

## 2. Public Finance

### Outline of Government Finance

- 2.01 Revenue mobilization is the major source of the government expenditure. A minimal gap between expenditure and revenue is to be maintained for fiscal balance. There was a significant improvement in revenue mobilization and capital expenditure in FY 2006/07 compared to that in FY 2005/06. However, looking at the fiscal trends of the last couple of years, responsible efforts are needed to improve the structural problems such as increasing trend of recurrent expenditure, declining trend of capital expenditure and challenges related to overall fiscal stability. Comparing the fiscal statistics of FY 2006/07 with that of FY 2000/01, the contribution of revenue on total expenditure increased to 65.7 percent in FY 2006/07 from 61.2 percent in FY 2000/01. In this period the overall expenditure increased at an annual average rate of 9 percent, while the revenue mobilization increased at an annual average rate of 10.2 percent. The fact that fiscal deficit to total expenditure ratio decreased to 22.5 percent in FY 2006/07 from 30.3 percent in FY 2001/02 indicates that the fiscal deficit in the recent years is under control.
- 2.02 The combined share of recurrent expenditure and principal repayment in total expenditure increased to 70.3 percent in FY 2007/08 from 64.5 percent in FY 2000/01 (the share of principal repayment alone increased to 12.6 percent in FY 2006/07 from 7.1 percent in FY 2000/01). Therefore, the gap between the ratio of revenue mobilization to total expenditure and the ratio of combined recurrent and principal repayment expenditure to total expenditure increased to 4.6 percentage points (70.3 percent minus 65.7 percent) in FY 2006/07 from 3.3 percentage points (64.5 percent minus 61.2 percent) in FY 2000/01. In FY 2005/06, such gap had increased to a higher level of 8.1 percentage points. In FY 2005/06, the shares of recurrent expenditure and principal repayments in total expenditure were 60.4 percent and 12.9 percent respectively with their combined share at 7.3 percent while the amount of revenue was 65.2 percent of the total expenditure. As the gap was brought down to the level of 4.6 percentage points in FY 2006/07, there was a significant improvement in controlling the deficit between revenue mobilization and recurrent and principal repayments expenditure.
- 2.03 The capital expenditure, however, showed a declining trend in this period. The share of capital expenditure in total expenditure was 35.5 percent in

FY 2000/01, which came down to 26.7 percent in FY 2005/06 indicating that there was no expansion of resource allocation to the development activities from the government sector. The share of capital expenditure to total expenditure stood at 30.9 percent in FY 2001/02, 26.6 percent in FY 2002/03, 25.8 percent in FY 2003/04, 26.7 percent each in FY 2004/05 and FY 2005/06. In FY 2006/07, the ratio increased by 3.0 percentage points to 29.7 percent.

**Table 2(a) : Ratio of Fiscal Heads to Total Government Expenditure**

(in percentage)

<i>Fiscal heads</i>	2000/01	2007/02	2002/03	2003/04	2004/05	2005/06	2006/07
<b>Expenditure</b>	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<b>Recurrent Expenditure</b>	57.4	61.0	62.0	62.1	60.1	60.4	57.7
<b>Capital Expenditure</b>	35.5	30.9	26.6	25.8	26.7	26.7	29.7
<b>Principal Repayment</b>	7.1	8.0	11.4	12.1	13.2	12.9	12.6
<b>Resources</b>	69.7	71.4	80.4	82.3	82.4	77.7	77.5
<b>Revenue</b>	61.2	63.0	66.9	69.7	68.4	65.2	65.7
<b>Foreign Grants</b>	8.5	8.4	13.5	12.6	14.0	12.5	11.8
<b>Surplus (+)/Deficit (-)</b>	-30.3	-28.6	-19.6	-17.7	-17.6	-22.3	-22.5
<b>Sources of Deficit Financing</b>							
<b>Foreign Loan</b>	15.1	9.6	5.4	8.5	9.0	7.4	7.5
<b>Domestic Borrowing</b>	8.8	10.0	10.6	6.3	8.7	10.7	13.4
<b>Change in Reserves (- surplus)</b>	6.4	9.0	3.6	2.9	-0.2	4.3	1.6

2.04 The ratios of total expenditure and revenue to GDP increased in FY 2006/07 compared to that in FY 2005/06. The ratio of revenue mobilization to GDP in FY 2006/07 increased by 1.0 percentage point and reached 12.1 percent compared to the ratio of 11.1 percent in FY 2005/06. The ratio of government expenditure to GDP increased to 18.4 percent in FY 2006/07 from 17.1 percent in FY 2005/06. Due to the increase in the ratios of revenue to GDP and total expenditure to GDP, the gap between revenue mobilization and total expenditure increased by 0.4 percentage points to 6.3 percent in FY 2006/07 from 5.9 percent in FY 2005/06.

**Table 2(b) : Ratio of Government Expenditure and Revenue to GDP**  
(GDP at Current Producers' Price)

(in percentage)

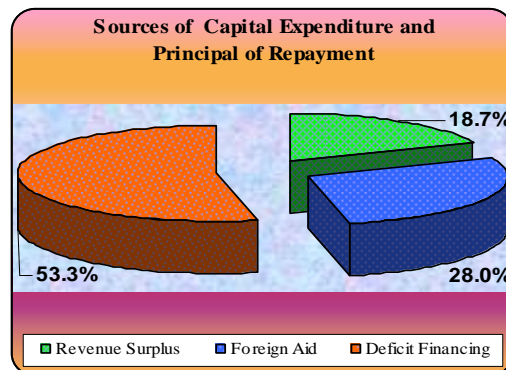
<b>Fiscal Year</b>	<b>Government Expenditure</b>				<b>Revenue Mobilization</b>	<b>Gap between exp. and revenue</b>
	Recurrent	Capital	Principal Repayment	Total		
2000/01	10.4	6.4	1.3	18.1	11.1	7.0
2001/02	10.6	5.4	1.4	17.4	10.9	6.5
2002/03	10.6	4.5	1.9	17.1	11.4	5.6

2003/04	10.3	4.3	2.0	16.7	11.6	6.0
2004/05	10.5	4.6	2.3	17.4	11.9	5.5
2005/06	10.2	4.5	2.2	17.0	11.1	5.9
2006/07	10.6	5.5	2.3	18.4	12.1	6.3

*Source: Financial Comptroller General Office and Central Bureau of Statistics*

2.05 There is a significant improvement in the revenue surplus, calculated as the difference between revenue mobilization and regular expenditure, in FY 2006/07 compared to than in the previous fiscal year. Such surplus is considered as a sustainable source to finance the capital expenditure and principal repayments. The increase in the ratio of revenue surplus to the capital and principle repayments expenditure in FY 2006/07 was attributed to a significant increase in the revenue mobilization compared to the growth of total expenditure. The ratio of revenue surplus to the capital and principal repayment expenditure in FY 2006/07 increased by 6.7 percentage points to reach 18.7 percent from 12.0 percent in FY 2005/06. On the sources of financing capital and principal repayments, the share of foreign grants compared to that in FY 2005/06 decreased by 3.5 percentage points to 28 percent in FY 2006/07. Similarly, such ratio of deficit financing in FY 2006/07 decreased by 3.2 percentage points to 53.3 percent.

2.06 On the sources of deficit financing in FY 2006/07, the share of foreign loan remained at 17.8 percent, domestic borrowings at 31.7 percent and change in cash balance at 3.8 percent in FY 2006/07, the share of foreign loan and cash balance decreased by 1 percentage point and 7 percentage points respectively, but the share of internal borrowings increased by 4.8 percentage points. On the sources of financing capital and principal repayments in FY 2006/07, the share of revenue surplus remained at 18.7 percent, foreign grants at 28.0 percent and deficit financing at 53.3 percent. Since the revenue surplus increased by 6.7 percentage points and foreign grants decreased by 3.5 percentage points, the share of deficit financing decreased by 3.3 percentage points to 53.3 percent in FY 2006/07.



**Table 2(c) : Capital Expenditure and Principal Repayment, and Sources of Financing**

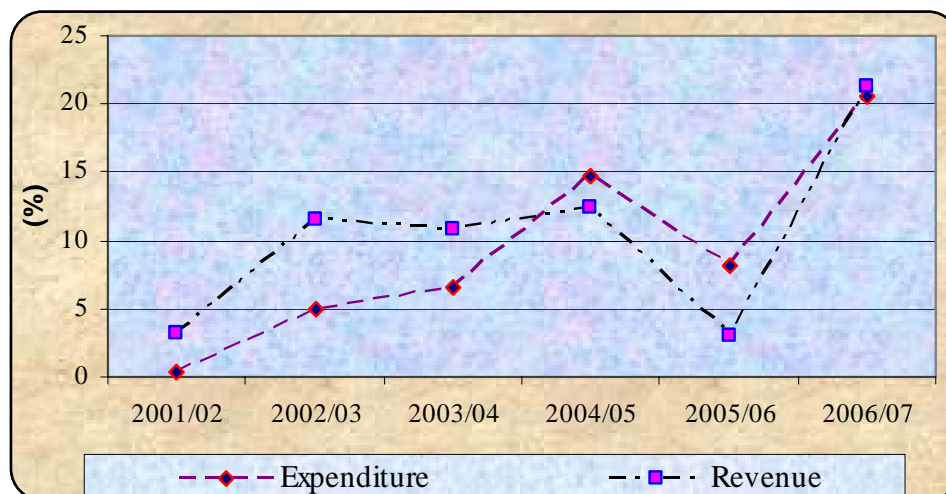
Descriptions	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
<b>Total Capital &amp; Principal Repayment Expenditure (Rs. Billion)</b>	34.00	31.21	31.92	33.89	40.87	43.87	56.48
<b>a. Capital Expenditure</b>	28.31	24.77	22.36	23.10	27.34	29.60	39.73
<b>b. Principal Repayment</b>	5.69	6.43	9.56	10.79	13.53	14.26	16.75
<b>Sources ( in Percentage)</b>							
<b>a Revenue Surplus</b>	9.0	5.1	13.0	20.0	20.6	12.0	18.7
<b>b. Foreign Grant</b>	19.9	21.4	35.5	33.3	35.2	31.5	28.0
<b>c. Deficit Financing</b>	71.1	73.5	51.4	46.7	44.2	56.5	53.3
<b>Foreign Loan</b>	(35.4)	(24.7)	(14.3)	(22.5)	(22.7)	(18.8)	(17.8)
<b>Domestic Borrowing</b>	(20.6)	(25.6)	(27.8)	(16.5)	(21.9)	(26.9)	(31.7)
<b>Change in Reserves</b>	(15.1)	(23.2)	(9.4)	(7.7)	(-0.4)	(10.8)	(3.8)

Source: Financial Comptroller General Office

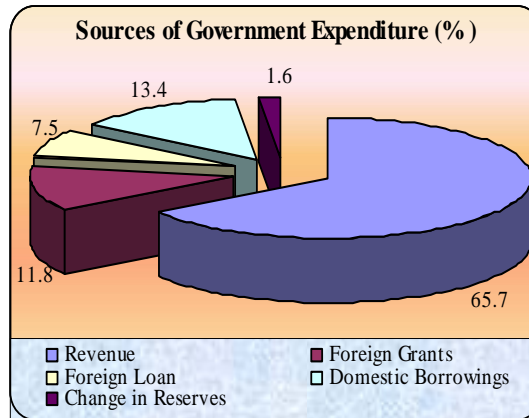
## Public Finance

2.07 The increasing expenditure trend continued in FY 2006/07 too. The total expenditure increased by 20.5 percent in FY 2006/07 compared to the growth of 8.1 percent in FY 2005/06. As per the components of total expenditure, recurrent expenditure increased by 15.1 percent in FY 2006/07 compared to the growth of 8.6 percent in the previous year. Capital expenditure increased by 34.2 percent in FY 2006/07 over an increment of 8.3 percent in FY 2004/05. Principal repayment increased by 17.4 percent in FY 2006/07 compared to the growth of 5.4 percent in the previous year.

**Chart 2(a) : Growth Rate of Government Expenditure and Revenue**



2.08 Of the total expenditure amounting to Rs.110.88 billion in FY 2005/06, the revenue mobilization financed 65.2 percent, foreign grants 12.5 percent, foreign loan 7.4 percent and domestic borrowings 10.7 percent. Sources of financing the total expenditure of Rs.133.60 billion in FY 2006/07 included revenue mobilization, 65.7



percent, foreign grants 11.8 percent, foreign loan 7.5 percent, domestic borrowings 13.4 percent and cash balance 1.6 percent. As a result of increase in the domestic borrowing by 51.2 percent in FY 2006/07 compared to FY 2005/06, change in cash balance in FY 2006/07 was limited to a deficit of Rs.2.15 billion.

### Recurrent Expenditure

2.09 In FY 2006/07 compared to in FY 2005/06, the recurrent expenditure increased by 15.1 percent to Rs.77.12 billion. The total recurrent expenditure in FY 2006/07 stood at Rs.67.01 billion in FY 2005/06. On the components of recurrent expenditure, the share of expenditure of constitutional bodies remained at 1.3 percent, general administration at 14.4 percent, revenue and fiscal administration at 1.3 percent, fiscal administration and planning at 0.9 percent, judiciary administration at 0.8 percent and foreign services at 1.1 percent. Likewise, the share of defense expenditure remained at 13.1 percent, expenditure on social services at 38.2 percent, economic services at 10.9 percent, and interest payments at 8 percent, and miscellaneous expenditure at 10.0 percent.

2.10 In FY 2006/07, major chunk of recurrent expenditure (Rs.29.5 billion) was spent on education, health, drinking water, local development and other social services. Likewise, other major expenditure heads of the recurrent expenditure were general administration Rs.11.07 billion, defense Rs.11.13 billion and

economic services Rs.8.38 billion. The expenditure on interest payments of principal remained at Rs.6.16 billion.

- 2.11 Among the major expenditure heads of the recurrent expenditure in FY 2006/07 compared to that in FY 2005/06, the increment rates were social service expenditure 16.2 percent, defense expenditure 4.4 percent, general administration 19.5 percent, judiciary administration 3.0 percent, foreign services 2.5 percent, economic services 11.4 percent, revenue and fiscal administration 64.3 percent, fiscal administration and planning 100.6 percent, constitutional organs 69.5 percent and miscellaneous expenditure 47.4 percent. Likewise, the interest payment increased by 0.1 percent.

### **Capital Expenditure**

- 2.12 Capital expenditure in FY 2006/07 increased by 34.2 percent to Rs.39.73 billion. In the FY 2005/06, the total capital expenditure stood at Rs.29.61 billion. Among the components of capital expenditure, economic services expenditure remained at Rs.17.94 billion, social services at Rs.15.53 billion, and defense at Rs.1.08 billion. Likewise, the capital expenditure on general administration remained at Rs.4.51 billion, judiciary administration at Rs.240.6 million and miscellaneous at Rs.223.1 million. The share of economic services in capital expenditure remained at 45.1 percent, that of social services 39.1 percent, defense 2.5 percent, general administration 11.4 percent, judiciary administration and miscellaneous 0.6 percent each. When compared to the capital expenditure of FY 2005/06, capital expenditure for social services increased by 53 percent, that for economic services by 21.2 percent, defense expenditure by 37.7 percent and general administration by 281.8 percent. Similarly, the expenditure on revenue and fiscal administration increased by 51.6 percent, judiciary administration by 37.1 percent, and fiscal administration and planning by 29.1 percent.

### **Principal Repayment**

- 2.13 The expenditure on principal repayment is on an increasing trend. In FY 2006/07, the principal repayment expenditure increased by 17.4 percent to Rs.16.75 billion from the level of Rs.14.26 billion in FY 2005/06.
- 2.14 In FY 2006/07, the share of domestic loan repayment remained at 55 percent of the total principal repayment. So, and the share of foreign loan repayment in the total principal repayment stood at 45 percent.

Compared to the repayment in the previous fiscal year, the domestic loan repayment and the foreign loan repayment in FY 2006/07 increased by 26.6 percent and respectively 7.9 percent.

### **Expenditure in the First Eight Months of FY 2007/08**

2.15 Based on the total disbursement and the operation of revolving fund, total expenditure increased by 46.2 percent to Rs.101.82 billion in the first eight months of FY 2007/08 when compared to that of the same period last year. In the same period in FY 2006/07, the total expenditure was at the level of Rs.69.63 billion. Of the total expenditure in the review period of FY 2007/08, the recurrent expenditure amounted to Rs.64.6 billion, capital expenditure Rs.26.69 billion and principal repayments Rs.10.52 billion. Such expenditures in the same period of the previous year were Rs.48.60 billion, Rs.15.20 billion and Rs.5.82 billion respectively. The growth of recurrent expenditure and capital expenditure in the review period of FY 2007/08 was 32.9 percent and 75.6 percent respectively while the principal repayments was decreased by 80.8 percent in the same period.

### **Revenue**

2.16 Revenue mobilization, foreign grants and loans, domestic borrowing and use of cash balance have been used as fiscal instruments to fund government expenditure. Government revenue, the major source of government resources, increased by 21.3 percent to Rs.87.71 billion in FY 2006/07 compared to that in last year. In FY 2005/06, the government revenue had increased by 3.1 percent compared to that in the FY 2004/05. While, the government revenue had financed 65.2 percent of the government expenditure in FY 2005/06, it had financed 65.7 percent of the expenditure in FY 2006/07. In FY 2004/05, the government revenue was 68.4 percent of the total expenditure.

2.17 Of the total revenue, the shares of tax revenue and non-tax revenue in FY 2006/07 were 81.1 percent and 18.9 percent respectively. Such ratios in the previous year were 79.5 percent and 20.5 percent respectively.

2.18 In FY 2006/07, tax revenue increased by 23.8 percent as compared to the growth of 6.1 percent in the previous year. In FY 2006/07, the share of customs revenue in the total tax revenue was 23.5 percent, while the share of tax on production and consumption of goods and services remained at 49.8 percent. Similarly, the share of land and

house registration tax was 3.2 percent, and that of the income, profit and property tax was 23.5 percent.

- 2.19 In the tax revenue front, the customs revenue increased by 8.9 percent in FY 2006/07. During the year, the tax on production and consumption of goods and services grew by 26.0 percent, tax on income, profit and property rose by 41.9 percent, and land and house registration tax increased by 3.3 percent. Of the customs revenue, the import tax and the export tax revenue increased by 16.0 percent and 13.3 percent respectively, while the Indian excise refund decreased by 18.1 percent. Of the tax on production and consumption of goods and services, VAT revenue increased by 20.7 percent and excise revenue increased by 43.6 percent.
- 2.20 In FY 2006/07 non-tax revenue increased by 11.7 percent to Rs.16.59 billion in comparisons to the previous year. Of the total non-tax revenue the share of fees, fines and forfeitures was 11.7 percent, revenue from public services and sales was 28.8 percent, dividend was 29.8 percent, royalty and sales of government properties was 6.6 percent, principal and interest was 12.6 percent and miscellaneous non-tax revenue was 10.5 percent. Compared to the previous fiscal year, the growth of firm registration fees was 39.0 percent, and that of the administrative fees, fines and forfeitures was 16.4 percent. While the dividend from service-oriented organizations decreased by 28.8 percent, the tax from the income of other government organizations was 24.0 percent. In FY 2006/07, the principal and interest from companies and enterprises decreased by 33.2 percent and 39.0 percent respectively.

### **Revenue in the First Eight Months of FY 2007/08**

- 2.21 In the first eight months of FY 2007/08, the revenue mobilization has increased to Rs.60.89 billion from Rs.48.04 billion in the same period of the previous year. The revenue growth is 26.8 percent in the review period when compared to the same period last year. Of the total revenue collection, Rs.50.90 billion was collected from tax revenue sources and Rs.9.99 billion from non-tax revenue sources. in the review period the growth of tax revenue was 25.5 percent, whereas the growth of non-tax revenue was 33.4 percent.
- 2.22 The customs revenue in the first eight months of FY 2007/08 compared to the same period of last year increased by 37.5 percent to Rs.14.03 billion. Similarly, tax on production and consumption of

goods and services in the review period increased by 15.5 percent to Rs.24.18 billion. On the customs revenue front, the import tax revenue, which constituted 80.3 percent of the total customs revenue in the first eight months of the review period, increased by 39.0 percent. The share of import revenue on total customs revenue was 79.4 percent in the same period last year. While the export tax revenue in the review period decreased by 46.8 percent, the Indian excise refund increased by 63.9 percent. Similarly, the registration fee, income tax (public sector) and vehicle tax in the first eight months of FY 2007/08 increased by 21.3 percent, 65.7 percent and 15.1 percent respectively.

### **Foreign Aid**

- 2.23 The foreign aid commitment in FY 2006/07 increased by 76.9 percent against a decline of 45.2 percent in FY 2005/06. In FY 2006/07, committed foreign assistance amounted to Rs.37.02 billion. Compared to an amount of Rs.20.92 billion in FY 2005/06. Of the total foreign aid commitment, the bilateral assistance constituted Rs.17.71 billion, whereas the multilateral assistance was equivalent to Rs.19.32 billion. While classifying the foreign aid into grants and loans component for FY 2006/07, foreign grants amounted to Rs.30.86 billion and foreign loans amounted to Rs.6.16 billion. In FY 2005/06 as compared to the previous year, the foreign grants had increased by 69 percent and the foreign loans had increased by 131.7 percent respectively.
- 2.24 While analyzing the foreign aid commitment in FY 2006/07 on a sectoral basis, the share of foreign aid commitment for agriculture, irrigation and forestry was 3.9 percent, electricity 4.7 percent, local development 5.3 percent, education 16.9 percent, health sector 9.2 percent, and other 45.9 percent. Similarly, the share of foreign aid commitment for the transport and communication sector was 14.1 percent.

### **Foreign Aid Commitments**

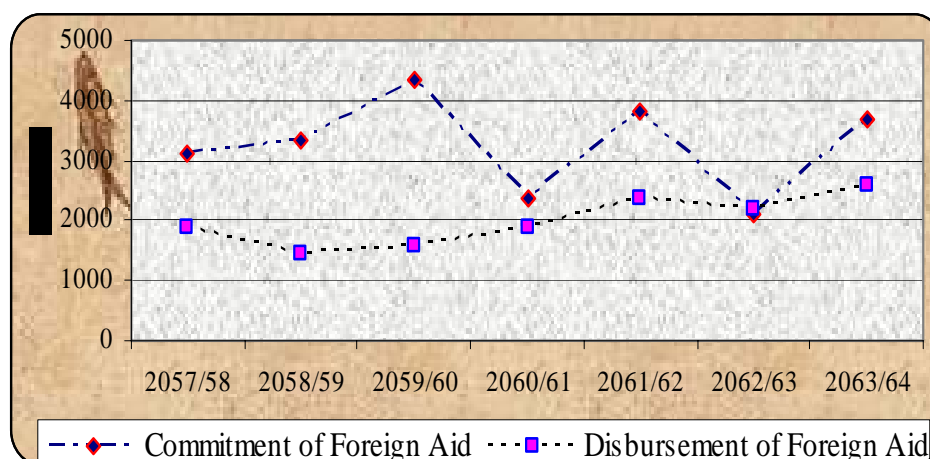
- 2.25 In the first eight month of FY 2007/08, the foreign aid commitment increased by 89.1 percent to Rs.48.67 billion. Of the total foreign aid commitment, the committed foreign grants amounted to Rs.40.55 billion (83.3 percent of the total) and the committed foreign loans Rs.8.12 billion (16.7 percent of the total). In the first eight months of FY 2006/07, the committed foreign aid amounted to Rs.25.74 billion,

of which foreign grants was Rs.19.57 billion and foreign loans Rs.6.16 billion. Of the total commitment, the composition of grants and loans was 76.1 percent and 23.9 percent respectively.

### Commitment and Disbursement

2.26 In the first eight months of FY 2007/08, the share of bilateral assistance in total commitment was 26.9 percent while the share of multilateral assistance was 73.1 percent. In the same period last year, the shares of bilateral and multilateral assistance were 40.2 percent and 59.8 percent respectively. While analyzing sector-wise, the foreign aid commitment in the first eight months of FY 2007/08 for electricity sector was Rs.2.72 billion (5.6 percent), education sector 3.78 billion (7.8 percent), local development Rs.6.72 billion (13.8 percent), agriculture, irrigation and forestry 4.34 billion (8.9 percent), transport and communication Rs.3.35 billion (6.9 percent) and other sectors Rs.27.76 billion (57 percent).

**Chart 2(b) : Commitment and Disbursement of Foreign Aid**



2.27 In FY 2006/07 compared to that of FY 2005/06 the disbursement of foreign aid increased by 17.3 percent to Rs.25.85 billion. Of the total foreign aid disbursement in FY 2006/07, Rs.15.80 billion (61.1 percent) was foreign grants and Rs.10.05 billion (38.9 percent) foreign loans. In the previous year, the foreign aid disbursement amounted to Rs.22.04 billion, of which Rs.13.83 billion (62.7 percent) was foreign grants and Rs.8.21 billion (37.3 percent) foreign loan. Of the total foreign aids disbursement in FY 2006/07, Rs.9.44 billion (36.5 percent) was through multilateral assistance and Rs.16.41 billion (63.5 percent) through bilateral assistance. In the

previous year, the multilateral aid disbursement had amounted to Rs.14.38 billion (65.3 percent) and bilateral assistance Rs.7.66 billion (34.7 percent).

- 2.28 The foreign aid disbursement on a sectoral basis in FY 2006/07 shows that, foreign aid disbursement in social sector was Rs.15.18 billion (58.7 percent of the total), transport, electricity and communication sector Rs.6.06 billion (25.8 percent), agriculture, irrigation and forestry Rs.3.72 billion (14.4 billion), industry and commerce Rs.116.8 million (0.5 percent) and others Rs.173.1 million (0.7 percent). On comparison of the foreign aid disbursement on a sectoral basis for FY 2006/07 with that of FY 2005/06, the foreign aid disbursement in social sector increased by 3.6 percent, agriculture, irrigation and forestry by 55.3 percent and industry and commerce by 10.9 percent, while the disbursement in transport, electricity and communication sector decreased by 5.9 percent.

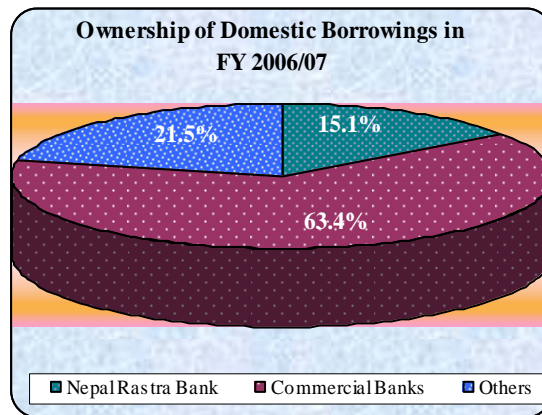
### **Foreign Loan**

- 2.29 Foreign loan has played a crucial role in the Nepalese economy, mainly due to inadequate revenue mobilization to meet the expenditure. The net outstanding foreign loan compared to the level of Rs.233.96 billion in FY 2005/06 decreased by 7.4 percent to Rs.216.63 billion in FY 2006/07.
- 2.30 Net outstanding foreign debt at the end of first eight months of FY 2007/08 (adjusting gross borrowing and principal repayment in the first eight months) decreased by 7.9 percent to Rs.216.20 billion compared to the net outstanding foreign debt of Rs.234.81 billion at the end of the first eight months of FY 2006/07.
- 2.31 The ratio of net outstanding debt to GDP at producers' price reduced to 29.8 percent in FY 2006/07, from 35.8 percent in FY 2005/06 and 37.3 percent in FY 2004/05. The net outstanding debt to GDP ratio further reduced to 26.3 percent during the first eight months of FY 2007/08.

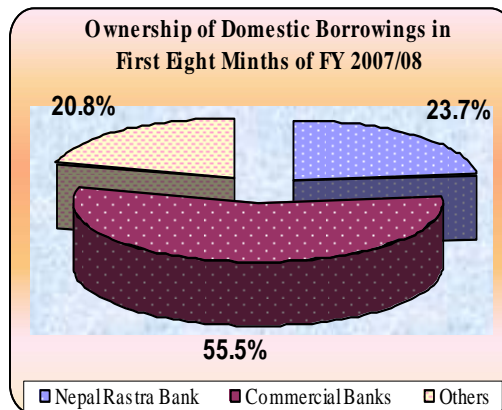
### **Domestic Borrowing**

- 2.32 Outstanding domestic debt increased by 9.6 percent to Rs.103.78 billion in mid-July 2007 from the level of Rs.94.71 billion in mid-July 2006. Of the total outstanding debt in mid-July 2007, Nepal Rastra Bank held Rs.15.63 billion (15.1 percent), commercial banks held Rs.65.84 billion (63.4 percent) and other non-bank institutions

and private sector held Rs.22.31 billion (21.5 percent). On analyzing domestic borrowing by instruments, 71.7 percent was Treasury Bills, 18.5 percent development bonds, 1.5 percent National Savings Certificate, 1.3 percent Citizen Savings Certificates and 7.0 percent special bonds.



2.33 In the first eight months of FY 2007/08, outstanding domestic debt increased by 5.2 percent. The outstanding domestic debt increased to Rs.107.66 billion during the same period in FY 2007/08 from the level of Rs.102.39 billion at the end of the first eight months of FY 2006/07. Of the total outstanding debt at the end of the first eight months of FY 2007/08, Nepal Rastra Bank held 23.7 percent; commercial banks held 55.5 percent and other non-bank institutions and private sector held 20.8 percent. When analyzing domestic borrowing by instruments, Treasury Bills amounted Rs.80.44 billion (74.7 percent), development bonds Rs.18.07 billion (16.8 percent), National Savings Certificates Rs.3.52 billion (3.4 percent), Citizen Savings Certificates Rs.1.87 billion (1.7 percent), and special bonds Rs.5.77 billion (5.4 percent). The outstanding domestic debt in the form of development bond decreased by 5.8 percent, National Savings Certificate by 60.9 percent and special bonds by 28.1 percent in the first eight months of FY 2007/08 compared to the level of the same period in FY 2006/07. In the first eight months of FY 2007/08 compared to the same period of FY 2006/07, the domestic debt in the form of treasury bills increased by 15.4 percent and the Citizen Savings Certificates by 16.8 percent. The outstanding domestic debt



to GDP ratio remained at 14.5 percent in FY 2005/06, 14.3 percent in FY 2006/07 and 13.1 percent at the end of first eight months in FY 2007/08.

### **Fiscal Deficit**

2.34 As a result of smaller revenue and foreign grants as compared to the level of expenditure, the fiscal deficit increased to Rs.30.09 billion in FY 2006/07 from Rs.24.78 billion in FY 2005/06. The fiscal deficit that was in a decreasing trend since 2000/01 showed an increasing trend since FY 2004/05. The fiscal deficit to GDP ratio, which was at 3.8 percent in FY 2005/06, increased by 0.3 percentage point to reach 4.1 percent in FY 2006/07.

**Table 2(d) : Fiscal Deficit (amount in Rupees Million)**

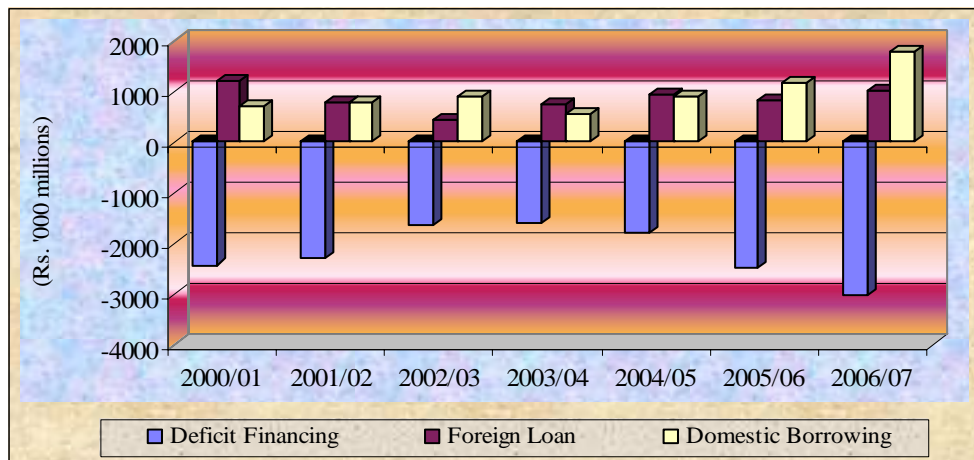
<i>Fiscal year</i>	<i>Fiscal Deficit</i>	<i>Fiscal Deficit/GDP ratio</i>
<b>2000/01</b>	24188.1	5.5
<b>2001/02</b>	22940.6	5.0
<b>2002/03</b>	16437.2	3.3
<b>2003/04</b>	15828.2	2.9
<b>2004/05</b>	18046.5	3.1
<b>2005/06</b>	24779.6	3.8
<b>2006/07</b>	30091.7	4.1

Source: Financial Comptroller Generals Office

### **Sources of Deficit Financing**

2.35 The fiscal deficit, the result of imbalance between expenditure and non-debt resources, has been financed through foreign loan, domestic borrowing and cash balance. Of the fiscal deficit of Rs.30.09 billion in FY 2006/07, Rs.10.05 billion (33.4 percent) was financed through foreign loan, Rs.17.89 billion (59.5 percent) through domestic borrowing and remaining Rs.2.14 billion (7.1 percent) through the change in cash reserves. The sources of financing the fiscal deficit of Rs.24.78 billion in FY 2005/06 were foreign loan (Rs.8.21 billion), domestic borrowing (Rs.11.83 billion) and change in cash balance (Rs.4.73 billion).

**Chart 2(c) : Fiscal Deficit, Government Loan and Domestic Borrowing**



### Challenges

- 2.36 It is evident from the contraction in the economic growth rates in the recent past that the overall economic expansion has been affected adversely due to the slackness in the development activities. Therefore, to increase the developmental activities, the challenge is to mobilize revenue at least to the level that could meet the recurrent and principal repayment expenditures. Similarly, there is a need to allocate best possible amount of resources for the capital outlay and give special priority to control unproductive and wasteful expenses. This will give a positive boost for the economic expansion and help create sustainable base for the realization of higher economic development.
- 2.37 On one hand, for maintaining economic balance, there is need to keep government fiscal deficit within the appropriate limit and, on the other hand, it is necessary to increase public expenditure for fulfilling unlimited wants of people. There is big challenge to maintain a balance in between these two dilemmas.
- 2.38 The gap between the expenditure and revenue must be lowered for fiscal stability. Since there is a mismatch between the two, the gap has not been reduced. In this context, the effort must be given to increase revenue, increase the grant component in foreign aid, improve recurrent expenditure management and speed up the capital expenditure.

- 2.39 As foreign loan component remained higher in the past planning phase, the pressure of foreign debt servicing on revenue is increasing. Therefore, there is a need to increase gross domestic saving ratio, control unproductive recurrent expenditure and increase capital expenditure in productive sector for maintaining the foreign debt servicing at a healthy level.
- 2.40 The use of foreign grants in prioritized projects would help expedite the development activities besides contribute to reduce the burden of foreign debt servicing in the upcoming budgets. It is, therefore, necessary to make effective use of foreign assistance according to this framework.
- 2.41 Revenue mobilization remained satisfactory in the last two years. To give continuity to this, the challenge is to control tax leakages after identifying the possible leakage areas, especially in VAT and income tax, the two major contributors of tax revenue. Areas such as the expansion of tax base and change in tax rates should be reviewed, revised and implemented them in addition to developing programs related to tax education and tax awareness so as to increase revenue mobilization. Similarly, the services delivery by the tax administration to the taxpayers needs to be improved as per the need of the time. Revenue leakages through the rampant and illegal use of the duty-free goods need to be controlled. Efforts should be made towards full atomization of tax administration, simplifying income tax procedures and reducing tax exemption limit. As the revenue mobilization is based on the efficiency of tax administration, effectiveness and professionalism, imparting the training for the human resources to effect structural changes in the tax administration seems inevitable.
- 2.42 Customs revenue mobilization has been affected by the illegal trade, that has adversely hit the formal trade, and under-invoicing. The challenge is to discourage these tendencies. There is a need to make the customs valuation system more objective and initiate systematic changes and administrative improvements with utmost priority. As Nepal is a member of World Trade Organization, there is a less possibility that she could mobilize more revenue through customs duties in a long-term. As per the commitment with the WTO there is a need to reduce customs tariff. As a member of the regional fora such as the SAFTA and BIMSTEC the customs rate needs to be lowered under the concept of unrestricted trade. As this will reduce

the revenue collection from customs, the stress should be on alternative sources, which is a major challenge.

- 2.43 Sustainable base of revenue mobilization would be the enhanced levels of production and productivity. For this, there is a need to mobilize and utilize the possible opportunities. Looking into the contribution of agricultural sector in the economy, it is self-evident that modernization of agriculture would help expand the economy and attain economic development objectives. However, since agriculture, which has a higher contribution to GDP, is exempted from both VAT and income tax, the tax base has become narrower as a result of which the VAT revenue and income tax revenue are not increasing as per the rules of economic expansion. For the development of agriculture, both food crops and cash crops need to be developed which will boost export sector. Therefore, for increasing revenue mobilization through increased national income based on the modernization of agriculture, through implementation of specialized programs the areas of comparative advantage such as tea, the coffee and cardamom farming as well as the increased cultivation of the oil-seeds, pulses and horticulture need to be promoted.
- 2.44 Long-term revenue policy needs to be formulated to tie up revenue with the economic growth, making revenue growth perfectly elastic to economic growth. This policy must help in fuller utilization of domestic resources, attracting foreign resources, adjusting the tax rates as per the commitment expressed in the international organizations, expanding the tax base so as to make the revenue growth suitable for a longer period, and ensuring effective implementation under the specified timeframe.
- 2.45 It has been seen that the firms registered in income tax are showing artificial losses to evade income tax and some persons are evading tax through transfer pricing in the same business group on the basis of involvement in various activities that attract different tax rates. Controlling such tax leakages has also become a major challenge.