



RESOURCE MOBILIZATION FOR SUSTAINABLE LDC GRADUATION OF NEPAL
IN THE CONTEXT OF EMERGING CHALLENGES TO DEVELOPMENT FINANCING

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February 2022



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Foreword

The Development Papers Series of the UNESCAP South and South-West Asia Office (UNESCAP SSWA) promotes and disseminates policy-relevant research on the development challenges facing South and South-West Asia. It features policy research conducted at UNESCAP SSWA as well as by outside experts from within the subregion and beyond. The objective is to foster an informed debate on development policy challenges facing the subregion and sharing of development experiences and best practices.

This paper by Paras Kharel explores ways and means for improving resource mobilization for financing sustainable graduation of Nepal from the LDC category. Nepal met the criteria for graduation in the triennial review of 2021 conducted by the United Nations Committee for Development Policy (CDP) and has been nominated for graduation from the LDC group. Following an extended transition period granted in the aftermath of socio-economic disruptions caused by COVID-19 pandemic, Nepal's graduation is scheduled to become effective in 2026.

One of the key challenges faced by graduating LDCs is that of resource mobilization for sustaining development financing, given that international support measures (ISMs) including financial assistance that are exclusively available for LDCs will be phased out after graduation. Apart from the long-term goal of adapting to a more self-reliant development financing strategy, graduating LDCs also need to meet the short-term funding requirements for the implementation of specific policy programmes aimed at smooth and sustainable transition. In the aftermath of the COVID-19 pandemic, graduating LDCs are forced to deal with the twin challenges of shrinking revenues due to wide-spread disruptions to economic activities on the one hand, and increased health and social sector spending commitments raised by the pandemic on the other hand. This situation is exerting severe strains on the resource mobilization capacities of graduating LDCs and threaten to widen their resource gaps.

Against this background, with the objective of assisting policy makers in addressing potential issues of development financing, the paper analyses the development financing landscape of Nepal constituted by various domestic (tax, non-tax revenues, government bonds etc.) and external (remittances, ODA, FDI etc.) sources. It finds important avenues for strengthening resource mobilization from traditional sources and for exploring new financing instruments. It underscores need for aligning policy programmes for sustainable graduation with implementation of the Sustainable Development Goals (SDGs) for maximizing efficiency of public expenditure.

The paper offers a rich set of policy perspectives on diversification and expansion of Nepal's development financing portfolio. We hope that the policy prescriptions offered by this paper will assist policy makers and stakeholders in adopting measures for improving prospects of sustainable development financing in Nepal in particular, and in the graduating LDCs of South Asia in general.

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Resource Mobilization for Sustainable LDC Graduation of Nepal in the Context of Emerging Challenges to Development Financing

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Abstract

This paper evaluates Nepal's challenges related to resource mobilization for sustainable graduation in the aftermath of COVID-19 and potential avenues to overcome them. Nepal's graduation is scheduled to become effective in 2026, and the country also aims to become an upper middle-income country by 2030. With the lowest per capita income among graduating LDCs, the continued developmental challenges faced by Nepal include premature de-industrialization, low productive capacity and low rate of job creation. While the country already faces substantial gaps in development financing, resource mobilization for implementing transitional strategies is being challenged by additional resource demands in the aftermath of the COVID-19 crisis. Against this backdrop, this paper analyses the issues in securing development finance for Nepal and derives policy suggestion for the way forward. It examines the structure of development finance landscape of Nepal, projected investment needs and resource gaps faced by the country in the current context. Domestic fiscal space is assessed in detail, considering the potential for improving both revenue and expenditure sides of public finance. The paper calls for a reassessment of additional investment needs and gaps in the post-COVID-19 context, and proposes ways to revitalize domestic financing and to capitalize on potentials for tapping external sources such as foreign aid, FDI and remittances.

JEL Codes(s): F30, F35, G20, G32, H20, H50, H60

Key words: Financing for development, LDC graduation, sustainable development

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1. Introduction

While Nepal made substantial progress in poverty reduction and several other development outcomes, such as those related to health and education, as part of the Millennium Development Goals and has been making further progress since the launch of the Sustainable Development Goals (SDGs) in 2016, it faces a challenging road ahead to meet its development aspirations, notably to become an upper middle-income country by 2030. The country is graduating from the least development country (LDC) category in 2026 without meeting the income criterion. It has the lowest per capita income among the dozen LDCs on track towards graduation. This reflects a key structural challenge faced by the Nepali economy masked by other, more positive, development outcomes. The challenge pertains to de-industrialization, low productive capacity and a poor rate of creation of decent jobs. As a result, the country has seen massive outmigration for work, with remittances emerging as the mainstay of the economy and contributing to the progress towards other development goals. The Covid-19 pandemic has hit the economy hard, caused huge job losses, and in all likelihood reversed some of the gains made in poverty reduction.

Finding the resources to meet development goals was always a challenge. A huge resource gap was already staring at policymakers as the government embraced the SDGs. LDC graduation and the pandemic are shocks that will trigger additional resource demands while making resource mobilization more difficult, for both public and private sectors.

Against this backdrop, this paper analyses the issues and challenges in securing development finance for Nepal, and suggests a way ahead. It discusses challenges pre-existing the pandemic as well as pandemic-specific challenges and the implications of LDC graduation. Section 2 presents an overview of Nepal's development experience, goals and challenges. Section 3 summarizes the investment needs for meeting development goals, and the resource gap. Section 4 introduces the federal structure of governance adopted by Nepal to set the scene for later discussions of the issues and challenges in development finance in the context of fiscal federalism. Section 5 analyses the trends in and structure of government revenue, and the challenges in revenue mobilization, including in the context of federalism. Section 6 analyses the trends in, and structure and features of foreign aid in Nepal, with a focus on official development assistance, before discussing the implications of LDC graduation and a rising per capita income. Section 7 discusses fiscal space, looking at trends in government debt stock and debt servicing, while also emphasizing the potential for improving the efficiency of expenditure. Section 8 discusses the role of remittances as an important development resource, and the challenges to harnessing it further. Section 9 briefly discusses foreign direct investment trends and features, and notes the difficulty faced in attracting it. Finally, Section 10 presents suggestions for securing various sources of development finance.

2. An overview of Nepal's development experience, goals and challenges

From MDGs to SDGs

In the two decades preceding the launch of the SDGs, Nepal had made significant improvements in several aspects of socio-economic development. The proportion of people living in absolute poverty had declined from 49 percent in 1992 to 23 percent in 2015, child and maternal mortality rates had seen dramatic reductions, primary school enrolment had increased significantly, accompanied by gender parity, and the average life expectancy at birth had crossed 70 (NPC, 2017). Alongside these achievements, the Nepali economy was characterized by de-industrialization, as reflected in the declining share of manufacturing in total value addition and growth in non-tradable services sectors. Poor rates of job creation prompted as many as half a million people, mostly youths—almost equivalent to the number of annual entrants to the labour force—to go overseas for work every year, making remittances a mainstay of the economy. These features cast some doubt on the sustainability of the achievements of the Millennium Development Goals (MDGs) (2000-2015), accomplishing the unfinished basic development agenda, for example, ending poverty, hunger and privations that, for example, underlie the Multidimensional Poverty Index², and achieving high and sustained income growth. These features remain even half a decade into the SDG period.

In an assessment of progress towards the SDGs during 2016-2019, the National Planning Commission (NPC), Nepal's apex policymaking body that is also the nodal agency on SDGs, concludes that progress has been "quite satisfactory" on SDG 1 (ending poverty)³ and SDG 10 (reducing inequalities), progress has been "moderate" on SDG 4 (SDG 4 (inclusive quality education), SDG 5 (gender equality), SDG 7 (clean energy), SDG 15 (terrestrial system) and SDG 17 (partnership for sustainable development), while progress on SDG 2 (zero hunger), SDG 3 (healthy lives and well-being), SDG 6 (water and sanitation), SDG 8 (decent work and economic growth), SDG 11 (sustainable cities), SDG 13 (climate action) and SDG 16 (peace and justice) has remained "slow", and there has been "no progress at all" on SDG 9 (industry and infrastructure) and SDG 12 (responsible consumption and production) (NPC, 2020). Thus, two SDGs (8 and 9)—which constitute a means to achieving and sustaining other development goals, which were not explicitly part of MDGs and which, fundamentally, relate to the economy's capacity to generate output and employment—have seen slow or no progress⁴ during 2016-2019, that is, even before

² See CBS (2021) for a discussion of the Multidimensional Poverty Index.

³ Poverty measured by \$1.9 per day at PPP value fell from 36 percent to 15 percent against the target of 28.5 percent for 2019 and 4.9 percent for 2030. The proportion of population living below the national poverty line fell from 21.6 percent to 16.7 percent against the target of 17.1 percent for 2019 and 4.9 percent for 2030. Further, CBS (2021) reports that the percentage of Nepalis that are multidimensional poor fell from 30.1 percent in 2014 to 17.4 percent in 2019, with just under five million people in multidimensional poverty.

⁴ Road density (km/sq.km) was 0.63 against the target of 1.3 for 2019 (NPC, 2020). Manufacturing value added as a proportion of GDP declined from 6.6 percent in 2015 to 5.65 percent in 2019 against a target of 8.8 percent for 2019 and 15 percent for 2030. The share of industry (manufacturing; construction; and electricity, gas, and water) fell from 15 percent in 2015 to 14.47 percent in 2019 against the target of 17.7 percent for 2019 and 25 percent for 2030.

the onset of the Covid-19 pandemic and the additional challenges it introduced. The investment needs as well as the financing gap are among the highest for sectors directly related to these two goals (as will be discussed in Section 3).

The per capita real income growth rate exceeded the SDG target for 2019 (NPC, 2020). During 2016/17-2018/19, per capita real income (GDP) growth averaged 6.3 percent.⁵ That was in large part on the back of the reconstruction boom following the 2015 earthquake. GDP growth rate was already petering out in the first three quarters of FY 2019/20, before the onset of Covid-19.⁶ Achieving the target per capita income (GNI) of US\$2,500 by 2030 in real terms would require real income per capita to grow by 7.8 percent between 2019 and 2030.⁷ The GDP or GNI growth rate would have to be about 1.2 percentage points higher than that. Nepal government's 15th (development) Plan (2019/20-2023/24), which incorporates the SDGs, is even more ambitious in that it envisions Nepal becoming an upper-middle income country by 2030.⁸ To achieve this, Nepal's per capita GNI must be at least US\$4,096 by 2030 (based on the World Bank's definition of upper-middle income country for 2021/22).⁹ Given that the country's GNI per capita was US\$1,190 in 2020¹⁰, achieving this aim calls for real GNI per capita growth of at least 13.2 percent per annum during 2020-2030.

The Covid-19 pandemic

The disruption to economic activities by the pandemic—with at least two waves in Nepal, one in 2020 and the other in 2021, both leading to sweeping lockdowns and other containment measures—and the uncertainty it has created make achieving the targeted economic growth rate(s) all the more challenging. In 2019/20, per capita real GDP contracted by 3.4 percent and 2020/21 saw a tepid rebound of 2.6 percent.¹¹ As a result, per capita real GDP in 2020/21 was still 0.86 percent lower than in 2018/19. The nominal per capita GDP and GNI in 2020/21 were, respectively, US\$1,195 and US\$1,201. The per capita gross national disposable income (GNDI), which is GNI plus net transfer from abroad (the bulk of which is workers' remittances), remains significantly higher at US\$1,501.

The excess of per capita GNDI over per capita GNI has averaged 24.8 percent in the two fiscal years hit by the pandemic, 2019/20 and 2020/21, almost the same ratio as in the preceding two fiscal years. The pandemic threatens to undo the development achievements (including in health,

⁵ Nepal Rastra Bank's Current Macroeconomic and Financial Situation (2020/21).

⁶ Quarterly GDP estimates by Central Bureau of Statistics (<https://cbs.gov.np/>, accessed 25.06.21).

⁷ Using year 2019 per capita income (US\$1,097) as mentioned in NPC (2021).

⁸ National Planning Commission, Government of Nepal, *15th Plan (Fiscal year 2019/20-2023/24)*, available at <https://npc.gov.np/en> (accessed 27.09.21).

⁹ <https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups> (accessed 26.09.21).

¹⁰ Data from World Development Indicators (accessed 26.09.21). GNI calculation is based on Atlas method.

¹¹ Nepal Rastra Bank's Current Macroeconomic and Financial Situation (2020/21).

education and poverty) made so far. The economic slowdown triggered by the pandemic has had a major impact on employment: one estimate (NPC, 2021b) has it that about 924,000 individual had lost their jobs due to the pandemic by July 2020, while another estimate¹² suggests more than 40 percent of economically active workers reported a job loss or prolonged work absence in 2020. International tourist arrivals crashed by nearly 81 percent in 2020, and the activities of hotels, restaurants, travel and tourism are unlikely to revert to pre-pandemic levels until a sustained containment of the pandemic.¹³ The pandemic is likely to have reversed part of the reduction in multidimensional poverty witnessed between 2014 and 2019. Continued growth of remittances amid the pandemic (discussed in Section 8), defying initial predictions of a contraction, helped cushion Covid-19's impact on the economy to an extent.

The national vaccination drive has picked up, with about 20 percent of the population fully vaccinated¹⁴ as of 26 September 2021. Assuming there will not be a third wave, the government projects GDP growth rate for 2021/22 at 7 percent.¹⁵ However, the ADB forecasts a 4.1 percent growth for 2021/22.¹⁶ GoN's growth projection for the previous year, 2019/20, was also very ambitious, with about half of it being realized (4 percent). The ADB identifies as downside risks the uncertain trajectory of the pandemic, a possible surge in Covid-19 cases, and the resulting strict containment measures.

GoN's fiscal policy for 2020/21 focused on health care, increasing (planned) allocations for health by nearly 47 percent, as opposed to a nearly 4 percent reduction in the size of the overall budget.¹⁷ It also provided tax relief to businesses hit hard by the pandemic. Monetary policy measures included a dedicated refinancing facility, rebates on interest rates on loans, and concessional lending for affected businesses. Strengthening the nation's health care system and an accommodative monetary policy remain the key features of fiscal and monetary policies for 2021/22. Allocations for health rose by 23 percent in the government's planned expenditure for 2021/22.¹⁸

While allocations for health increased, allocations for the economic affairs heading in the budget fell by 28 percent in 2020/21, and although they rose by 13.6 percent the following year they were still less by 18 percent than the allocations for 2019/20. The government did not provide direct aid—food or cash—to needy households, economically hit hard by the pandemic, although some

¹² World Bank, 2021, *South Asia Vaccinates*, South Asia Economic Focus (March), World Bank, Washington, D.C. <https://openknowledge.worldbank.org/bitstream/handle/10986/35274/9781464817007.pdf?sequence=5&isAllowed=y> (accessed 26.08.21).

¹³ <https://www.adb.org/news/nepal-economy-modestly-grow-fy2022> (accessed 26.09.21).

¹⁴ <https://www.facebook.com/HEOCMoHP> (accessed 26.09.21).

¹⁵ GoN's financial plan for 2021/22, introduced through a Replacement Bill on 10 September 2021, available at <https://mof.gov.np/> (accessed 26.09.21).

¹⁶ <https://www.adb.org/news/nepal-economy-modestly-grow-fy2022> (accessed 26.09.21).

¹⁷ GoN's Budget Speech 2020/21.

¹⁸ GoN's Budget Speech 2021/22.

food aid was provided by or routed through local governments. In a revised financial plan for 2021/22, the government has allocated about US\$400 million to a new cash transfer programme meant to provide a one-off cash assistance—the first of its kind—to 500,000 poor families having members who lost their livelihoods to the pandemic.¹⁹ While it remains to be seen how effectively this scheme will be targeted at the most needy, this could lead to demand for direct assistance for households facing economic hardships in possible future waves of the pandemic, as well as a more generic cash transfer programme, directed at households at the bottom of the economic ladder, even in post-Covid-19 times. Social security expenses have surged in recent years, increasing more than fourfold between 2014/15 and 2019/20, and making up over 6 percent of total (actual) expenditure in the final year (GoN, 2021).

LDC graduation

The substantial gap between GNP (or GDP) and GNDI, noted earlier, sets Nepal apart from other South Asian countries and most low-income countries and LDCs. It is a visible symptom of its low productive capacity. It is the only country among the dozen LDCs on track towards graduation that is leaving the LDC status without meeting the income threshold (WTO, 2020), in itself very low. This raises concerns about the sustainability of the impending graduation, slated for 2026. Loss LDC-specific trade preferences as a result of graduation is the biggest cause for concern. The possible impact on foreign aid is discussed separately in Section 6.

The graduation shock is estimated to cause Nepal's merchandise exports to fall by 2.5 percent (or US\$20.14 million), lower than a loss of 6.4 percent projected for 12 graduating LDCs as a group (WTO, 2020). The projected export loss for Nepal is relatively low since over 60 percent of the country's exports are absorbed by India, with which Nepal has as a separate bilateral preferential trade agreement, and partly because of low productive capacity and severe supply-side constraints Nepal has not been able to effectively utilize LDC-trade preferences offered by most countries, barring those available in the European Union market. Beyond these estimates from partial equilibrium models, Nepal's longstanding aspiration to jumpstart its moribund export sector, whose earnings have remained less than US\$1 billion till 2021/22, and make it a pillar of economic growth and job creation will run into difficulties upon graduation.

As Kharel (2021) argues, "the fact that the prospect of tapping the country's export potential is partly predicated on preferential tariffs implies much higher export losses than predicted by standard modelling exercises. This underlines the urgency of tackling productive capacity and supply-side constraints and strengthening factors of non-price competitiveness." In addition, the projected export losses will be concentrated in the EU, a market where a lot of small and medium enterprises are selling. Helping such firms adjust to the loss of trade preferences and, more

¹⁹ GoN's financial plan for 2021/22, introduced through a Replacement Bill on 10 September 2021, available at <https://mof.gov.np/> (accessed 26.09.21).

generally, improving export-related productive capacity and alleviating supply-side constraints to turn the export sector into a major source of growth will have to be part and parcel of a transition strategy in the wake of graduation (Kharel, 2021). This will call for investments. While putting a number on the investment requirement would be a separate study in itself, the resource needs could be in addition to the needs projected for achieving the SDGs, which we will discuss next.

3. Development financing needs

This section summarizes Nepal's development finance needs. Given that SDGs have been integrated into the country's ongoing five-year development plan, we will focus on the investment requirements to meet the SDGs and the expected financing gap. Unless otherwise stated, all the estimates in this section are drawn from the needs assessment and costing done by the National Planning Commission (NPC, 2018).

The annual investment requirement for SDGs is estimated at 48 percent of GDP on average during the entire SDG period 2016-2030, amounting to NPR 2,025 billion, or US\$19.68 billion, per year (at 2014/15 constant prices). Table 1 lists the total, public sector and private sector investment requirements and financing gaps. The investment needs are the highest for transport, industry and ICT; education; energy; urban infrastructure, housing and reconstruction; poverty; health; and agriculture (Table 2).

Table 1: Annual average investment requirements for meeting SDGs (NPR billion, 2015 prices)

Sectors	2016-19	2020-22	2023-25	2026-30	2016-30
Total SDG investment need	1055	1559	2046	3070	2025
Total SDG investment need (in USD at 2015 prices)	10.25	15.14	19.87	29.82	19.68
Total SDG investment need as % of GDP	43.8	48.8	48.8	49.7	47.8
Private investment requirement	259	443	736	1303	739
Private resources available (including FDI)	224	333	418	488	373
Private finance gap	35	110	318	815	366
Public investment requirement	702	979	1134	1505	1111
Public resources available (including ODA)	521	698	905	1300	893
Public finance gap	181	281	229	205	218

Source: Table 1 in NPC (2018).

While the public and the private sector are expected to contribute over 90 percent of the investment requirements, remittances have increased the ability of a certain segment of households to bear a part of the required expenditure on SDGs. Households could finance up to 4.5 percent of the total SDG investment requirements. The contribution amounts to about 11 percent of the per capita

income. NGOs and cooperatives are expected to finance about 4.3 percent of SDG investment needs.

**Table 2: Public sector SDG investment requirement, financing sources and financing gap
(NPR billion, 2015 prices)**

SDG Area	Total Investment Requirement	Share of Public Investment in Total Investment	Public Investment Requirement	Available Public Finance (Domestic)	Available Finance (ODA)	Financing gap in public Sector
Poverty	2295	87.8	2015	984.7	162.2	903.9
Labour and Tourism	853.2	35.5	302.9	236.5	56	10.4
Agriculture	1768.3	69.9	1236.8	1233.9	261.2	258.3
Health	2012.1	64	1286.8	844.6	319.2	122.9
Education	4593.8	72.4	3326.8	2705.6	344.4	276.8
Gender	234.1	83.4	195.1	80.5	33.2	81.5
Water and Sanitation	1155.4	82.3	950.7	525.6	230.1	195
Energy	3906	48.3	1887.5	633.9	464.1	789.5
Transport, Industry and ICT	9207.7	32.9	3030.7	1899.8	288.7	841.2
Urban Infrastructure, Housing and Reconstruction	2554.2	35.4	903.7	531.8	268.5	103.4
Climate Change	372	88.9	330.8	69.2	198.9	62.7
Forestry	561.8	84.1	472.2	309.7	86.2	76.3
Governance	870.4	83.9	730.5	377.6	286	66.9
Total	30,384.00	55	16669	10397.6	2998	3273.1
Financing Sources, % of Total Public Investment Need				62	18	19.6

Source: Table 4.3 in NPC (2018).

The public sector is expected to contribute about 55 percent of the SDG investment requirements (Table 2). The government expects revenue mobilization and internal borrowing to finance about 62 percent of the public sector investment requirement, with ODA financing another 18 percent. Expected ODA averages NPR 200 billion per year. The government estimates that two thirds of domestically raised resources by the public sector and about 91 percent of ODA will need to be directed towards SDG areas. The financing gap in public sector investment will be about 19.6 percent of the requirements and 5.92 percent of GDP on average during the entire period.

The financing gap in the public sector, which is expected to average NPR 218 billion per year, will be the highest in infrastructure, followed by poverty reduction. Revenue is expected to reach 27 percent of GDP by 2030 in these projections, although NPC (2017), presenting a roadmap for the entire SDG period, set a target of 30 percent of GDP by 2030. Gross domestic borrowings are expected to be 5 percent of GDP. As public investment needs for SDGs are frontloaded, financing gap as percentage of public sector investment requirements will peak at 28.7 percent in 2020-22, before falling to 13.5 percent in 2026-30. ODA inflows will have to double from pre-SDG era levels to meet the financing gap.

Table 3: Private sector SDG investment requirement, financing sources and financing gap
(NPR billion, 2015 prices)

SDG Area	Total Investment Requirement	Share of Private Investment in Total Investment (%)	Private Investment Requirement	Available Private Finance (incl. FDI)	Available Private Finance (FDI)	Financing gap in private Sector
Poverty	2295	5	114.8	195.6	0	-80.8
Labour and Tourism	853.2	61	520.5	700.8	27.0	-180.3
Agriculture	1768.3	18.2	321	395.6	5.3	-74.5
Health	2012.1	27.6	556.3	185.2	9.6	371.2
Education	4593.8	17.2	791.5	319.6	4.8	471.9
Gender	234.1	6	14	2.8	0	11.3
Water and Sanitation	1155.4	8.1	93.1	56.6	4.8	36.6
Energy	3906	45.5	1776.4	480	98.1	1296.3
Transport, Industry and ICT	9207.7	58.5	5389.7	2937.7	91.0	2452
Urban Infrastructure, Housing and Reconstruction	2554.2	54.1	1380.7	275.4	9.6	1105.3
Climate Change	372	5	18.6	5.5	0	13.1

Forestry	561.8	5	28.1	8.4	0	19.7
Governance	870.4	10	87	25.9	0	61.2
Total	30,384.00	36.5	11091	5589	250	5503

Source: Table 4.5 in NPC (2018).

The private sector is expected to shoulder 36.5 percent of investment requirements. Private financing in the forms of domestic equity financing (17 percent), bank credit (31 percent), and FDI inflows (2.3 percent) is expected to meet half of the private sector SDG investment requirements. FDI is expected to average NPR 16.67 billion per year during the entire SDG period. The financing gap in the private sector, averaging NPR 367 billion per year (or about 50 percent of private investment requirements), is higher than the gap in the public sector by nearly NPR 150 billion. The gap, in absolute amounts, would be the highest for transport, industry, energy, and urban development (Table 3). These are also the sectors where private sector's contribution is expected to the 45.5 percent of 58.4 percent of investment requirements.

Almost 50 percent of bank credit is expected to flow into SDG areas, including five percent that is already mandated to cover “deprived sectors.” This implies the importance of continuing with the existing sectoral directed credit (including for agriculture, small and medium enterprises, tourism, energy and select manufacturing sectors). The government notes that the financing gap in the private sector will have to be met by reorienting non-SDG investments towards SDGs, mobilizing larger volumes of equity, bank financing, and attracting large FDI inflows, especially in industries and physical infrastructure. Viability gap funding, where the government provides a grant to cover part of private sector investment requirements in projects that are economically justified but are not financial viable, is also acknowledged as an important avenue of meeting the financing gap in private sector investment needs.

All the above projections are based under an "optimum scenario" of 8.67 percent average annual GDP growth in 2016-2030 and revenue-to-GDP ratio reaching 27 percent by 2030. The total financing gap will average NPR 585 billion per year, or 12.8 percent of GDP. The gap will increase in later years as private sector financing gap, which is higher than public sector financing gap, addresses investment needs that are higher in later years in contrast to public sector investment needs that are frontloaded. If the GDP growth rate is sub-optimal, at 5 percent, then the gap will surge to NPR 1,512 billion per year, as internal resource mobilization will fall. In this scenario, public sector financing gap, as a proportion of public sector investment needs, will be 30 percent instead of 19.6 percent. If economic growth is the same as in the optimum growth scenario but revenue-to-GDP ratio reaches 25 percent rather than 27 percent by 2030, the financing gap is expected to be higher by NPR 354 billion compared to the optimum scenario. Public sector financing gap, as a proportion of public sector investment needs, will be 21 percent rather than 19.6 percent. It must be noted that financing needs arising from the pandemic and the likely LDC graduation-induced adverse shocks to the export sector have not been taken into account in these projections.

4. Federalism

Since the promulgation of the 2015 Constitution, Nepal has federated into 753 municipalities and seven provinces. The roles and responsibilities in economic development, social development, infrastructure development, environmental management and institutional development and sustainability provided by Nepal's Constitution to 753 urban and rural municipalities touch upon all 17 SDGs (NPC, 2021a). The roles and responsibilities delineated for province governments also speak to SDGs. Municipalities are allowed to mobilize internal revenue through taxes, fees and charges and also entitled to receive transfers in the form of revenue sharing and grants from federal and province governments. Province governments also receive revenue and grant transfers from federal government, besides having some revenue-generating authority. Even in areas where provinces have the authority to formulate procedures and rates for taxation, the responsibility for collecting taxes rests with local bodies.

The implementation of fiscal federalism started proper from 2018/19, by which time elections to all three tiers of government had been completed. The central government disbursed 28.9 percent of its total (actual) budget as grants to province and local governments in 2018/19, which increased to 32.4 percent in 2019/20 (Figure 1). The central government accounted for 66.2 percent of total government expenditure (after adjusting for double counting due to transfers) in 2018/19, while province governments and local governments made up 8.1 percent and 25.7 percent respectively (Figure 2).²⁰ The share of central government in total government expenditure declined to 62 percent in 2019/20.²¹ About a quarter of the planned total health expenditure of the central government has been allocated to subnational governments in 2021/22.²² This is lower than before the pandemic, when the share was about a third in 2019/20,²³ and could be due to increased (planned) spending directly by the central government to fight the pandemic. Subnational governments are heavily dependent on the central government for resources, and their revenue-generating potential remains underutilized (see discussion in Section 5). They have the right to borrow, but detailed legal and institutional framework and modalities to operationalize the authority are lacking.

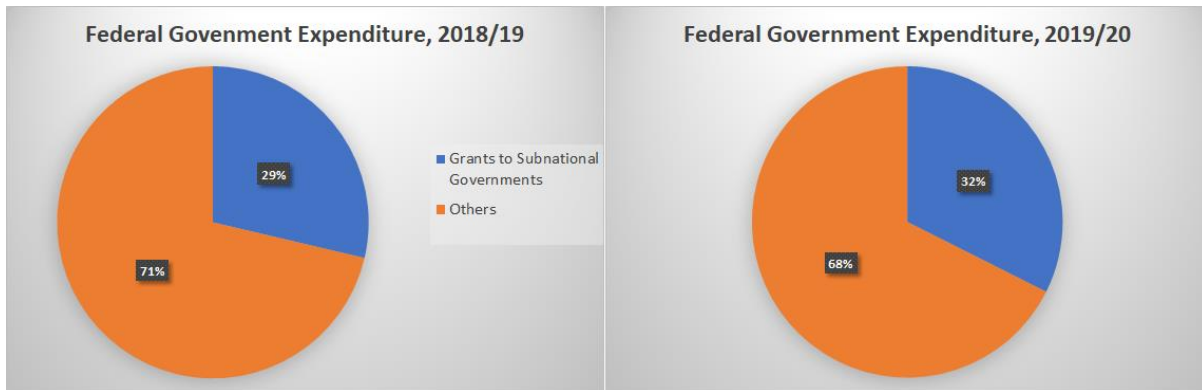
²⁰ Consolidated Financial Statement of the Financial Comptroller General Office, GoN for the year 2018/19.

²¹ Consolidated Financial Statement of the Financial Comptroller General Office, GoN for the year 2019/20.

²² GoN's Budget Speech for 2021/22.

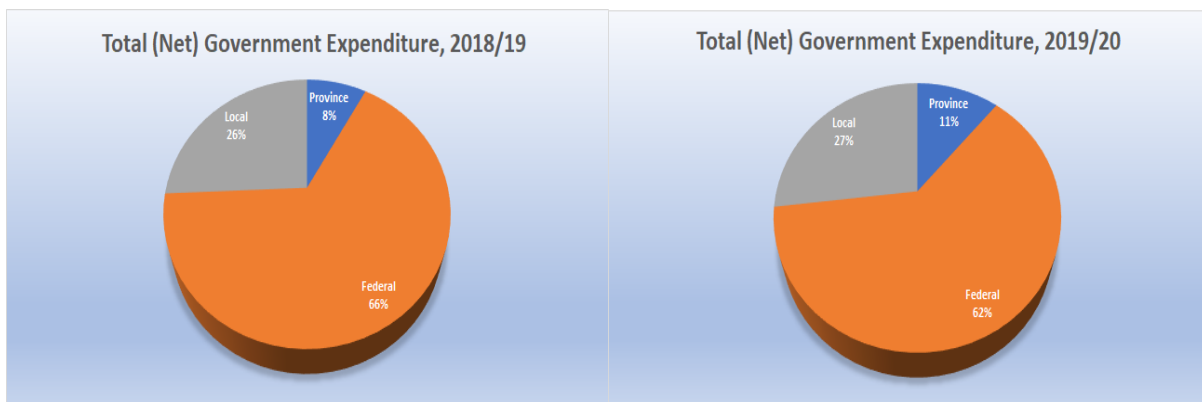
²³ GoN's Budget Speech for 2019/20.

Figure 1: Federal government expenditure going out as grants



Source: GoN (2021).

Figure 2: Shares of three tiers of government in total government expenditure



Source: Financial Comptroller General Office, GoN, Consolidated Financial Statement, various years.

5. Government revenue

5.1 Trends and structure

Nepal government's revenue has increased robustly in the last one decade, recording a growth rate of 19.65 percent per year on average from 2015/16 to 2018/19 (GoN, 2021)²⁴, a pre-Covid period. Nepal's revenue-to-GDP ratio, at 21.5 percent in 2018/19 (GoN, 2021), is the highest in South

²⁴ Unless otherwise stated, all data in this subsection are from or calculated from the Economic Survey (GoN, 2021).

Asia.²⁵ It was 16.7 percent in 2014/15. While quite high relative to GDP, revenue mobilization can be deemed low relative to gross national disposable income (GNDI). Tax revenue makes up about 90 percent of total revenue.²⁶ Revenue has normally been able to meet recurrent expenditure (barring 2019/20, a Covid-19 year), but its coverage of recurrent expenditure has been declining, from 119.5 percent in 2014/15 to 102.1 percent in 2018/19. Revenue has been significantly lower than total expenditure, and the proportion of total expenditure covered by revenue has declined, from 76.4 percent to 65.9 percent in the same period. Thus, revenue growth has not been able to keep pace with total expenditure.

Under SDG 17 (Strengthening the means of implementation), target 17.1 concerns domestic resource mobilization. In its assessment of progress towards SDGs for the period 2016-2019 (NPC, 2020), GoN finds the revenue-to-GDP ratio to have exceeded the target for 2019²⁷, but the proportion of government budget funded by domestic taxes was not just below target in 2019 but lower than the 2015 baseline. The 2030 target for revenue-to-GDP ratio is 30 percent (although the estimated financing for SDGs in NPC (2018) is based on a more conservative projection of 27 percent). The 2030 target for the proportion of budget funded by domestic taxes is 80 percent.

In 2018/19, the year all three tiers of government were in place for the first time following the introduction of federalism in 2015, about 12 percent of central government-collected revenue was transferred to provinces and municipalities. Underlying this sharing is a legally mandated allocation of 30 percent of total VAT collections and 30 percent of excise duties collected on internal activities to subnational units (whereby provinces and municipalities get 15 percent each). Revenue growth of the central government in 2018/19, at 14.2 percent, was significantly lower than the previous four years' average; part of the reason was that the authority to collect and retain revenue from some sources that accounted for 4.4 percent of total revenue were handed over to lower tiers of government.²⁸ The loss of revenue from house and land registration charge, in particular, took a bite out of revenue growth. The central government also allocated about 29 percent of its total budget as grants to subnational governments in 2018/19—over and above the revenue transfer. These grants amounted to 44 percent of spendable revenue of the central government.

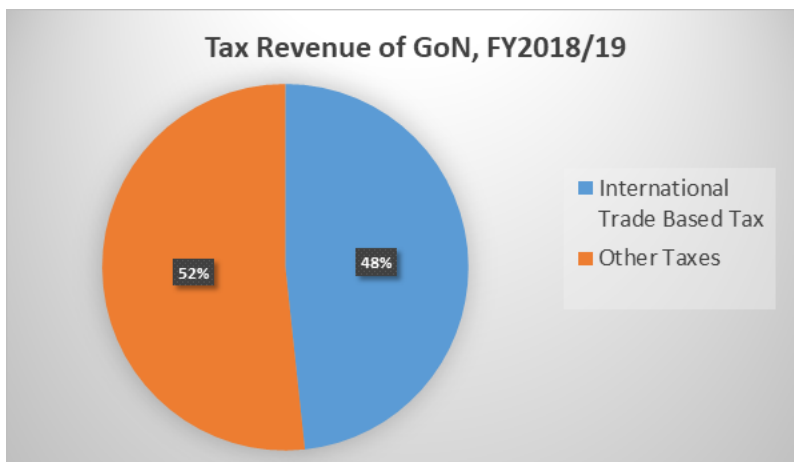
²⁵ South Asia data are from the World Bank's World Development Indicators.

²⁶ Average for 2017/18 and 2018/19.

²⁷ Note that the values of revenue-to-GDP ratios we have used in this paper are based on a new GDP series, whereas NPC (2020) uses an old GDP series, and hence the two are not directly comparable.

²⁸ Calculations covering house and land registration charge and vehicle tax.

Figure 3: Importance of international trade-based tax in tax revenue



Source: GoN, Budget speech 2020/2021.

In the last two decades, the share of customs duties in total tax revenue has declined while the shares of VAT, excise duty and income tax have increased (Figure 4). If in 2001/02, customs duties contributed 32 percent of tax revenue, VAT 31 percent, income tax 23 percent and excise 10 percent, by 2018/19, the share of customs duties had fallen to 21 percent, the share of VAT had increased to 33 percent, that of excise duty had risen to 16 percent and that of income tax had risen to 26 percent (NRAC, 2021). VAT has not grown as "expected" despite being a key instrument for revenue mobilization emphasized by Nepal government (NRAC, 2021). The declining share in customs duties masks the fact that international trade (mostly, import trade)-based taxes—customs tariffs, VAT on imports, excise on imports, agriculture reform free on agricultural imports and other import charges, besides a small amount of export taxes/charges—still account for about half of total tax revenue (48.3 percent in 2018/19; Figure 3)), a share that stood at 46.7 percent in 2011/12.²⁹ Some 63 percent of VAT and 39 percent of excise duty collections were collected from imports in 2018/19 (Figure 5).³⁰ The contribution of imports to VAT collections is the same as in 2011/12 but the contribution of imports to excise duty collections has increased from 35 percent in 2011/12.³¹ Nearly half the 248 percent growth in tax revenue between 2011/12 and 2018/19 was due to international trade based taxes—20.4 percent due to VAT on imports, 18.3 percent due to customs tariffs, and 7.2 percent due to excise duty on imports.³² About 63 percent of VAT revenue growth was due to imports and 40 percent of excise revenue growth was due to imports.³³

²⁹ Calculations from GoN's Budget Speech, 2020/21. Export-based taxes made up 0.03 percent of total tax revenue in 2018/19.

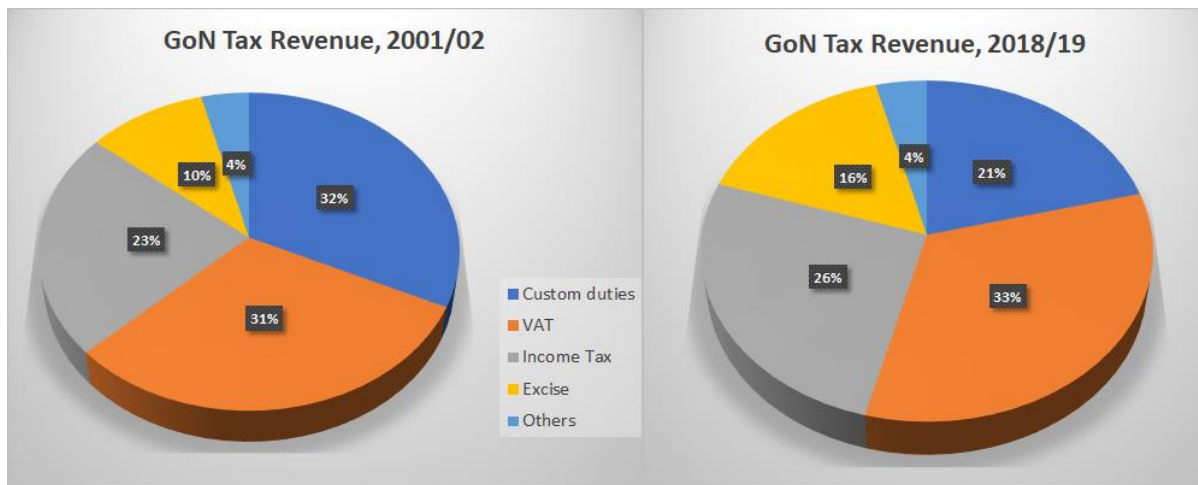
³⁰ Calculations from GoN's Budget Speech, 2020/21.

³¹ Calculations from GoN's Budget Speech, 2013/14.

³² Calculations from GoN's Budget Speeches, 2013/14 and 2020/21.

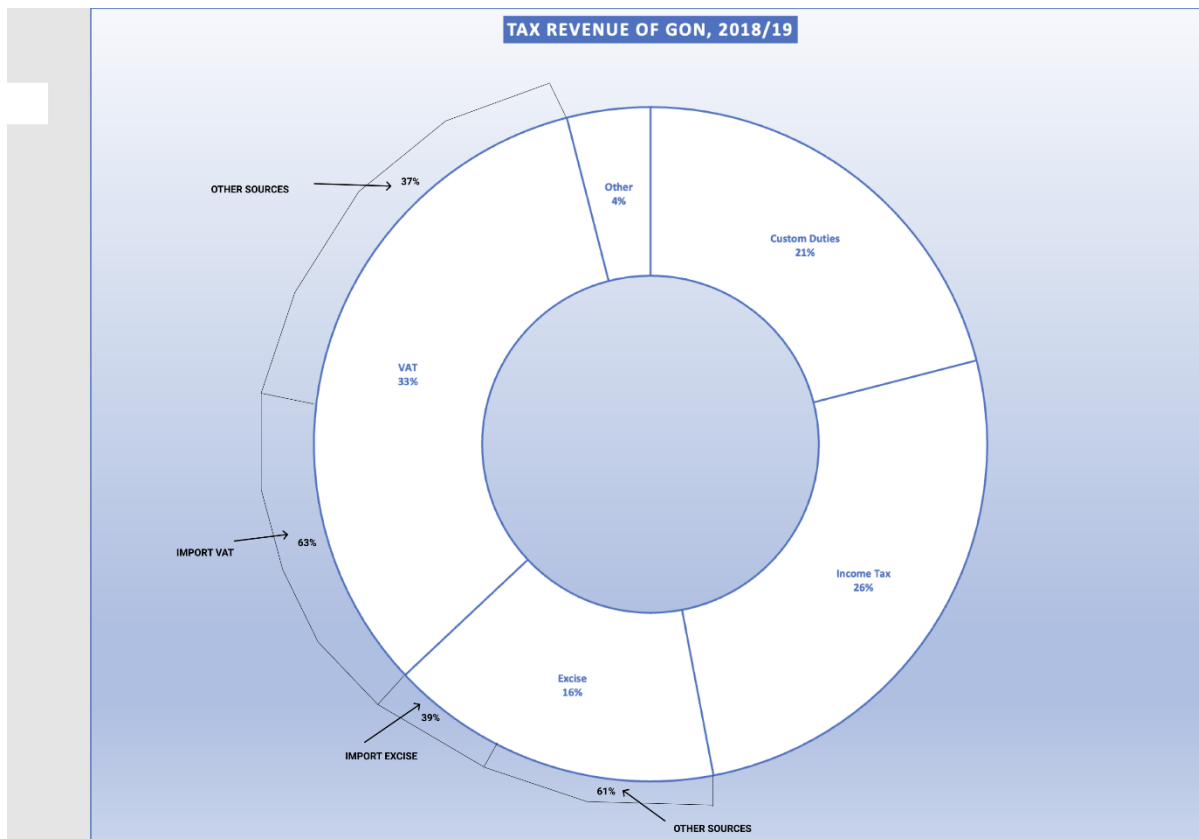
³³ Calculations from GoN's Budget Speeches, 2013/14 and 2020/21.

Figure 4: Composition of tax revenue



Source: NRAC (2021).

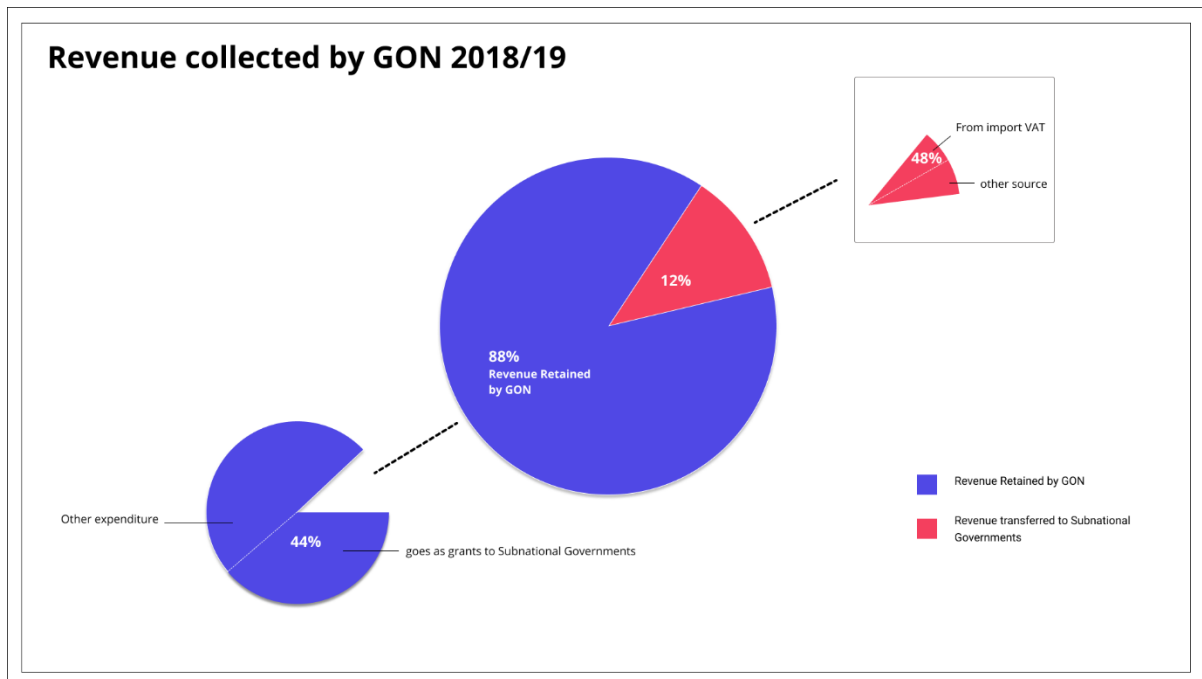
Figure 5: Further decomposition of tax revenue: the role of import-based VAT and excise duty



Source: GoN, Budget Speech, 2020/21

Thus, the growth of central government revenue is heavily driven by the growth in import tax collections. Since province and local governments are dependent on the central government for resources, resource availability with subnational governments hinges critically on the country's imports and taxes collected on imports. About 48 percent of revenue (total VAT and excise on internal activities) transferrable by the centre to subnational governments in 2018/19 came from import-based VAT (Figure 6). Taking a step back further, remittance inflows, which grew by 145 percent between 2011/12 and 2018/19,³⁴ have fuelled, and provided the forex wherewithal to fund, imports. Goods imports, which grew by 307 percent,³⁵ have, in turn, buoyed revenue. Thus, rising remittances, a source of development finance in its own right at the household level, discussed in Section 8, are contributing significantly to the growth of government revenue.

Figure 6: Revenue collected by GoN and transferred to subnational governments



Source: GoN (2021).

The share of targeted revenue that was actually collected fell from 108.5 percent in 2016/17 to 96.1 percent in 2017/18 and then drastically to 87.9 percent in 2018/19.³⁶ This was not because the target was more ambitious in 2018/19, but because of the slow growth in collections that year. Still, revenue targets are set more realistic than foreign aid targets (see Section 6). The pressure to mobilize more revenue is high given the centre's responsibility to fund the bulk of the expenditure of province and local governments. Province governments, in the aggregate, get only about 11 percent of their receipts (excluding cash surplus from the previous year) from internal revenue,

³⁴ Calculations based on Nepal Rastra Bank's Current Macroeconomic and Financial Situation.

³⁵ Ibid.

³⁶ Targeted revenue is drawn from GoN's Budget Speeches and the actual revenue is drawn from the Economic Survey (GoN, 2021).

with the balance coming from transfers from the centre in the form of grants and revenue sharing transfers (Figure 7).³⁷ Likewise, in the aggregate, local governments get about 92 percent their receipts (excluding cash surplus from the previous year) as transfers (77.5 percent as grant-like transfers and 14.5 percent as revenue sharing transfers) from the centre and province, with the remainder (8 percent) coming from internal revenue.³⁸ Over 92 percent of grant-like transfers received by local governments are from the centre.³⁹

Figure 7: Sources of receipts of subnational governments



Source: Financial Comptroller General Office, GoN, Consolidated Financial Statement, various years.

5.2 Challenges

A major challenge confronting GoN in revenue mobilization is the need to shift the revenue regime from one dependent on import trade to one based on domestic economic activities. Revenue raised from internal economic activities is from a narrow base. With income tax accounting for about a quarter of tax revenue, revenue is largely based on indirect taxes, which are intrinsically regressive. The implementation of VAT, a key instrument for revenue mobilization emphasized by the government, has been weak, with a limited base and a high degree of noncompliance (NRAC, 2021). The government faces the challenge of balancing competing considerations in revenue policy: mobilizing revenue to meet the immediate pressure of increased expenditures, and incentivizing and stimulating domestic industry. The revenue advisory committee of the government, in its 2021 report, expresses concern about trade liberalization under multilateral and regional trade agreements leading to revenue loss, and adverse impacts on domestic production, investment and employment (NRAC, 2021). Following Nepal's graduation from LDC, it is likely to come under increased pressure to liberalize trade, which could further stress government revenue mobilization. The pressure to collect revenue appears to have sowed ideas of revenue

³⁷ Based on data for 2018/19 in the Consolidated Financial Statement of the Financial Comptroller General Office, GoN for the year 2018/19.

³⁸ Average for 2018/19 and 2019/20 (calculated from Consolidated Financial Statement of the Financial Comptroller General Office, GoN).

³⁹ Ibid.

measures without taking into account international trade rules. The revenue advisory committee recommends expanding the excise duty base and introducing multiple rates of VAT as a tool to, *inter alia*, offset the challenges to domestic industry and revenue loss resulting from tariff reductions (NRAC, 2021). This implies imposing excise duty differentially across imports and domestic production, which is not in keeping with World Trade Organization (WTO) rules.

Even within the existing revenue structure, the full potential of revenue from imports has not been realized due to the "disorganized" nature of import trade that makes tracking, tracing and monitoring extremely difficult (NRAC, 2021). Informal economic activities are pervasive, and these go beyond subsistence agriculture and the smuggling of goods through the porous border with India, the latter hurting domestic production and industry on the one hand and government revenue on the other. Nearly half of the economic establishments in Nepal are not registered (CBS, 2019). Huge amounts of revenue discounts and exemptions pose another challenge to revenue mobilization. In 2018/19, such discounts and exemptions amounted to 12 percent of total tax revenue and over 3 percent of GDP (NRAC, 2021). The effectiveness of these tax discounts and exemptions in meeting their stated objectives of stimulating investment and production, increasing revenue, and equity has not been rigorously assessed. Other problems and challenges include (NRAC, 2021): weak organizational structure and inadequate capacity of human resources; lack of legal clarity in matters of adjudication and delays in the workings of the judicial system; poor tax compliance (for example, non-issuance of tax invoices is pervasive; about 47 percent of those registered with income tax did not file their tax returns); a very weak non-tax revenue administration (for example, the base, rates, areas, criteria and principles for non-tax revenue have not been clearly determined); and online businesses and electronic transactions still out of the tax net.⁴⁰ The Department of Revenue Investigation files lawsuits claiming lost revenues amounting to tens of billions of rupees every year. The claims were about NPR 19.9 billion in 2020/21 and NPR 15.1 billion in 2019/20.⁴¹ Likewise, there is a case in the court filed by the Commission for the Investigation of Abuse of Authority against the tax discounts provided by a 2014 Tax Clearance Commission to firms and individuals yet to clear their tax dues, claiming an embezzlement of about NPR 12 billion.⁴²

Subnational governments have been given responsibilities entailing significant expenditures, including those contributing to the achievement of the SDGs (as noted in Section 4). Due to their dependence on transfers from the centre, they have low incentive to generate their own resources. However, there are also other factors constraining their ability to mobilize revenue, utilizing the

⁴⁰ However, the government in a revised financial plan for 2021/22 announced that if any person receives payments in foreign currencies for the provision of software and similar other electronic facilities outside the country, financial institutions shall deduct an advance tax of 1 percent (GoN's financial plan for 2021/22, introduced through a Replacement Bill on 10 September 2021, available at <https://mof.gov.np/> (accessed 26.09.21)).

⁴¹ Quarterly Bulletin (September 2021) of Department of Revenue Investigation, GoN, <http://dri.gov.np/ne/noticedetail/241/2021/85968318> (accessed 28.09.21).

⁴² <https://www.nayapatrikadaily.com/news-details/71731/2021-09-28> (accessed 28.09.21).

powers given to them to generate revenue (Swashasan Adhdhyan Pratishtan, 2021)⁴³: there is a lack of legal clarity on the taxation authority of the three tiers of government in a number of areas; province governments lack a tax administration; province and local governments tend to lack institutional and human resource capacity to formulate revenue policy, act, regulations and medium-term expenditure framework to identify potential revenue sources, make projections and collect revenue; they also lack an integrated database necessary for taxation, and are at a loss as to how to create one; and there is inadequate coordination and cooperation among the three tiers of government on taxation matters, reflected in conflicting legal provisions, which has restrained local governments from generating more internal revenue and also led to double taxation.

The Inter-government Fiscal Management Act makes it mandatory for the Government of Nepal, provincial governments and local governments to prepare a mid-term expenditure framework (MTEF). The MTEF imposes discipline in terms of prioritizing expenditures and projecting and arranging finance in a credible and realistic manner. It makes projections for three years, with the current year projection implemented through the annual programme and budget. The revenue advisory committee and the resource estimation and budget ceiling determination committee at the local level have a critical role to play in the MTEF and budget formulation process. The technical capacities of these committees is generally weak. Many local governments have not formulated MTEF.

In addition to these problems and challenges facing revenue mobilization that pre-exist Covid-19, the government is facing additional challenges on this front arising from the pandemic. Revenue collections fell by 4.3 percent in 2019/20, in contrast to the double digit growth recorded in previous years.⁴⁴ Tax revenue fell by 5 percent, and within it, international trade-based revenue fell by nearly 17 percent, as lockdowns inside the country, border disruptions and disruptions to regional and global supply chains hit merchandise imports, which crashed by 15.6 percent.⁴⁵ Comparable data are not yet available for the entire year of 2020/21, but central bank data show a rebound in revenue as economic activities picked up as lockdowns and other restrictive measures were relaxed and a vaccination drive was rolled out. A slightly broader measure of revenue saw collections increase by 16.3 percent in 2020/21 compared to a meagre 0.2 percent growth in the previous year.⁴⁶ The rebound in revenue was led by a 28.7 percent growth in merchandise imports, with customs duty collections expanding by 46 percent.⁴⁷ Despite the rebound, revenue mobilized in 2020/21 was about 15 percent lower than what would have been mobilized if the average revenue growth rate of 2017/18 and 2018/19 (about 17.1 percent) had continued in the subsequent

⁴³ The cited study was commissioned by the Revenue Advisory Committee of GoN.

⁴⁴ Revenue data from the Economic Survey (GoN, 2021).

⁴⁵ Revenue data from the Economic Survey (GoN, 2021), and import data from Nepal Rastra Bank's Current Macroeconomic and Financial Situation.

⁴⁶ Nepal Rastra Bank's Current Macroeconomic and Financial Situation.

⁴⁷ Ibid.

two years.⁴⁸ GoN introduced a tax relief package in the wake of the pandemic. It faces the challenge of balancing the pressure to provide tax relief in these exceptional times and the general need it has felt, since before pandemic times, for scaling back tax discounts and waivers that eat into revenue without demonstrable and verifiable contributions towards their stated objectives.

6. Foreign aid

6.1 Trends, features and general issues

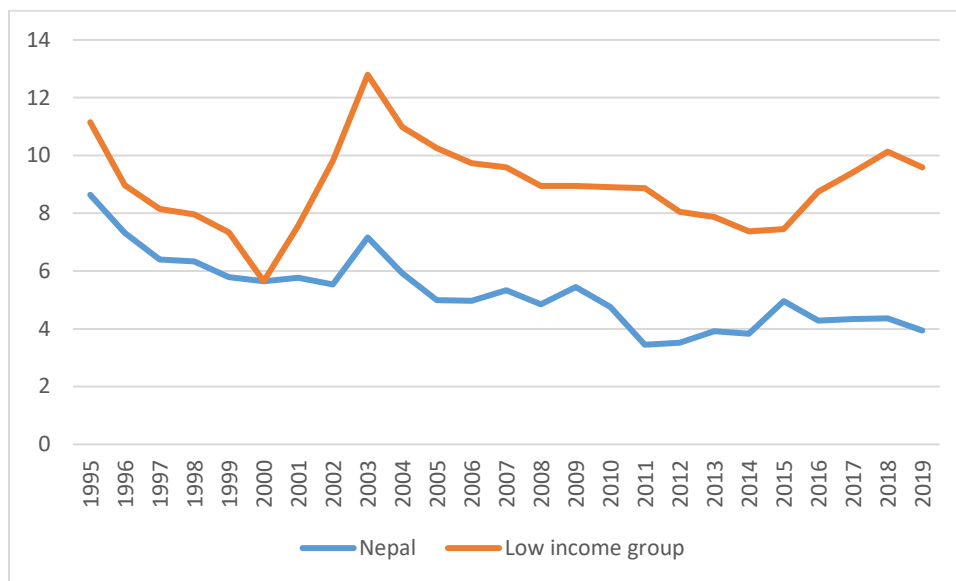
Foreign aid is an important source development finance for Nepal, especially in the form of official development assistance (ODA). ODA disbursements averaged US\$1,282 million per year during 2013/14-2018/19 (MoF, 2021). There was a sharp increase in 2016/17, as aid poured in for relief and reconstruction following the devastating earthquake of 2015. ODA flows averaged US\$1,520 million per year during 2016/17-2018/19 (MoF, 2021). This broke a stagnation in aid flows observed during 2010/11-2015/16, when they averaged US\$1,036 million per year (MoF, 2021). But the growth in volume is much less than the doubling that GoN's SDG financing strategy says is required (NPC, 2018).

ODA disbursements as a percentage of GDP are fairly stable, averaging just above 5 percent during 2010/11-2018/19 (MoF, 2021). On a per capita basis, Nepal received US\$52 as ODA in 2018, the fourth largest recipient in South Asia and the fifth largest recipient among the eight LDCs of Asia (ibid.). Net ODA as a percentage of GNI has remained lower than the average for low-income countries (Figure 8). ODA as a proportion of the national budget has remained under 30 percent (MoF, 2021). It rose to 29 percent in 2016/17 in the wake of the earthquake, but had fallen to 24 percent by 2018/19 (ibid.). Not all ODA is on-budget (recorded in the budget), as we shall see below, so when only considering on-budget ODA, its contribution to (actual) government expenditure has fallen over the long term, from 26.4 percent in 1999/2000 to an average of 12 percent in 2016/17-2018/19⁴⁹ (Figure 9). GoN's assessment of progress towards the SDGs during 2016-2019 (NPC, 2020) finds that in contrast to the target of increasing ODA as a proportion of the national budget between 2015 and 2019, the share actually declined to 11.2 percent (against the target of 15.8 percent for 2019 and 18 percent for 2030).

⁴⁸ Calculations based on Nepal Rastra Bank's Current Macroeconomic and Financial Situation.

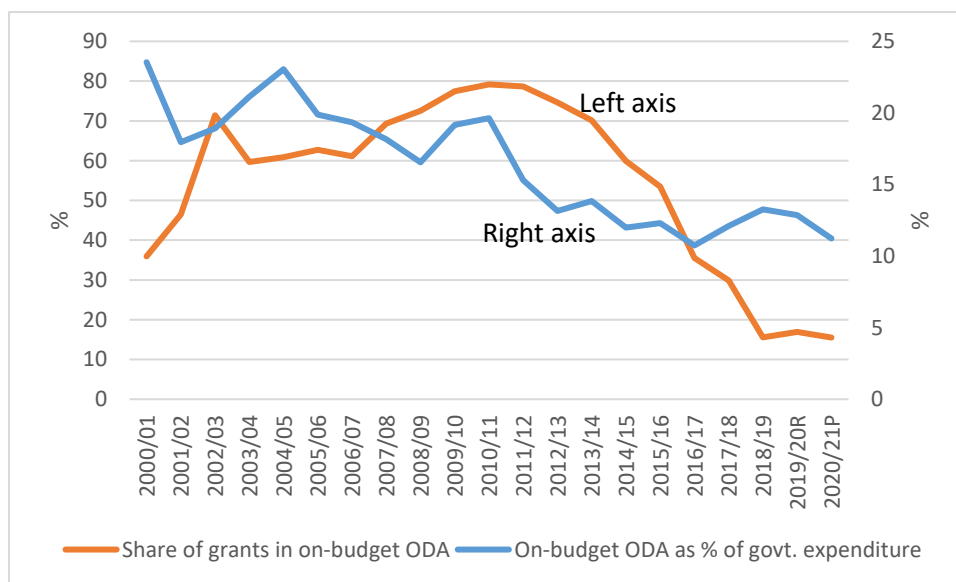
⁴⁹ Calculations based on Nepal Rastra Bank's Current Macroeconomic and Financial Situation.

Figure 8: Net ODA received as % of GNI



Source: World Bank, World Development Indicators.

Figure 9: Declining share of ODA in govt. expenditure and declining share of grants



Source: Nepal Rastra Bank, Current Macroeconomic and Financial Situation.

Partly an indication of weak absorptive capacity, ODA expenditure as a percentage of ODA allocation has been falling, from 66 percent in 2010/11 to 44 percent in 2018/19 (MoF, 2021). This is much lower than the utilization of the overall government budget allocation, that is, expenditure as a percentage of budget allocation—84.4 percent in 2018/19.⁵⁰ There is also a huge gap between

⁵⁰ Consolidated Financial Statement for 2018/19 (Financial Comptroller General Office, GoN).

foreign aid projected by the government in its annual budget speech, which details expected receipts and planned expenditure for the coming fiscal year, and the actual aid received and utilized. During 2017/18-2020/21, the actual foreign grants and loans utilized on budget were 44.7 percent and 46.6 percent of projections, respectively.⁵¹ This is inclusive of the increase in utilization-to-projection rates in 2020/21. In contrast, projections for internal borrowing have materialized at an average rate of 88.6 percent.⁵² This suggests a tendency of making unrealistic projections of on-budget foreign aid to finance an unrealistically high planned expenditure.

Loans have increased both in absolute amounts and as a share of total ODA while grants have been falling even in absolute amounts and technical assistance has remained by and large stable. Increasing monotonically since 2012/13, loans exceeded grants in 2016/17 and have remained so since (MoF, 2021). Loans accounted for about 60 percent of ODA in 2018/19, with grants making up about 27 percent and technical assistance about 13 percent (ibid.). In contrast, loans were just a third of grants in 2010/11. A key factor behind the rising share of loans is that multilateral development banks, namely World Bank and the Asian Development Bank (ADB), by far the largest two donors to Nepal, are increasingly disbursing their aid to Nepal as loans rather than as grants. The declining share of grants contrasts with the financing strategy for SDGs chalked out by GoN that banks on a greater share of grants in an expanded ODA envelope to maintain macroeconomic stability and increase fiscal space (NPC, 2018).

Just above a third of the aid pledged for reconstruction by the international community in an international conference held in Kathmandu in July 2015 had been disbursed by mid-2020, even though commitments made through the signing of formal agreements with GoN amounted to about 95 percent of the pledged amount (MoF, 2021).

The government mobilizes a greater share of loans committed than grants committed.⁵³ During 2016/17-2018/19, on average 70.8 percent of on-budget loan commitments were mobilized as opposed to 54 percent of on-budget grant commitments (GoN, 2021).

The share of multilateral donors in ODA inflows has been increasing, with a corresponding decline in the share of bilateral donors. Multilateral donors contributed 60 percent of total ODA disbursements in 2018/19, while bilateral donors contributed 40 percent (MoF, 2020). The top two multilateral partners are the World Bank and the Asian Development Bank, which supply over half the total ODA disbursements.⁵⁴ The European Union, the International Fund for Agriculture Development (IFAD) and the United Nations Country Team have also appeared as major donors in some years. The top five bilateral partners are China, the United Kingdom, Japan, the United

⁵¹ Projections are from GoN's Budget Speeches, various years, and utilizations are from the Economic Survey (GoN, 2021).

⁵² Ibid.

⁵³ Mobilization does not mean actual utilization.

⁵⁴ GoN's Development Cooperation Report, various years.

States of America and India. They contributed 33 percent of total ODA disbursements in 2018/19 (MoF, 2020). The share of loans in utilized multilateral ODA rose from an average of 46 percent in 2012/13-2013/14 to an average of 79 percent in 2016/17-2018/19 (GoN, 2021). In the same period, the share of loans in utilized bilateral ODA rose from 9.8 percent to 49.2 percent.

Sector wise, economic affairs is the leading recipient of actually utilized ODA, absorbing on average 64 percent of aid during 2016/17-2018/19 (GoN, 2021). This was followed by housing and communities, at 13 percent, driven by aid flowing for post-earthquake reconstruction activities after 2015. Next are education, health and general government service, averaging just above 5 percent each.

Although budgetary support (not tied to any specific project) is the preferred ODA modality for GoN on the grounds that it ensures coherence with the effectiveness principle of country ownership (as articulated in the government's International Development Cooperation Policy 2019), and ODA in the form of such support has been on an increasing trend, it generally remained less than half of project support till 2018/19.⁵⁵ In 2018/19, 55.1 of ODA was disbursed as project support and only 15.2 of it was disbursed as budgetary support (MoF, 2020). Programme support is another major form of ODA (17 percent in 2018/19), whereas disbursements under sector-wide approach have fallen in absolute value and as a share of ODA, and were 2 percent of ODA in 2018/19 (MoF, 2020).

While GoN prefers on-budget (ODA directly reflected and recorded in the budget) and on-treasury mode of aid delivery on the grounds that it contributes to aid effectiveness, it notes that encouraging development partners to provide on-budget and on-treasury development aid remains a challenge (MoF, 2021). In 2018/19, 78 percent of ODA was recorded on budget, and of such ODA, 46 percent was on treasury. The major multilateral donors (the World Bank and the ADB) provide over 90 percent of ODA on budget.⁵⁶ Among other major multilateral donors, the EU, and among major bilateral donors, Germany, the UK and the US, provide a low percentage (less than half) of their aid on budget.⁵⁷

The medium-term predictability of ODA in Nepal—as measured by cooperation information available in forward-looking expenditure plans of development partners—is significantly lower than the global average and the average for LDCs.⁵⁸ ODA in Nepal remains highly fragmented, with a given development partner working in multiple sectors and ministries, and the same ministry/sector receiving aid from multiple sources.⁵⁹ There have long been concerns about aid providers' priorities taking precedence over Nepal's needs and priorities in practice (although

⁵⁵ Ibid.

⁵⁶ Ibid.

⁵⁷ Ibid.

⁵⁸ Ibid.

⁵⁹ Ibid.

technically most aid is aligned with Nepal's needs and priorities), and a significant proportion of aid goes back to the provider, especially in the case of bilateral aid, hurting national and local capacity building.⁶⁰

Besides ODA, Nepal also receives substantial foreign aid through INGOs. Reported disbursement of aid by INGOs from their core fund—over and above ODA—stood at US\$110 million in 2017/18 and US\$215 million in 2018/19. These disbursements largely go to the education and health sectors.

6.2 Aid in the time of pandemic

2019/20 is the latest year for which complete aid data are available for the whole year. Therefore, we will focus on this year when analysing the immediate impact of Covid-19 on aid.⁶¹ In 2019/20, the last quarter of which coincided with the onset of the pandemic, ODA disbursements increased significantly, by 27 percent to US\$2,003 million, much like the increased disbursements seen following the earthquake of 2015. As a proportion of GDP, these flows increased to 6.17 percent from 5.14 percent in the previous year, as GDP contracted. ODA commitments increased by 59 percent in 2019/20, having declined by 19.3 percent and 31.6 percent in the previous two fiscal years. Of the total ODA, US\$512.9 million was disbursed for pandemic response and recovery, and nearly 90 percent of this came from new, pandemic-specific projects.

The top disbursing donors for Covid-19 response and recovery were the Asian Development Bank, the International Monetary Fund, the United States, the European Union and the World Bank. Nearly 95 percent of such disbursements came from multilateral donors. This increase in total ODA was almost entirely due to an increase in loans, which increased by 48 percent, while grants fell by 12 percent. The share of ODA disbursed as budgetary support more than doubled, to 36.5 percent. One explanation for this is donors' prompt support to the government's relief and recovery efforts. Similarly, the share of on-budget disbursement rose to 83.5 percent, and within it, the share of on-treasury disbursement also rose, to 52.8 percent. About 91 percent of Covid-19-related aid came as loans, and nearly 94 percent of Covid-19-related aid was provided on budget.

However, ODA expenditure as a percentage of allocation in 2019/20 fell to 40 percent from 44 percent in previous year. There was a significant change in the distribution of ODA across sectors. The health sector emerged as the top recipient of ODA. Disbursements to the health sector rose 265.8 percent to reach US\$318.4 million, making up 16 percent of all ODA. Two thirds of this

⁶⁰ A news report cites the report of the Public Expenditure Review Commission on poor alignment, and quotes an experienced former head of the foreign aid division of the Ministry of Finance as saying that more than three fourths of aid provided to Nepal flow out of the country as payments for foreign equipment, workers and consultants, among other things.: <https://www.nayapatrikadaily.com/news-details/71738/2021-09-28> (accessed 30.09.21).

⁶¹ Unless otherwise, state data used in this subsection are drawn from GoN's Development Cooperation Report for 2019/20 (MoF, 2021).

support was loans, with technical assistance making up 21 percent and grants 12.4 percent. About 79 percent of this support was on budget. Disbursements by INGOs fell by 39 percent to US\$133 million in 2019/20. The Ministry of Finance (MoF, 2021) speculates that this decline could be due to fewer INGOs reporting to the Aid Management Information System, which it considers to be a matter of "great concern". INGOs contributed about US\$5.5 million to Covid-19-related efforts.

Data for the first eight months of 2020/21 reveal even sharper changes in the sectoral composition of ODA flows in the second year of the pandemic. Using data on the sectoral utilization of aid from the Economic Survey (GoN, 2021), we find that in this period, the volume of ODA remained almost the same as in the same period in the previous fiscal year. However, while ODA in the health sector rose by 128 percent, ODA in economic affairs, a leading recipient of aid in pre-pandemic times, contracted by 49.5 percent, ODA in housing and communities fell by 23 percent (which had seen contractions in the previous couple of years, too, as post-earthquake reconstruction started winding up) and ODA in education fell by 43.8 percent. Preliminary estimates from the central bank show that ODA reflected in the government budget for the whole year 2020/21 fell by 5.5 percent.⁶²

6.3 Implications of LDC graduation and rising per capita income

Graduation from LDC status is unlikely to affect most current sources of ODA (NPC and UNDP, 2020). This is because the provision of aid from top multilateral financial institutions is based critically on income level and debt sustainability rather than LDC status. On the other hand, strategic and political considerations affect bilateral aid, and available information indicates the terms and conditions of such aid will not be significantly affected by graduation (ibid.). There is scope to access bilateral loans on concessional terms, given the declining share of grants in bilateral aid. Governance and human rights factors also determine bilateral ODA (WTO, 2020), especially that provided by North American and European donors. The interpretation of and emphasis on these factors are likely to gain importance in the context of sharpening geopolitical rivalries.

Grants as a share of aid from multilateral sources have been on a declining trend, so the implications of graduation for the terms and conditions of loans from these sources are more relevant. Since lending terms are based on the recipient country's risk of debt distress, level of GNI per capita and creditworthiness, there is no immediate and direct impact of graduation on lending terms. As a low-income country as per the World Bank's definition using the Atlas method, Nepal has remained eligible for and received concessional credit under the "regular" window of the International Development Association (IDA), the concessional arm of the World Bank. Loans under this window have a very long maturity period of 38 years, a grace period of six years, a

⁶² Nepal Rastra Bank's Current Macroeconomic and Financial Situation.

service charge of 0.75 percent and an equal amortization period.⁶³ Based on year 2019 data Nepal moved out of the low-income country group of the World Bank to join the lower-middle income group in 2020.⁶⁴ In the wake of Covid-19, Nepal's GNI per capita fell in 2020 but was high⁶⁵ enough to be in the lower-middle income category in the 2021 classification.⁶⁶ The income level was, however, US\$15 lower than the cut-off income (for 2022) for continued eligibility for IDA finance.⁶⁷

As Nepal has a low level of risk of external debt distress and is deemed creditworthy, once its per capita income crosses the cut-off for regular IDA credit (which is updated annually) and the crossing is sustained for two consecutive years so that it becomes a "gap" country, which could happen by 2026 even with less than a fifth of the nominal growth rate targeted under the SDGs⁶⁸, Nepal will likely not be able to access "regular" IDA credits and will likely have to take loans on "blend"-credit terms.⁶⁹ The latter are still concessional (30-year maturity, 5-year grace period, 1.25 percent interest rate apart from a 0.75 percent service charge, and an amortization rate of 3.3 percent for year for years 6-25 and 6.8 percent for years 26-30) but also a blend of IDA concessional and the market lending (LIBOR+) terms of International Bank for Reconstruction and Development (IBRD) and hence less concessional than "regular" credits.⁷⁰ IDA credits include an acceleration clause, whereby principal payments from creditworthy borrowers are doubled if per capita income remains above eligibility thresholds.⁷¹ A blend country is graduated to IBRD-only status based on an assessment of the country's macroeconomic prospects, risk of debt distress, vulnerability to shocks, institutional constraints, and levels of poverty and social indicators (Dobronogov et al., 2020).

As regards aid from the ADB, another top aid-provider to Nepal, in 2021 Nepal is still in Group A (concessional assistance-only group) but, within it, in the third of the four subgroups where the first subgroup receives the most concessional terms and conditions.⁷² Nepal is in the COL-only (0

⁶³ For IDA lending terms, see <https://ida.worldbank.org/financing/ida-lending-terms> (accessed 16.09.21).

⁶⁴ <https://blogs.worldbank.org/opendata/new-world-bank-country-classifications-income-level-2020-2021> (accessed 16.09.21).

⁶⁵ US\$1,190, <https://data.worldbank.org/indicator/NY.GNP.PCAP.CD?locations=NP> (accessed 16.09.21).

⁶⁶ Low-income countries are those with per capita GNI of less than US\$1,045, <https://blogs.worldbank.org/opendata/new-world-bank-country-classifications-income-level-2021-2022> (accessed 16.09.21).

⁶⁷ The threshold is US\$1,205, <https://ida.worldbank.org/about/borrowing-countries> (accessed 16.09.21).

⁶⁸ The key assumption is that the gap-country income threshold increases by 1 percent per year (which is slightly higher than the 0.8 percent increase in low-income country threshold between the 2020 and 2021 reviews by the World Bank). For Nepal's per capita GNI to increase from US\$1,190 in 2020 to the projected gap-country threshold of US\$1266.5 by 2025, it would have to grow at the rate of 1.25 percent per annum, which is 16.3 percent of the 7.7 percent annual average growth in (nominal) income required during 2019-2030 to achieve the (nominal) income target set by GoN under the SDGs for 2030.

⁶⁹ For IDA lending terms, see <https://ida.worldbank.org/financing/ida-lending-terms> (accessed 16.09.21).

⁷⁰ Ibid.

⁷¹ Ibid.

⁷² For ADB lending policies, see <https://www.adb.org/what-we-do/public-sector-financing/lending-policies-rates> (accessed 17.09.21).

percent grant) subgroup [Concessional Ordinary Capital Resources (OCR) Lending]. Concessional loans under Group A have a maturity of 24 years (policy-based loans) or 32 years (project loans), a grace period of 8 years, and an interest rate of 1 percent during the grace period and 1.5 percent during the amortization period, with equal amortization. Even when its GNI per capita increases further so that it becomes a "gap" country as defined by the IDA, it will still be eligible for COL-only concessional borrowing. Thereafter, if debt sustainability indicators are fine, Nepal could graduate into Group B, where countries are eligible for OCR blend credit with slightly less concessional terms and conditions. Bangladesh, an LDC set to graduate from LDC status in 2026 along with Nepal, is already in Group B, where the maturity is 25 years, the grace period is of 5 years, the interest rate is 2 percent, and equal amortization is allowed. The next group of countries (Group C) are eligible for LIBOR-based loans only. Reclassifications are based on a case-by-case basis that must be approved by the ADB's Board (WTO, 2020).

LDC graduation may have a negative impact on Nepal's access to United Nations support. The United Nations Development Programme (UNDP) and the United Nations Children's Fund (UNICEF) have targets allocating 60 percent of core resources to LDCs (NPC and UNDP, 2020). However, the impact on Nepal is not yet measurable (*ibid.*). While after graduation Nepal will not have access to travel support for participation in UN and other international forums, and will not receive discounts on budgetary contributions to UN entities, the resulting increase in costs will not be significant (see WTO, 2020; NPC and UNDP, 2020).

Nepal's access to several LDC-specific funds and technical assistance and capacity building programmes will be lost or curtailed upon graduation. After graduation, Nepal will not be eligible to receive new funding from the LDC Fund for climate change, which supports the preparation and implementation of national adaptation programmes of action under the United Nations Framework Convention on Climate Change (NPC and UNDP, 2020). However, projects already approved and funded will continue till completion (*ibid.*). Nepal will also be excluded from the priority group of the Green Climate Fund but will have access to the Special Climate Change Fund (*ibid.*).

Nepal's access to funds from the WTO's Enhanced Integrated Framework (EIF), which provides institutional and policy-related support as well as funds for projects addressing supply-side constraints, will continue automatically for three years after graduation and possibly for a further two years subject to justification and approval by the EIF board (NPC and UNDP, 2020). However, there is some uncertainty over the five-year extension due to the time-bound operation of the EIF, with the implementation of its current phase ending in 2024 (WTO, 2020). The policy-related support provided by EIF can be leveraged to incorporate graduation-related analysis and roadmap into the diagnostic trade integration study that will have to be conducted to prepare a successor strategy to the existing Nepal Trade Integration Strategy 2016-2020. It must be noted, though, that receipts from EIF are very modest in size and other multilateral financial institutions (notably, the

World Bank and the Asian Development Bank) are by far the biggest sources of aid for trade, particular for building productive capacity and alleviating supply-side constraints.⁷³

Nepal will have continued access to the Technology Bank for five years after graduation (WTO, 2020). The Bank aims to strengthen science, technology and innovation capacity of LDCs and give them better access to intellectual property (ibid.). Nepal's access to United Nations Capital Development Fund (UNCDF), which provides access to microfinance and investment capital to LDCs, will be affected. UNCDF-funded programmes can continue for three years after graduation (NPC and UNDP, 2020). For another two years, funds can be provided on a 50-50 cost-sharing basis with the government or a third development partner (ibid.).

7. Fiscal space

With increased expenditure demands of post-earthquake reconstruction and federalism spurring the government to borrow more, the total outstanding public debt increased by 50 percent between 2016/17 and 2018/19, and as a percentage of GDP rose from 22.7 percent to 27.1 percent.⁷⁴ With Covid-19 hitting revenue hard in 2019/20, total debt increased by 36.2 percent that year, propelled by a doubling of domestic loan mobilization. Total debt increased by 21.1 percent in 2020/21. In sum, in a five-year period to 2020/21, total public debt increased by 148 percent, reaching 40.5 percent of GDP. In mid-July 2021, internal debt was 18.8 percent of GDP and external debt 21.8 percent of GDP. The contraction in GDP in 2019/20 and the tepid rebound in 2020/21 also contributed to an increase in public debt as a percentage of GDP. While external and internal debt contributed roughly half each to the increase in debt in the five-year period, the growth of internal debt was faster (182 percent versus 124). The outstanding public debt-to-GDP ratio has exceeded not just the periodic targets of the SDGs but also the final 2030 target of 35 percent.

Debt servicing (principal repayment and interest payment) made up some 6.8 percent of actual government expenditure in 2018/19.⁷⁵ This proportion has come down over time, from 13.9 percent in 2014/15. Similarly, debt servicing amounted to 10.3 percent of revenue (spendable by central government) in 2018/19, falling from 18.2 percent in 2014/15. These proportions increased by just under a percentage point each in 2019/20, when government expenditure and revenue fell. They could increase further in future, given the rise in public debt since 2016/17. Internal debt servicing makes up about two thirds of total debt servicing. Since total debt has been soaring, debt servicing burden is likely to increase in the next few years. As regards external debt servicing, although the share of loans in total ODA has increased monotonically, external debt servicing as a percentage of goods and services exports has remained fairly stable in recent years. It has not reached 11 percent since 2014/15, averaging 9.4 percent, and has declined since 2016/17 to reach

⁷³ The EIF's allocations to Nepal in its current phase of support amount to just under US\$8 million (WTO, 2020).

⁷⁴ Nepal Rastra Bank's Current Macroeconomic and Financial Situation (2020/21).

⁷⁵ Calculations based on GoN's Economic Survey (GoN, 2021).

8.2 percent in 2018/19. Loans from multilateral sources have so far been on highly concessional terms. As external loans have a grace period, the impact on debt servicing takes time to be observed. As of mid-July 2020, multilateral donors accounted for about 88 percent of Nepal's total outstanding external debt.⁷⁶ About 48 percent of Nepal's outstanding external debt was owed to the IDA of the World Bank, 34 percent to the ADB and 3.3 percent to the IMF. Japan, China and India were the top three bilateral sources of outstanding external debt, at 4.5 percent, 3.2 percent and 3.09 percent, respectively, of total outstanding external debt.

GoN has been able to service its debt fairly comfortably and prevent an even greater explosion in public debt partly because it underspends its targeted budget, notably capital budget, releasing resources for principal and interest payments. On average it was able to spend 71 percent of its capital budget during 2015/16-2018/19, and this metric has been on an increasing trend. It fell to 46.3 percent in 2019/20, when the pandemic disrupted construction activities. Likewise, provincial governments also underspend their budget, as do local governments in general.⁷⁷ Future significant increases in spending rates will shrink the fiscal space.

Despite the surge in public debt, the government still has a relatively comfortable fiscal space. The debt-to-GDP ratio is one metric of measuring fiscal space, and its value for Nepal is not in the danger zone. This should not, however, be the only approach to gauging fiscal space. Expenditure efficiency has considerable potential to generate or maintain fiscal space, although GoN, in its roadmap for the SDGs, does not attach much importance to it, instead cautioning about the need to weigh expenditure efficiency against redistribution priorities (NPC, 2017). A report of the Public Expenditure Review Commission estimates that government expenditure can be slashed by up to 35 percent by, *inter alia*, rationalizing the number of ministries and other agencies, ending duplication in the activities done by central, provincial and local governments, paring down the number of municipalities, and scrubbing unnecessary and wasteful expenses.⁷⁸ Furthermore, every year the Auditor General's report shows huge amounts of government transactions that are unaccounted for or feature suspected irregularities. The value of such transactions in fiscal year 2019/20 is put at NPR 104.38 billion (OAG, 2021). The report gives examples galore of such transactions, including obviously wasteful and gratuitous spending, at central, provincial and local levels. It questions the effectiveness of a plethora of subsidies, and tax rebates and concessions. The bunching of central government expenditure in the last month of the fiscal year illustrates another dimension of expenditure inefficiency: during 2015/16-2019/20, on average, a quarter of total expenditure and about 39 percent of capital expenditure were spent in the final month, although such expenditure concentration has been falling.⁷⁹

⁷⁶ Consolidated Financial Statement 2019/20.

⁷⁷ For province governments' spending, see <https://www.nayapatrikadaily.com/news-details/69334/2021-08-23>

⁷⁸ The report is not in the public domain. Its key findings have been reported by the media, for example, <https://www.nayapatrikadaily.com/news-details/44104/2020-05-27> (accessed 28.09.21).

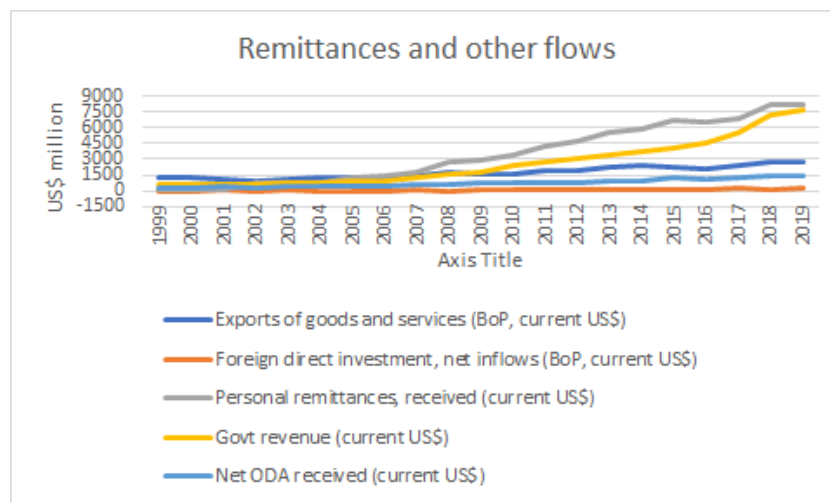
⁷⁹ Consolidated Financial Statement 2019/20.

8. Remittances

8.1 Trends and contribution

Remittances sent by Nepalis working abroad are a major source of income—for the economy as a whole in terms of foreign exchange earnings and for households as direct income. Remittance inflows are greater than the combined value of exports of goods and services, ODA and foreign direct investment (Figure 10). They have amounted to at least a fifth of GDP in recent years.⁸⁰ There are at least 2.8 million Nepalis working abroad, as per an estimate based on the 2017/18 national labour force survey (Baniya et al., 2020). For about a decade till the onset of the pandemic, the number of Nepalis going overseas for work through formal channels was 75-90 percent of the about 500,000 people that entered the labour force each year.⁸¹ At least 30 percent of households receive remittances from abroad (Kharel, 2019). There is evidence that remittances have contributed to poverty reduction and improvements in socio-economic outcomes such as education and health (see, for example, Lokshin et al., 2010; Acharya and Leon-Gonzalez, 2014, 2013; Shrestha, 2017) and, therefore, helped in the achievement of the MDGs.

Figure 10: Remittances inflows



Source: Calculations based on World Bank, World Development Indicators.

8.2 Remittances in the time of pandemic

Remittance inflows have come to the economy's rescue at crunch time. They helped cushion the impact of the devastating 2015 earthquake. In the wake of the Covid-19 pandemic, when the economy contracted in the last quarter of 2019/20, remittances remained fairly resilient. They

⁸⁰ Nepal Rastra Bank's Current Macroeconomic and Financial Situation (2020/21).

⁸¹ Based on data from Department of Foreign Employment, Government of Nepal.

contracted by 0.5 percent in 2019/20, far less than what was predicted by national and international agencies, and, again defying initial projections, rebounded with a 9.8 percent growth in 2020/21 even as the domestic economy was showing a tepid recovery. This was despite the number of permits issued for Nepalis going overseas for work (including permits for new entrants, those with legalized status, and renewed entry) crashing by 28 percent and 55 percent in 2019/20 and 2020/21, respectively. This was also despite some half a million Nepalis losing jobs abroad (NPC, 2021b). The likely reasons behind the resilience in remittances include: migrant workers remitted more money to support their families hit by the pandemic-induced economic crisis; a greater proportion of remittances entered the country through the formal financial channel as lockdowns and other restrictions on mobility deflected flows from the informal *hundi* channel; migrants spent less on TVs and other gadgets that they normally bring home with them or send via fellow migrants returning home; and the number of returnees was a small portion of the total stock of migrant workers abroad (see Pokharel, 2021).⁸²

With the easing of the pandemic in destination countries, the resumption of international flights and the vaccination drive in Nepal gathering pace, the number of work permits issued in the first two months of 2021/22 (mid-July to mid-September) rose nine-fold.⁸³ While GoN has officially accorded priority to those with foreign job offers in its vaccination drive, many of them struggle to get vaccinated, and not all the vaccines used in Nepal are accepted in some destination countries. This is probably restraining the rebound in outmigration.⁸⁴ Sharp hikes in airfare and the high financial cost of quarantine in destination countries are also straining the finances of outbound workers.⁸⁵

Remittances are necessary for achieving many SDGs, including poverty reduction. A specific target for Nepal under SDG target 17.3 (mobilizing additional resources) is to increase remittances as a percentage of GDP from 29.1 percent in 2015 to 35 percent in 2030 (NPC, 2020). The government targeting an increase in remittance-to-GDP ratio by 6 percentage points in 15 years underlines the importance it attaches to remittances and its belief that nominal GDP will grow much slower than remittances during this period. As per the progress report on SDGs for 2016-2019, the remittances-to-GDP ratio in 2018/19 was less than the target for that year (30.7 percent) by five percentage points (NPC, 2020). While the ratios for 2019/20 and 2020/21 were about 22.5 percent each, these values are based on the new GDP series and hence are biased downward when compared to the values based on the old series. Even after accounting for the change in the method of GDP calculation, the values for 2019/20 and 2020/21 are likely to remain less than the target of

⁸² See also <https://kathmandupost.com/money/2021/08/22/remittance-hits-rs961-billion-an-all-time-high-in-the-time-of-covid-19> (accessed 29.09.21).

⁸³ <https://www.karobardaily.com/news/157361> (accessed 29.09.21).

⁸⁴ <https://www.nayapatrikadaily.com/news-details/70998/2021-09-17;https://kathmandupost.com/national/2021/08/03/the-woes-of-migrant-workers-to-get-vaccines-and-certification> (accessed 29.09.21).

⁸⁵ <https://www.nayapatrikadaily.com/news-details/70998/2021-09-17> (accessed 29.09.21).

30.7 percent for 2018/19. Since around 2015, the number of people going overseas for work has been on a declining trend and remittance growth has also slowed down. Moreover, the overwhelming majority of outbound workers are in the unskilled or semi-skilled category (MoLE, 2018; MoLESS, 2020) and earn relatively low incomes, although more than what they would have earned in Nepal. Add to this the uncertainty created by the pandemic, and meeting the remittance-to-GDP target set out in Nepal's SDGs will be challenging.

8.3 Challenges

There are concerns that outmigration and remittances cannot become a durable source of prosperity for Nepal. Outmigration has created labour shortages, including in industry. Remittances have contributed to an appreciation of the real exchange rate (Portugal and Zildzovic, 2016). These do not augur well for industrialization goals, which are also part of the SDGs (Goals 8 and 9). Mobilizing remittances into "productive" activities—that which create output and jobs quickly—and utilizing the skills and resources of returnee migrants receive emphasis in policy announcements. However, the foreign employment bonds issued by the central bank are grossly undersubscribed (a key factor being inadequate promotion)⁸⁶, the uptake of a subsidized credit scheme for returnee migrants is very low⁸⁷, and over half of returnees are either unemployed or outside the labour force (MoLESS, 2020).

It is now acknowledged that remittances not saved (about 72 percent, as per NRB, 2016) are not necessarily unproductive as the money spent on food, health and education is improving living standards and contributing to human capital formation. However, the discourse on encouraging "productive" use of remittances by somehow inducing recipient households to save and invest more misses the fact that the quarter of remittances spent on daily consumption (NRB, 2016) represent effective demand, a significant part of which is leaking out of the economy through imports, while domestic agriculture and industrial sectors have not been able to utilize this opportunity (Kharel, 2019). It also misses the fact that even when remittances are used to repay loans (25.3 percent) or pay for educational and health expenses (9.7 percent) (NRB, 2016), the money most likely in due course enters the formal financial system, and the government and the central bank have the tools to direct or nudge those funds towards job-creating activities. In fact, financial institutions in the country owe their lending capacity in large measure to the steady inflow of remittances.

Moreover, it may be unrealistic to expect the average remittance-receiving household to invest in enterprises. For example, Kharel, Davalos and Dahal (2021) find remittances discourage female members of remittance-receiving households from engaging in economic activities in general and in non-farm self-employment in particular, and that this disincentive effect is strong enough to

⁸⁶ See <https://bizmandu.com/content/20210907163953.html> (accessed 29.09.21) and NRB (2016).

⁸⁷ As can be inferred from the data in Nepal Rastra Bank's Current Macroeconomic and Financial Situation.

exert a negative impact on the revenues of non-farm enterprises operated by such households. This suggests many of those operating household enterprises are reluctant entrepreneurs engaged in their vocation out of desperation (see Banerjee and Duflo, 2011).

To increase remittances and utilize the skills of returnee migrants, the government faces the challenging tasks of skilling aspirant migrants, providing them with effective pre-departure orientation, diversifying destination markets, entering into and lobbying for the enforcement of labour agreements with destination countries, replicating the relative success of the government-to-government foreign employment arrangement with South Korea to ensure transparency in the recruitment process and curb workers' exploitation, further formalizing remittance inflows, reducing recruitment costs borne by migrant workers and the cost of remitting, and putting in place a system under government-industry collaboration to match returnee migrants with employers.

9. Foreign direct investment

9.1 Trends and features

Despite policy and institutional reforms in recent years aimed at attracting FDI (NRB, 2021), Nepal struggles to attract FDI. This is worrying as GoN is banking on substantial inflows of FDI to meet a huge gap in private financing for SDGs (see Section 3). As of mid-July 2020, total FDI stock in Nepal was about US\$1.64 billion (NRB, 2021), or 5.1 percent of GDP.⁸⁸ Portfolio (foreign) investment is not allowed into Nepal. Domestic private entities in Nepal in general are not allowed to take foreign loans and although banks are allowed to borrow abroad subject to restrictions, they have not been able to mobilize much capital through this avenue as, *inter alia*, Nepal has not been rated by international credit rating agencies.

FDI inflows pale in comparison to those received by comparator countries, including low-income countries on average, and South Asian countries such as Bangladesh, India, Pakistan and Sri Lanka, and two East Asian LDCs, Cambodia and Lao PDR (Figure 11).⁸⁹ Annual FDI inflows to Nepal have never exceeded US\$200 million.⁹⁰ Net FDI flows to Nepal have picked up in recent years: they averaged US\$139 million during 2016-2019 compared to US\$62 million during 2012-2015.⁹¹ However, they have remained less than (approved) dividend repatriations—less than a half in 2017/18 and 2018/19 (NRB, 2021).

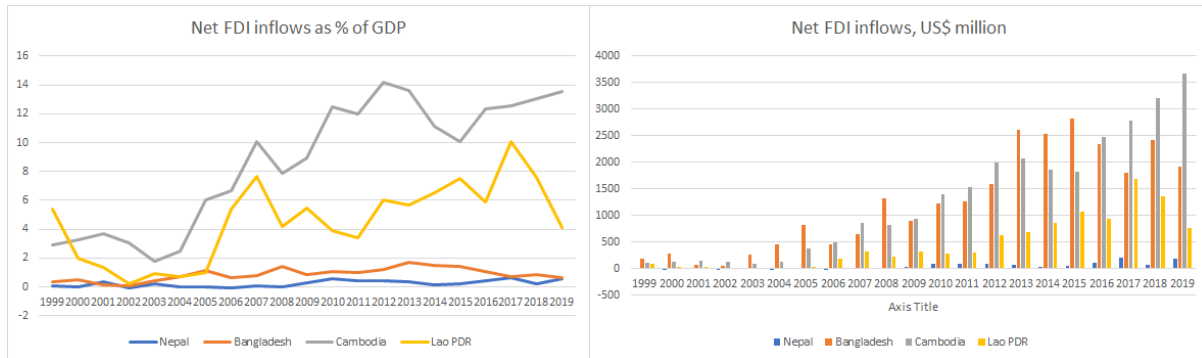
⁸⁸ GDP for 2019/20 is taken from the new series available in Nepal Rastra Bank's Current Macroeconomic and Financial Situation (2020/21).

⁸⁹ Comparisons based on data from the World Bank's World Development Indicators.

⁹⁰ Based on data from the World Bank's World Development Indicators.

⁹¹ Ibid.

Figure 11: FDI inflows



Source: World Bank, World Development Indicators.

There is a significant gap between FDI approved and FDI actually received. On average, between 1995/96 and 2019/20, total actual net FDI inflow amounted to 34.1 percent of the value of total FDI approved (NRB, 2021).

India is the top source of FDI, accounting for 31.5 percent of total FDI stock in Nepal (NRB, 2021). It is followed by China (15.6 percent), Saint Kitts and Nevis (7.7 percent), Ireland (6.5 percent) and Singapore (6.3 percent). Among major FDI sources, China has seen the fastest growth in FDI into Nepal.

Industry has received 48.8 percent of total investment and services have drawn 51.1 percent (NRB, 2021). The top FDI-receiving sector is manufacturing, mining and quarry (28.6 percent). This is followed by financial intermediation (27.4 percent), electricity (20 percent), transport, storage and communication (14.5 percent), and hotel and restaurant (4.3 percent). Electricity production, chiefly hydropower-based, has been the prime draw for FDI in recent years, and this sector has also attracted foreign loans in addition to FDI (ibid.).

9.2 FDI in the time of pandemic

Gross flows to Nepal increased by 18.2 percent in 2019/20,⁹² the last quarter of which saw a pandemic-induced contraction in economic activities in Nepal. In what could be a response to the pandemic's impact, the growth of such flows slowed down sharply to 1.2 percent in 2020/21.⁹³ Approved FDI was also affected: After increasing by 51.4 percent in 2019/20, approved FDI fell

⁹² Nepal Rastra Bank's Current Macroeconomic and Financial Situation (2020/21).

⁹³ Ibid.

by 15.4 percent in 2020/21.⁹⁴ Likewise, the number of approved FDI projects fell by 33.8 percent in 2019/20 and 19.4 percent in 2020/21.⁹⁵

9.3 Implications of LDC graduation and challenges

There is a thesis suggesting a potential positive impact of LDC graduation on FDI, arguing graduation would elevate an LDC's standing in the eyes of rating agencies and inspire foreign investors' confidence in its economy (NPC and UNDP, 2020). However, a counterargument is that the difference in the volumes of FDI flows into Nepal and fellow LDCs such as Bangladesh, which is also set to graduate in 2026, and Lao PDR and Cambodia suggests that "LDC status per se is not a critical factor behind Nepal's poor record in attracting FDI" (Kharel, 2021). Of course, obtaining sovereign credit rating could help in attracting FDI, but getting one does not hinge on LDC status. Without addressing existing constraints to attracting FDI—from policy, institutional, managerial and procedural constraints to infrastructural constraints (see, for example, DoI, 2021)—LDC graduation alone is unlikely to have a notable impact on FDI inflows.

10. Way forward

Estimation of additional investment needs and gaps

This study has indicated in qualitative terms the likely increase in investment requirements and financing gaps pertaining to development goals on account of the Covid-19 pandemic and the impending graduation from the LDC group. GoN must estimate the increments and put them in the context of pre-existing financing gaps.

Government revenue

GoN should formulate a **federal revenue policy** that provides it a clear, integrated and unified guiding framework, as it is currently operating without one. The policy should take into account the federal structure of governance. It should guide GoN on the matter of balancing the needs of revenue mobilization and protecting domestic industry on the one hand and providing incentives to domestic industry and exporters on the other. Changes to various tax laws should be made with reference to the revenue policy. A periodic action plan with outputs, targets, milestones and indicators can contribute to the operationalizing of the policy. Some of the recommendations made by the National Revenue Advisory Board—for example, with regard to expanding the tax base and improving tax compliance—verified with further studies, can inform the revenue policy and go into the action plan to improve the chances of their implementation. While plugging leakages at customs points should get attention, given the current dominance of import-based taxes in the revenue structure, note should be taken that these are indirect taxes and hence in general regressive

⁹⁴ Data from Department of Industry, Ministry of Industry, Commerce and Supplies, GoN (<https://doind.gov.np/>, accessed 26.09.21).

⁹⁵ Ibid.

by nature. A campaign to bring more individuals and entities with the capacity to pay income taxes into the income tax net and ensuring compliance should be introduced with full support from the Prime Minister's Office.

GoN should work out legal arrangements, for example, through the introduction of an integrated or **umbrella revenue act**, to address and prevent confusions and conflicts in matters of taxation and revenue collection authority among the three tiers of government, and prevent double taxation.

To enable subnational governments (province governments and local governments) to utilize their authority to raise tax and non-tax revenues, efforts must be redoubled to **enhance the institutional and human resource capacity of subnational governments** to formulate revenue policy, act, regulations and medium-term expenditure framework and identify potential revenue sources, make projections, build an integrated database necessary for taxation, and collect revenue. The technical capacities of revenue advisory committees and the resource estimation and budget ceiling determination committees at the subnational level need to be strengthened. Given the huge gap between internal revenue and expenditure that will remain even with improved revenue mobilization by subnational governments, GoN must help them exercise the option to borrow by establishing detailed institutional and regulatory arrangements and operational modalities, and building their capacity to plan productive projects for the issuance of, say, **municipal bonds**, and service and manage the resulting debt. Likewise, the capacity of subnational governments to forge public-private partnerships, including through **viability gap funding**, must be enhanced.

The National Revenue Advisory Board should conduct/commission studies that rigorously assess the **impact of tax rebates and concessions** to determine whether they are meeting desired/stated objectives and ascertain the net effect on revenue. It should initiate the process of investigating the possible **impact on revenue and revenue policy space** of Nepal's **graduation from the LDC group** in 2026 in coordination with other relevant agencies (e.g., Ministry of Industry, Commerce and Supplies, and Ministry of Agriculture and Livestock Development). This investigation should serve as an input to developing revenue strategies, which can go into the aforementioned revenue policy, to promote industry and mobilize revenue without contravening trade rules and by optimally utilizing whatever policy space is available. These strategies should be integrated into the post-graduation transition strategy that GoN will be preparing. Rigorous studies should also underpin positions and concessions in tariff reduction negotiations at the multilateral, regional and bilateral levels. Given the country's high dependence on import-based revenue, an operational **revenue loss compensation mechanism** should be sought during further tariff reduction negotiations under SAFTA. In this regard, the **research and analysis capacity** of the Board should be strengthened. This is a potential area for development partners to provide technical assistance.

The **revenue-related judicial system** needs to be **reformed** for quick decisions on unsettled disputed revenue claims. The government should accord priority to bringing **electronic**

transactions and online businesses into the **tax net** effectively, with required regulatory and institutional changes.

Studies **estimating potential revenues** from different possible measures, by sector and tax type, are needed to get an idea, even if a rough one, of the additional revenue that can be raised through various policy, regulatory and institutional interventions. Putting a number on lost revenues will help create public pressure for action and also motivate the authorities into action. For instance, since the entry of goods into Nepal through the porous border with India by avoiding official customs points has constantly been identified as a source of revenue leakage⁹⁶, it is high time the revenue implications of such informal trade were analysed. The few serious studies on unauthorized trade between the two countries do not quantify revenue losses despite estimating trade volumes. Similarly, having an idea about the potential amount of revenue that can be raised by checking trade-related mispricing and misclassification at official customs points could provide an impetus to revenue mobilization drives. Estimating revenue that can be generated by bringing professionals (individual service providers) into the tax net effectively is another useful enquiry.

GoN should prioritize the expansion of **border police outposts** and provide the security personnel thus stationed with necessary infrastructure and resources to effectively monitor the border and check unauthorized trade. Cooperation among border agencies in Nepal should be improved.

The implementation of the recently unveiled *Customs Reform and Modernization Plan 2021/22-2025/26* should be monitored and evaluated also on the metric of realization of potential revenue. It has important activities and interventions for increasing revenue.

Public expenditure efficiency

Acting on the evidence presented in the report of the Public Expenditure Review Commission that there is a significant room to cut government expenditure, including through a restructuring and rationalization of ministries and other public agencies, GoN should roll out a timebound roadmap towards improving **expenditure efficiency**. GoN should be explicit about which recommendations in the Commission's report are feasible to be implemented promptly and which are not, if feasibility is an issue at all. The report should be placed in the public domain. Subnational governments should also prepare well-planned budgets guided and disciplined by mid-term expenditure frameworks—for which GoN should prioritize effective capacity building programmes.

Foreign aid

Improving **absorptive capacity** to mobilize and utilize ODA committed by development partners will generate substantial resources for GoN. This could also help generate more aid commitments.

⁹⁶ See, for example, *Quarterly Bulletin* (September 2021) of Department of Revenue Investigation, GoN, <http://dri.gov.np/ne/noticedetail/241/2021/85968318> (accessed 28.09.21).

Given that Nepal is **graduating from the LDC category** with a very low per capita income (less than the income criterion), weak productive capacity and severe supply-side constraints, and will be losing trade preferences without having significantly realized its export potential, GoN has a **justified case for seeking additional ODA**, especially to build infrastructure and human resources necessary for enhancing its **export capacity**. The successor to the Nepal Trade Integration Strategy 2016-2020 must incorporate interventions to address graduation-related challenges. It must identify infrastructure and human resource development needs, among other things, and estimate investment requirements and the volume of ODA needed. A component of additional aid for trade must be targeted directly at helping firms, especially SMEs, adjust to the loss of trade preferences. This could be part of a **trade adjustment programme**, to be later extended to help other firms adjust to tariff liberalization that GoN may have to undertake following graduation. The trade adjustment programme also needs to help GoN adjust to possible immediate revenue losses arising from tariff reductions. When development partners prescribe tariff cuts—say, in their reports and studies—they are well-advised to explore the idea of providing such support. Revenue loss concerns strengthen the case for providing an increased proportion of aid as budgetary support.

Development partners must recognize that a reason why Nepal is not in **debt distress** is that GoN's underspending its budget, especially capital budget, has released resources to service debt. When the budget is no longer underspent significantly, debt servicing could become more stressful. A sharp reduction in the concessionality of ODA may further push the government towards domestic borrowing, with the attendant risk of crowding out resources for the domestic private sector investment that GoN, in its SDG financing strategy, expects to fund some 36.5 percent of SDG financing needs. It is noteworthy that the private sector financing gap is estimated to be about 70 percent bigger than the public sector financing gap. These aspects should be taken into account before any decision is taken on reducing the **concessionality of loans** and the share of grants in aid provided to Nepal, as its per capita income inches upwards.

GoN invokes macroeconomic stability as a reason why it wants greater proportions of aid to flow in as grants to help the public sector meet SDG financing needs. This expectation is not matched by reality, with the share of grants continually falling. Increasing the absorptive capacity with regard to grants could be one way of attracting more grants, especially from bilateral sources, as the government's current rate of **utilization of grants** is much lower than that of loans. Further, since factors other than income determine ODA from bilateral sources more than that from multilateral sources, GoN must step up **economic diplomacy** to secure **more bilateral ODA**, including grants. It must approach bilateral aid sources with proposals for **combining ODA with technology transfer** and initiatives to forge **partnerships between the private sectors** of both countries. GoN, in its financing strategy for SDGs prepared in 2018, talks about calling for **debt relief**. The pandemic has enhanced the relevance of debt relief.

Development partners should **improve coordination** among themselves to reduce aid fragmentation, which remains high. They must **share aid-related information** accurately and promptly, and actively contribute to GoN-led initiatives aimed at better coordination. The huge amount of ODA targeted for meeting SDG financing needs calls for a speedy and sufficiently accurate mapping of aid flows to SDGs, a process that GoN has initiated and needs the cooperation of development partners. Off-budget ODA and foreign aid provided by INGOs (which is not ODA) are in particular need of better coordination between GoN and development partners and among development partners to **avoid duplication and improve alignment** with national needs and priorities. Development partners should improve **predictability** in aid flows and be agreeable to providing aid under a **sector-wide approach** in more areas. An honest dialogue is needed between GoN and development partners on the issue of a significant proportion of ODA flows still bypassing the country's **public finance management system**.

Given the huge resource gap in development financing that ODA alone is unlikely to meet and the challenges faced in attracting huge amounts of purely private FDI, GoN, in its reports, sees **blended finance** as a possible new avenue of development finance (e.g., MoF, 2020). To take this forward, GoN must assess the feasibility of this mode drawing on the experience of countries at similar levels of development, identify the required institutional and regulatory framework and put it in place, and address capacity gaps to structure, implement and monitor bankable projects.

FDI

GoN has identified **policy, institutional, managerial and procedural constraints** to attracting FDI. These should be addressed. Inputs from existing and potential foreign investors should be drawn in such investigations. Getting **sovereign credit ratings** for Nepal would provide additional ideas to GoN on the reforms needed to reduce real or perceived risks for investors. In order to better sell the benefits of investing in Nepal, the **economic diplomacy** apparatus needs to be made more effective through **improved coordination** between diplomatic missions abroad, the foreign ministry, other ministries and public agencies, and the private sector. Diligent and regular follow-ups are needed, including after investment summits (the commitments made in the two held so far having mostly failed to materialize). A possible blended finance approach discussed in the previous subsection should be made a part of the strategy to attract FDI.

Remittances

Sustained growth of workers' remittances will be important for meeting Nepal's development goals. The government has to review and refine initiatives meant to **skill aspirant migrants** and provide them with effective pre-departure orientation. It has to **diversify destination markets**, enter into and lobby for the **enforcement of labour agreements** with destination countries, and strive to replicate the relative success of the government-to-government foreign employment arrangement with South Korea to **ensure transparency** in the recruitment process and curb workers' exploitation in other destinations. The government and the central bank have to take stock

of existing measures, and refine them as appropriate, to **formalize remittance inflows and induce savings** (e.g., through effective promotion of the central bank-issued bonds for migrant workers and their families), and **reduce recruitment costs** borne by migrant workers and the **cost of remitting**. A system under government-industry collaboration should be established to **match returnee migrants with employers**.

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