, Norway, and Switzerland.

reforms. Even with Nepal's impressive strides over the past 25 years, there is still much room for improving and strengthening the tax system. In view of capacity constraints on the expenditure side of the budget, however, it is arguable that future improvements in the tax system should aim at supporting private sector development by lowering tax rates and reducing compliance costs, rather than by increasing the tax yield much above 20 percent of GDP.

Fifth, human resource management is a vitally important area for attention—and a major point of unfinished business in Nepal. Effective tax administration requires suitable conditions of service and HR systems to professionalize operations, institutionalize integrity, and create attractive paths for career development for tax officers.

Finally, the case of Nepal demonstrates an evolving role for foreign assistance. In early stages of DRM reform, donor support played an essential and catalytic role in promoting transformational reforms to the tax system. As the Nepal government developed its own capacity to drive the reform program, the role for development partners has focused on supporting technical improvements, rather than on triggering transformational changes. Equally important, the experience in Nepal shows the value of donor cooperation. For example, after USAID's support for the introduction of VAT, Danida stepped in to assist with implementation. Later, Danida and GIZ joined hands to assist IRD, particularly with ICT implementation. Similarly, the IMF, the ADB, and the World Bank have coordinated at various times to assist DOC. Sustained coordination of this sort has provided continuity needed to maintain the momentum for reform.

Appendix A – Timeline of Major Tax Policy Reforms

Year	Reform	Notes
FY1993/94	Excise taxes on 32 items abolished; number of sales tax rate brackets reduced from five to two (10% and 20%)	
1993	Self-assessment system introduced	VAT Steering Committee and VAT Task Force formed to prepare for VAT introduction
FY1994/95	Excise taxes on additional 11 items abolished	
FY1995/96	Uniform sales tax rate of 15% introduced	To prepare for VAT
1997	VAT Act implemented, at 10% VAT rate	Replaced sales tax, hotel tax, entertainment tax, and contract tax
2000	New Income Tax Act approved by Parliament, including introduction of the Permanent Account Number (PAN) system, and expansion of withholding at source.	New Income tax act replaced and substantially reformed 1974 Act
2002	New Income Tax Act signed into law and took effect; new Excise Act passed	
2005	VAT rate raised from 10% to 13%	
2007	New Customs Act and regulations	To modernize customs
2008	Tax exemption limit raised to Rs. 115,000 for an individual and Rs. 140,000 for couples	Original threshold in the Income Tax Act of 2002 was Rs. 80,000 for individuals and Rs. 100,000 for couples
2009	Social Security tax at 1% introduced; 40% excise duty rate reduced to 30%; capital gains tax rate cut from 15% to 10%	
2010	35% tax band added PIT structure for individual incomes above Rs. 2.5 million; tax exemption limit raised to Rs. 160,000 for an individual and Rs. 200,000 for couples	
2015	Income tax exemption limit increased to Rs. 250,000 for individual and Rs. 300,000 for couples; Finance Act expands withholding at source	High Level Tax System Review Commission (HLTSRC) submits tax reform recommendations in the same year
2016	VAT threshold increased from Rs. 2 lakh to Rs. 5 lakh; income tax exemption limit increased to Rs. 350,000 for individuals and Rs. 400,000 for couples	
2017	Single Tax Code being drafted	

Appendix B – Timeline of Major Tax Administration Reforms

Year	Reform	Notes
1992	Revenue Group created within the Nepal Administrative Service	
1993	Revenue Investigation Department created; Sales Tax and Excise Departments merged	
1996	Planning for VAT Department to replace Sales Tax and Excise Departments	
1997	VAT Department established; introduction of ASYCUDA at Customs	VAT Department adopted functional organization and automated systems
2001	IRD created merging VAT Department and Tax Administration Department; major components of ICT improvements in IRD implemented	
2003	First Customs Reforms and Modernization Strategies and Action Plan (CRMSAP) 2003–06 developed	
2004	Large Taxpayer Office (LTO) created	
2006	Second CRMSAP (2006–09) developed	
2007	Performance-based incentive system introduced in IRD	
2009	Declared as "Tax Compliance Year" with increased focus on PAN registration; Third CRMSAP (2009–13) developed	
2010	Additional IRD Taxpayer Service Offices (TSOs) established to serve small-size taxpayers; Post Clearance Audit Office established; 2010/11 declared as "Tax Enforcement Year"	
2012	DOC payment through bank with security-enabled receipt at five major Customs offices	
2013	First IRD Strategic Plan (FY2012/13–2016/17) developed and Reform Plan (FY2012/13-2014/15); Fourth CRMSAP (2013–17) developed	GIZ assistance in preparing framework of IRD Strategic Plan; IMF assistance in preparing framework of CRMSAP Plan and IRD Reform Plan
2017	Fifth CRMSAP (2017–21) developed; ASYCUDA World being implemented; integration of all IRD ICT systems	

Appendix C – Nepal Selected Data

General Overview of the Economy

	1999	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
GDP per capita, PPP (current international $)	1,145	1,659	1,777	1,853	1,946	2,031	2,142	2,239	2,387	2,450	2,468
GDP growth (annual %)	4.4	3.4	6.1	4.5	4.8	3.4	4.8	4.1	6.0	2.7	0.6
Inflation, consumer prices (annual %)	7.5	5.7	9.9	11.1	9.3	9.3	9.5	9.0	8.4	7.9	N.A.
Consumer price index (2010 = 100)	53	75	82	91	100	109	120	130	141	152	166
Population growth (annual %)	1.9	1.1	1.0	1.0	1.0	1.1	1.2	1.2	1.2	1.2	1.1
Population, total	23.3	26.2	26.5	26.7	27.0	27.3	27.7	28.0	28.3	28.7	29.0
Labor force participation rate, total (% of total population ages 15+) (modeled ILO estimate)	86.0	83.9	83.6	83.5	83.4	83.3	83.2	83.1	83.0	83.0	83.0
Personal remittances received (% of GDP)	1.7	16.8	21.7	23.2	21.6	22.3	25.4	29.0	29.4	31.6	29.7
Agriculture, value added (% of GDP)	41.3	33.6	32.7	34.0	36.5	38.3	36.5	35.0	33.8	33.0	33.0
Services, etc., value added (% of GDP)	36.9	49.3	49.9	49.6	47.8	46.3	48.0	49.2	50.7	51.6	52.4
Industry, value added (% of GDP)	21.8	17.1	17.3	16.4	15.6	15.4	15.5	15.7	15.4	15.4	14.6
Manufacturing, value added (% of GDP)	9.5	7.7	7.6	7.2	6.5	6.5	6.6	6.6	6.4	6.3	5.8
Annual growth in agriculture, value added	2.7	1.0	5.8	3.0	2.0	4.5	4.6	1.1	4.5	0.8	1.3
Annual growth in services, value added	5.3	3.8	7.4	6.3	6.1	3.2	5.2	6.2	6.1	3.7	2.7
Annual growth in industry, value added	6.0	3.9	1.7	-0.6	4.0	4.3	3.0	2.7	7.1	1.5	-6.3
Annual growth in manufacturing, value added	5.3	2.6	-0.9	-1.0	3.0	4.1	3.6	3.7	6.3	0.4	-9.9

Source: World Development Indicators (WDI), World Bank (https://data.worldbank.org/products/wdi).
Note: N.A. = not available.

General Overview of the Economy (Continued)											
	1999	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Gross value added at factor cost (in billions of current local currency units)	321	676	755	910	1,083	1,248	1,387	1,525	1,759	1,889	2,007
Household final consumption expenditure, etc. (% of GDP)	77.5	81.0	80.3	79.8	78.6	76.5	78.3	79.5	77.8	80.2	83.8
Imports of goods and services (% of GDP)	29.7	31.7	33.3	34.7	36.4	32.9	33.6	37.5	40.8	41.7	39.4
Exports of goods and services (% of GDP)	22.8	12.9	12.8	12.4	9.6	8.9	10.1	10.7	11.5	11.7	10.7
Merchandise imports (in billions of current US$)	1.4	3.1	3.6	4.4	5.1	5.8	6.1	6.6	7.6	6.7	9.7
Merchandise exports (in billions of current US$)	0.6	0.9	0.9	0.8	0.9	0.9	0.9	0.9	0.9	0.7	0.7
Net official development assistance (ODA) received (% of GNI)	6.9	5.8	5.5	6.6	5.1	4.7	4.1	4.5	4.3	5.6	N.A.

Source: World Development Indicators (WDI), World Bank (https://data.worldbank.org/products/wdi).
Note: N.A. = not available.

Tax Structure		
	As of FY2017	**Notes**
Value added tax (VAT) rate	13%	Changed from 10% in 2005
VAT threshold	Rs. 500,000	VAT threshold increased from 2 lakh rupees to 5 lakh rupees in 2016 budget
VAT year	1997/98	
Corporate income tax (CIT) rate	25.0%	Also, CIT rates of 20.0% and 30.0% exist for specific categories of businesses
Personal income tax (PIT) minimum rate	0.0%	No PIT for income levels below Rs. 350,000 (not taxed), Social Security tax of 1% still applies
PIT minimum income level	Rs. 350,000	Rs. 350,000 through Rs. 700,000 taxed at 15%
PIT maximum rate	35.0%	For incomes exceeding Rs. 2.5 million
PIT maximum income level	Rs. 2,500,000	Income above Rs. 2.5 million taxed at 35%
Social Security rate (payroll tax)	1.00%	Social Security tax introduced since July 2009
Tax wedge	1.00%	As measured at the minimum wage of Rs. 9,700 per month (as of 2016)

Source: T.R. Upadhya & Company. Income Tax Rates 2016-17, available at http://www.trunco.com.np/pdf/TRU_Tax_Rates_2016_17.pdf.

Tax Administration

	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16
Cost of collection for Rs. 1,000	16.4	9.9	5.6	5.0	12.7	10.0	10.2	10.0	7.6	7.8
e-Filing, %	N.A.	N.A.	N.A.	N.A.	87	N.A.	N.A.	97	98	87
VAT non-filer, %	14.6	16.7	19.0	27.0	21.3	22.3	21.5	31.0	24.2	30.3
Income tax non-filer, %	82.7	58.7	55.5	57.9	58.4	55.6	55.5	39.5	40.0	38.0
Returns audited, %	N.A.	N.A.	N.A.	N.A.	2.8	2.4	3.8	1.9	N.A.	N.A.
Active taxpayers audited, %	N.A.	N.A.	N.A.	N.A.	1.3	1.1	1.7	1.2	N.A.	N.A.
Online registration, %	N.A.	N.A.	N.A.	N.A.	96.8	N.A.	N.A.	98.2	99.1	N.A.
PAN registration	256,421	288,670	356,855	407,471	463,378	539,014	623,439	684,552	765,605	849,236
PIT registration	N.A.	N.A.	N.A.	98,444	220,482	271,460	356,062	432,947	526,740	603,581
VAT registration	53,014	59,741	69,708	82,684	7,731	113,919	129,713	134,091	153,850	167,530
Excise license	N.A.	N.A.	N.A.	21,112	23,837	23,837	36,174	34,967	46,987	54,311

Sources: Government of Nepal, IRD 2016 and prior year annual reports, Strategic Plan 2012/13 – 2016/17 (Government of Nepal, IRD 2012), and Reform Plan 2015/16 – 2017/18 (Government of Nepal, IRD 2016a).
Note: N.A. = not available.

Domestic Resource Mobilization (As a percent of GDP)											
	FY00	**FY07**	**FY08**	**FY09**	**FY10**	**FY11**	**FY12**	**FY13**	**FY14**	**FY15**	**FY16**
Total domestic revenue and grants	**12.8**	**14.2**	**15.7**	**17.9**	**18.2**	**18.5**	**18.7**	**19.7**	**20.9**	**21.2**	**23.3**
Total grants	1.5	2.2	2.5	3.5	3.2	3.6	2.7	2.1	2.1	1.8	21.6
Total domestic revenues (excluding grants)	11.3	12.1	13.2	14.4	14.9	14.9	16.0	17.6	18.8	19.4	21.6
Tax revenues	8.7	9.8	10.4	11.8	13.4	13.3	13.9	15.3	15.9	16.8	18.7
Personal income tax (PIT) revenues	0.1	0.6	0.7	0.8	0.8	0.9	0.8	0.9	1.0	1.1	1.3
Personal or sole trading firm	0.0	0.3	0.3	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Remuneration tax	0.1	0.3	0.3	0.3	0.4	0.4	0.4	0.5	0.5	0.5	0.6
Capital gains	0.0	0.0	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.3
Other tax included with PIT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Corporate income tax (CIT) revenues	1.2	1.3	1.3	1.5	1.7	1.9	2.0	2.2	2.3	2.5	3.2
Excise revenues	0.8	1.3	1.4	1.6	2.0	2.0	2.0	2.1	2.3	2.5	2.9
VAT revenues	2.6	3.6	3.7	4.0	4.6	4.6	4.6	4.9	5.1	5.3	5.4
VAT on imports	1.6	2.3	2.3	2.6	2.9	2.9	2.9	3.2	3.4	3.4	3.2
Trade revenues	2.8	2.3	2.6	2.6	3.0	2.7	2.8	3.4	3.5	3.5	3.7
Social contributions	—	—	—	—	—	—	0.1	0.1	0.1	0.1	0.1
Other revenues	1.2	0.7	0.8	1.2	1.3	1.3	1.5	1.7	1.6	1.8	2.1
Non-tax revenues	2.6	2.1	2.4	2.2	1.5	1.7	2.1	2.2	2.6	2.4	2.7
Tax performance: VAT efficiency ratio	26%	28%	28%	31%	35%	35%	36%	38%	40%	41%	42%

Sources: Calculated using data from Ministry of Finance Budget speeches for current and prior years and GDP figures from Central Bank of Nepal's Nepal Rastra Bank statistics (https://www.nrb.org.np/statistics.php).
Note: — = not applicable.

Domestic Resource Mobilization (As a percent of Total Tax Revenues)	FY00	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16
Personal income tax (PIT) revenues	1.4	6.1	6.8	7.1	5.8	6.5	5.8	6.0	6.2	6.3	7.1
Personal or sole trading firm	0.0	3.2	2.9	3.1	2.4	2.7	2.6	2.4	2.5	2.4	2.3
Remuneration tax	1.4	2.8	2.9	2.8	2.8	3.1	2.9	3.3	3.1	3.2	3.2
Capital gains	0.0	0.0	0.9	1.1	0.7	0.7	0.3	0.4	0.6	0.7	1.6
Other tax included with PIT	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Corporate income tax (CIT) revenues	13.4	13.1	12.7	13.1	12.6	14.2	14.4	14.3	14.5	14.6	16.9
Excise revenues	9.4	13.1	13.1	13.2	15.1	14.9	14.2	14.0	14.5	15.0	15.6
VAT revenues	29.7	36.7	35.0	34.1	34.4	34.6	33.5	32.2	32.4	31.6	29.1
VAT on imports	18.5	23.1	22.3	22.2	21.6	21.9	21.2	21.2	21.4	20.5	17.3
Trade revenues	32.6	23.5	24.7	22.1	22.0	20.2	20.5	22.0	21.8	21.0	19.5
Social contributions	—	—	—	—	—	—	0.7	0.7	0.8	0.8	0.8
Other revenues	13.5	7.5	7.6	10.4	10.0	9.5	10.9	10.9	9.8	10.5	11.1

Sources: Calculated using data from Ministry of Finance current and prior year budget speeches (see References section).
Note: — = not applicable.

Taxes and The Business Environment

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Ease of Doing Business Rank	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	100
Overall Distance to Frontier (DTF)	N.A.	N.A.	N.A.	N.A.	60.4	58.1	59.6	60.1	60.9	60.1	59.4
Paying Taxes – Rank	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	138
Paying Taxes – Payments (number per year)	34	34	34	34	34	34	34	34	34	34	34
Paying Taxes – Time (hours per year)	408	408	408	408	338	338	326	326	334	334	334
Paying Taxes – Post-filing index (0-100)	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	33.5
Percent of firms visited or required to meet with tax officials—average for all manufacturing	N.A.	N.A.	N.A.	57.9	N.A.	N.A.	N.A.	61.6	N.A.	N.A.	N.A.
Percent of firms visited or required to meet with tax officials—average for all services	N.A.	N.A.	N.A.	65.9	N.A.	N.A.	N.A.	67.5	N.A.	N.A.	N.A.
If there were visits, average number of visits or required meetings with tax officials—average for all manufacturing	N.A.	N.A.	N.A.	2.0	N.A.	N.A.	N.A.	2.3	N.A.	N.A.	N.A.
If there were visits, average number of visits or required meetings with tax officials—average for all services	N.A.	N.A.	N.A.	2.0	N.A.	N.A.	N.A.	2.9	N.A.	N.A.	N.A.
Percent of firms identifying tax rates as a major constraint—average for all manufacturing	N.A.	N.A.	N.A.	5.9	N.A.	N.A.	N.A.	15.2	N.A.	N.A.	N.A.
Percent of firms identifying tax rates as a major constraint—average for all services	N.A.	N.A.	N.A.	6.4	N.A.	N.A.	N.A.	9.3	N.A.	N.A.	N.A.
Percent of firms identifying tax administration as a major constraint—average for all manufacturing	N.A.	N.A.	N.A.	12.0	N.A.	N.A.	N.A.	12.9	N.A.	N.A.	N.A.
Percent of firms identifying tax administration as a major constraint—average for all services	N.A.	N.A.	N.A.	6.8	N.A.	N.A.	N.A.	7.3	N.A.	N.A.	N.A.
Percent of firms expected to give gifts in meetings with tax officials—average for all manufacturing	N.A.	N.A.	N.A.	17.3	N.A.	N.A.	N.A.	11.0	N.A.	N.A.	N.A.
Percent of firms expected to give gifts in meetings with tax officials—average for all services	N.A.	N.A.	N.A.	14.0	N.A.	N.A.	N.A.	10.1	N.A.	N.A.	N.A.

Sources: Doing Business Indicators, World Bank (http://www.doingbusiness.org/); Enterprise Survey Data, World Bank (http://www.enterprisesurveys.org/).
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