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ASSESSMENT OF NEPAL'S FISCAL ENVELOPE

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October 26, 2014

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EXECUTIVE SUMMARY

This study analyses the fiscal envelope in Nepal with an emphasis on identifying possible areas to free fiscal space to fund increased allocation to key social investment. It hopes to contribute to the on-going debates about future policy directions and further initiate a broader and inclusive dialogue that will ultimately arrive at the optimal policy mix that maximizes the society's social welfare.

Nepal's transitioning population pattern produces a favorable demographic situation in which working age population has expanded in proportion to the general population. Nepal has not been able to adequately translate this demographic window of opportunity into higher economic growth rates. This in particular highlight the necessity of timely and relevant public investments in key social sectors to ultimately improves productivity and generate employment for the working-age population bulge. While the government of Nepal has significantly stepped up its planned spending for fiscal year 2014/15, the projected public spending is uneven across the different sectors and even per capita spending on education is budgeted to decrease in real term.

The tax system in Nepal is characterized by high share of indirect taxes on goods and services. Further, these taxes have been increasing at a higher rate than the direct tax items, indicating a possible welfare loss and increased regrisivity of the tax system in Nepal.

Nepal has been able to almost half its public debt /GDP ratio over the past decade and currently stands at a low level in comparison with regional comparators. Foreign exchange reserves are very high in Nepal and have continued to build up benefiting from sustained growth in remittance inflows.

TABLE OF CONTENTS

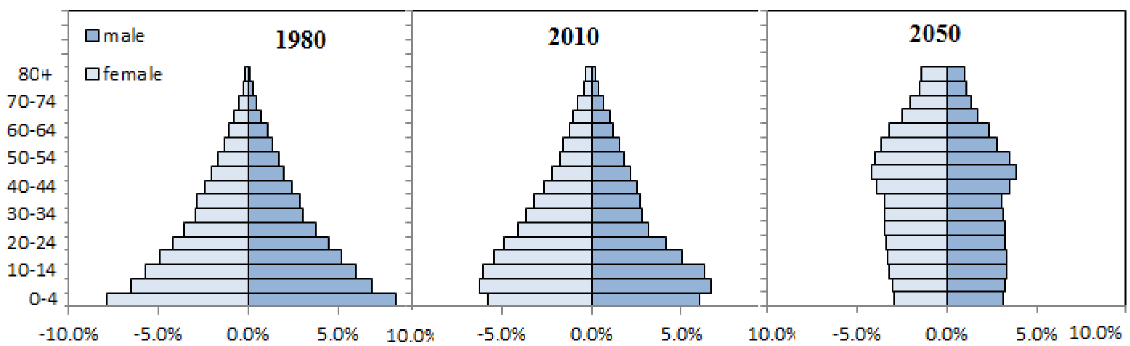
LIST OF TABLES

LIST OF FIGURES

1. SOCIOECONOMIC BACKGROUND

The most recent population census of 2011 estimated Nepal's population at 26.5 million. Between 2005 and 2010, Nepal's population is estimated to have increased at an average annual rate of 1.2 percent (UNDESA, 2013). The pattern of natural population growth (excluding migration) can be explained by two underlying factors: fertility rates and mortality rates. Since 1980, Total Fertility Rate (TFR) decreased by almost half, from 5.65 children per woman in early 1980 to 2.99 children per woman in 2005-2010 (UNDESA, 2013). The second factor, the mortality rate, has shown significant improvement over the same period. The crude death rate was estimated at 7.3 deaths per 1,000 live in 2005-2010, more than half the rate of 16.1 deaths per 1000 in the early 1980s. Life expectancy at birth, therefore, increased steadily and reached 65.9 years in 2005–2010, compared to 49.4 years in 1980-1985 (UNDESA, 2013). As a result of declining fertility rates, improved mortality and increased life expectancy, the population structure has changed notably over the past few decades. The median age in Nepal increased from 19.2 in 1980 to 21.3 in 2010 (UNDESA, 2013).

Figure 1: Population pyramid, 1980 - 2050



Source: Own calculation based on data from on UNDESA, 2013

The broadening midsection of Nepal's population pyramid presents a favourable demographic environment in which the working age population has expanded at a higher rate than that of the general population, which is widely referred to as a *demographic window of opportunity*. Nevertheless, Nepal must overcome two main challenges to translate this favourable demographic window of opportunity into a sustained long-term path of economic growth. These challenges include:

1- Create adequate jobs to absorb the rapid entry into the labour market by new participants.
2- Productivity improvement.

Data from the labour market in 2008 suggests that labour force participation rate is relatively high (87.5 and 80.1 percent for male and female population age 15 or more respectively). Unemployment is also contained at a very low level (2.2 and 2 percent for male and female labour force participants respectively). However, the labour underutilisation rate is significantly high and stood at 36 percent for male and 20.8 percent for female labour force participants (Govenment of Nepal, 2009). Coupled with an aging infrastructure, this translates into constrained productivity and therefore creates an impediment for the local economy to reach its potential in terms of economic growth. From 2011 and 2013, Nepal's economy grew at an estimated average annual rate of 3.97 percent in real terms, and is projected to grow at an average annual rate of 4.31 over the period between 2014 and 2018 (IMF, 2013). While this is above the population growth rate, resulting in an improvement in real GDP per capita, it is still below what Nepal can reach if it utilises its demographic window of opportunity discussed earlier.

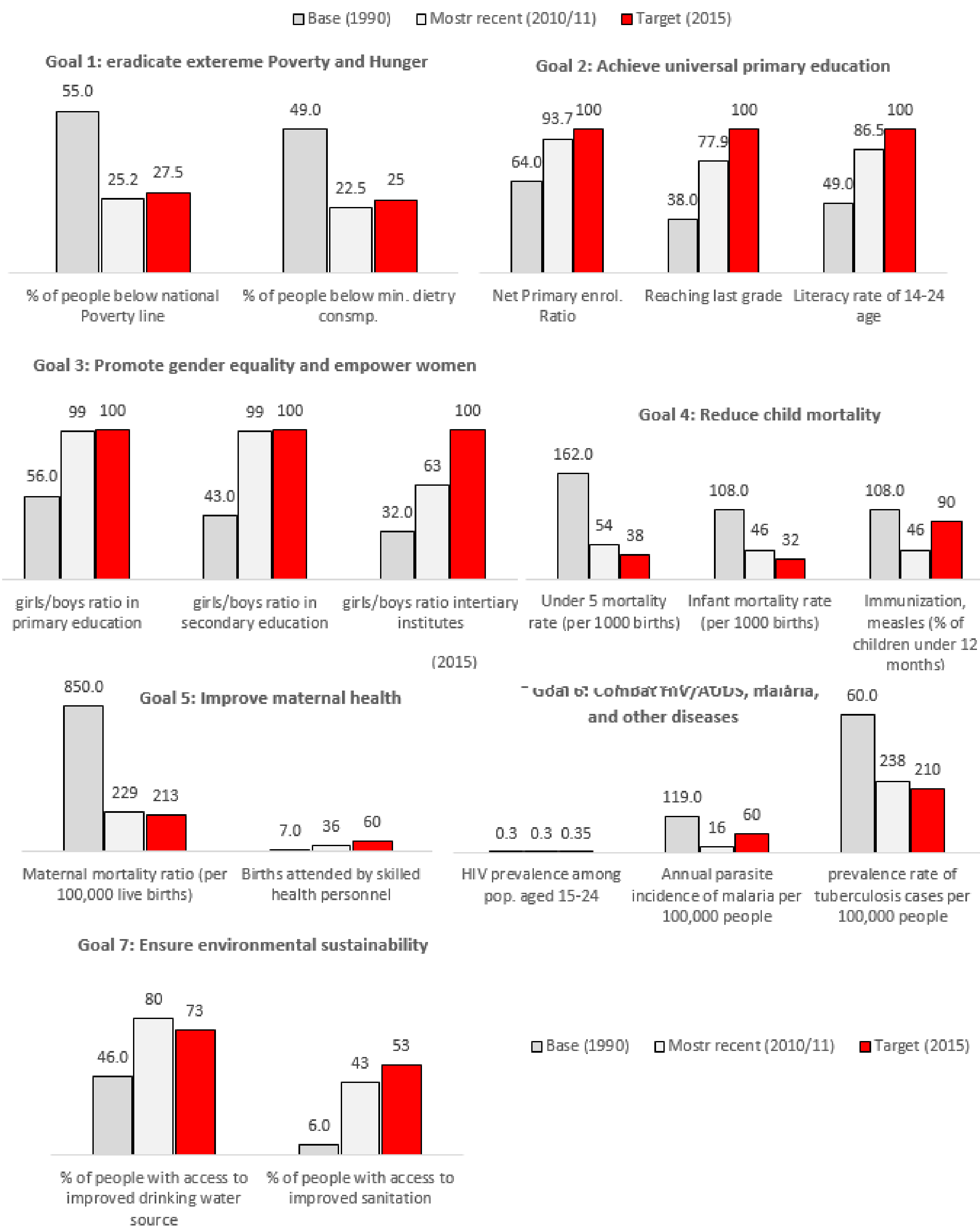
Table 1: Main Economic Indicators, 2004-2013

Economic Indicators	2004	2006	2008	2010	2012	2013
GDP, current prices, Billion NRs	536.75	654.08	815.66	1,192.77	1,536.00	1,701.19
GDPper capita, current LC	21,537.2	25,516.2	31,073.4	44,430.2	55,906.7	61,199.6
GDPper capita, current US$	291.9	352.8	477.9	596.1	690.0	695.8
Inflation (CPI), percent	3.96	7.96	6.69	9.52	8.31	9.86
GDP growth, real	4.68	3.37	6.11	4.82	4.85	3.65
Exchange rate, NRs per 1 US$	73.79	72.32	65.02	74.54	81.02	87.96

Source: Based on data from IMF (2013)

Despite of this modest economic growth rates, Nepal has achieved progress on income poverty reduction. Further, Nepal has made considerable strides on some of the non-income dimensions of human development.

Figure 2: Millennium Development Goals Indicators



Source: Based on data from IMF (2014)

2. FINANCING AND FISCAL SPACE

The study recognises the importance of the national budget as a tool to achieve sustainable progress in the fulfilment of societies' goals. Government expenditures on public goods and services (education, health, Water and Sanitation among other sectors) and infrastructure are a precondition to achieving and sustaining \achievements in human development goals. Further, its choices for financing options (taxation public debt) have also equitable consequences. This chapter provides an assessment Nepal's fiscal envelope to identify preliminary areas to free some fiscal space that can be used to initiate a broader and inclusive dialogue that will ultimately arrive at the mix that maximizes the society's social welfare.

Fiscal space is defined as "the room in the government's budget that allows it to provide resources for a desired purpose without jeopardising the sustainability of its financial position or the stability of the economy' (Heller, 2005). In general, there are several options available for decision makers to create fiscal space to fund economic and social development. Main options include (Roy, Heuty, & Letouze, 2009):

- Improved taxation
- Reprioritization of expenditures
- More accommodating macroeconomic framework (e.g. tolerance to some inflation, fiscal deficit, borrowing)
- Using fiscal and central bank foreign exchange reserves
- Increased aid and transfers

Before investigating each option, the national budget including the overall accumulated debt for the past two years as well as the 2014/5 budget are presented below in current currency and as a percent of GDP, the information in the budget will be referred to frequently in the coming sections.

Table 2: National Budget in Billion Nepali Rupees (NRs.) and as a Percent of GDP, 2012/13-2014/15[1]

	Billion NRs.			Percent of GDP		
	2012/13	2013/14	2014/15	2012/13	2013/14	2014/15
Total Revenue	**333.17**	**401.84**	**514.82**	**19.68**	**20.81**	**23.58**
Tax	259.21	312.62	374.71	15.31	16.19	17.16
Non-tax revenue	36.81	41.91	48.19	2.17	2.17	2.21
Cash Balance from last year	1.92	-	18.54	0.11	0.00	0.85
Grants	35.23	47.31	73.39	2.08	2.45	3.36
Total Expenditure	**302.05**	**380.51**	**515.71**	**17.84**	**19.71**	**23.62**
Current expenditure	**247.46**	**316.64**	**398.95**	**14.62**	**16.40**	**18.28**
Salaries and allowances	66.05	84.26	104.91	3.90	4.36	4.81
Goods and services	23.29	29.01	63.11	1.38	1.50	2.89
Debt service	13.74	17.55	23.35	0.81	0.91	1.07
Subsidies to public and private enterprices	4.23	1.15	2.62	0.25	0.06	0.12
Grants (to LB and agencies)	102.49	142.33	146.35	6.05	7.37	6.70
Social Assitance (Protection)	37.54	42.05	58.24	2.22	2.18	2.67
others	0.13	0.29	0.37	0.01	0.02	0.02
Capital expenditure	**54.60**	**63.87**	**116.76**	**3.22**	**3.31**	**5.35**
Budget Deficit (Surplus)	**(31.12)**	**(21.33)**	**0.89**	**-1.84**	**-1.10**	**0.04**
Overall Debt	**533.30**	**588.96**	**648.35**	**31.5**	**30.5**	**29.7**
Local	193.00	212.41	235.76	11.4	11.0	10.8
Foreign	340.29	376.55	412.59	20.1	19.5	18.9

Source: Based on data from Ministry of Finance (2014) and IMF (2014).

2.1. Improved taxation

Over the past couple of years, revenue growth has remained strong. The national budget for fiscal year 2013/14 projected total revenue to stand at NRs. 374.71 billion, which is 23.58 percent of GDP for the same year. This is an increase by 2.77 percentage point of GDP over one year (Ministry of Finance, 2014). This increase has placed Nepal at a higher revenue/GDP ratio as compared with countries at the same economic level and regional comparators. Nevertheless, total tax rate expressed as a percentage of commercial profits compares favorably with countries at the same economic level and regional comparators.

[1] The budget for fiscal year 2012/13 is actual, for fiscal year 2013/14 is the revised, and for fiscal year 2014/5 is budgeted.

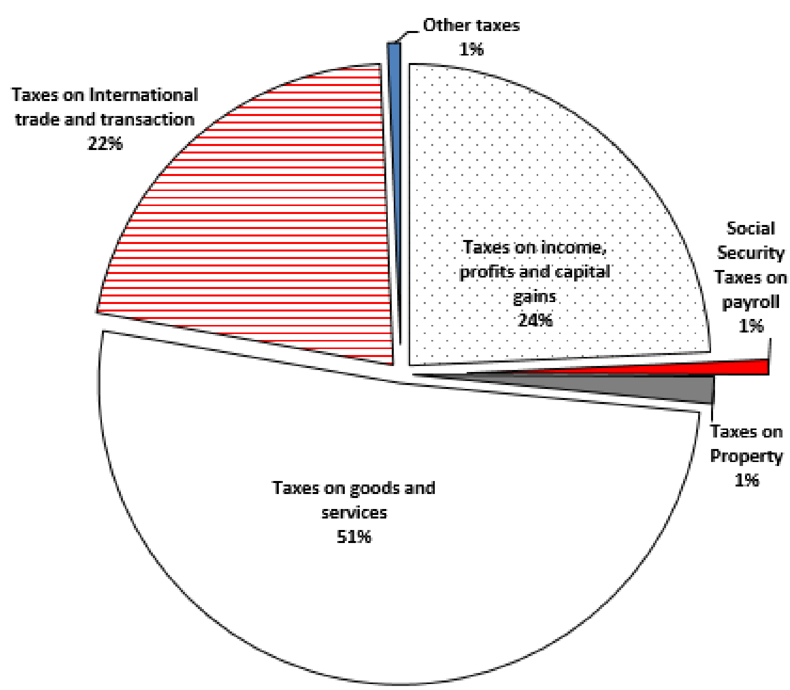
Table 3: Budget Revenues (Tax and non-Tax) as a Percent of GDP for Nepal and Comparator Regions

2011	Revenue (excluding grant)	Tax Revenue	Total Tax Rate
	% of GDP		% of commercial Profits
Nepal (2014/15)	20.2	17.2	31.5
Least Developed Countries	17.9	14.5	52.0
South Asia	11.5	9.0	40.6

Source: based on data from World Bank (2014) and ministry of Finance (2014)

The share of taxes on goods and services (mostly VAT and excises) in the total tax collection is high and amounts for more than half of the total tax revenue in budget 2014/15 (Ministry of Finance, 2014). VAT is generally a regressive tax[2] as it taxes consumer goods and services that make up a higher share of total household expenditures in low income households compared with higher income groups; which highlights the need for tax system assessment and possible reforms as well as parallel measure to offset the potential welfare loss for low income groups.

Figure 3: Different Taxes as a Percent of total Taxes, Budget Fiscal Year 2014/5

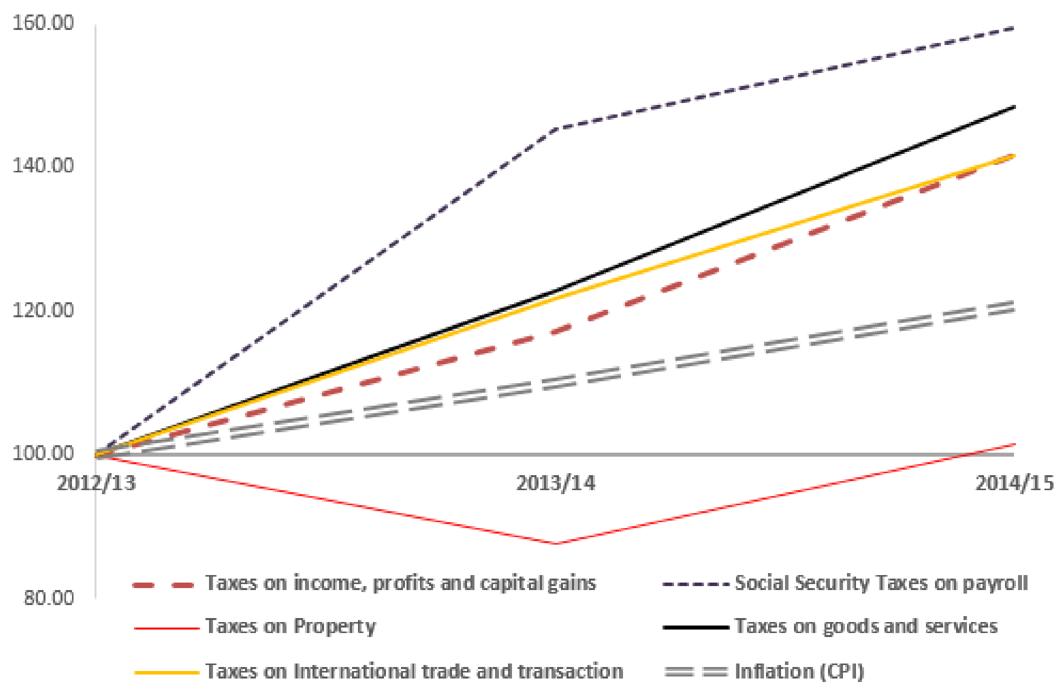


Source: Based on data from Ministry of Finance (2014).

[2] Note that a tax burden analysis is needed to conclude on the impact of the various tax items on different socio-economic group. Also exempting goods/services that are disproportionally consumed by the poor can reduce regressivity and may actually make the VAT progressive.

The more progressive direct tax items on property, income, profits, and capital gain constitute about a quarter of the total tax collection. While the direct taxes can potentially grow further benefiting from the tax rate differentials highlighted in table 3, their growth rate was at a lower rate than that of the more regressive tax items; indicating a potential increase in the overall regressivity of the tax system in Nepal.

Figure 4: different Taxes and Inflation Growth Rates (Base year is 100 in 2012/13)



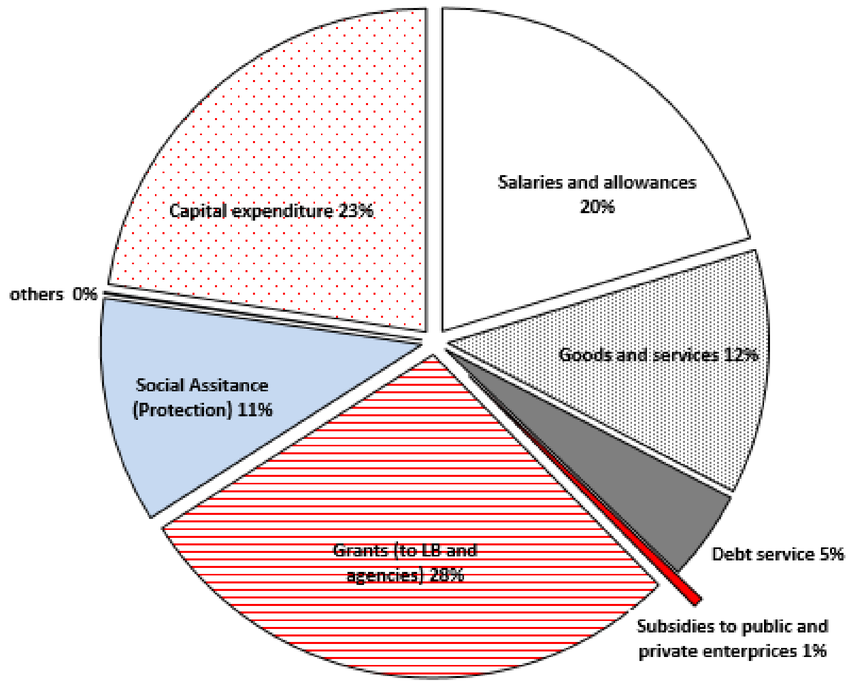
Source: Based on data from Ministry of Finance (2014).

Revenues are projected to further grow, though at decreasing rate, and stabilize in the medium term at between 21-22 percent of GDP according to the IMF (IMF, 2014).

2.2. Reprioritization of expenditures

The national budget for fiscal year 2014/15 projected a large public spending increase of 27.5 percent in real term from last year's national budget. The bulk of the increase in the budget is in the capital budget, which is projected to increase from 3.31 percent of GDP in fiscal year 2013/14 to 5.35 percent of GDP in fiscal year 2014/15 (Ministry of Finance, 2014).

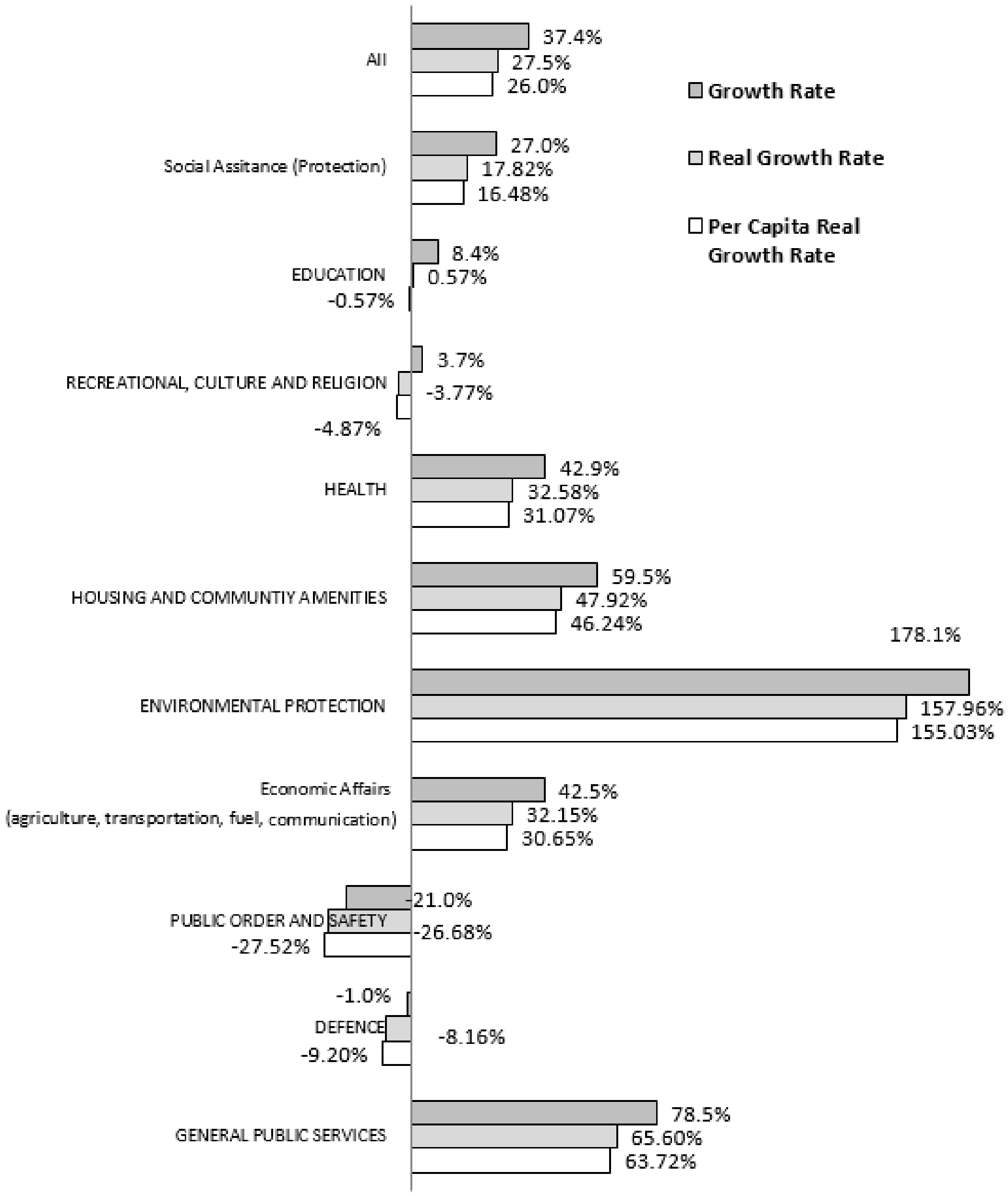
Figure 5: Public Spending as a Percent of Total Spending, Economic Classification, 2014/15



Source: Based on data from Ministry of Finance (2014).

Functional classification of the budget shows that the projected increase in public spending is uneven across the different sectors. Allocation to education is projected to grow at almost half of one percent in real term; which is a negative growth in per capita spending as shown in below figure. In the other hand, allocation to health is slightly higher than the average increase in the overall public spending (Ministry of Finance, 2014).

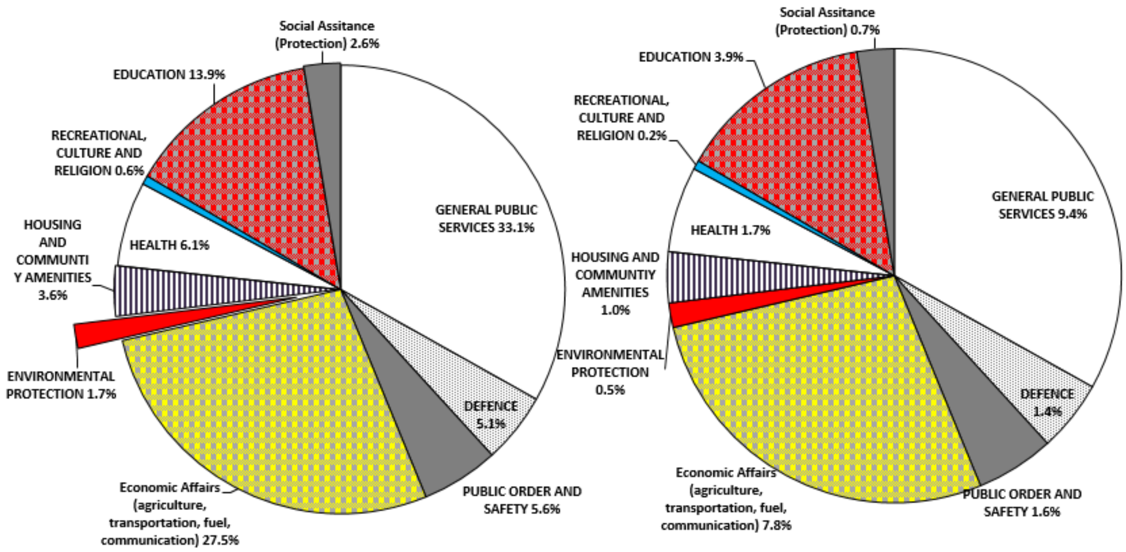
Figure 6: Nominal, Real-Term, and Per Capita Growth Rates in National Budget between Fiscal Year 2013/14 and 2014/15.



Source: Based on data from Ministry of Finance (2014).

Education's share of the overall budget for fiscal year 2014/15 stands at 13.9 percent of the overall public spending (Ministry of Finance, 2014), which represents 3.9 percent of GDP for the same year. It is still below recommended spending of 20 percent of overall spending according to the Education for All Initiative 2000. As for health, the high increase projected is particularly important and needed to account for the low government allocation to health, projected to constitute only 6.1 percent of the overall budget for fiscal year 2014/15 (Ministry of Finance, 2014), which represents only 1.7 percent of GDP for the same year.

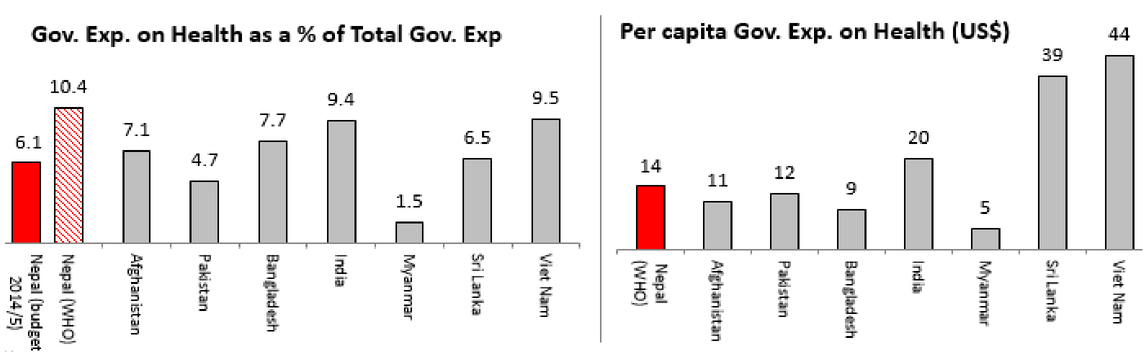
Figure 7: Public Spending Functional Classification as A Percent of Overall Spending and as a Percent of GDP, Fiscal Year 2014/15



Source: Based on data from Ministry of Finance (2014).

Other international sources estimate allocation to health at a higher level. The WHO puts it at about 10.4 percent of the overall budget for 2012 (WHO, 2014). Using the WHO data, Nepal seems to be in line with regional comparators.

Figure 8: Expenditure on Health as a Percent of GDP and in Per Capita USD, 2009[3]



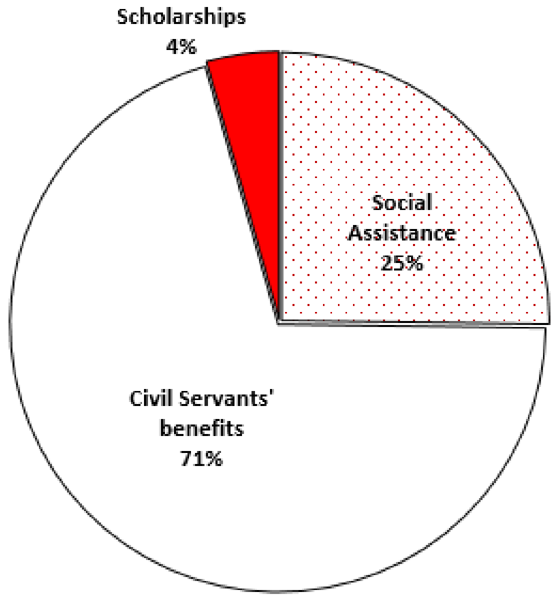
Source: Based on data from Ministry of Finance (2014) and WHO (2014)

Allocation to social protection continues to increase. Fiscal year 2014/5 allocation to social protection is projected to reach to 2.67 percent of GDP as shown in table 2. This is higher than regional average of 2.4 percent of GDP (The World Bank, 2013). However, the bulk of the social protection spending is on formal social security programs to the civil servants. Nevertheless, the social assistance program

[3] Definition of health vary between countries. For comparability, study uses the WHO data, but also includes for Nepal the National budget figure.

increased significantly over the past few years and projected to increase by 17.82 percent in real-term for the fiscal year 2014/15 (Ministry of Finance, 2014).

Figure 9: Distribution of the Social Protection Allocation across the Different Programs, 2014/15.



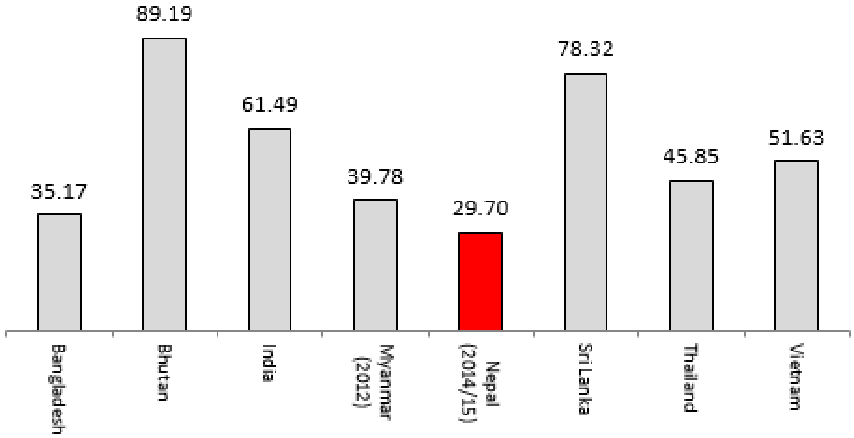
Source: Based on data from Ministry of Finance (2014)

2.3. More accommodating macroeconomic framework

This option entails expansionary fiscal and monetary policy framework. This includes two main instruments: 1- tolerance to higher budget deficit and; 2- higher levels of inflation.

For the first option, budget deficit, Nepal enjoyed over the past couple of years a budget surplus due to improved taxation but also due to low budget execution, especially expenditure on the capital budget. As a result, Nepal enjoys a low public debt projected to decline to only 29.70 percent of GDP by end of fiscal year 2014/5 (Ministry of Finance, 2014), which is half of the ratio of around 60 percent a decade ago (IMF, 2014). It also compares favourably with regional comparators. Given the low public debt in Nepal, the IMF's recent assessment indicates a modest expansion is affordable without endangering debt sustainability.

Figure 10: General Government Gross National Debt as a Percent of GDP, 2013



Source: Based on data from Ministry of Finance (2014) and IMF (2014).

For the second option, higher levels of inflation, this option is limited given the relatively high inflation rates averaged 9.24 percent over the period 2010-1024 (IMF, 2013). It is worth noting that the Nepali rupee's peg to Indian rupee and the close trade relationship with India creates some benefits but also risks. For instance, an IMF econometric analysis finds that the Indian inflation is the key driver of Nepali inflation, with one percent increase in India's inflation leading to 0.45 percent increase in Nepali inflation (IMF, 2014).

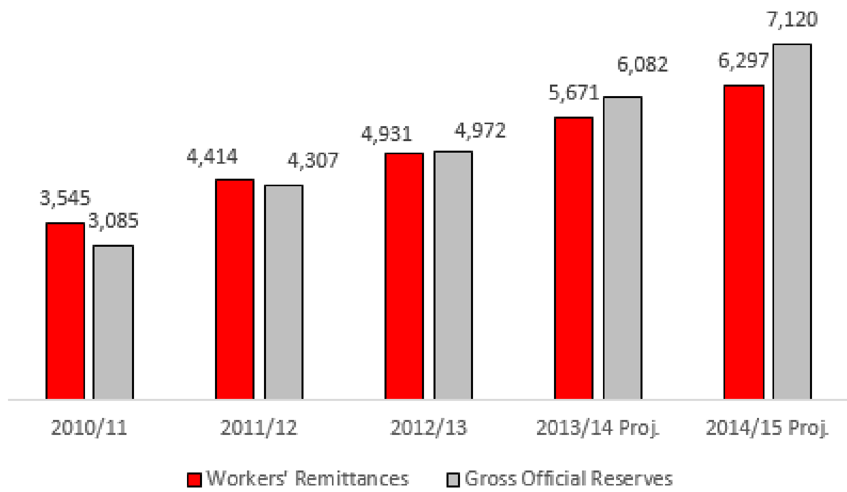
2.4. Using fiscal and central bank foreign exchange reserves

This option includes two main sources: First, fiscal reserves including savings from budget surpluses and other state revenues. Second, foreign exchange reserves in the central bank.

The improved tax/GDP ratio, increased grants to the budget, coupled with low budget execution, especially capital budget have continued to build up budget surpluses discussed earlier. The fiscal year 2014/15 projected a slight budget deficit in the budget in the planned effort to accelerate capital spending discussed earlier.

Foreign exchange reserves are accumulated through foreign exchange market interventions by central banks within the context of current account surpluses and/or capital inflows. Countries build up foreign exchange reserves usually to self-insure against economic and financial shocks and also as part of broader efforts to stabilize the macro-economy, especially exchange rates (Ortiz, Chai, & Cummins, 2011). Continuation of growth in remittance inflows, estimated to have reached about 30 percent of GDP in 2013/14 as compared with only 9 percent of GDP in 2000, has boosted the build-up of Nepal's Net International Reserve, which is currently totalling US$ 5.846 billion as of March 2014 (IMF, 2014).

Figure 11: Workers' Remittances and Gross Official Reserves, Millions USD, 2010/11- 2014/15



Source: Based on data from IMF (2014).

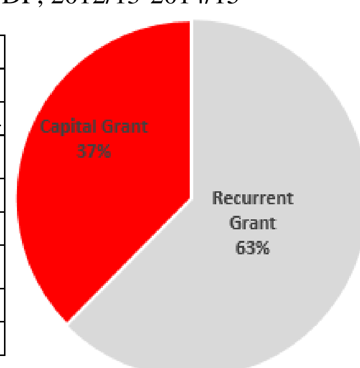
By any measures, the Gross Official reserves are very high. For instance, it covers almost 8.1 months of prospective imports as of March 2014 (IMF, 2014) - significantly higher than the three-month safe level benchmark. The IMF also projected the fiscal reserve to continue to build up, but at a lower rate. With low public debt in Nepal, the government has an ample room to create fiscal space by borrowing form the central bank's reserve to increase public spending.

2.5. Increased aid and transfers

In addition to the remittances inflow discussed earlier, Nepal continues to benefit from inflows of grants. As shown in table 2, grants are projected to amount 3.6 percent of GDP for fiscal year 2014/15. Most of the grants are directed to recurrent spending.

Figure 12: Grants Billion Nepali Rupees (NRs.) and as a Percent of GDP, 2012/13-2014/15[4]

	Billion NRs.			Percent of GDP		
	2012/13	2013/14	2014/15	2012/13	2013/14	2014/15
Total Grants	35.23	47.31	73.39	2.08	2.45	3.36
Grants from Foreign Governments	**16.78**	**24.95**	**31.41**	**0.99**	**1.29**	**1.44**
Recurrent Grant	12.87	16.46	19.47	0.76	0.85	0.89
Capital Grant	3.91	8.49	11.94	0.23	0.44	0.55
Grants from International Organizations	**18.45**	**22.36**	**41.98**	**1.09**	**1.16**	**1.92**
Recurrent Grant	12.18	16.66	26.41	0.72	0.86	1.21
Capital Grant	6.26	5.70	15.57	0.37	0.30	0.71



Source: Based on data from Ministry of Finance (2014)

[4] The budget for fiscal year 2012/13 is actual, for fiscal year 2013/14 is the revised, and for fiscal year 2014/5 is budgeted.

In addition to legal financial flows, curtailing Illicit Financial Flows (IFFs) could also free up additional resources. IFFs involve capital that is illegally earned, transferred or utilized and include, inter alia, traded goods that are mispriced to avoid higher tariffs, wealth funnelled to offshore accounts to evade income taxes and unreported movements of cash (Ortiz, Chai, & Cummins, 2011). A study estimated on average IFFs outflow from Nepal between 2000-2008 to have totalled US$ 563 million annually (Dev Kar & Curcio, 2011), which is about 7.12 percent of GDP over the same period.

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