NEPAL DEVELOPMENT UPDATE

September 2017

Fiscal architecture for federal Nepal

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Acknowledgements

The Nepal Development Update is produced twice a year with the following two main aims: to report on key economic developments over the preceding months, placing them in a longer-term and global perspective; and to examine (in the Special Focus section) topics of particular policy significance. The Update is intended for a wide audience including policy makers, business leaders, the community of analysts and professionals engaged in economic debates, and the general public.

This Update was produced by the World Bank Macroeconomics and Fiscal Management (MFM) team for Nepal consisting of Damir Cosic, Sudyumna Dahal, Roshan Bajracharya, Saurav Rana and Fernando Blanco under the guidance of Manuela Francisco and Takuya Kamata. Sabin Shrestha contributed to the analysis of the financial sector. Mona Prasad provided helpful comments. Rajib Upadhya, Richa Bhattarai and Gayatri Sharma managed media relations and dissemination. Diane Stamm edited the document. Sunita Kumari Yadav and Alina Thapa managed the publication process.

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Cut-off date for data included in this report was September 11, 2017.

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Global growth is picking up and the growth in the South Asia region continues to remain strong. A recovery in industrial activity has coincided with a pickup in global trade, after two years of marked weakness. Growth in South Asia remains strong, with regional output projected to grow by 6.8 percent in 2017 and an average of 7.2 percent in 2018–19.

Economic activity in Nepal, which rebounded strongly in FY2017, reaching 7.5 percent (year-over -year [y/y]) following two challenging years, has again been impacted by severe flood affecting more than one-third of the country

High inflation in the last two years induced by disruptions moderated sharply by early 2017 and further slowed, reaching decade-low inflation by the end of FY2017, due to moderating inflation in India.

Credit growth soared during the first half of the fiscal year and, coupled with a simultaneous slow deposit mobilization, which had led to a squeeze on the availability of loanable funds at banks, had eased off by the end of the fiscal year. However, interest rates have not come down despite the availability of loanable funds because the banks had committed to offer higher interest rates to attract new deposits during credit crunch.

As imports continue to surge and exports to falter, the trade deficit has further increased. Remittances, which financed almost all imports in previous years, have continued to slow. Consequently, the current account has narrowed significantly from 6.2 percent of GDP in FY2016 to a deficit of -0.4 percent of GDP in FY2017.

Annual revenue growth has been robust, with government exceeding the revenue target. Public spending has also significantly picked up in real terms, with capital spending reaching a record high at almost 8 percent of GDP in FY2017. The fiscal deficit reached 3.3 percent of GDP in FY2017.

Outlook, Risks, and Challenges

Economic activity, which was expected to progress well in FY2018, has been set back by another natural disaster. Severe floods in mid-August, the third major shock in three consecutive years, has caused severe disruptions and damage especially in the southern plains. Over 1.7 million people have been affected by flood and landslides.

Houses, bridges, roads, and other infrastructure have also been damaged.

While the estimates of damage remain preliminary, the growth for FY2018 is expected be lower than earlier forecasted and moderate thereafter, in line with the potential averaging 4.5 percent in the forecast period.

With increased government spending due to a transition to new federal structure and earthquake and flood-related spending, the fiscal deficit is expected to widen in FY2018 to 4.3 percent of GDP. Financing is not expected be a problem given ample fiscal space with a low debt -to-GDP ratio and a large cash balance at hand.

Meanwhile, the current account, which turned into a marginal deficit in FY2017, is expected to widen as import growth is expected to remain high, while remittances and exports growth are expected to grow slowly.

Both domestic and external risks predominate and are on the downside. The political environment remains fluid as the term of the new government—which was sworn in in July 2017 as part of the power-sharing agreement among the coalition partners—will come to an end in late 2017, after the provincial and federal elections.

Transition to a new federal structure and smooth service delivery are also going to be new risks and challenges. With local elections expected to be completed by September 2017 and provincial and federal elections by December 2017, FY2018 will be a transitional year in implementation of the new federal constitution.

Despite improvements, the overall pace of earthquake reconstruction remains modest, which is now compounded by flood recovery as the government needs to manage response to two separate natural disasters.

The external environment is likely to pose a risk, as well. The decline in migrant workers' outflow has been compounded by Qatar's political woes—a major destination of Nepalese migrants—which may cause a sharper deterioration in balance of payments.

Special Focus

In this edition of the *Update,* we take a closer look at the main emerging issues and potential risks in the design of fiscal architecture for the new federal Nepal.

In general, issues regarding the transition to federalism can be grouped into three categories: the functions category (that is, which level is responsible for delivering which service), the finance category (that is, which level or levels collect revenue and raise debt), and the functionaries category (that is, how will the existing civil service be transformed). All the issues under these three categories need to be resolved effectively for government service delivery not to get disrupted.

In sum, while the constitutional provisions and laws currently under consideration in the Parliament will create a mismatch between the levels that collect revenue and those that are responsible for service delivery, this does not have to be problematic if the system of inter-governmental transfers is designed properly.

A. Recent Economic Developments

1. Global growth is picking up and the growth in the South Asia region continues to remain strong

Global growth is firming, contributing to an improvement in confidence. A recovery in industrial activity has coincided with a pickup in global trade, after two years of marked weakness. In emerging market and developing economies, obstacles to growth among commodity exporters are gradually diminishing, while activity in commodity importers remains generally robust. As a result, and despite substantial policy uncertainty, global growth is projected to accelerate to 2.7 percent in 2017, up from a postcrisis low of 2.4 percent in 2016, before strengthening further to 2.9 percent in 2018–19 (World Bank 2017).

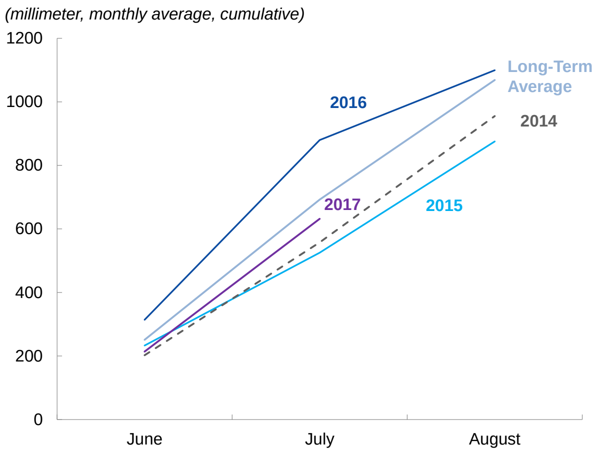
Growth in South Asia remains strong, with regional output projected to grow by 6.8 percent in 2017 and an average of 7.2 percent in 2018–19. Excluding India, growth is projected to average 5.8 percent in 2017–19, with some cross -country variation. Robust domestic demand, an uptick in exports, and strong foreign direct investment inflows underpin this forecast. Domestic risks to the outlook include policy uncertainty related to upcoming elections and possible setbacks to reform progress. External risks include an increase in global financial volatility, a slowdown in remittance inflows, and rising geopolitical tensions (World Bank 2017).

2. Economic activity in Nepal, which had strongly rebounded in FY2017, has been affected by one of the worst floods in decades

Economic activity rebounded strongly in FY2017, reaching 7.5 percent (y/y) according to the first estimate by the Central Bureau of Statistics (CBS). On the supply side, all three major sectors grew at above-trend rates in FY2017. Rice production reached a record high at 5.2 million tons, on the back of one of the best monsoons in recent years, boosting agricultural output. Industry's growth was high as well, due in part to the electricity subsector with a record-high hydropower capacity addition (more than 100 MW) and construction on the back of earthquake reconstruction gathering speed. Growth in the service sector was aided by the wholesale/retail trade and hotels subsectors fully normalized from the shocks of the previous two years. Tourist arrivals rebounded strongly and reached a record high in FY2017. On the demand side, gross investments contributed the most to headline growth. Gross fixed capital formation is estimated to have reached 25 percent of GDP in FY2017, up from 21 percent the year before, with both private and public investment rebounding strongly. Consumption, however, slowed, most likely in light of the slowdown in remittances.

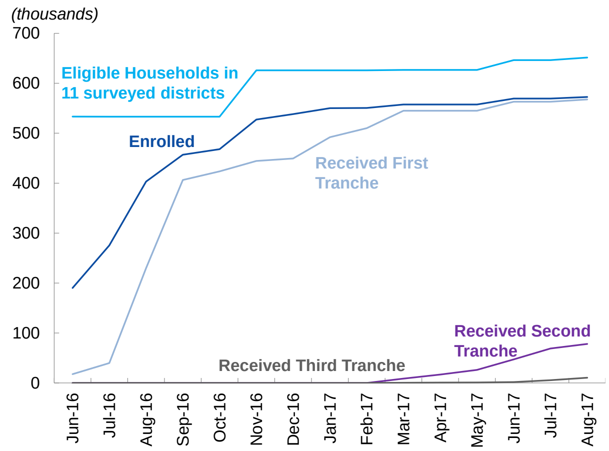
After a strong rebound in FY2017, economic activity was expected to perform well in FY2018. A normal paddy output was expected on the back of the 2017 monsoon that was only slightly less than the long-term average, and was expected to catch up in August (Figure 1). Construction-related activities had been picking up, aided by reconstruction works. After two years of slow progress, postearthquake housing reconstruction picked up some speed. Of the 646,419 beneficiaries eligible for housing grants, over 90 percent have been enrolled and received the first tranche in July 2017 (Figure 2). However, while many houses are under construction as beneficiaries start receiving grants, disbursement of the second and third tranches is still slow. As in previous years, the service sector was performing well. Tourist arrivals in the first half of 2017 reached more than 450,000 (Figure 3), a record high indicating the sector had recovered from the adverse

Figure 1 Monsoon rains had been slightly less than the long-term average before the floods



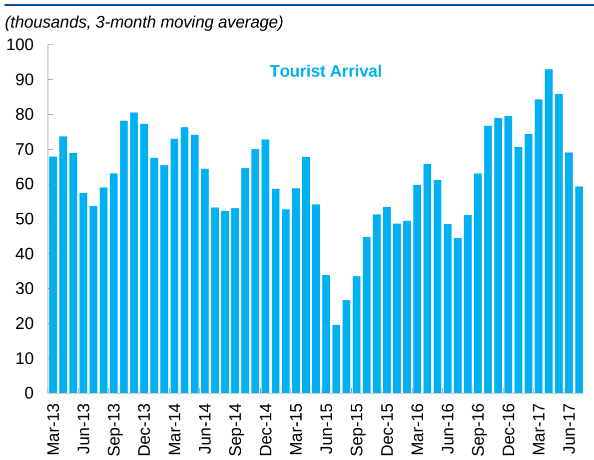
Source: Department of Meteorology.

Figure 2 After two years, housing reconstruction was also finally picking up



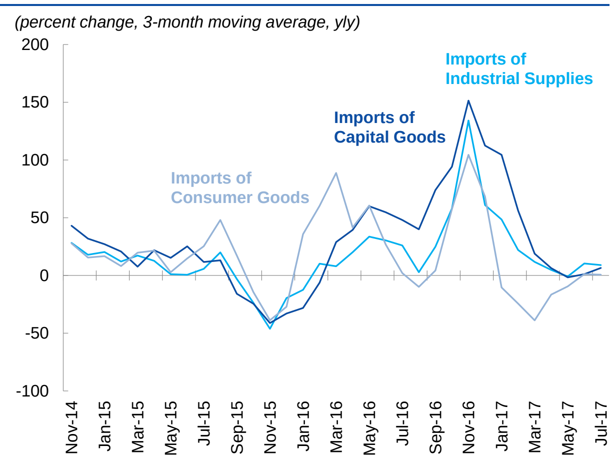
Source: Ministry of Urban Development.

Figure 3 The spring season has seen record tourist arrivals



Source: Ministry of Tourism.

Figure 4 Consumption slowed while imports of industrial and capital goods picked up



Source: Department of Customs.

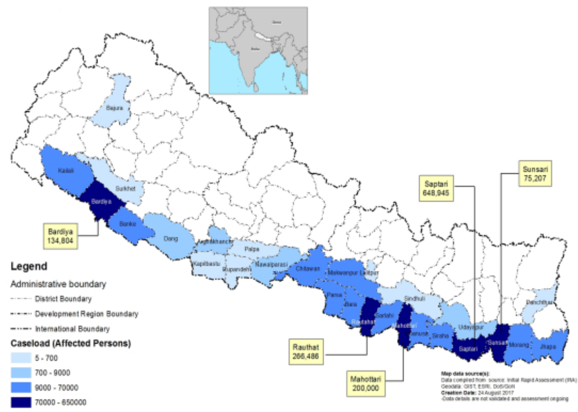
impacts of the earthquakes and the trade blockade during the last two years. Despite a slowdown in consumption, most likely due to a slowdown in remittances, trade, which is the largest contributor of the service sector, grew robustly on the back of reconstruction, industrial, and capital goods imports (Figure 5).

However, severe floods in mid-August, the third major shock in three consecutive years, caused severe disruptions and damage especially in the southern plains (Figure 4). Over 1.7 million people have been affected by flooding and landslides affecting more than one-third of the country. This includes over 460,000 people displaced and nearly 65,000 homes destroyed by floodwaters. Bridges, roads, and other infrastructure have also been severely damaged. Several districts recorded the heaviest rainfall in 60 years, and over 80 percent of land in the southern Terai region was inundated by floodwaters (United Nations 2017).

Economic activity has also been affected. While the estimates of damage and losses caused by the floods are being carried out, preliminary estimates show that agriculture is expected to be most affected. Agricultural sector output, which was earlier expected to be average, has been severely hit by major floods in the Terai plains, the breadbasket of Nepal. It is estimated that 64,000 hectares of standing crops have been destroyed. The manufacturing sector is also expected to suffer temporarily, as most of the industries are also located in the Terai region. Some of the major tourist destinations, like Chitwan, have also been affected by the floods.

Poverty reduction efforts are likely to be affected, too. The floods have had a significant impact on critical infrastructure, with 80 schools across 28 districts destroyed and 710 damaged. Ten health posts have been destroyed and 64 partially damaged (United Nations 2017). Due to crop damage, the livelihoods of farmers are also likely to be impacted and food insecurity increased, because food stocks have also been destroyed. As a result, poverty reduction efforts are also likely to be affected.

Figure 5 However, severe floods have caused severe damage, especially in the southern plains



Source: United Nations.

3. High inflation in the last two years moderated sharply, reaching a 13-year low

Inflation slowed to 2.7 percent (y/y) in July 2017, averaging 4.5 percent for whole of FY2017 (Figure 6). This is the lowest rate since FY2004 and well below the FY2017 monetary policy target of 7.5 percent. Food and beverage inflation declined dramatically in the last 12 months, from contributing 4.1 percentage points to headline inflation in August 2016 to -0.4 percentage points in July 2017. Very low inflation of cereal grains (0.04 percentage points in July 2017) has been a boon to Nepal's population, whose main diet is rice. Although nonfood items are driving inflation, they too have moderated from contributing 4.5 percentage points in August 2016 to 3.1 percentage points in July 2017.

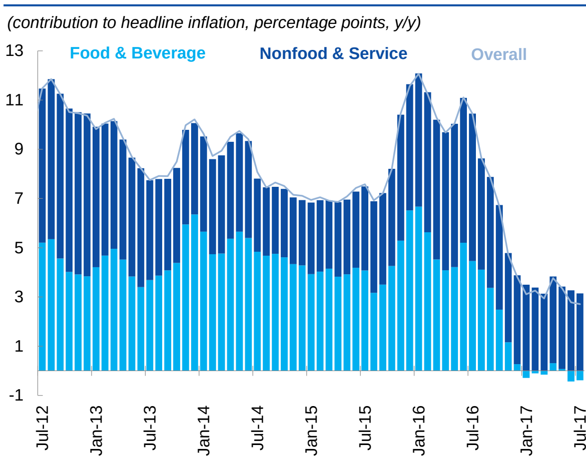
Nepal's inflation divergence with India declined in July after picking up in recent months. The overall inflation differential reached 0.3 percentage points in July 2017 from a low of — 1.7 percentage points in March 2017 (Figure 7). Moving forward, implementation of the Goods and Services Tax (GST) in India might lower inflation in India, especially as many staple food items have been exempt from the tax (Box 1). In the short term, this will increase the Nepal-India inflation differential due to prices declining faster in India but remaining sticky in Nepal. However, in the long run Nepal is likely benefit from low inflation in India as prices in Nepal adjust accordingly.

4. Government revenue continued to remain robust while spending increased significantly, but underspending of budget continues

Revenue collection in FY2017 exceeded the government's annual target and reached a record high of 24.8 percent of GDP (Figure 8). Driven by improved tax collection, revenue collection was consistently strong throughout FY2017 (Figure 9). Value-added tax (VAT) collection, the largest tax source, grew by 31.3 percent in FY2017 to reach NPR 160 billion supported by the large import bill, as in the previous years. Similarly, customs duties and income taxes also registered healthy growth at 36.7 percent and 26.6 percent, respectively, in FY2017.

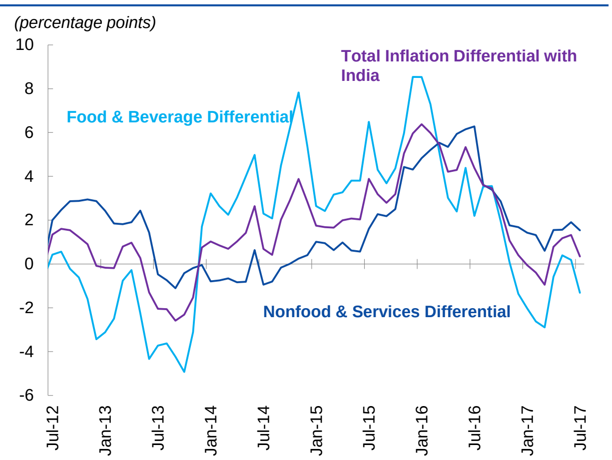
Government spending saw a massive jump in FY2017 driven by both recurrent and capital expenditures. However, nearly 27 percent (NPR 137 billion) of the recurrent budget was spent during the last month of the fiscal year (Figure 10). Overall, government expenditure grew by nearly 6 percentage points of GDP over FY2016, reaching 29.3 percent of GDP overall in

Figure 6 Inflation has further slowed primarily due to low food prices…



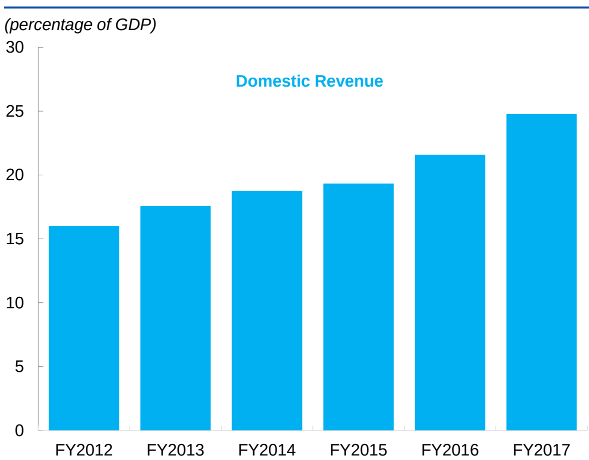
Source: NRB.

Figure 7 And is trailing India's inflation



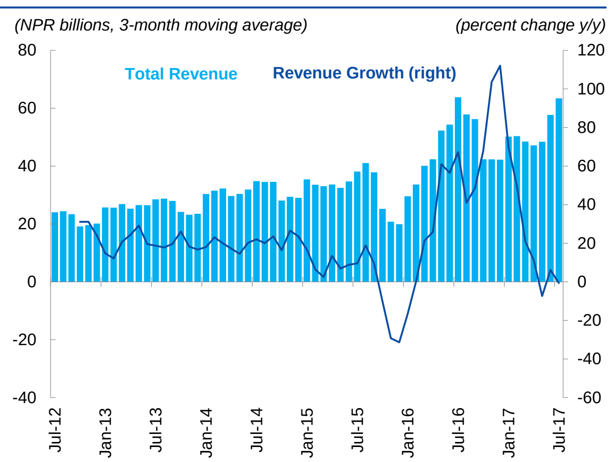
Source: NRB and CSO India.

Figure 8 Revenue collection reached a record high…



Source: MoF.

Figure 9 On the back of strong revenue collection throughout the year



Source: NRB and World Bank staff calculations.

Table 1 Selected fiscal indicators
(percent of GDP unless noted otherwise)

	FY2014	FY2015	FY2016	FY2017 b	FY2017 e	FY2018 b	FY2018 f
Total Revenue and Grants	20.6	20.8	23.2	25.9	26.1	27.8	26.6
Total Domestic Revenue	18.8	19.3	21.6	21.8	24.8	25.3	25.3
Tax	15.9	16.7	18.7	19.6	22.1	23.1	22.8
Nontax	2.6	2.3	2.7	2.1	2.7	2.2	2.5
Grants	2.1	1.8	1.8	4.1	1.3	2.5	1.3
Total Expenditure	18.8	20.1	23.7	38.3	29.3	42.1	30.9
Recurrent	15.5	15.9	16.5	23.7	19.9	27.9	20.6
Capital	3.4	4.2	5.4	12.0	7.9	11.6	8.7
Net Lending	1.1	1.8	1.7	2.6	1.6	2.6	1.6
Fiscal Balance	0.6	-1.1	-0.4	-12.4	-3.3	-14.3	-4.3

Sources: MoF, NRB for history and estimates; WB staff for forecasts.
Note: b=budget, e=estimate, f=forecast.

FY2017. Capital budget execution was a record high at almost 8 percent of GDP (Figure 11) despite significant underspending that was at only 65 percent of planned expenditures.

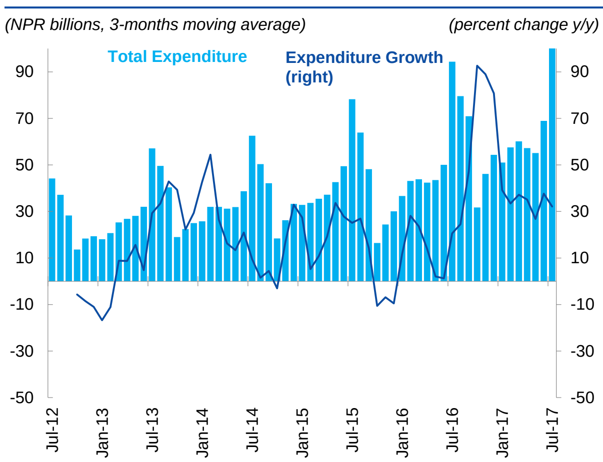
Hence, the expenditure target was missed as before and remained significantly below the planned budget. Budget underspending has become a systemic issue in Nepal, primarily because of unrealistic budget targets (Table 1). Furthermore, allocation of public funds to large infrastructure projects that are not ready for implementation also leaves large chunks of government funds unspent.

Quality of expenditure continues to be a problem. FY2017 once again saw a large bunching of capital expenditure**.** About 61 percent of the capital budget was spent in just the last quarter (Figure 12). The deterioration of the quality of public expenditure is a major concern and can impose higher costs in the future.

5. Imports have reached a new high while exports have permanently declined

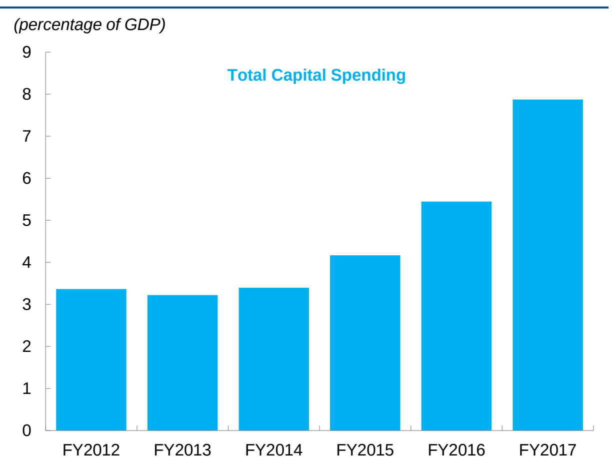
Imports surged to a record high of 37 percent of GDP in FY2017 (Figure 13). Imports increased consistently throughout FY2017 averaging US$768

Figure 10 FY2017 expenditure increased significantly, as well



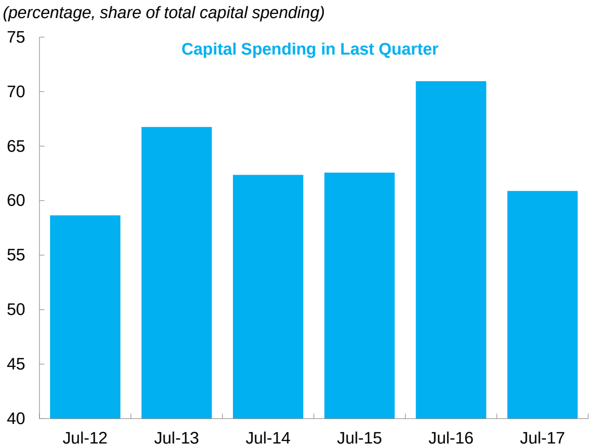
Source: NRB and World Bank staff calculations.

Figure 11 Capital spending reached a record high despite underspending…



Source: MoF.

Figure 12 A large share of capital expenditure in the last quarter has raised quality concerns



Source: MoF.

million per month (Figure 14). This is well above the US$557 million per month average registered over the previous five years, and higher imports seem to be the new normal. Unlike in the last two years, imports have been driven by industrial supplies, capital goods, and fuel imports, while consumption and food imports have slowed.

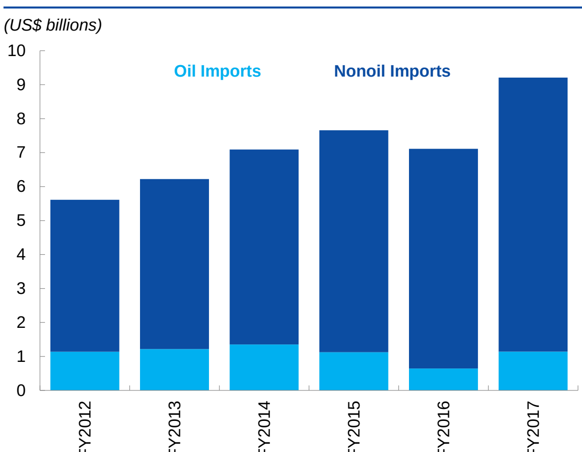
Exports have structurally declined after remaining below the five-year average for two consecutive years. Unlike imports, Nepal's exports never fully recovered following the end of the trade blockade. Even after a full year of normal economic activity and the economy registering high growth in FY2017, exports have remained below the five-year average (Figure 15). This is mainly due to lower and declining exports to India, as exports to other countries have reached predisruption levels (Figure 16). In addition, the continued appreciation of the real effective exchange rate (REER) of the Nepalese rupee is also having a negative impact on Nepalese exports (Figure 17). The REER appreciated by 18.8 percent in FY2017 from the average level in FY2014.

Service exports are performing well. The continued arrival of tourists is pushing service exports up (Figure 18). However, this is being offset by service imports as more Nepalese are traveling abroad, including for education (Figure 19).

6. External sector pressure mounts as trade deficit expands and remittances slow

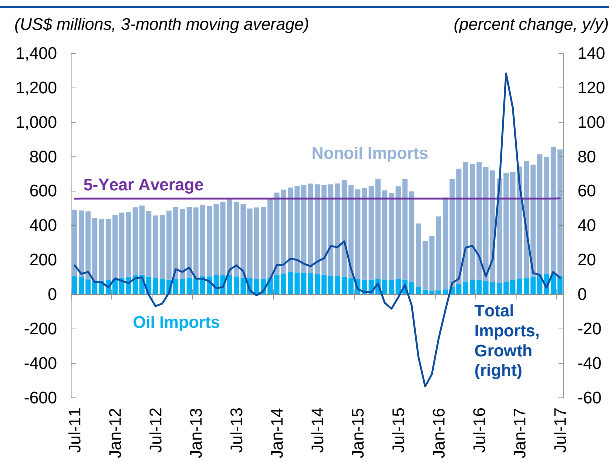
Remittances picked up slightly in FY2017, but growth remains slower than the double-digit growth of the past. The volume of remittance inflow is still large, at US$6.5 billion in FY2017. Using a standard statistical technique developed by the U.S. Census Bureau, we adjust the data to remove the effect of seasonal variation (Figure 20). Analyzing the seasonally adjusted data we observe that remittance growth was only 2 percent in July 2017. However, as in the past, a large amount of remittances are received through informal channels that are not captured in the balance of payments.

Figure 13 Imports have reached a record high…



Source: NRB.

Figure 14 Averaging US$750 million per month in FY2017



Source: NRB and World Bank staff calculations.

Box 1 Indirect tax reforms in India and impact on Nepal's economy

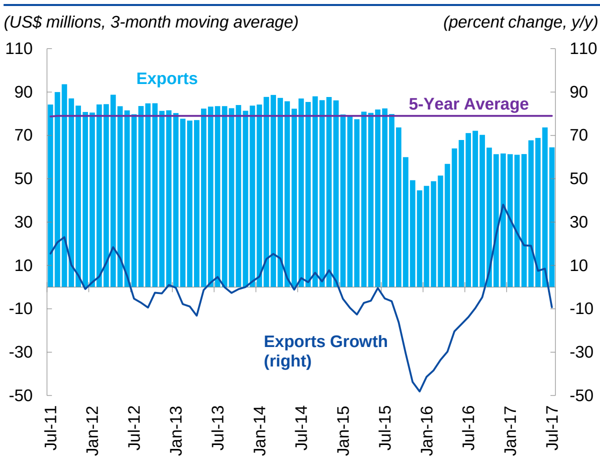
India launched the Goods and Services Tax (GST) in July 2017 which replaces and subsumes 17 central and state taxes. It reduces rates of over 50 percent of items, with many essential items exempt from tax, and charges standard rates of 5 percent, 12 percent, and 18 percent, while a higher tax rate of 28 percent is charged on luxury and "sin" goods. The GST provides taxpayers a refund against their sales within 60 days. Similarly, exporters will get refunds within seven days. To protect consumer rights, the new law includes antiprofiteering provisions.

The GST is expected to have a positive and significant impact in India as it simplifies the indirect tax regime. It is expected to yield growth dividends, but the magnitude is difficult to quantify. The GST is also intended to be revenue neutral, which should ensure that impact on inflation is minimal. However, in the long term, the GST is expected to increase formalization of the economy because sellers who are not in the GST chain will be unable to claim input tax credits, putting them at a disadvantage vis-à-vis registered vendors. As more sellers register in the GST chain and record economic transactions, it may have a strong positive impact on tax collection and lead to higher revenues.

Although the exact impact on Nepal's economy is yet to be ascertained, Nepalese exporters may suffer from a loss of competitiveness in the Indian market as goods produced in India become cheaper due to the new lower tax rates. This is especially likely for agricultural exports, many of which have been exempt of taxes in the GST regime. In contrast, since Indian exporters will get a tax refund against their sales, Indian export goods will be cheaper, which may increase imports from India in Nepal. In the short run it may affect Nepalese producers adversely as they now have to compete with cheaper goods from India. However, in the long run it should catalyze Nepalese producers to improve their efficiency to regain their competitiveness and adjust to the new environment.

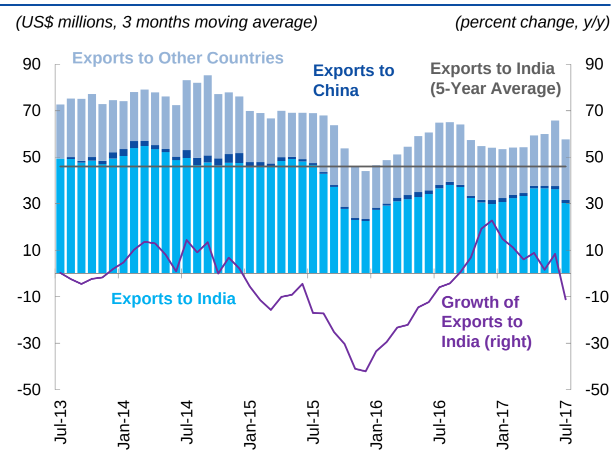
Migrant worker outflow has contracted three years in a row and reached a five-year low in FY2017. Less than 400,000 Nepalese migrant workers went abroad in FY2017, leading to growth contraction for three consecutive years (Figure 21). The initial decline in the last two years came from workers going to Malaysia, followed by Saudi Arabia and other Gulf Countries. However, workers leaving for Qatar also contracted by a third in July 2017—likely a reflection of the

Figure 15 Goods exports may have permanently declined …



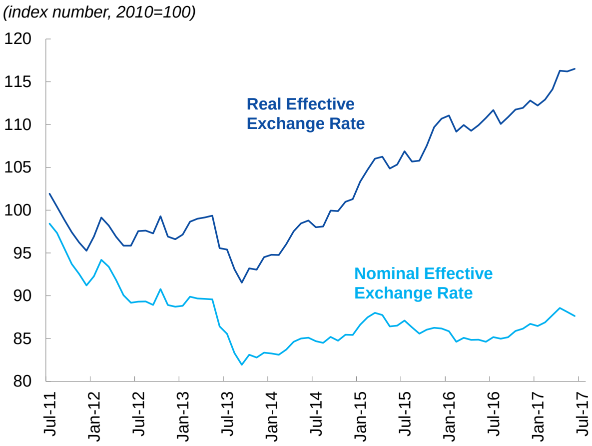
Source: NRB and World Bank staff calculations.

Figure 16 As exports to India are not recovering…



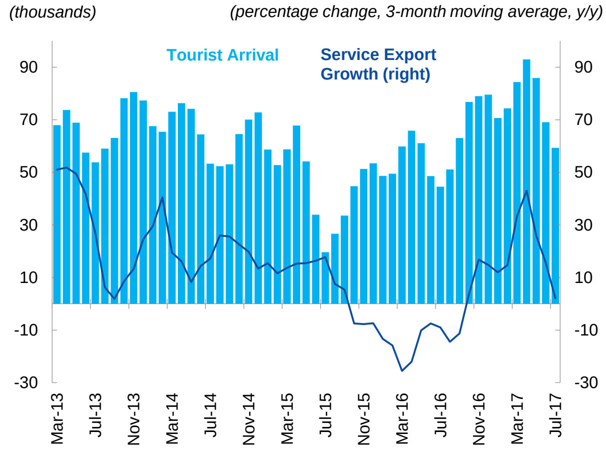
Source: NRB and World Bank staff calculations.

Figure 17 …And the continued appreciation of the real effective exchange rate



Source: World Bank staff calculations.

Figure 18 Service exports are performing well…

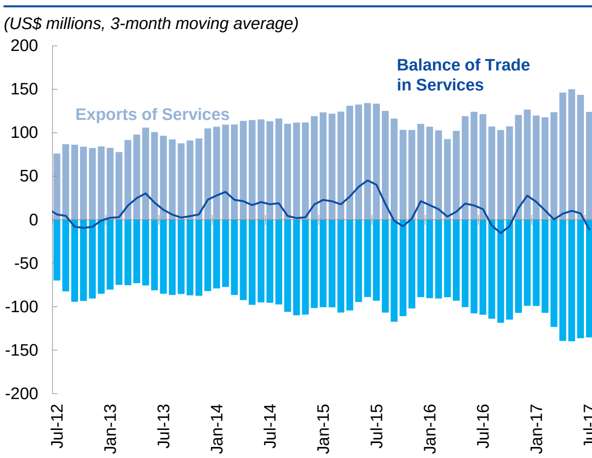


Source: NRB and World Bank staff calculations.

economic blockade imposed on Qatar by its neighbors (Figure 22). There was also a reduction in the number of workers migrating to Saudi Arabia and Kuwait. This may be due to these oil-producing countries cutting back on public spending to ease fiscal pressures from the persistently low crude oil prices in international markets.

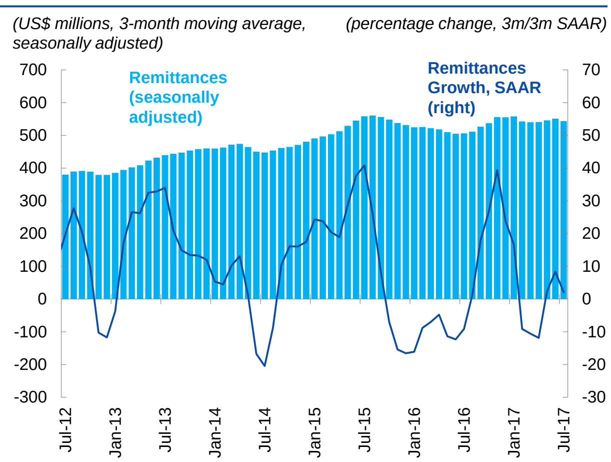
Slower remittances and a surging trade deficit have begun to put pressure on the current account. The trade deficit has been financed by ever increasing remittances in the last few years. The trade deficit reached a historic high of US$8.4 billion in FY2017. However, remittance inflow of only US$6.5 billion was unable to offset the large trade deficit. Consequently, the current account has significantly narrowed to a deficit of -0.4 percent of GDP compared to a huge surplus averaging 5 percent of GDP in the last five years (Figure 23). As a result, although still high at US$10.5 billion, foreign reserves accumulation has slowed, covering 11.4 months of merchandise and services imports down from the peak of 18.7 months one and half years ago (Figure 24).

Figure 19 But are being offset by Nepalese traveling abroad



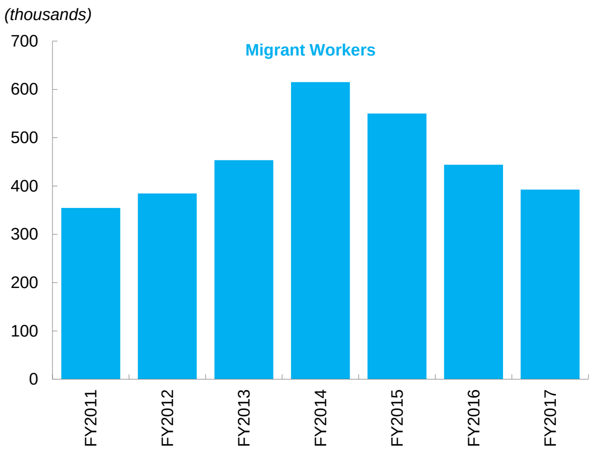
Source: NRB and World Bank staff calculations.

Figure 20 Controlling for seasonality, remittance growth is low



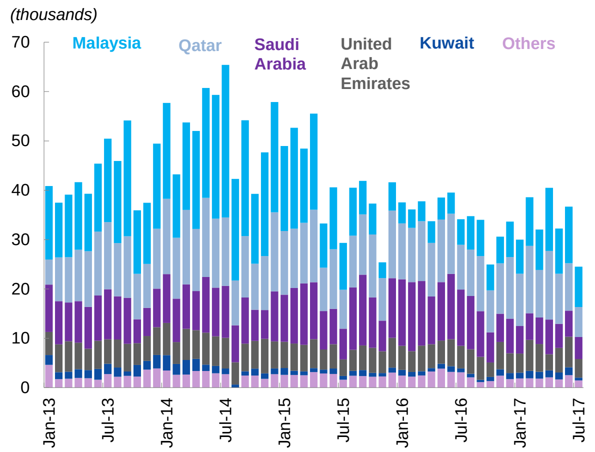
Source: NRB and World Bank staff calculations.

Figure 21 Migrant worker outflow has contracted for three consecutive years…



Source: Department of Foreign Employment (DoFE).

Figure 22 As worker outflow seems to have declined to a new lower level

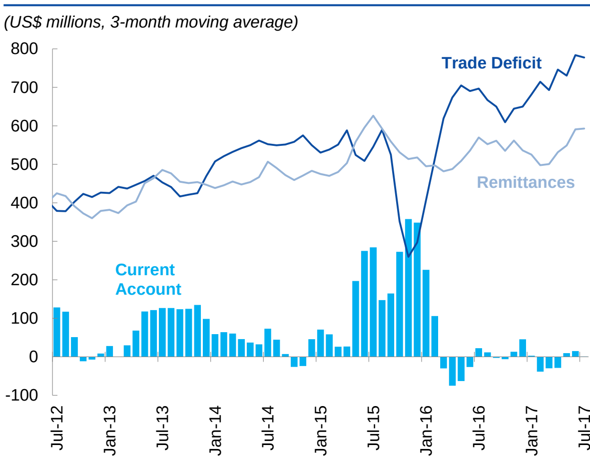


Source: DoFE and World Bank staff calculations.

7. Credit growth has moderated but deposit mobilization continues to slow

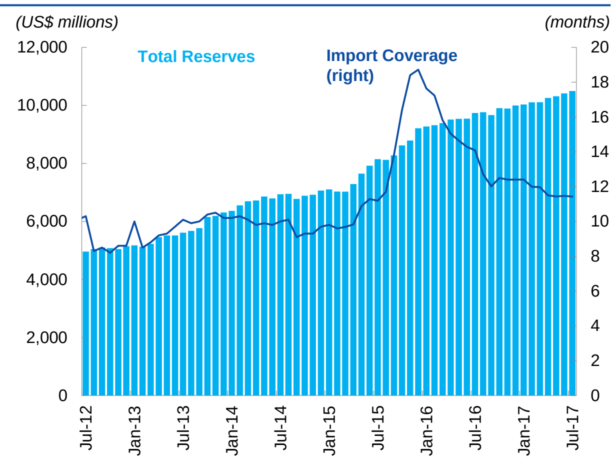
Credit growth after a surge has slowed steadily over the last six months. Credit growth soared during the first half of the fiscal year, and coupled with a simultaneous slow deposit mobilization led to a squeeze on the availability of loanable funds at banks. In response, the NRB (the Nepal Rastra Bank, the central bank of Nepal), introduced temporary restrictions on bank lending, such as reducing the limit on personal overdrafts by NPR 2.5 million and restricting banks from financing more than 50 percent of the value of vehicles through auto loans. This impacted credit growth, which slowed from a peak of 31.9 percent (y/y) in February 2017 to 18.1 percent (y/y) in July 2017 (Figure 25), as banks curtailed lending on all their loan products (Figure 26). However, with the adoption of the FY2018 monetary policy, most of these measures have expired or eased. The provision on auto loans has been relaxed to allow banks to finance up to 65 percent of the value of the vehicles. Most importantly, the expiration of the provision allowing banks to calculate their Credit to Core Capital and Deposit (CCD) ratio by

Figure 23 A surging trade deficit and slowing remittances are pressuring the current account …



Source: NRB.

Figure 24 Leading to slower accumulation of foreign reserves



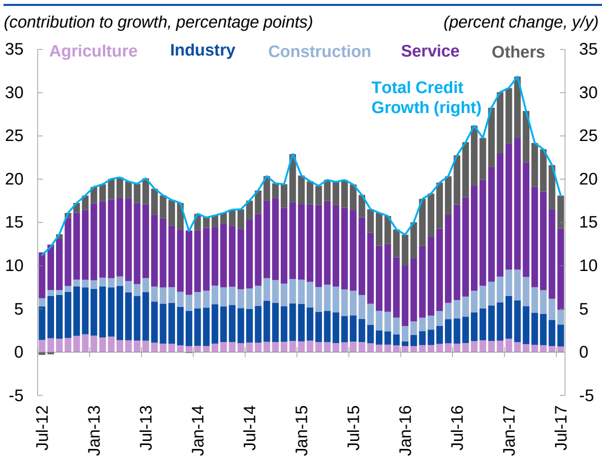
Source: NRB.

applying only 50 percent risk weightage to productive sector loans resulted in the availability of more loanable funds. The NRB has, however, increased the limit on home loan financing to NPR 15 million from NPR 10 million, which may increase credit uptake in the residential construction sector.

Deposit mobilization continues to slow. Slower deposit growth vis-à-vis credit growth was the other reason for the squeeze on banks' CCD at the midpoint of FY2017. While NRB's interventions to restrict credit growth succeeded in controlling the surge of credit, deposit mobilization has not picked up. In fact, deposit growth slowed to 14.5 percent (y/y) in July 2017 from 19.6 percent (y/y) in February 2017 (Figure 27). The contributions to deposit growth from all sectors declined during the last six months, leading to an overall slowdown in deposit growth.

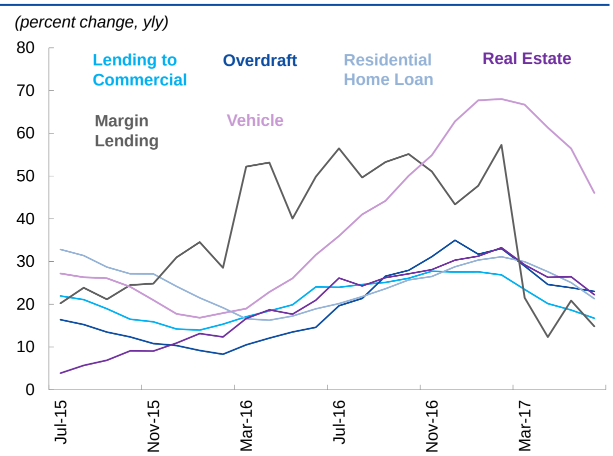
The CCD ratio of banks has lowered due to decline in credit growth and some relaxation in the definition of calculating the CDD ratio. The slowdown in credit growth has helped lower the CCD ratio of banks from 78.1 percent at the end of

Figure 25 Credit growth has slowed steadily after the rapid surge…



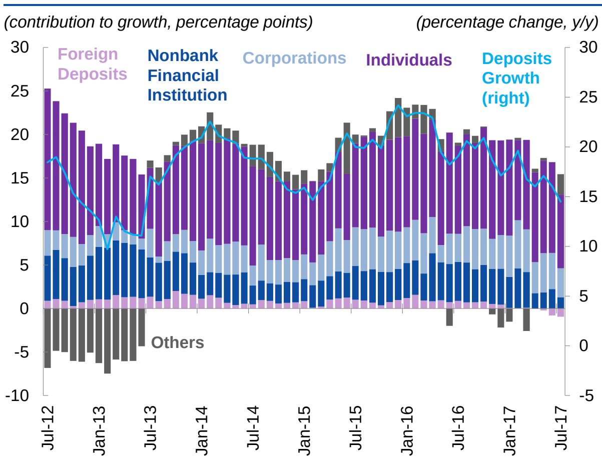
Source: NRB and World Bank staff calculations.

Figure 26 As bank lending to all sectors declined



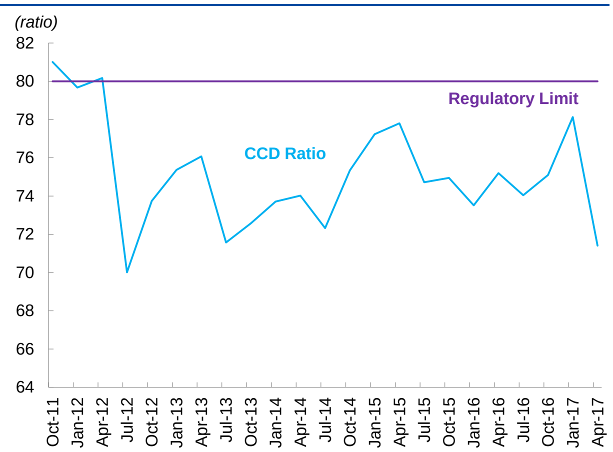
Source: NRB and World Bank staff calculations.

Figure 27 Deposit growth, which had somewhat picked up, has slowed…



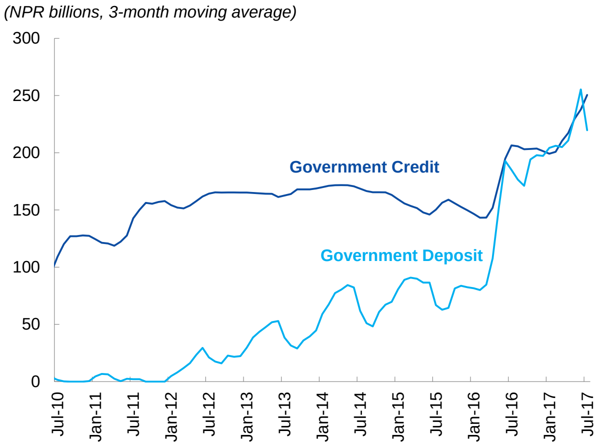
Source: NRB and World Bank staff calculations.

Figure 28 CCD ratio lowered due to slowdown in credit growth and relaxation in calculating the ratio



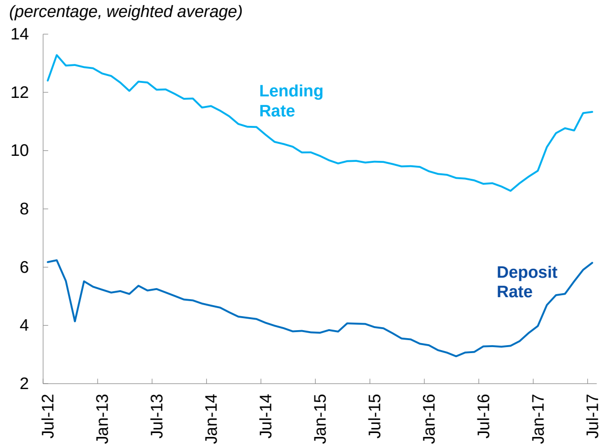
Source: NRB and World Bank staff calculations.

Figure 29 Large government deposits have soaked up liquidity



Source: NRB.

Figure 30 As a result, interest rates have remained sticky at higher rates



Source: NRB.

Q2 FY2017 to 71.4 percent at the end of Q3 FY2017 (Figure 28). This is also because the NRB has allowed banks to calculate the CCD ratio by reducing the weightage applied to "productive purposes" by 50 percent until the end of FY2017. While this has created some space for banks to extend credit, the slowing deposit growth continues to be a challenge.

The government's inability to manage the cash balance is impacting the financial sector. Despite the increase in capital spending, FY2017 ended with government deposits at nearly 8.5 percent of GDP in its NRB account (Figure 29). As this balance is held by the NRB and out of the banking system, it has in effect "mopped up" an equivalent amount of liquidity from the domestic market, which also played a role in creating the credit crunch in the financial system (see Nepal Development Update, May 2017).

Despite improvement in the availability of loanable funds, deposit and credit rates continue to rise. As government spending significantly increased toward the end of the fiscal year, some of the balance held by the government came back into the banking system. However, as the banks had already offered higher interest rates to attract deposits during the credit crunch, the cost of funds has already increased. As a result, the weighted average deposit rose to 6.2 percent in July 2017, as banks seek to attract more deposits (Figure 30). Similarly, the weighted average lending rate has also remained sticky, reaching a high of 11.3 percent in July 2017, due to an increase in the cost of funds during the credit crunch. This is indeed a challenge in doing business particularly at a time when Nepal is recovering from series of shocks and disruptions.

B. Outlook, Risks, and Challenges

Outlook

Looking ahead, economic growth is expected to be lower than earlier forecasted and is expected to moderate in line with the country's potential, averaging 4.5 percent over the next two fiscal years (Figure 31 and, Figure 32). Particularly agricultural output, which was expected to be normal, will be impacted by the floods. The impact on industry sectors is expected to be temporary, while construction is likely to remain strong driven by earthquake and flood reconstruction. Activity in the remaining sectors is expected to be affected by uncertainty stemming from the transition to the federal structure, several elections, and the possibility of a further slowdown in remittances.

On the supply side, the service sector is expected to continue driving growth, albeit more slowly than in previous years. Services are expected to grow at 5.8 percent, on average, during the forecast period, driven by trade, transport, and tourism. The outlook in services is also dependent on remittances stabilizing at the present level, particularly given the large share of wholesale and retail trade subsectors. However, the boost in tourism, in particular, is expected to continue in the forecast period, as some of the damage done by the floods in places like Chitwan is expected to be restored by the fall tourist season. The damage to the harvest of agricultural products as a result of floods, however, is expected to hamper agricultural output in FY2018. Industry is likely to get some boost in FY2018, as the electricity generation and construction subsectors continue to perform relatively well. However, manufacturing is expected to face some temporary setbacks as the Terai region, where most of the industries are located, has been severely affected by floods. With the Upper Tamakoshi (465 MW) expected to be delayed until FY2019, hydropower generation will be lower than earlier expected. Nonetheless, small hydropower projects will continue to provide some boosts to the electricity subsector. Hence, internally generated electricity and additional imports from India are expected to keep the manufacturing sector running smoothly in FY2018, as well. Reconstruction activities are expected to pick up at a relatively faster pace in FY2018, as they had begun to speed up by the last quarter of FY2017. This will benefit the construction sector.

Table 2 Nepal macroeconomic outlook
(annual percent change unless noted otherwise)

	FY2014	FY2015	FY2016	FY2017 e	FY2018 f	FY2019 f
Real GDP Growth, at Constant Market Prices	6.0	3.3	0.4	7.5	4.6	4.5
Private Consumption	4.1	2.9	-0.8	2.4	2.0	3.0
Government Consumption	10.0	7.4	-0.4	21.5	20.9	12.8
Gross Fixed Capital Investment	11.4	19.6	-12.3	34.0	15.1	10.5
Exports, Goods and Services	18.8	6.8	-13.7	16.9	10.1	6.3
Imports, Goods and Services	20.9	9.6	2.8	22.0	8.0	8.0
Real GDP Growth, at Constant Basic Prices	5.7	3.0	0.0	6.9	4.6	4.5
Agriculture	4.5	1.1	0.0	5.3	2.7	3.0
Industry	7.1	1.4	-6.3	10.9	5.0	3.2
Services	6.1	4.8	2.0	6.9	5.8	5.8
Inflation (Consumer Price Index)	9.1	7.2	9.9	4.5	5.5	6.5
Current Account Balance (% of GDP)	4.6	5.1	6.2	-0.4	-2.0	-2.8
Fiscal Balance (% of GDP) [a/]	0.6	-1.1	-0.4	-3.3	-4.3	-4.6
Debt (% of GDP)	28.3	25.6	28.0	27.6	29.4	31.0

Sources: CBS, NRB, MoF for history and estimates; World Bank staff for forecasts.

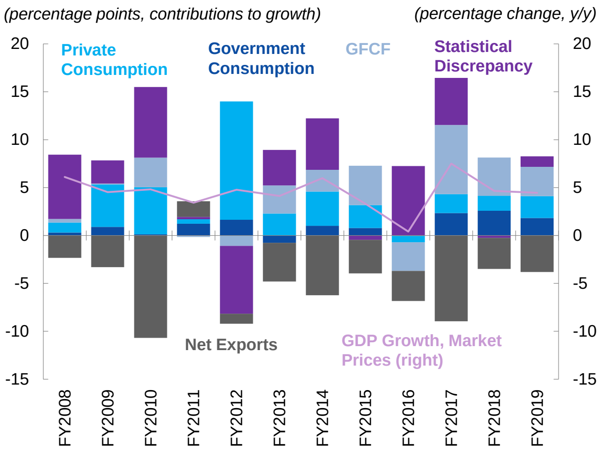
Notes: a/ fiscal balance includes net lending, e = estimate, f = forecast.

On the demand side, gross investments are expected to drive growth, while slower growth in consumption is expected to continue. Growth in gross fixed capital formation is expected to remain strong during the forecast period. Public investment is likely to face challenges as the country implements a new political and bureaucratic structure, but is still expected to remain robust as capital spending by local governments is expected to increase as a result of the successful local government elections in more than two decades. Private investment is also expected to remain strong given that the power supply remains regular, which will help spur investments in other private activities. Growth in private consumption is expected to moderate during the forecast period in line with a more sanguine outlook for growth of remittances. Government consumption, however, is expected to grow substantially, as FY2018 is the first "de-facto year" in terms of implementing a federal structure. In addition, the final phase of local elections in province number two, followed by federal and provincial elections expected to be held by early 2018, will further add to government consumption. Exports of services are expected to continue as tourism continues to pick up. Exports of goods are also expected to grow, albeit modestly in FY2018, in light of continued power availability in Nepal, and with the normalization of demand in India as the demonetization and GST affect subsides, but are expected to moderate in line with their long-term average thereafter.

The fiscal deficit is expected to widen during the forecast period; however, given the large cash balance on hand, financing is not expected to be a problem, yet. The FY2018 budget called for an expenditure increase of nearly 11 percent of GDP over actual expenditures in FY2017. However, as in previous years, significant underspending of the budget will continue. Nevertheless, government spending will grow substantially in FY2017, owing to increases in earthquake- and flood-related cash assistance and proposed election-related spending. The government's recurrent expenditure is expected to continue to grow substantially in the forecast period, particularly as a result of implementation of the new federal constitution, which calls for creation of an entirely new provincial level of government.

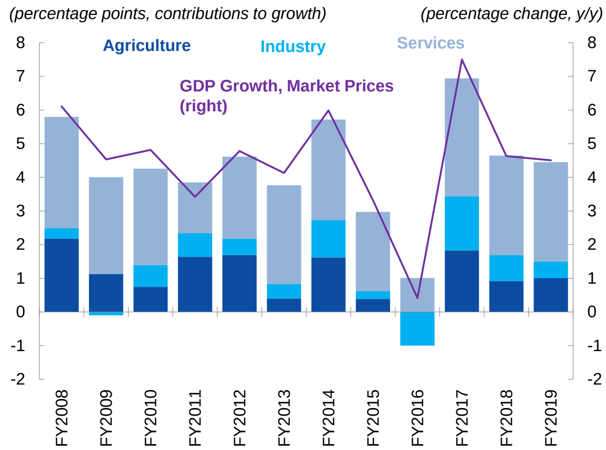
The FY2018 budget envisions a substantial increase in transfers to the newly elected local governments, which will increase government spending (see the discussion of fiscal federalism in the Special Focus section, below). The growth in revenues is expected to continue on the back of strong capital imports, but may slow if the inflow of remittances slows further, particularly

Figure 31 GDP growth after a strong rebound is expected to moderate



Source: CBS and World Bank staff calculations.

Figure 32 Agriculture was particularly impacted by the floods of 2017



Source: CBS and World Bank staff calculations.

hampering consumption-related taxes. With increased government spending as a result of a new federal structure and earthquake- and flood-related reconstruction, the fiscal deficit is expected to widen in FY2018. Meanwhile, the current account, which had remained in surplus over the last several years but turned into a deficit in FY2017, is expected to continue in deficit as import growth is expected to remain high, while remittances and exports growth are expected to slow. If the large trade deficit continues to persist and remittance slowdown continues, it is likely to start putting pressure on Nepal's foreign reserves, too.

From a significantly moderated rate of FY2017, inflation is expected to pick up modestly during the forecast period. Inflation was at a 13-year low during all of FY2017. However, it is expected to pick up somewhat in FY2018, as the effect of demonetization tapers off in India. Also, due to severe floods in Nepal and India affecting agricultural products and connectivity, food prices are likely to see some uptick, albeit temporarily. The sharp uptick in the prices of rental housing and utilities following the earthquake, which continued in FY2017 due to slow reconstruction, is expected to moderate somewhat in FY2018, as housing reconstruction is expected to gather speed. However, some pressures are likely to emerge in FY2018 as a result of the houses damaged by floods, particularly in the Terai region

Challenges and Risks

There are an increasing number of downside risks to this forecast, with both domestic and external risks increasing. The political environment in Nepal remains fluid as the term of the current government—which was sworn in in July 2017 as part of the power-sharing agreement among the coalition partners—will come to an end after the federal-level election scheduled to be conducted by early 2018. In addition, a series of elections—provincial and federal —needs to be held by early 2018, as stipulated in the new constitution.

With the difficulties surrounding the implementing architecture of the new federal structure, budget execution is going to be particularly challenging in FY2018. Budget execution has been a persistent problem in the past and has been exacerbated since the FY2016 budget, which called for a substantial increase in expenditures, driven to a large extent by increased needs in postearthquake reconstruction. However, actual spending has been significantly below the planned budget for the last two fiscal years . An overly ambitious budget has continued into FY2018 as well which is going to pose a challenge because of the lack of clarity around spending in the federal structure and several upcoming elections. Normally, the government stops all major activities in the run-up to elections. Moreover, as the country moves to a federal structure, there is lack of clarity regarding the fiscal architecture in the federal context , which can cause unintended interruptions in service delivery and execution of capital projects.

Despite improvements, the pace of earthquake reconstruction remains a concern, which is now compounded by flood recovery and reconstruction. The delay in disbursement of the second and third tranches of the housing reconstruction grant has meant that fewer than 10,000 households have received all three tranches of government subsidy for housing reconstruction more than two-and-a-half years after the earthquake. Reconstruction in other sectors (cultural heritage, schools, hospital, public buildings, and so forth) has barely started. The Ministry of Finance has confirmed that nearly all the money pledged during the donor conference has been committed by the donors, and the risk of nondelivery from the Government of Nepal is increasing. The recent floods affecting more than one-third of the country have further compounded this problem.

The external environment is likely to be less favorable, as well. Continued underperformance of exports despite the end of disruptions remains a persistent challenge. Remittances account for 30 percent of GDP, with the majority of migrants going to oil-exporting Gulf Cooperation Council (GCC) countries. Significant spending cuts, including in capital spending announced in the GCC countries, and persistent contraction in departures of migrants, contributed to lower growth of remittances. The recent blockade of Qatar and the sharp slowdown of migrants going there increase the risk of a further slowdown of remittances during the forecast period.

C. Special Focus: Fiscal architecture for federal Nepal

Background

Following adoption of a new federal constitution in September 2015, Nepal embarked on an ambitious reform path to shift from a unitary to a federal government system. The constitution adopts a "big bang" approach to decentralization, envisaging three tiers of government—federal, provincial, and local—with significant devolution of decision-making powers and resources. The seven provinces created in the constitution, with executive, legislative, and judicial powers, represent a completely new type of subnational structure in the history of Nepal. Local governments have existed in the form of district and village development committees and municipalities. Under the new system, they will be consolidated from more than 3,000 village development committees and municipalities into 753 local governments that also have executive, legislative, and judicial powers. Seventy-five districts that had played important administrative and service delivery functions will cease to exist as a separate tier of government; however, they are expected to play a coordinating role for local governments during the transition period.

The constitution calls for elections at the three levels to be completed by January 2018, which will be a historic step towards implementation of the federal system of government. After a period of 20 years, citizens of Nepal enthusiastically embraced the opportunity to vote in the local government elections in two rounds on May 14 and June 28, 2017. The third and final phase of local elections is expected to take place on September 18. Two rounds of elections for the provincial and federal levels of government were announced for November 26 and December 7, 2017, the successful implementation of which will fulfill the constitutional requirement for holding elections.

Restructuring of the state to a federal model is a complex task, but issues can be grouped into three broad categories. In general, issues regarding the transition to federalism can be grouped into three categories: the functions category (that is, which level is responsible for delivering which service), the finance category (that is, which level or levels collect revenue and raise debt), and the functionaries category (that is, how will the existing civil service be transformed). All the issues under these three categories need to be resolved effectively for government service delivery not to get disrupted.

The aim here is to assess what are the main emerging issues and risks in the design of fiscal federalism (that is functions and finance categories) that warrant attention as Nepal transitions to a federal country. This is important because fiscal federalism arrangements will have a strong impact on the quality of public service delivery. Starting in FY2018, a large proportion of federal spending is expected to be passed on to subnational governments, which will be automatic, constitutionally mandated, and once transferred will be beyond the control of the federal government. A "big bang" decentralization to a nonexistent level of state and local governments carries both opportunity to do things differently and improve outcomes of service delivery as well as risks in a low-capacity environment.

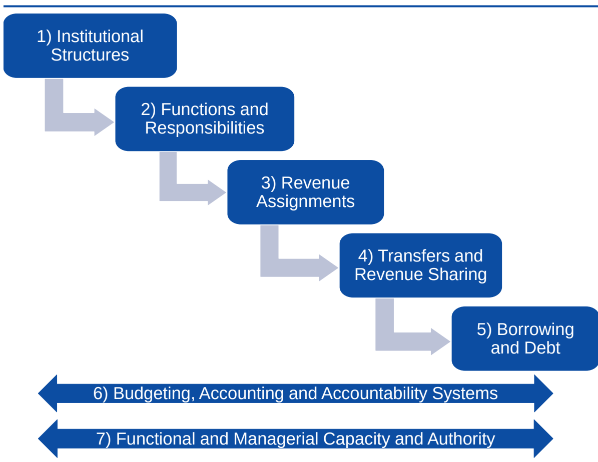
Analytical framework

Fiscal federalism deals with the financial relationships among different tiers of government in a federal country. There are seven major components of fiscal federalism, as outlined in Figure 33. However, the analysis presented in this note will examine the relationship among the four key dimensions of public finance in decentralized systems, also known as the "decentralization diamond" (Figure 34 and Figure 37): (i) expenditure responsibilities, (ii) revenue generation, (iii) intergovernmental transfers, and (iv) public borrowing. These facets of fiscal federalism influence each other in complex ways. For example, as the economic costs of raising subnational taxes tend to be higher than for raising federal broad-base taxes, the more taxes collected by the federal government and then transferred to subnational governments is, in principle, an efficient arrangement. However, the asymmetry between the ability to generate own revenues and expenditure responsibilities causes a vertical fiscal gap, which increases the reliance of subnational governments on intergovernmental transfers or borrowing. This in turn may affect revenue collection incentives of recipient governments and impact the quality of subnational spending.

Functional assignments

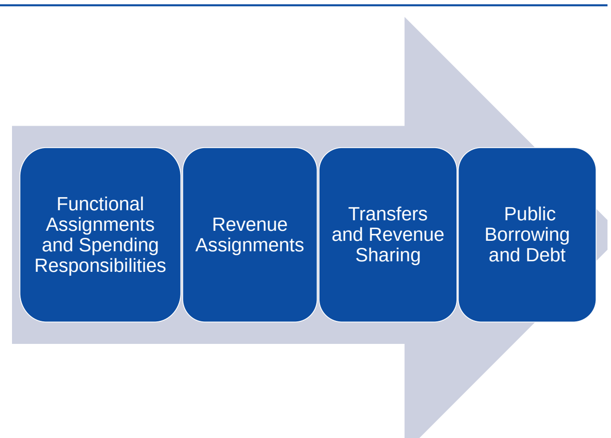
Going forward, the subnational governments will play a critical role in Nepal's public expenditure system. Following the principle of subsidiarity, the 2015 Constitution mandates substantial responsibility for the provision of essential public services such as education, health care, and basic infrastructure to the local governments and provinces. If we take the FY2018 budget as an indication, transfers to the subnational governments are expected to be five times larger than the previous year. From an estimated spending of about NPR 50 billion in FY2016, the FY2018 budget has proposed NPR 242 billion in transfers to subnational

Figure 33 Components of fiscal federalism



Source: Adapted from Dafflon (2014).

Figure 34 Components of fiscal federalism analyzed in this note



Source: World Bank staff.

governments, much of which are transfers to the local government.

However, there are several issues with the expenditure assignments. First, many responsibilities have been assigned as "shared or concurrent responsibilities" of the federal, provincial, and local governments. For example, primary and secondary education is assigned by the constitution as a responsibility of local governments, but education is also listed in the concurrent or shared list of responsibilities for federal, and provincial governments as well. Concurrent powers are common in federations, but a large set of concurrent responsibilities dilutes accountability, as there is no clarity on which level of government is ultimately responsible for which concurrent responsibility. Hence, a clear expenditure and functional assignment is a first step in fiscal decentralization. Lack of clarity in functions was a problem even when Nepal had a unitary system (World Bank 2013). Consequently, timely resolution and clear delineation of responsibility is needed to prevent potential duplication and lack of accountability that can be exacerbated in a federal system.

Second, there is a need to be watchful about the size of the local government and provinces and the associated costs. In the pre-federal structure of Nepal, local governments—particularly the village development committees—were too small to effectively deliver services like health and education. About 3,300 local governments served an average population of 7,000 to 9,000 people. In the current federal setup, there would be 753 local governments serving an average of 35,000 people per local government, which is better than the previous arrangement. This is comparable to the size of local governments in other countries. However, there are two potential issues. First, if the number of local governments were to increase in future, it could lead to many local governments with a less-than-average population size. Second, lack of clarity in the functioning of wards (units making up local governments) and districts (units coordinating local governments) with the current 753 local governments adds complexity. In general, lack of government capacity is an issue in Nepal, and transformation of the bottom tier of government from administrative units that had some capacity (districts, municipalities, villages) to new ones that do not (wards, local governments, and councils) poses significant risks. If there is limited capacity, or inadequate funding, of the local governments service delivery could be affected.

Revenue assignments

Low subnational tax revenues are likely going to be a persistent key feature of fiscal federalism in Nepal. The 2015 Constitution has not noticeably enhanced the ability of subnational governments to collect tax revenues or other sources of own revenues. Subnational own-source revenue amounted to less than 0.5 percent of GDP in pre-federal Nepal and is likely to remain in this range in the current federal structure. Major sources of revenue—income tax, VAT, custom, excise—are all to be collected by the central government, with limited own-source revenues provided to provinces and local bodies. Consequently, approximately 80 to 85 percent of the existing revenues is likely to remain with the center. Hence, revenue collection will not change much in pre- and post-federal Nepal. In recent years, the dependence of the local bodies on central transfers did not decrease. In the federal structure, the dependence on central transfers is likely to increase.

The limited revenue base available to the subnational governments and their general low collection efficiency are not going to help the decentralization of tax revenues. Consumption or indirect tax bases are typically the most important sources of state and local tax revenue, but in Nepal these sources are exclusively listed in the schedules of the central government in the constitution, while subnational governments are left with the authority to levy taxes with small bases. As a result, subnational taxes in Nepal will not be significantly different from the unitary system, that is, less than 1 percent of GDP, and likely to represent less than 2 to 3 percent of total general government revenue. This is low compared to other federal countries like Argentina (where subnational taxes account for 5 percent of GDP and 16 percent of total tax revenue), Brazil (11 percent of GDP and 30 of total tax revenue), and Canada (16 percent of GDP and 50 percent of total tax revenue).

Revenue collection will continue to be highly uneven between local governments and provinces in Nepal. In pre-federal Nepal, because of considerable differences in revenue potential across village development committees (VDCs) in the country, revenue collection was highly skewed among the VDCs of a few districts. Most VDCs had extremely low internal revenue generating capacity. In FY2012/13, 80 percent of VDCs collected less than 10 percent of their revenue from own sources (LBFC 2014). For instance, in the same year, the internal revenue of VDCs in Kathmandu district (the wealthiest) amounted to NPR 179 million, while the internal revenue of VDCs in Bajura district (the poorest) was only NPR 0.38 million (LBFC 2014).

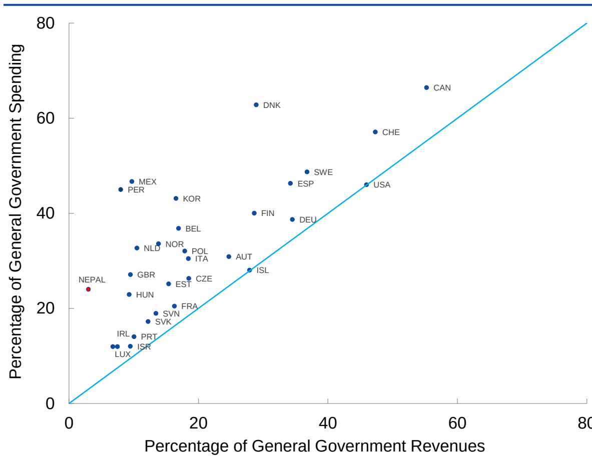
Finally, capacity is going to be a major factor for subnational governments, resulting in low revenue collection efficiency. Even when the assigned taxes could be a good source of income, it would be difficult for the subnational governments, which are yet to be established to determine the optimal tax policy and effective tax administration. Hence, subnational revenue collection is going to be much below the average of 10 percent of GDP observed in other large federations. Even unitary states in Latin America, such as Chile and Colombia, collect more tax revenue at the regional and local levels.

Creating a large vertical fiscal gap in addition to a long-standing horizontal fiscal gap

Given large functional responsibilities, own-source revenues will be insufficient to cover spending needs as devolved by the constitution, which will result in a so-called "vertical imbalance" or "vertical fiscal gap." Major tax revenue sources, such as personal and corporate income taxes and consumption taxes, can often be more efficiently levied at the federal level. Meanwhile, spending on public services is often better managed by subnational governments, which are more intimately familiar with regional and local needs and conditions. The resulting combination of centralized tax collection and decentralized service provision creates vertical fiscal gaps. While, centralized tax collection combined with transfers to subnational governments can maximize efficiency on the revenue side, increasing own-source revenue collection by subnational governments can promote expenditure efficiency by improving accountability and strengthening taxpayer oversight. Moreover, the appropriate balance between subnational taxation and intergovernmental transfers will vary from country to country (Figure 36).

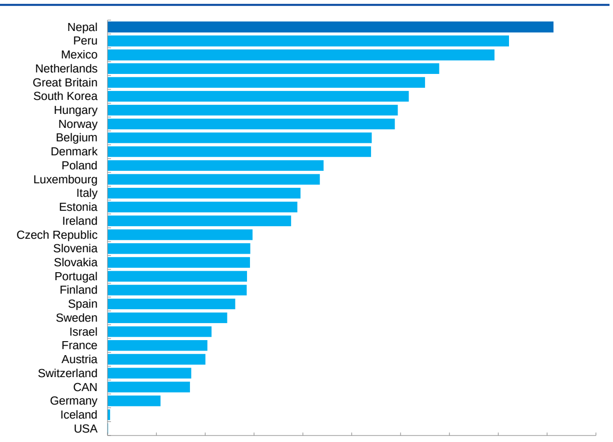
However, while Nepal's vertical fiscal gap is going to be very large it does not have to be problematic. The FY2018 budget indicates that subnational governments are going to already account for around 23 percent of general government spending, which is likely to increase as more expenditure assignments are devolved to the subnational government as mandated in the constitution. However, in a federal structure with

Figure 35 Vertical fiscal gap varies among countries



Sources: OECD; MoF; LBFC; and World Bank staff calculations

Figure 36 Nepal's vertical fiscal gap is going to be one of the largest among federal countries



Sources: OECD; MoF; LBFC; and World Bank staff calculations only 2 to 3 percent of total general government revenue likely to be collected by the subnational governments, the vertical fiscal gap is going to be one of the largest among federal countries (Figure 36).

While it is difficult to determine the optimal vertical fiscal gap for each federal system, recent empirical studies indicate that incentives for expenditure efficiency are reduced when fiscal gaps are very large, or when subnational own-source revenues are very low. A heavy dependence on transfers can reduce efficiency among subnational governments by externalizing the cost of raising revenue. Transfers can also weaken fiscal discipline, as subnational governments and their creditors may expect the central government to bear the ultimate responsibility for deficits and debt. Finally, limited revenue autonomy reduces the ability of subnational governments to implement fiscal adjustments, because in the absence of revenue-side measures, spending cuts are their only available policy instrument.

In addition to vertical imbalances, so-called horizontal imbalances have also been historically high in Nepal. Large disparities in socioeconomic development among various parts of Nepal have existed throughout history. Poverty and other socioeconomic indicators follow a similar pattern, and these differences are reflected in the strong spatial concentration of tax bases and the even wider differences in tax collection. Own-source revenue per capita in Kathmandu district is 10 times higher than in Darchula district in pre-federal Nepal (LBFC, 2014), and this will continue in the federal context too.

Increased dependence of subnational governments on intergovernmental transfers

The 2015 Constitution and the draft Inter-Governmental Fiscal Management (IGFM) bill as discussed in the Parliament has defined four broader types of intergovernmental transfers. These transfers are principally designed to address vertical and horizontal imbalances and ensure the effective provision of public goods and services at the subnational level. In addition, transfers are to provide appropriate incentives for expenditure efficiency, fiscal discipline, and tax collection among subnational governments. The four major categories of transfers proposed in Nepal are:

Revenue sharing: to address vertical fiscal imbalances among the central, provincial and local governments.

Royalty sharing: Nepal needs to be careful in the sharing of natural resource royalties, because they can exacerbate horizontal imbalances if the distribution criteria give excessive weight to the location in which the natural resource (for example, hydropower) is placed.

Fiscal-equalization grant: designed to address horizontal imbalances among subnational governments.

Conditional, matching, or special transfers: that incentivize subnational governments to provide public services that generate positive externalities or contribute to national development priorities.

Large vertical and horizontal fiscal gaps on one hand, and the decentralization of expenditure assignments on the other hand, will make intergovernmental transfers a central element of Nepal's fiscal federalism framework. Transfers financed by revenue sharing mechanisms in the draft IGFM bill as discussed in the Parliament try to mitigate some of the significant vertical and horizontal gaps. Revenue sharing comprises fixed percentages of a pool of federal revenues from the VAT and excise tax that will be channeled to states and local bodies. However, it is hard to judge whether such revenue sharing is enough to continue service delivery by subnational governments given that detailed costing of devolved service delivery has not been done. The draft bill proposes that 15 percent of the VAT and 7 percent of the internal excise tax go to local governments and provinces.

Hence, intergovernmental transfers in federal Nepal are likely to be high, at about 10 percent of GDP, and will finance around 80 to 85 percent of all spending by subnational governments. Transfers had already started to increase in pre-federal Nepal, following the decentralization of social services in the early 2000s after enactment of the Local Self-Governance Act (LSGA). Demand from the parliamentarians to increase their constituency fund further fueled the increase of transfers.

However, the effort to increase the tax base and efficiency was virtually nonexistent.

However, transfer systems can be designed in a way that mitigates negative aspects of vertical fiscal gaps. Own-tax sources will rarely meet the funding requirements of subnational governments, nor does the theory of fiscal decentralization suggest that each tier of government should be self-sufficient. Fiscal transfers typically have a conditional and an unconditional portion. The former leads to a more hierarchical system of accountability—the center holding the subnational accountable for proper use of central transfers. The latter falls in the category of discretionary resources, for which subnational governments are directly accountable to their constituencies. Also critical is the predictability of fiscal transfers, essential in allowing subnational governments to plan local service delivery more effectively. Predictability is enhanced using a formula-based allocation systems driven by simple measures of equity and efficiency. In general, the use of unconditional, formula and block transfers enhances both the predictability and "own-revenue" properties of such fiscal flows.

The constitution stipulates that the design of equalization formula is a key mandate of the National Natural Resources and Fiscal Commission. A form of equalization formula was already introduced in pre-federal Nepal for a small share of transfers provided by the central governments to district and local governments, known as Minimum Condition and Performance Condition (MCPM) grants. However, the share of this equalization grant was very small in the overall grants to the local bodies. Also, despite the inclusion of "tax collection performance criteria" in the distribution formula, these transfers did not provide substantial incentives to enhance tax collection efficiency among recipient local governments. The constitution and the draft bill on the Fiscal Commission mandate that the National Natural Resources and Fiscal Commission devise the formula based on certain principles. It is important for the formula to be simple, and numerous criteria will only have a marginal impact on their respective goals, that is, (i) a fiscal-equalization transfer to reduce horizontal imbalances, and (ii) a transfer to incentivize tax collection efficiency at the state level.

In addition, it will be important to design equalizing distribution criteria for all or a large part of the fiscal revenues related to the exploitation of natural resource royalties. International experience shows that the distribution of resource revenues among regional and local governments is one of the most disruptive factors negatively affecting the achievement of the equalizing objectives of transfer systems, as they are usually distributed based on origin or derivation principles. The compensation for the exploitation of natural resources to the regions or local jurisdictions where the natural resources are located is justified by the negative externalities generated by such activities in the affected regions. However,

Table 3 Fiscal decentralization trends in Nepal, FY2010 through FY2018

	2010	2011	2012	2013	2014	2015	2016	2017 e	2018 p
Direct Subnational Spending									
Percent of GDP	2.5	2.9	2.8	2.4	2.5	2.5	2.7	3.5	11.1
Percent of Total General Government Spending	13.2	14.2	12.9	12.5	12.5	11.3	11.1	11.9	23.6
Subnational Own-Source Revenue									
Percent of GDP	0.3	0.4	0.3	0.3	0.4	0.4	0.4	0.5	0.5
Percent of Total General Government Revenue	1.8	2.4	1.9	1.9	1.8	2.1	2.0	2.0	2.1
Intergovernmental Transfers									
Percent of GDP	2.5	2.4	2.3	2.0	2.1	2.1	2.2	3.1	9.6
Percent of Total Subnational Government Revenue	90.0	87.3	84.5	82.2	83.0	80.2	79.4	82.4	84.5
Percent of Total General Government Spending	13.2	11.6	10.6	10.1	10.5	9.5	9.2	10.3	20.5

Sources: MoFALD, LBFC, MoF
Note: e = estimate, p = projected based on FY2018 budget

distribution rules based on the origin of the natural resources are excessively generous, with normally few beneficiaries, and tend to eliminate any equalization effects of other transfers. Hence, with equalizing transfer formulas, it is important to prevent natural-resource-rich regions or localities that receive substantial amounts of royalties from also receiving equalizing transfers.

Finally, it is important to consider the incentives that the transfer system is expected to generate, especially in the efficiency of tax collection and on the spending side. As in other federal systems, transfers in Nepal can negatively affect the behavior of both federal and state governments. For example, both theoretical and empirical analyses have demonstrated that intergovernmental transfers inhibit tax collection efforts by recipient governments. A single fund that rewards the revenue-collection efficiency of provinces and local governments would help eliminate perverse incentives.

Whether subnational governments finance their spending through own-source tax revenues, federal transfers, or borrowing has important implications for the efficacy and accountability with which public goods and services are provided. Intergovernmental transfers seek to bridge the gap between local governments' limited capacity to raise revenues and their much larger expenditure responsibilities. However, they can also create perverse incentives. Overreliance on intergovernmental transfers can undermine expenditure efficiency, and international experience has shown that a large share of transfers in state or local budgets tends to undermine the collection of own-source revenues. Moreover, recent research on fiscal decentralization suggests that a heavy reliance on transfers is also associated with excessive subnational indebtedness. In this context, the increasingly prominent role of subnational governments in Nepal's public expenditure system underscores the importance of their fiscal behavior to the country's overall macroeconomic stability.

Borrowing and Debt

Faced with large spending obligations and a limited capacity to boost own-source revenues, provinces and local governments are likely to relatively increase their borrowing in federal Nepal. While the overall stock of subnational debt remained virtually nonexistent in the pre-federal era, this may change going forward.

A clause that enables the federal level to regulate subnational indebtedness has been rightly included in the constitution (Article 59, section 7). The details of borrowing or debt rules for lower levels of government have rightly not been included in the constitution and can be defined by law and regulations. This is a key aspect, because in many countries, national fiscal rules cannot be applied to subnational governments and can be problematic as subnational debt starts to threaten the overall macroeconomic stability. The IGFM draft bill as discussed in the parliament proposes that only the federal government seek foreign debt and aid, while all three levels of government can borrow domestically. However, the lower levels need the consent of the central government.

A small number of highly focused fiscal rules will be important in federal Nepal. For example, appropriately defined "rules of the game" build in resilience by avoiding costly debt crises. It is important to define fiscal rules that are clear and implementable, and that avoid micromanagement by the federal government while preserving some flexibility at the subnational level. Enactment of a comprehensive fiscal responsibility law can help establish such clear "rules of the game." However, such subnational fiscal rules should be simple and limited to the two or three most necessary to achieve the government's objectives in the current environment, where institutional capacity is limited.

One of the main weaknesses of the subnational indebtedness framework in federal countries is the lack of reliable and uniform financial information. Ensuring the transparency and timeliness of fiscal indicators is especially important to conduct policy adequately in a decentralized system. It is crucial to establish criteria for public accounting and financial reporting from the outset, and to make it mandatory for states and local governments to adopt its uniform methodology as principally guided by the 2015 Constitution, as well. Improvements in financial accounting and reporting are critical to the effectiveness of fiscal rules and the continued development of the subnational credit market. Fiscal rules also require accurate subnational financial and debt information.

Conclusion

In sum, from a previous centralized fiscal system, the projected trends of Nepal's new fiscal federalism system depicted in the fiscal decentralization diamond (Figure 37) suggest a marked asymmetry between a stronger decentralization of spending responsibilities and relatively unchanged low decentralization of tax collection powers, which are expected to remain highly concentrated at the central or federal level. Thus, intergovernmental transfers will be the main financing revenue source of provincial and local governments. Due to nonexistent credit markets for subnational governments, it is expected that borrowing will be restricted to finance their spending responsibilities, too.

Sequencing of political, fiscal and administrative decentralization matters. Ideally, subnational governments should first be given clarity about their functions and associated expenditure responsibilities and, based on these, the proper assignment and design of tax instruments and transfer systems should be made. The rule that finance follows function appropriately defines this sequencing. In addition, to ensure service delivery and the exercise of devolved powers in general, decentralization of the civil service should be implemented along with expenditure and fiscal arrangements. Function, finance, and functionaries all need to be sequenced properly.

The following are the critical emerging issues in the design of fiscal architecture for federal Nepal:

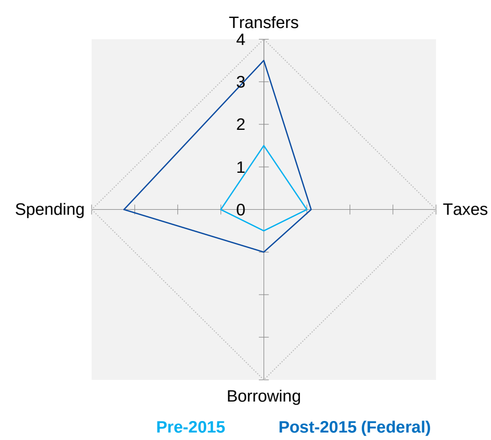
Functional assignments: too many responsibilities are "shared" among the three levels of government. A negotiated delineation of responsibilities and adequate costing of devolved responsibilities are critical first steps. Detailed costing of devolved services to be delivered is critical.

Revenue assignments: revenue collection and tax administration remain relatively unchanged and highly centralized, with limited existing tax bases for subnational governments.

Transfers and revenue sharing: the resulting mismatch between revenue collection and service provision (vertical imbalance) can be closed through intergovernmental transfers. This is one more reason why proper delineation of responsibilities and realistic and impartial costing of devolved responsibilities are critical. Without them, the debate on the size of transfers is not made on the grounds of what subnational units require to provide services. The same holds for horizontal imbalances (that is, differences between different regions of Nepal). Having a transparent, evidence-based formula for equalization among provinces is critical to design an effective depoliticized process.

Public borrowing and debt: The constitution has adequate provisions for prudent debt management in a decentralized system. However, these provisions should be developed in greater detail though a fiscal-responsibility-type law that provides clear, simple, yet flexible rules for behavior of different levels of government. In addition, the creation and deployment of accounting and debt reporting systems remains a critical short-term priority.

Figure 37 Fiscal decentralization diamond: pre- and post-federal constitution



Source: World Bank staff. *Note*: On the horizontal axis, a greater distance from the origin point indicates higher tax revenues and spending decentralization. On the vertical axis, a greater distance from the origin point represents increased reliance on intergovernmental transfers and borrowing.

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