



— FIVE YEARS OF —  
**GOVERNMENT**



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**FIVE YEARS OF GOVERNMENT**  
A REVIEW



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# Executive Summary

Nepal has never seen a continued period of stability. Internal political strife and external economic shocks has meant that Nepal has always had to deal with both endogenous and exogenous shocks. Whereas during the global financial crisis of 2007/2008, Nepal was able to shield itself from the global downturn, things are much different today. Since the adoption of the new constitution in 2015, a relatively stable (as compared to a decade earlier) environment has meant that Nepal has been able to successfully integrate, although with some shortcomings, with the rest of the world. This has meant that the global economic downturn and the precautionary measure that followed the world over has had visible effects on Nepal as well. Nepal's history is full of both internal and external shocks, to that end it is not possible to provide a comprehensive review of the government in power. We have not attempted to isolate the effects of endogenous and exogenous shocks, rather we attempt to provide an update on the state of the state in Nepal. In doing so, we critically examine policies, actions, and agendas. Our review is limited to a few core areas that are related to economic governance.

The tenure of the outgoing government started on February 2018 i.e. in the middle of the third quarter of a given fiscal year. To that end, the new government was bound by the policies of the old government, and it also inherited the shortcomings of the old one. The new government's tenure started on the backdrop of a relatively modest economy. Growth for the past two years, before the start of the new tenure, had averaged six percent. Reconstruction efforts for the damages done by the earthquake had shown significant effects on Nepal's capital spending, remittances were increasing, foreign investment and commitments were rising, the number of industries registered were showing promising signs and private sector investment as a percentage of GDP too was on an upward trend. The tenure thus started on the backdrop of increasing economic activity and political stability. Some cleavages in the political arena remained, however.

Nepal has had a long history of political instability. Alliances across ideological lines are frequently formed and broken. It has helped that the leaders of almost all well-performing political parties belong to the same upper caste. To that

end, a bargain between the political parties is always a possibility. During the past five years, things have been no different, alliances have been formed and broken. There is however, the risk of the rules being written entirely differently in order to facilitate the bargaining process. In the past five years, the rules of the game have been frequently changed. It should also be noted that preventive measures taken for the Covid-19 pandemic greatly facilitated such change.

Nepal's transition to federalism provided it with an opportunity to pursue bottom-up development. In the past five years, local government and provincial governments have both performed well within the given limitations. Nepal's handling of the Covid-19 crisis was relatively better than the earthquake. In large parts this is because decision making powers had been given to representatives rather than the bureaucracy. Although trust in public institutions has been declining, trust in local level institutions and local level leaders is increasing. There are, however, signs of the federal government frequently trying to take back power. This has either come in the form of action or inaction. In the former case, during the early days of the pandemic, power was given to district offices, a remnant of the old unitary structure. In the latter case, important legislation that needs to be enacted for a successful transition has not been made as of date. Similarly, on a yearly basis more and more funds are being allocated to subnational governments by attaching conditions to them.

From a macroeconomic perspective, Nepal's economy is reliant on the agriculture sector. It is still the highest contributor to the GDP and employs the largest share of the worker. Yet Nepal's agriculture productivity is also some of the lowest in South Asia. Agriculture sector in Nepal has been reliant on exogenous factors such as a good monsoon. Targeted policies that address the structural problems of the agricultural sector such as the shortage of fertilizer on a yearly basis, the fault lines in the agricultural subsidy policy, and the lack of any technological advancement have been missing.

Nepal is also undergoing a stage of premature deindustrialization. The manufacturing sector, after peaking in the 1990s, remains depressed. Policies to address the problems of the sector have been made, yet their implementation remains a crucial challenge. For instance, to equip workers with the skills required, the government in fiscal year 2020/21 made a policy to change the curriculum of the current technical and vocational education being provided, it has however, failed to achieve its desired goals. Precautionary measures also had an impact on the sector; however, its recovery was quicker. With increased electricity generation, the manufacturing sector has seen some growth in the past five years, yet fundamental problems remain unaddressed. Neither the

policy to produce goods in Nepal, nor a policy to promote self sufficiency have had any impact. Special economic zones and industrial pockets too have failed to achieve the desired goals.

On the demand side, consumption has been fueled by remittance. Remittance has increased significantly. Outward labor migration had been on a declining trend, however, since fiscal year 2020/21, it has sharply increased signaling the lack of job opportunities in Nepal. While remittance earning has most notably improved the living standard of many and lifted many households out of poverty, it has also led to a lack of incentives to create job opportunities within Nepal.

On a yearly basis, Nepal has also been able to reduce its fiscal deficit to less than 3 percent of the GDP. This, however, is not because of fiscal prudence or proper planning. Since expenditure in Nepal is lower than revenue collection, fiscal deficit is within control. Revenue mobilization in Nepal has remained strong, except for the fiscal year 2022/23. In the past five years, the government has exceeded its revenue collection target on all fiscal years except 2022/23. There is however the risk of over-dependence on import tariffs. A large portion of revenue gets collected at the customs point. Nepal is also among the countries to have the highest tariff rate. Additionally, the tariff structure also promotes import of finished goods rather than raw materials required for production. Although government policy is to promote self sufficiency and domestic production, a holistic approach to Nepal's manufacturing sector remains missing, the revenue base too stands on shaky grounds.

In terms of government spending, things have remained the same. Expenditure has been bunched to the final quarter of the fiscal year and fiscal management reforms remain inadequate. Budgetary process in Nepal has lacked both transparency and active participation, additionally it has also remained highly optimistic often leading to budgets being downsized. Parliamentary engagement in the budgetary processes too has remained weak. Some reforms have started to show effects. In the past five years, the amount of virements and irregularities has been on a declining trend, at least for the federal government. Line Ministry Budget Management system has been improving, other reforms have not been initiated. In terms of the actual plans and policies, on a yearly basis at least three plans are repeated under each sector, their implementation status and ex-post evaluation is never initiated.

When taking a comparative perspective of the first federal government's tenure against previous government's things have remained the same. Although the fiscal architecture of Nepal has changed and the country has transitioned into a federal state, the underlying structure remains unchanged. Making

a structural transformation and achieving the goals envisioned in the 15th periodic plan require urgent reform. Political stability in Nepal may be a distant dream, however, policy stability and bureaucratic changes remain a possibility in Nepal. Reforms in the agricultural sector and manufacturing sector hold the key for achieving south Asian convergence for Nepal. Similarly, Nepal's tax code especially value added tax laws need revision, a diversified revenue mix is also required. Our planning processes have been heavily based on extrapolation, it also does not consider the use of metrics for project identification and project selection. Reforms in our planning process, especially rule-based selection of project, are required. This must also be supplemented by changes to the current procurement policy which are based on least cost evaluation. The bureaucracy too lacks any reward and punishment mechanism. Although performance contracts have been used at higher echelons, an effective evaluation mechanism is missing.

## CHAPTER ONE

## The context of the review

Following a successful departure from the previously unitary state of government and a monarchical form of governance, the 2015 Constitution of Nepal restructures the government into three tiers of government and explicitly rests sovereignty in the hands of the people. The constitution itself is the result of several events in the history of Nepal including but not limited to the Civil war, the people's movement, and the Madhesh Andolan. It is also a result of constant bargaining between and within political parties of Nepal. Although unsuccessful in completely fulfilling the aspirations of all the parties involved in the making of the constitution, it is unique in the sense that it is the first constitution to be drafted by the people's representative and is accepted albeit critically. Its broader context is one of shifting balance of power between the political parties, the geopolitical nature of being between two of the largest economies i.e., India and China, and the institutional cleavages of state-enforced caste hierarchy.

Notwithstanding, the criticisms of the current Constitution of Nepal and any cleavages that remain in the form of state-enforced caste hierarchy, the Constitution of Nepal is a reimagination of the future trajectory of Nepal with a focus on the elusive quest for prosperity that remains undefined. One need not look any further than the directive principles, policies, and obligations of the state to determine that the imagination of the future trajectory is heavily reliant on multi-party democracy, rule of law, transparency, and private sector participation. The themes are merely expansions of the terminology "governance" that has been used so widely to stress the importance of rule of law, transparency, and private sector participation for achieving sustainable development.

The future trajectory of Nepal, therefore, outlined in both the constitution of Nepal in its preamble and through the periodic plans, is reliant on economic governance. It is also a matter of progressive realization that each successive government needs to work on and build on. Yet, as is so often true in Nepal, plans fail first due to their highly optimistic nature and second due to challenges in the implementation. To that end, this report is a modest attempt to analyze the past five years being restricted to key sectors that have been identified as being important for economic governance. Our analysis is limited to past achievements

and ongoing plans, it does not aim to establish any causal linkages, neither does it provide any definitive view of the future trajectory. Our analysis is only based on the past five years, although in doing so we provide data spanning more than five years to establish trends and more appropriately to give some context to our review. By the past five years we mean fiscal years 2018/19, 2019/20, 2020/21, 2021/22 and 2022/23. It must also be noted however that the current fiscal year 2022/23 has not been completed. To that end we only provide our analysis based on the first six months of the current fiscal year 2022/23, in some instances where the appropriate data is not available, we limit our analysis to fiscal year 2021/22.

It is also worth noting that the venture we have undertaken is a difficult one. Nepal has never seen a period of continued stability. Throughout its history, at least since the beginning of the practice of multi-party democracy in Nepal, there have been both internal and external shocks that have prevented the smooth functioning of both the government and the bureaucratic apparatus. First there was the civil war, then there was the backlog in framing the constitution, then there was the earthquake, then the Economic blockade and finally the Pandemic. In the past 20 years, no government has been able to complete its tenure without the happening of a certain event that has fundamentally affected the trajectory of the country, it is also the reason why plans have failed in Nepal. To that end, any attempt at a comprehensive review is flawed in so far as the existence of shocks and its effect on the functioning of the government is concerned. It is not possible to state with certainty whether a certain event has affected the functioning or whether institutions themselves are structured in such a way that they lack the capacity to respond to both internal and external events.

Notwithstanding the fatal flaw of taking on the task of a comprehensive review, a review is nonetheless required. The importance of analyzing achievements and failures is far more pronounced than the flaw itself. Our attempt here therefore has been to be mindful of the context in which we operate when reviewing certain select categories of economic governance.

Our review is based on secondary data sources available from periodic reports produced by the government of Nepal. We rely heavily on quarterly data released by the CBS and yearly data released by the financial comptroller general's office. Secondly, the report relies on key informant interviews and finally, the report draws extensively from literature on the history of Government spending in Nepal, Public expenditure review and Taxation policy.

We first begin by providing a summary of the global economy and the world economic outlook moving forward. To a certain extent, the global trends help

explain, Nepal's trend for the past five years and therefore it is worth mentioning albeit as a passing commentary. We then outline the political context in which the country has operated, highlighting the major events that have shaped the past five years. We then proceed to provide a review of the fiscal side of things before finally, highlighting plans, policies, and priorities of the last five years.



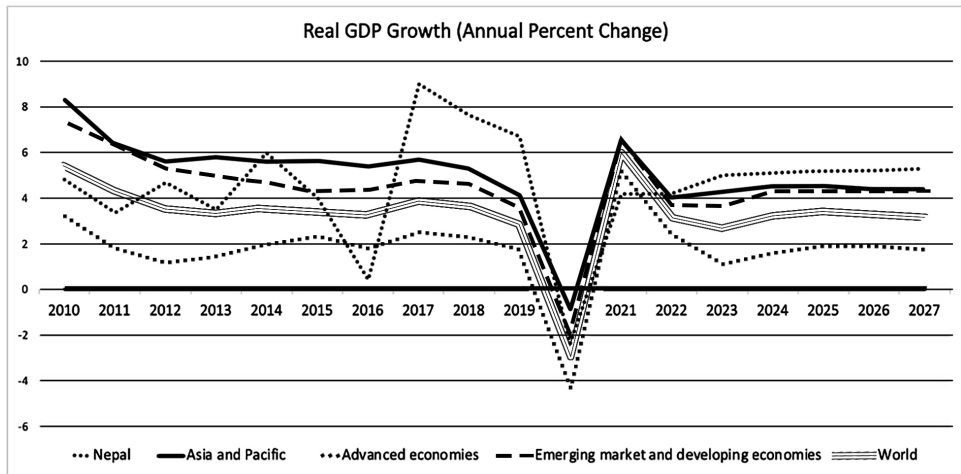
## CHAPTER TWO

## Global Context: Economic development and World economic Overview

Prior to the pandemic, the global economy was in a phase of prosperity and expansion with growing wages and falling unemployment rates. The International Monetary Fund (IMF, 2019) estimates that the world economy expanded at a 3.6% annual rate in 2019 which was a slight downturn than the growth rate of 3.7% in 2018. The global economy did, however, face significant difficulties before the pandemic. The persistent trade conflicts between important economies like the United States and China were one of these difficulties. Tariffs on goods imported from these nations, disrupted international trade and economic growth. The trade conflict between China and the United States also impacted Asian countries to some extent, as the regional growth rate was projected to slow down from 5.9% in 2018 to 5.4% in 2019 (Victoria, 2019).

The onslaught of the Covid-19 pandemic and the precautions taken to stop the virus's spread had a substantial influence on the global economy, causing economic downturns and recessions in numerous countries. Lockdowns, travel bans, and other restrictions interrupted supply chains and economic activity, resulting in job losses and decreased salaries. The pandemic's effects have been particularly severe in industries including tourism, hospitality, and retail. Countries closed their borders hampering commerce and transit systems resulting in workforce shortages at manufacturing facilities, distribution centers, and logistics hubs, disrupting the supply chain. Due to the adverse impact of COVID-19 on food production, some countries-imposed trade restrictions on food product exports and imports to meet domestic needs.

The growth projections of the world were expected to be a negative 4 percent. Advanced economies were estimated to negative 4.4 percent while that of Asian economies were expected to grow at a negative 0.9 percent as per the International Monetary Fund (2022).

**Figure 2.1 Real GDP Growth rate**

Source: IMF, 2022

After reaching historic lows in the year 2020, investments rebounded in the year 2021, increasing 49% in comparison to 2020. However, the overall commitments are still 12 percent below the pre-pandemic levels showing that the private sector is yet to fully recover from the recession induced by the COVID-19 pandemic.

The highest increase in private investment commitments were seen in Europe and Central Asia. \$15 billion in commitments were made in the region in 2021, a 400% increase from 2020 and twice the five-year average. A \$8 billion airport concession in Antalya, Turkey and a public-private partnership program in Uzbekistan contributed to the commitment of \$2.2 billion across five projects were significant contributors to this rise. But the crisis in Ukraine has now dimmed the outlook for infrastructure development in the area. Similarly, East Asia Pacific produced the greatest total commitment of \$28.1 billion, a 69% increase over 2020, while Europe and Central Asia showed the largest percentage rise in private sector commitments whereas Latin America and the Caribbean reported an increase in commitments of 22%, amounting to \$18.6 billion. Brazil took the lead in the region's recovery. In other regions, such as the Middle East and North Africa, South Asia, and Sub-Saharan Africa, private investment commitments fell by 90%, 17%, and 16% respectively.

Despite COVID-19's effects, the distribution of funding across public, private, and DFI sources was substantially unchanged. In 2021, infrastructure projects

remained heavily reliant on debt, raising a total of US\$13.6 billion in debt, or 64% of projects for which complete financing information was available. PPI projects received 63% of their funding from private sources. 18% more came from government sources, and 19% from organizations that provide development and export financing (DFI).

Government investment as a percentage of government spending can be seen declining. Government investment decreased from 9.3% of total government spending in 2007 to 8.1% in 2019 on average across the OECD nations. In 21 of the 36 OECD countries during the time of pandemic, investment as a percentage of total government spending decreased. Government investment averaged 3.3% of GDP across OECD countries in 2019, ranging from 1.3% of GDP in Mexico to 6.3% of GDP in Hungary. Five out of the ten governments spending the largest proportion of GDP on investment were Eastern European countries, partly as a result of EU structural funds.

The decrease in government investment as a percentage of total government spending could be a result of an increase in government spending on income support programs and other COVID-19 actions. In 2020, government investment relative to GDP increased in 25 of the 26 OECD countries. This may reflect investment in response to COVID-19, or it may be the result of GDP falling more quickly than investment in 2020.

The proportion of investment expenditure that was managed by the central government increased between 2019 and 2020 in 20 of the 27 OECD countries for which data are available. The distribution of investment spending throughout governmental levels differs significantly for federal and non-federal countries. 2019 saw national governments account for 40% of all government investments, followed by state and municipal governments, each of which contributed 30%. However, only 9 of the 37 OECD countries have state governments that allocate funds for investment. In 20 of the 35 OECD countries, the central government was responsible for more than 50% of all public investment.

In contrast, South Asian governments, on average, had a very less share in investment. Despite the overall low level of public spending as a share of GDP as a result of the COVID-19 pandemic, social sectors such as education and health were considered a priority. Education is typically the one receiving the most public funding in the region. All countries allocate over 10 per cent of the government budget to education expenditures (in Bhutan, the share exceeds 20 per cent), and the regional average is around 15 per cent (against 7 per cent for health). Both South Asia's regional average and its countries considered individually are close to the lower limit of or below recommended expenditure.

Government expenditures on education across South Asia have evolved since 2005. Education spending as a share of GDP has increased since circa 2010 in Afghanistan, Bhutan, Nepal, Pakistan and Sri Lanka. Meanwhile, it has decreased in Bangladesh and Maldives. In Maldives and Bangladesh, for example, GDP has increased significantly between 2010 and the latest available year for which data is available. This means that even though education expenditure as a share of GDP has decreased, the actual allocation of funds for education has increased in real terms. Data for India suggest a slight increase in public spending on education since circa 2005 (from 3.3 percent to 3.8 percent of GDP).

Throughout the world, governments have found it vital to boost resistance to turbulence in the world's financial systems and remove obstacles to potential output development. For instance, in the Philippines, trade and regulatory reforms aimed at raising agricultural productivity and competitiveness, and expanding economic opportunities in farming, were introduced. It helped the government increase investments that support market linkages and market-oriented value chain development to increase business viability and support private sector participation. Work to improve the production and aggregation of safe and quality agricultural products and facilitate linkages between high-value agriculture products and their corresponding global markets was done.

Similarly, governments throughout the world understood the importance of digital transactions and prioritized developing infrastructures for the same. The Asian Development Bank is working with the Cambodian Federation of Employers and Business Associations and training facilities in Singapore to enhance the standard of skills training and integrate digital skills into technical and vocational education and training programs in Cambodia (Baradas, 2022). Similarly, the Indonesian government took measures to reduce the economic strain the pandemic imposed on the businesses. By the end of 2020, the government aims to digitize 10 million MSMEs. Likewise, the ASEAN Coordinating Committee on Micro, Small, and Medium Enterprises initiated Go Digital ASEAN: Digital skills to address the economic impact of COVID-19, with the goal of promoting regional cooperation and equipping MSMEs with the necessary ICT skills to succeed in the region's digital economy.

The appropriate policy response to the economic crisis caused by the pandemic can be determined by the nature of the shocks created. However, COVID-19 caused both demand and supply shock (Ferreira, 2020). People spent less money while governments, on the other hand, imposed restrictions on business activities, so that even for those customers who needed goods and services, supply was artificially reduced. So, a policy for providing financial assistance

was adopted by the majority of the governments. Financial assistance aimed at keeping everyone afloat during the most difficult months, avoiding mass bankruptcies and severe poverty. Advanced countries were very active in proposing programs to firms, ranging from low-interest credit lines to direct assistance. Individuals received direct transfers from governments as well, and developing countries tended to place a greater emphasis on this type of policy (Ferreira, 2020).

Nepal is not immune to global trajectories and trends. Although, during the 2008/09 financial crisis, minimal effects were felt, a continued period of political stability has meant that internal markets have been able to connect with global markets. Moreover, research from NRB shows that Nepal borrows its inflation heavily from Indian markets given India's status as Nepal's largest trading partner. The effects of pandemic were pronounced worldwide, Nepal was not immune to this. Increasing transportation and freight costs during the earlier days led to an increase in inflation rate. After the Ukraine-Russia war broke out, the effects became more apparent. Although, Nepal does not trade significantly with either Russia or Ukraine, increase in fuel prices, metal and mineral prices as a result of war was expected to push inflation and increase current account deficit. Much of the increase in inflation during the latter half of fiscal year 2021/22 came from indirect effects of the war as fuel and transportation costs increased significantly. Similarly, demand and supply shocks induced by the covid-19 pandemic also meant that both foreign investment and development assistance to Nepal would be slightly lower than projected, effecting development projects and proposed plans. Despite the global scenario however, Nepal made a quick recovery, indeed this was helped by vaccine rollouts and lower infection rates than its southern counterparts. Recovery in both the manufacturing sector and the service sector was quick and helped by government packages that included waiver of fees and fines, a commitment to contribute to employer's share of social security, reduction in customs (for selected products), refinancing facility and waiver on taxes. It is also worth noting that Nepal's comfortable debt to GDP ratio shielded it from any additional fiscal burdens owing to recovery measures.

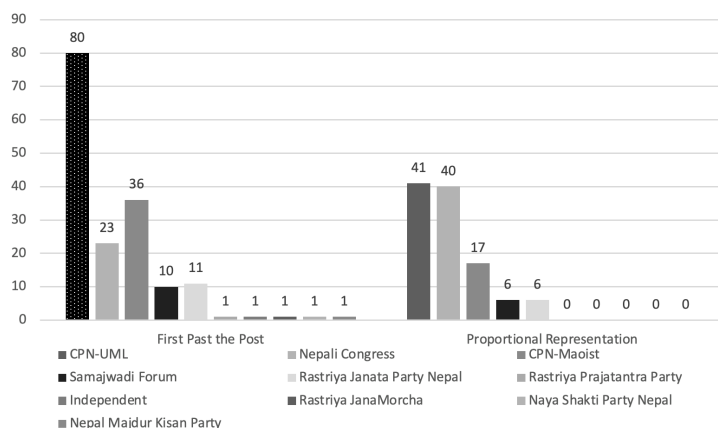


## CHAPTER THREE

## The Political context

After the successful restructuring, general elections on all three levels were held in 2017 with the participation of 48 political parties (Election Commission of Nepal, 2017). The Communist Party of Nepal – United Marxist Leninist (UML) and the Communist Party of Nepal – Maoist (CPN-Maoist) contested the election forming an alliance in which the UML won majority seats (Figure 3.1).

*Figure 3.1: Election Results, 2017*



Source: Election Commission of Nepal

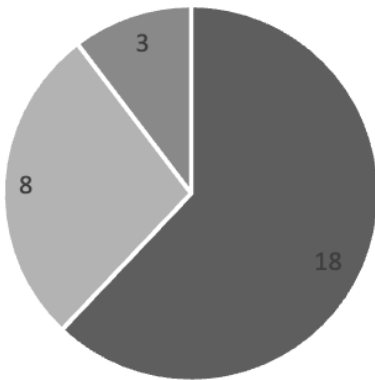
The leader of CPN-UML, KP Sharma Oli, with the support of CPN-Maoist became the Prime Minister of Nepal under article 76(2) of the Constitution of Nepal. Oli government started its tenure from February of 2018 (THT Online, 2018) with 17 ministries under its cabinet which was later increased to 22 plus 3 state ministers after the merger of CPN-Maoist with UML. The merger established a new party named “Nepal Communist Party” where both party leaders agreed to share equal power by forming a nine-member secretariat along with a 441 member Central Committee (221 from the UML and 200 from the Maoist center) and a 45 member Standing Committee (25 members from UML and 18 from the Maoist Centre) (Ranjan & Gurung, 2021). The alliance was supported by the Federal Socialist Forum – Nepal (FSF-N) (THT Online, 2018), Samajbadi Party,

Nepal and People’s Progressive Party, Nepal.

However, the Nepal Communist Party, was later split into two following a supreme court verdict. After nearly three years the supreme court decided that the election commission’s decision to legitimize the merger between the two parties and award the name of Nepal Communist party was illegitimate. The name had already been registered by Rishiram Kattel and following a petition from Kattel, the party was eventually split and reinstated to its pre-merger status (Pradhan, Supreme Court awards Nepal Communist Party to Rishiram Kattel, 2021). The decision came at an opportune time, following infighting among the two-party leaders, the split opened possibilities for a different coalition government to take charge of the government, as was later the case.

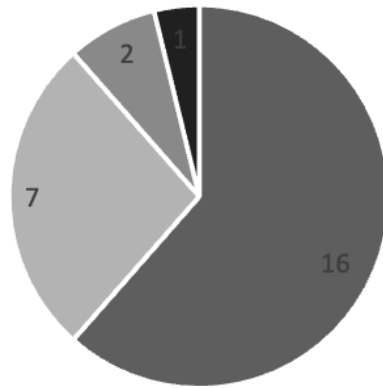
During the tenure of Oli government, the cabinet had been reshuffled (Online Khabar, 2020) multiple times and major ministries such as defense, finance, etc. faced changes in the leadership (Figure 3.2 and 3.3). A major ministerial reshuffle took place in December 2020, when ministers protested Oli’s move to dissolve the House of Representatives.

**Figure 3.2 Number of Ministers as per Party, Number of ministries by party, Feb 2018 - Nov 2019**

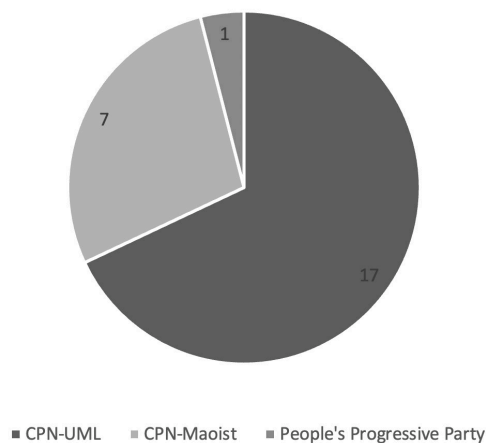


- CPN- UML
- CPN-Maoist
- Samajwadi Party, Nepal

**Figure 3.3, Number of ministries by party, Nov 2019-October, 2020**



- CPN-UML
- CPN-Maoist
- Samajwadi Party, Nepal
- People's Progressive Party

**Figure 3.4 Number of Ministries by party October 2020-December, 2020**

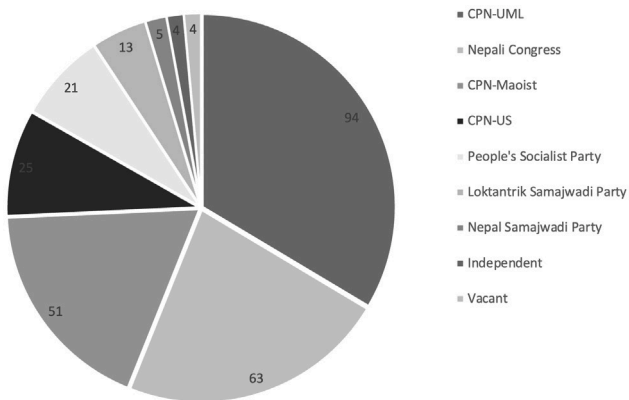
With the alliance of two biggest communist factions, even the northern neighbor, China, was very interested in the domestic politics. The Communist Party of China had conducted a virtual symposium for the majority party where the communist leaders shared their experience of running the country (The Kathmandu Post, 2020).

Despite having the majority government, the power tussle within the communist party did not end as Oli and Prachanda started disagreeing on their agreed points. Disputes also arose within members of the original CPN-UML. Frequent tensions between party leaders Dahal and Oli, and central committee members ultimately led to the formation of a new party, the Communist Party of Nepal – Unified Socialist (CPN-US) led by former UML leaders Madhav Kumar Nepal and Jhalanath Khanal.

After the elections, the majority leaders, KP Oli and Pushpa Kamal Dahal (Prachanda) had entered into an agreement that KP Oli would be the prime minister while Prachanda would be the party chair. However, the tussle between both leaders regarding their agreement led to in-party conflict among the leaders and co-leaders. The rival faction within the Nepal Communist Party accused KP Oli of not abiding by the party decisions and demanded for his step down. The House Speaker, being the member of the rival faction of the largest party, missed the constitutional council meetings resulting in the then prime minister KP Oli to issue an ordinance with proposed amendments that constitution council members can hold meetings with the majority (The Kathmandu Post, 2020). Prior to this, the Oli government had issued an

ordinance suggesting amendments to the Constitutional Council Act which the government was forced to rescind. However, in this case, because of the in-party conflict and miniscule support within the party for the ordinance, Oli by calling a cabinet meeting decided to recommend for parliament dissolution (The Kathmandu Post, 2020).

**Figure 3.5: Number of parliamentarians by party**



Source: Election Commission of Nepal

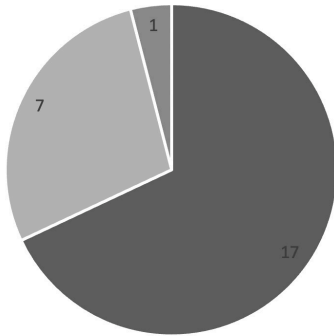
Soon after the parliament was dissolved Oli government decided on announcing the dates for the election, but the Supreme Court decided the house dissolution as void and unconstitutional. With the parliament reinstated, Oli repeatedly expressed his discontent with the parliament citing that the parliament was creating hurdles for the government to perform its duties. During this chaos, in May, Oli decided to hold a vote of confidence, where majority of the parliamentarians was skeptic regarding his leadership thus, declaring their no confidence with Oli (Online Khabar, 2021).

However, the president reappointed Oli to the post as he was the leader of the majority party, but this meant he had to go through another vote of confidence. The President then, declared that a candidate should claim the position of the Prime Minister with the evidence of majority support behind him/her. Both Oli and the opposition leader, Sher Bahadur Deuba, claimed the position with Oli providing a list of 153 parliamentarians while Deuba submitting the list of 149 parliamentarians. With claims from two candidates, the president rejected both the claims and once again dissolved the parliament and reappointed Oli as the prime minister until the election day. However, in the month of July, the

Supreme Court declared the president’s decision to dissolve the parliament as unlawful and ordered appointment of Sher Bahadur Deuba as prime minister for the remaining term (The Kathmandu Post, 2021).

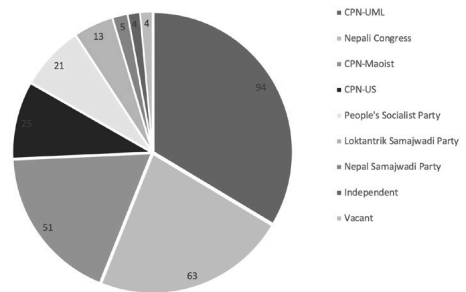
Both the Maoist center and the unified socialists formed an alliance to go against Oli’s decision of house dissolution and to further support Deuba (Leader of Nepali Congress) to be appointed as the Prime Minister. The alliance ultimately led the government for the remaining tenure, even contesting the local elections and the federal parliamentary elections under a power sharing arrangement.

**Figure 3.6: Number of ministries by party June 2021-till date**



■ CPN-UML ■ CPN-Maoist ■ People's Progressive Party

**Figure 3.7: Number of Ministries by party, June 2021**



■ CPN-UML  
 ■ Nepali Congress  
 ■ CPN-Maoist  
 ■ CPN-US  
 ■ People's Socialist Party  
 ■ Loktantrik Samajwadi Party  
 ■ Nepal Samajwadi Party  
 ■ Independent  
 ■ Vacant

Figure 3.8: Political Timeline

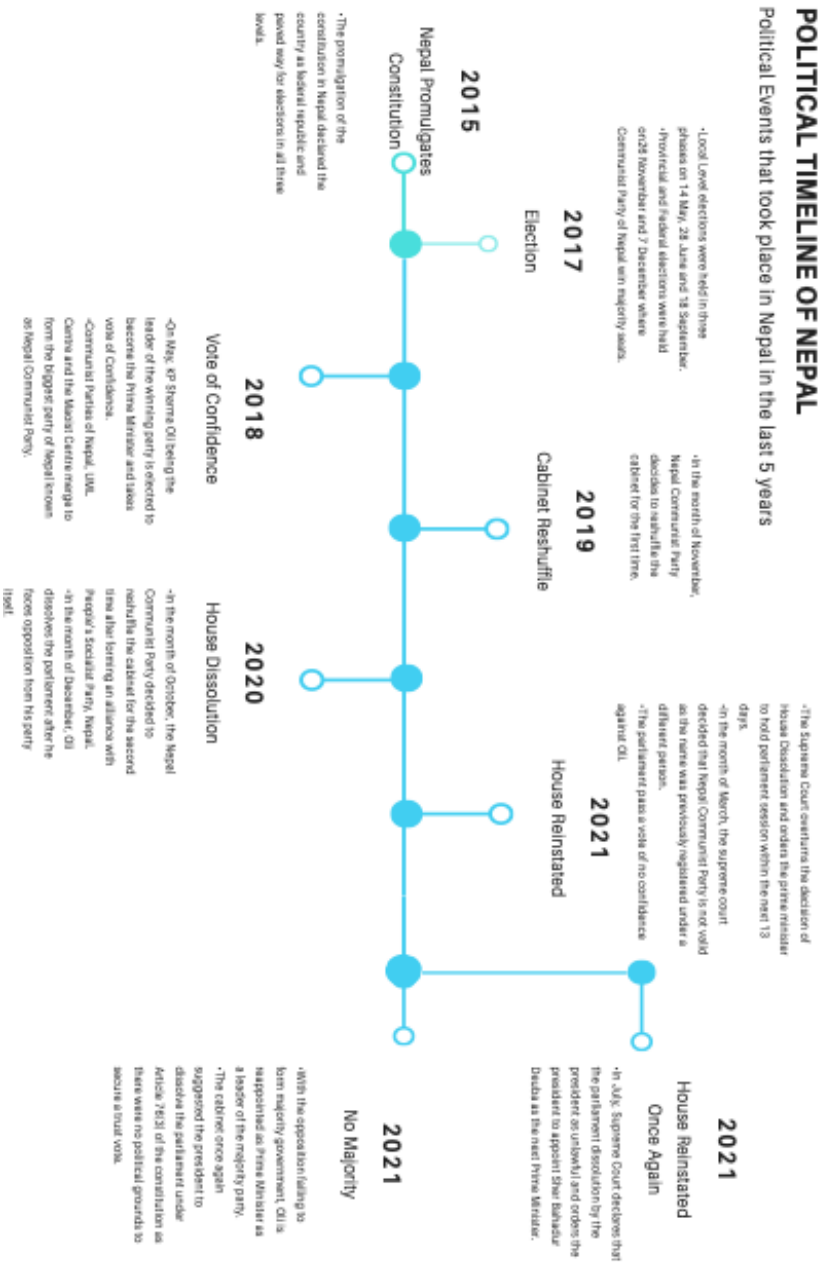
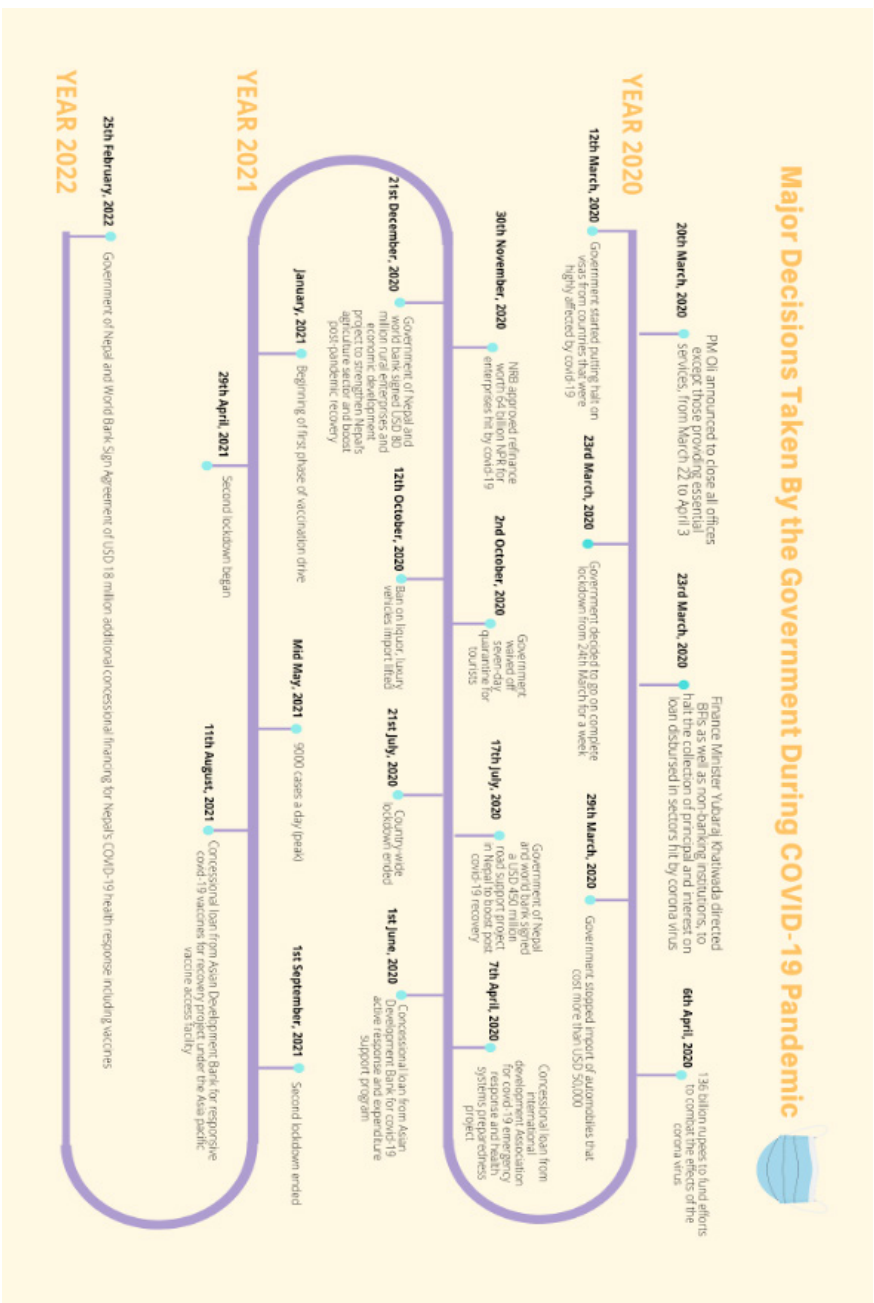


Figure 3.9: Major developments during Covid-19





## CHAPTER FOUR

## A quick note on Covid -19 and Government measures

The advent of COVID-19 pandemic took place during the tenure of Oli government with the then government taking decisions that highly impacted the economy. The government had initiated repeated border control measures and restricted economic activity to control the spread of the pandemic in the country. This decision to implement the first lockdown came at a time when the country had only two confirmed cases (Sharma, Banstola, & Parajuli, 2021) which negatively impacted the economy as the projected economy growth rate fell to 2.28 percent (Nepal Rastra Bank, 2020) from the expected growth rate of 8 percent.

As per the survey report of Nepal Rastra Bank, only 4 percent of the total enterprises (surveyed) were in full operation during the lockdown period, 35 percent were operating partially while 61 percent were not operating at all resulting in job loss of 22.5 percent. The survey report further suggests that hotel and restaurants, real estate along with transportation and storage services were highly impacted because of the lockdown whereas production from manufacturing sector decreased by approximately 73.8 percent because of which majority of businesses were required to take loans and refinancing services offered by the banks. Even after the lockdown the industries surveyed by the Nepal Rastra Bank reported inability to operate at maximum capacity. The industries suggested they were operating at 60 percent capacity even after the restrictions were lifted.

To a large degree Nepal's federal structure helped manage the pandemic. Major decision taking powers were in the hands of local and provincial governments. Unlike the earthquake where a majority of the decision was taken by the bureaucracy, direct representatives of the people in the form of parliamentary assembly members and local assembly members took charge. Local and provincial governments were at the fore front taking responsibility and accountability for their administrative regions as well as disseminating information published by the federal government in their local languages (Thapa, 2021) whereas the federal government was in charge of making nationwide policies such as travel and trade related policies, including repatriation of migrant workers stranded

abroad.

Additionally, provincial governments and local governments relied on bottom-up structures. For instance local governments relied on Tole Sudhar Samitis (small groups that exist at the ward level) for information on the number of people infected within a particular local government jurisdiction. Provincial governments structured their response to align with local government needs by establishing a clear channel of communication between the local government and the Ministry of Social Development at the provincial level. Instead of relying on specialized committees, as was the case with the federal government, local and provincial governments made use of already existing structures which were either used for the formulation of budget or to respond to disasters under the Disaster and Risk Management Act.

At the early stages of the pandemic, the federal government was hesitant to devolve the decision-making power to the subnational governments thus making it inefficient in handling the pandemic. The federal government took charge regarding distribution of test kits to the local and provincial governments resulting in delayed procurement process of test kits and its disbursement. Also, majority of the COVID-19 tests that were carried out had to be handed over to the federal government resulting in delay of results (Gautam, 2020 as cited in Thapa, 2021). However, the federal government eventually gave authority to the local and provincial governments as well as the private sector that significantly increased the number of tests done by the population.

*Figure 4.1: Covid 19 cases*

#### Nepal Situation

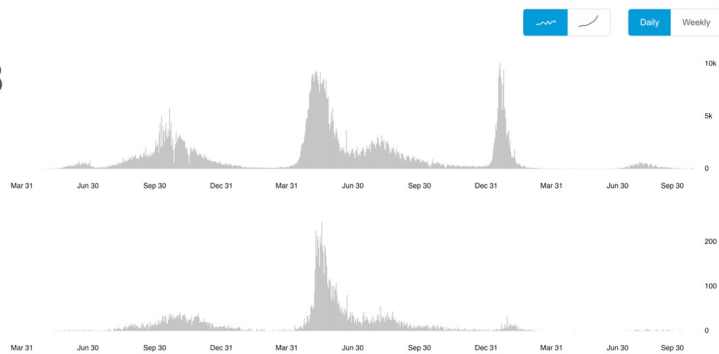
**1,000,078**

confirmed cases

**12,018**

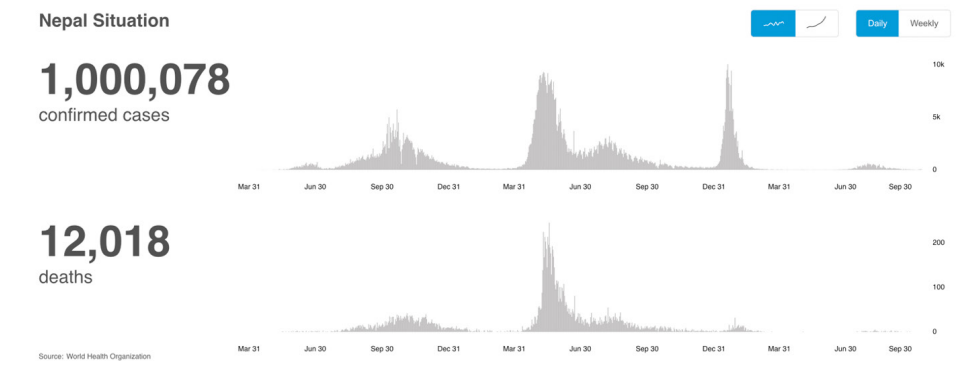
deaths

Source: World Health Organization



Likewise, quarantine infrastructures prepared by the government were subpar and did not meet the standards set by the World Health Organization (Maskey & Pandey, 2021). The absence of adequate human resources and health infrastructures at the quarantine facilities led to increase in COVID-19 cases in the country (Dhungana, 2020) thus, making the governments to request the general public to self-isolate. Additionally, government hospitals were also ill-equipped to treat patients infected with the virus as the doctors lacked proper safety equipment and had stopped treating of general patients during this time (Thapa, 2021).

**Figure 4.2 Vaccination status**



To reduce the impact of the pandemic, the government started vaccination campaigns with the beginning of 2021 (ibid.). Additionally, the government provided immediate relief program, economic support measures, and liquidity support measures through its fiscal and monetary policies (World Bank, 2020 as cited in Dangol, Chitrakar, & Yoo, 2020) as well as by taking support from the developing partners. As of mid-June 2022, a total of 140 enterprises affected from the pandemic has taken refinance facilities worth NRs. 1.8 billion provided by the banks (Nepal Rastra Bank, 2022). Similarly, the Ministry of Finance's Aid Management Information System portal discloses that till 2021 the government has received assistances of \$811 million while the commitment of assistance is \$936 million.



## CHAPTER FIVE

## Some Observations on Nepal's Federal Transition

The groundbreaking work of Douglas North (1991) and Acemoglu and Robinson (2012) stresses the importance of institutions both economic and political. For development to be both possible and sustainable one needs to have an institutional setting that is conducive to economic growth or more appropriately a shared vision of economic growth. Institutions are merely a set of norms or values and the rules of the game that underpin state functioning and economy. They are both enablers and constraints in the sense that they are organizational structures that follow from common norms and values which by way of extension are merely reflections of the norms and values that society at large holds. The set of institutional values and norms are what drive political outcomes or more appropriately an elite bargain leading to a political settlement. Consider for instance, the comprehensive accord, as Dercon (2022) puts it, it was only possible because a majority of leading positions in politics and the economy were held by two upper castes or the two elites. That the then monarch King Gyanendra's drastic actions led to the political parties coming together should then not be surprising, since an elite deal was always possible. Political party mechanisms to that end also mirrored the underlying structures of the society. Yet, having a mechanism for an elite deal to transpire is not enough. For development to take place, a country needs both a mechanism for political settlement to happen and a common shared vision. The vision need not entirely be fleshed out, yet there is a need for broader commitment for the same.

In the past five years, there have been hints at a broader commitment. This came in the form of a strong focus on poverty reduction, in which Nepal has done considerably better. In the time frame of five years (2014-2019), multi-dimensionally poverty index has gone from 30.1 percent to 17.4 percent. Projections suggest that Nepal is on its track to attain its commitment to Agenda 2030. Broader commitments on the need for development and the modality of said development are crucially missing. Whereas countries in the South Asian region more particularly, India and Bangladesh have been able to reach a broad consensus on the need for development and its modality, Nepal still has not been able to do so. In India the broad consensus is market led growth, with the Bharatiya Janata Party government now building on the liberalization

era reforms of the Indian National Congress government, in Bangladesh, the consensus was export-led development in labor-intensive sectors since the 1980s.

On a much more positive note, there have been instances in the past five years when it seemed possible for ruling elites to carve out a broader commitment to development. Indeed, the five-year periodic plan does lay-out the importance of private-sector led development and the Constitution of Nepal in its preamble imagines socialism based on democratic norms to build a prosperous nation. But as Dr. Baburam Bhattarai, noted in its speech in the parliament, Nepal needs to work on the definition of socialism based on democratic norms and the vision that it shares for prosperity. On a broader context, there is even resistance to already agreed mechanism of governance i.e., federalism. As preceding sections noted, there was a defined resistance to handover decision making power for Covid-19 response to local and provincial governments. Instead, earlier structures for covid-19 relied on central governance whether it be the High-level Co-ordination Committee for prevention and control of Covid-19 during the earlier days or Covid-19 Crisis Management Coordination center, both of which had minimal participation form local and provincial governments. If it weren't for a strong resistance from both the local governments and provincial governments, handling of the pandemic would have been akin to handling of the earthquake.

At the same time, there has been a significant effort to legally roll back provincial powers. In the fiscal year 2022/23, two legislations were enacted with the same effect. The first is the amendment to Nepal police and Provincial Police act. Per the amendment, the federal government is given a complete right to oversee peace and security matters of three districts i.e. Kathmandu, Bhaktapur and Lalitpur through the Nepal Police force. The second is the Metropolitan City Transportation Authority act, which envisages the concept of Federal Capital Districts, previously missing from any legislation. The act gives powers to the provincial governments to establish a transport authority to oversee public transportation system, however, for the three districts i.e. Kathmandu, Bhaktapur and Lalitpur, a Federal Capital City Transportation Authority will be established, the structure of the authority itself has very little provincial representation. Indeed, it is not uncommon in a federal governance system for the central government to have federal territories, yet such territories are part of the earlier negotiations. In Nepal, however, such territories were never imagined, to that end, any subsequent developments in that regard must be seen as a sign of conflicting ideas about the entire governance system. In fact, when the bill on Metropolitan City Transport Authority was first registered in the

National assembly, there was dissent within the ruling coalition of CPN-UML and CPN-Maoist center. Members of the Maoist-Center had vehemently opposed the initial design of the bill. As a result, some changes were made to ensure that some form of provincial participation is ensured within the architecture of the Authority.

Elite capture within Nepal's politics has come out as the major highlight from the events of the past five years. Distortion of policy to extract private gains has been a recurring theme. Whether this be in the form of passing Ordinances to either prevent a party-split or make it easier for a political-party to split or making changes to customs tariff rate for the benefit of a few private entities. Corruption cases during the covid-19 pandemic, especially the procurement of protective equipment and test kits, Finance Minister Janardan Sharma's resignation following accusations of foul play, the frequent news of both Omni and Yeti group, expedition of procurement of firearms and numerous other instances have only furthered the claim that Nepal's political elite mechanism remains the same i.e. one of patronage and rent-seeking. It is then not surprising that trust in federal institutions has been declining on a year-on-year basis.

Elite capture, whether it be within the political parties or in institutions, has been the norm. Nepal's political parties operate based on a patronage system. Infact, the patronage system is pervasive in almost all forms of institutions, but its influence is more pronounced within the political parties. Its manifestations within the political parties take place in the form of closed-door meetings among the top leaders. While on paper, Political parties are democratic and are based on the norms of consensus-based decision-making, it is rarely the case. Division of roles and opportunities are based on a bargaining between the leadership. This was also the case with the then coalition of CPN-UML and CPN-Maoist Center. Moreover, all political parties have a centralized structure with central and standing central committees, which essentially means that decision making powers are centralized and bargaining between the top leadership is always a possibility. Any perceived change to the existing norm is then met with resistance from the top leadership. This became more apparent during the second round of Local election, when the coalition of Nepali Congress, CPN-US, CPN-Maoist, Rastriya Jana Morcha and Janata Samajwadi party fielded common candidates. The decision for who gets to contest for the election was made entirely by the central leadership. Whereas the demand for a more decentralized political party system has been growing to accommodate the federal governance system, there is an apparent resistance. On a more positive note, however, this has also led to the rise of rebel candidates i.e., former party members who contested as independents after being denied party ticket. There

are, however, limited instances of rebel candidates and their subsequent win to conclusively state that political parties will change their structure following such developments.

Emerging commitment to growth led by private initiative with an equally strong focus on state-led social sector is commonly believed to be the right way for development. However, in Nepal's case except for perhaps documentary commitment for private initiative, underlying structures remain missing. Nepal's political institutions despite going through a change in governance structure remain embedded in elitism.

As Dercon put it,

*"In the end, whether by design or by implication, the economic structures did not change fundamentally. What has changed is a stronger focus on development in the poor rural areas in the plains, hills, and mountains, creating not only more local patronage and corruption, but also a gradual change in living conditions. Poverty and deprivation have declined, according to several indicators: poverty at the international poverty line, the survival chances of children beyond age five, and primary education now reaching levels better than those in India. The economy has picked up as well, with growth of GDP per capita at 4 per cent a year between 2006 and 2019, or double the rate achieved during the conflict decade. In 2021, per capita GDP in current dollars was just about \$1,000.<sup>46</sup> As a result, Nepal is clearly on its way to middle-income status. The economic deal that was chosen retained much of what was there by way of structures and how the elite could enrich themselves, but the distributive agenda was more inclusive. Yes, there were more rents, clientelism, and patronage that had expanded into rural areas, but they were accompanied by a more development orientation.<sup>47</sup> That economic deal bought peace and stability, and with it at least one of the key preconditions for progress in development. Nepal has by no means a development bargain, but what it does have is better than disintegration and conflict and it represents a chance to connect better to the fast growth engines in India and China."*

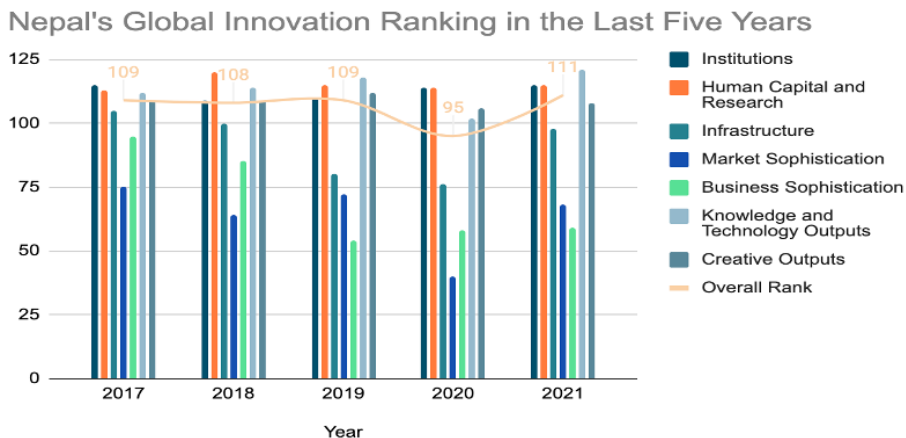
## CHAPTER SIX

## Indicators of Governance and Nepal's performance

After the local level elections in Nepal, the expectations of business market improvements were high in the country. A stable politics along with reforms in the policy environments were expected from the government. Global Innovation Ranking, which incorporates dimensions such as Institutions, Human Capital, Infrastructure, Market and Business Sophistication along with Knowledge, Technology and Creative Outputs highlights that Nepal's performance on key indicators has remained similar over the years.

For the first three years Nepal's ranking remained unchanged. In the fourth year, Nepal's ranking improved significantly (95th position from 109 in the previous year). The improvement was driven mainly by sub-indicators market sophistication and business sophistication which measures among other things ease of getting credit, microfinance as a percentage of gross loans, percentage of firms offering formal training, knowledge-intensive employment, and venture capital deals. Additionally, an increase in education budget in successive years also helped with the improvements as did the increase in use of digital payment mechanism during the pandemic.

Improvements however could not be sustained, with Nepal being ranked 111th in the subsequent year, although business sophistication and market sophistication both fared better, Nepal performed poorly in sub-indicators government effectiveness which measures the political environment, regulatory environment and business environment and Infrastructure which measures ICT use and access, Per-capita electricity consumption, and logistics performance.

**Figure 6.1 Nepal's Performance in Global Innovation Ranking**

Source: Global Innovation Index, 2017-2021

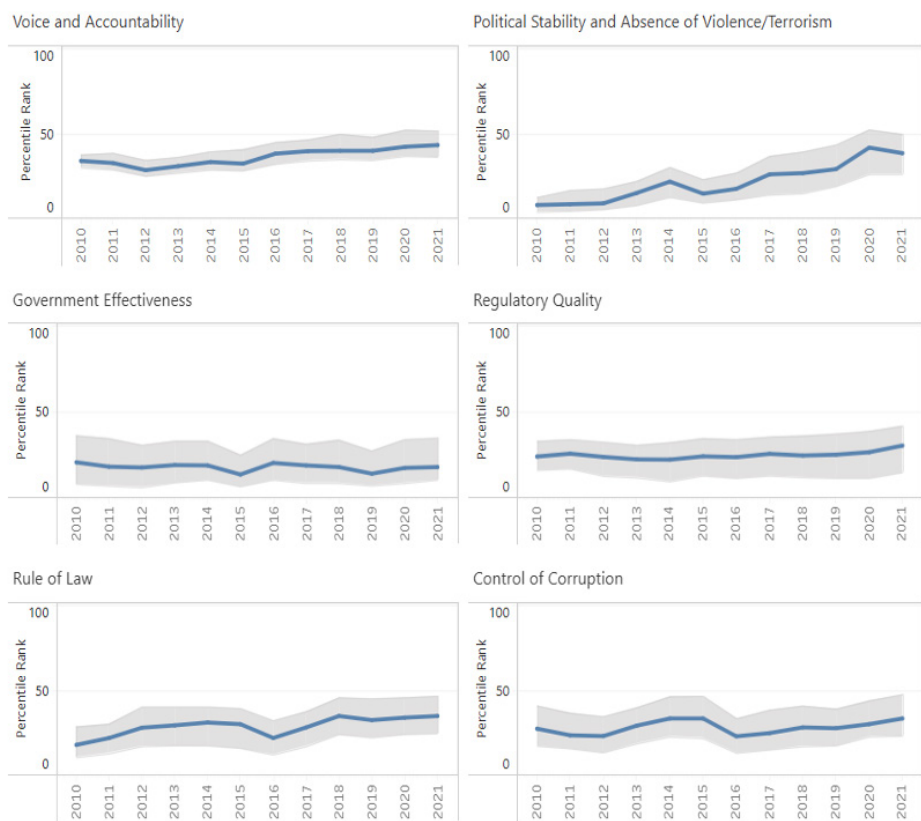
Nepal's performance in terms of governance also did not improve significantly as per the Worldwide Governance Indicator, prepared by the World Bank. The Worldwide Governance Indicator is a research dataset summarizing the views on the quality of governance and consisting of an aggregate of six dimensions of governance: Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption. The indicator ranks a total of 214 countries on a scale from 0 (lowest) to 100 (highest) based on the responses received from experts, citizens, and enterprises of the participating countries. The most recent ranks for Nepal in the dimension of Voice and Accountability is 43, Political Stability is 38.21, Government Effectiveness is 17.79, Regulatory Quality is 30.29, Rule of Law is 34.62, and for Control of Corruption is 33.17 (World Bank, n.d.).

Nepal's Rank in the Worldwide Governance Indicator in the Last Five Years improved marginally. A trend of the last five years shows that Nepal has made some minor changes, however over a period of 20 years, Nepal's improvement on all indicators is significant. It is also worth noting that for all five years, Nepal did not fare better than the south Asian average for all sub-indicators except for two i.e., voice and accountability and Political Stability and absence of terrorism. This should not be surprising given events in Sri-lanka, Pakistan and India. Since the end of the civil war and the signing of the comprehensive peace accord, Nepal has witnessed sustained periods of stability and non-violence except for a brief period during the Madhesi Uprising. Additionally, the Survey of Nepali people,

notes that in 2020, 85 percent of the respondents felt no threats in their locality and 3.4 percent reported feeling unsafe. In 2018, 6.1% of the respondents noted feeling unsafe. Moreover, violence in the time of election has also declined and there is a general acceptance of the election results which is a sign of maturing democracy.

The effects are however more pronounced for the sub-indicator government effectiveness which among other things measures quality of government's personnel, Bureaucratic rigidities, government efficiency in delivering services, predictability in changes in rules and laws, credibility of government's commitment to policies and government decentralization. Since, the beginning of the tenure in 2018, Nepal has performed poorly in comparison to her southern counterparts, performing only better than Afghanistan. Nepal's ranking for the five years has been lower by 33 percentage points than the South Asian Average.

**Figure 6.2 Nepal's Performance in Worldwide Governance Indicator**



Source: Worldwide Governance Indicators Dataset, 2022

Although, Nepal has only made slight improvements in the sub indicator, Control of corruption, there are nonetheless some signs of improvement in transparency and accountability measures. For the past two years, Nepal has been ranked as 117th in the Corruption perception index. Although, this metric on its own showcases signs of bribery and corruption in the public sector, on a year-on-year basis lower percentage of people report paying bribes to the avail public services as per the survey of Nepali People.

**Figure 4.3** Number of people reporting paying bribes.

**Bribe in exchange for services in provinces, by year**

		To get land related services	To get various documents	To take service from police	To take service from court	In search for employment	To receive health service	To get admission in school or university	To get vehicle related services	To take banking related services
Overall	2017	14.7%	10.7%	6.9%	5.7%	5.4%	1.8%	1.9%	-	-
	2018	9.2%	6.0%	4.1%	2.7%	3.4%	0.8%	0.7%	-	-
	2020	4.3%	4.5%	4.6%	3.7%	2.7%	0.8%	0.9%	6.1%	2.1%
Province 1	2017	9.9%	5.4%	3.4%	3.4%	3.0%	1.0%	0.9%	-	-
	2018	4.0%	2.2%	2.4%	1.9%	4.0%	0.1%	0.0%	-	-
	2020	3.0%	1.5%	1.2%	0.8%	0.8%	0.3%	0.2%	4.2%	2.1%
Province 2	2017	30.3%	31.4%	15.4%	10.1%	9.1%	3.3%	3.0%	-	-
	2018	20.2%	18.0%	11.5%	6.9%	3.6%	1.9%	2.1%	-	-
	2020	11.4%	13.6%	11.3%	5.5%	5.9%	2.6%	1.9%	10.9%	3.0%
Bagmati Province	2017	11.8%	4.3%	1.8%	2.0%	1.3%	0.5%	0.8%	-	-
	2018	8.7%	2.3%	0.2%	0.2%	4.0%	0.3%	0.3%	-	-
	2020	2.2%	2.5%	0.0%	2.8%	1.3%	0.2%	0.1%	3.2%	0.4%
Gandaki Province	2017	5.5%	2.6%	3.9%	4.0%	4.3%	2.6%	2.2%	-	-
	2018	1.4%	1.1%	1.0%	0.7%	2.8%	0.4%	0.2%	-	-
	2020	2.4%	2.3%	10.7%	7.7%	8.0%	0.5%	0.8%	1.0%	0.8%
Province 5	2017	16.4%	10.6%	13.7%	15.6%	15.7%	3.6%	4.2%	-	-
	2018	8.9%	4.4%	4.5%	4.7%	3.4%	1.3%	1.2%	-	-
	2020	5.9%	2.7%	6.3%	5.7%	3.5%	0.8%	1.5%	9.2%	2.9%
Karnali Province	2017	3.9%	1.1%	0.5%	0.6%	1.4%	0.5%	0.8%	-	-
	2018	2.4%	1.9%	2.4%	2.1%	1.2%	1.0%	0.3%	-	-
	2020	1.2%	1.5%	1.8%	0.0%	0.0%	0.3%	0.6%	3.2%	1.0%
Sudurpachim Province	2017	10.9%	3.1%	3.1%	1.0%	4.5%	0.3%	0.2%	-	-
	2018	14.6%	6.7%	6.6%	1.8%	4.5%	0.0%	0.2%	-	-
	2020	2.0%	2.1%	5.5%	5.4%	3.4%	0.8%	0.9%	5.7%	2.9%

Source: Survey of Nepali People, 2021, The Asia Foundation

Additionally, on a year-on-year basis, trust in public institutions has also been increasing. Survey data from Asian foundation suggests that since 2018, more respondents feel that their local governments are responsive to their needs. In 2018 48.8% of the people noted their local governments being responsive, by 2020, the number had jumped to 58.9%. As the country transitions completely into a federal state and decentralizes more, it is likely that this number is going to go higher, likely because of accessibility of public services.

At the same time however, the number of respondents not trusting the federal parliament and the federal government has also increased. In 2018 31.6% of the respondents distrusted the federal government, 33% distrusted the federal parliament, in 2020, this number increased to 32.8% and 34.8% respectively. More people, however, trust local political leaders over political parties. In 2018 68.1% of the respondents trusted local political parties, in 2020 this number increased to 80.9% whereas for political parties' trust has declined, with 58.2% of the political parties trusting them in 2018 and 56.2% trusting them in 2020.

Indicators of governance of are largely based on perception, to that end, it cannot be relied on for an accurate picture. Neither can it be an adequate method for conducting a comprehensive review. More often than not, the necessity of taking into account country context is lost on the creation of indices of governance. Nepal's performance, in international indicators is neither satisfactory nor strikingly poor. Over the period of five years, Nepal has neither climbed up significantly nor dropped down. Even in terms of general perception, more and more people believe that Nepal is heading in the right direction, the changed governance structure and relative period of political stability has indeed made the people optimistic. Strictly from a regional perspective, Nepal is only better off in ensuring voice and accountability and political stability/absence of terrorism. However, the country's own analysis within a time frame of 10 years does indeed highlight that Nepal is relatively better off than it was 10 years ago, much however much remains to be done and within the last five years, no extraordinary leaps have been taken.

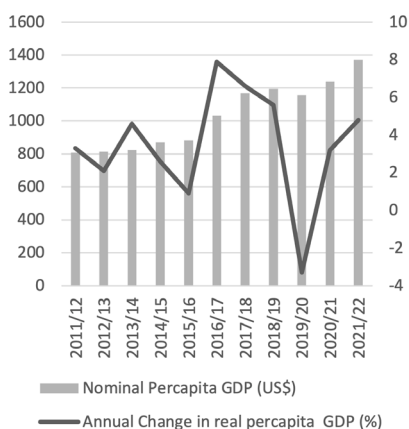


CHAPTER SEVEN

# Macroeconomic review

The first tenure of the government started under favorable yet tumultuous circumstances. Nepal had just witnessed a major earthquake three years prior and reconstruction work had not been completed yet. Similarly, two years prior, Nepal also faced a trade blockade. The tenure of the new government started during the last quarter of fiscal year 2017/18, despite past cleavages, Nepal was witnessing a strong economy fueled by reconstruction work and the release of pent-up demand after the economic blockade. After witnessing .433 percent growth in the fiscal year, 2015/16, the economy was projected for balanced growth (Nepal development update, 2017). In the fiscal year 2016/17, gross domestic product grew by 8.977 percent, followed by 7.66 percent in 2017/18, and 8.65 percent in 2018/19 (Figure 7.1). The first full fiscal year of the new government was a relatively stable period with modest growth in the gross domestic product, which increased the nominal GDP per capita to US \$ 1194 (Figure 7.2). The first tenure of the new government continued with the trend of more than 6 percent annual growth rates.

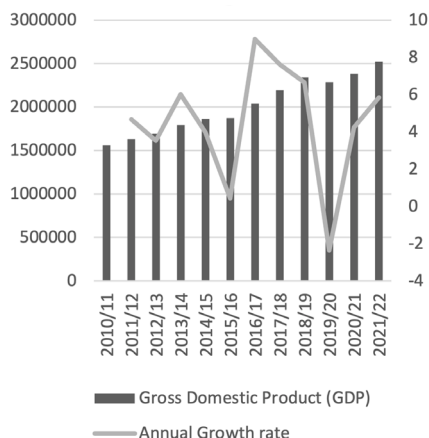
**Figure 7.1 Nominal per capita GDP in US \$ by fiscal year and annual change**



Source: CBS

**Figure 7.2 Gross domestic product and annual growth rate by fiscal year**

Note: 2010/11 as base year

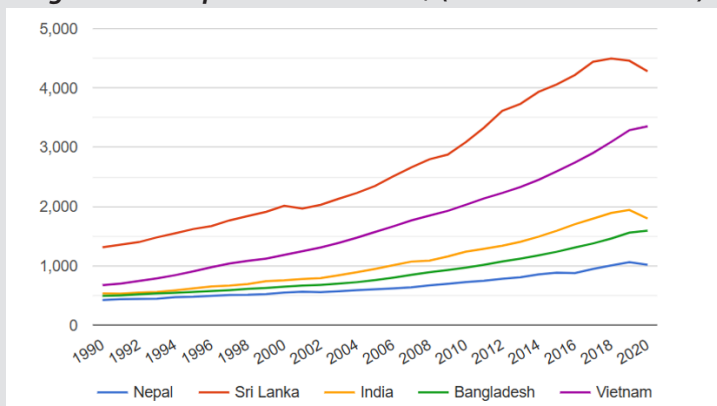


Source: CBS

### Box Case 1: Catching up or lagging behind

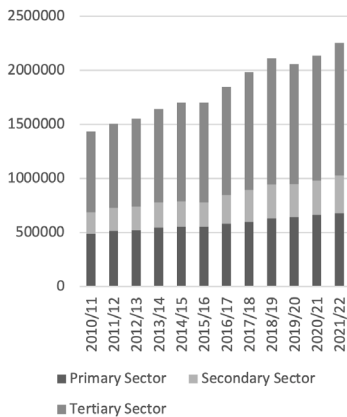
Increase in GDP per capita in constant terms is nowhere near Nepal's peers in Asia. Whereas, Nepal, started on the same footing, her peers in Asia have been able to reach much higher growth in per-capita GDP in US \$ constant terms. In fact, Nepal has underperformed in South Asia as well. Nepal's counterparts in South Asia are slowly converging to the South Asian Average, Nepal, however, still has a lot of catching up to do. Countries in South Asia started their transformation at the same time, a shift to more liberalized policy took place in the 1990s, whereas other countries have built on it, Nepal has been unable to do so. Indeed, during the early 2000s, Nepal was going through a civil conflict and during the earlier half of 2010s Nepal was deciding on its future trajectory both in terms of governance structure and the economic aspirations. Yet even after the completion of the bargaining process which resulted in a new constitution, Nepal has not been able to catch up. Economic Literature on Catching Up hypothesis suggests that countries with low initial income and productivity tend to grow more rapidly by making use of technological advancements within the region. The ability of catching up is dependent on a specific country's social capability, this includes the level of investment in research and development, education spending and capital investment. Nepal's spending on education as a percentage of GDP and capital investment as a percentage of GDP is comparable to her peers. Additionally, Nepal has also done remarkably well in reduction of poverty and has a relatively low unemployment rate. However, Nepal still remains among the poorest and slowest growing economy among its regional peers. Analysis suggests that there is no evidence of catching up, while being trapped in a low-investment, Low-growth equilibrium is also a fear.

**Figure 1: Per capita Income in US \$ (2010 constant terms)**



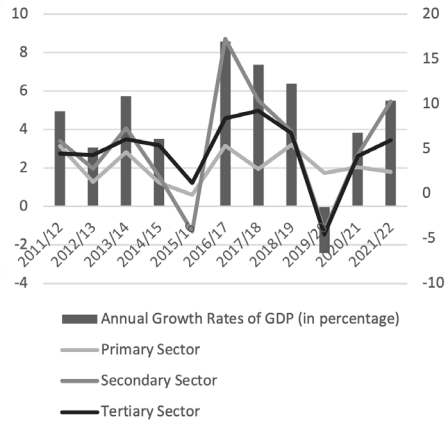
The effect of the covid-19 pandemic has been apparent. In fiscal year, 2019/2020, Nepal witnessed a negative growth rate of -3.3 percent (figure 7.1), which was largely due to the preventive measures taken including but not limited to lockdown in the latter half of the fiscal year. Nepal's fiscal cycle is such that a large part of government work takes place in the final quarter of the fiscal year (see analysis below). With lock down measures in place, consumption and government expenditure were subdued. Pronounced effects of the covid-19 pandemic were felt in the service sector which contracted by 4.19 percent. Additionally, Industrial capacity utilization also dropped to 46 percent during the final quarter of the fiscal year 2019/20, leading to an overall negative growth rate for both the tertiary and secondary sector in the fiscal year 2019/20 (Figure 7.3 and Figure 7.4).

**Figure 7.3 Composition of GDP by sector**



Source: CBS

**Figure 7.4: Percentage Change in GDP and sectors**



Source: CBS

**Box Case 2: Dependence on Agriculture is neither desirable not sustainable.**

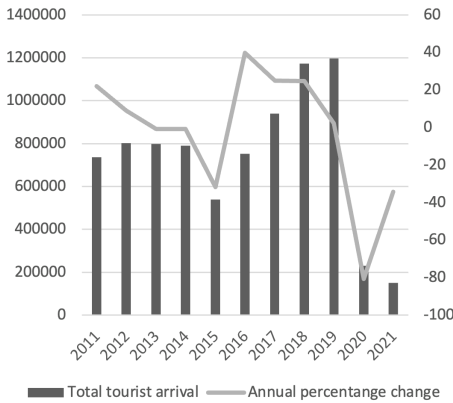
Although the share of Agriculture in GDP has been declining in recent years, it is still a significant contributor. Whereas the economy grew at an average rate of 5 percent, agriculture growth has remained below 3 percent in recent years, especially for the last five years. Moreover, agriculture still employs a large share of the labor. Nepal's agricultural productivity has also dependent on exogenous factors, such as adequate rainfall.

In terms of productivity of cereal crops, Nepal is nowhere close to her regional peers, however, in terms of cash crops and spices, Nepal does fare better even showing modest signs of coming close to regional productivity figures, yet Nepal's agricultural output remains skewed towards production of cereal crops. Diversification of agricultural output has been increasing; however, it is unlikely that it will happen in large scale. Some common themes occur when analyzing the productivity of agriculture in Nepal. The principal cause of low productivity of agriculture remains the low level of technical change and technical efficiency. Whereas Nepal's regional peers have been able to incorporate new technology in the agriculture sector, Nepal has failed to do so. Consequently, from being a net exporter Nepal has become a Net importer of both cereal and cash crops. Similarly, agriculture productivity is also affected by a weak fertilizer supply system. In the past five years, Nepal has not seen any significant improvement in the fertilizer supply system despite the agriculture development strategy hinting at the discontinuation of fertilizer subsidy and government monopoly. As a result, Agriculture has dragged down overall growth rate in per-capita terms.

The tourism sector was hit the hardest by the pandemic. Prior to the pandemic, the year 2020, was declared Visit Nepal 2020. The Pandemic is estimated to have resulted in the loss of US \$ 2 billion in tourism receipts. The relatively high inflow of tourists in the first half of the fiscal year 2019/2020 has shielded the tourism sector and the tertiary sector from plummeting even further (Figure 7.3 and 7.4). Despite preventive measures during the first half of 2020, fiscal year 2019/2020 still saw a high number of tourist arrivals as a whole and is recorded to be significant in terms of contribution to foreign exchange earnings and GDP (1.5 percent) (figure 7.5 and 7.6). Its recovery has been slower as global travel restrictions continued till the latter half of 2021.

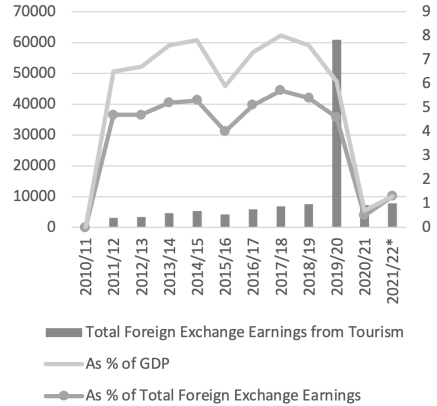
Expansionary fiscal policy and reactionary monetary policy have both helped with the recovery from the pandemic, however, the expected pace of recovery could not be attained due to weak execution of budget and fiscal measures aimed at recovery (see latter section for details). Whereas the government was criticized for aiming for an ambitious growth rate of 7 percent in the fiscal year 2020/21, Nepal achieved moderate growth of 4.24 percent and 7.84 percent the following year (figure 8.1). The recovery was primarily a result of increased consumption and industrial activity after lockdown measures were eased (see figure 8.4).

**Figure 7.5 Total tourist arrival and annual change by year**



Source: Department of Tourism

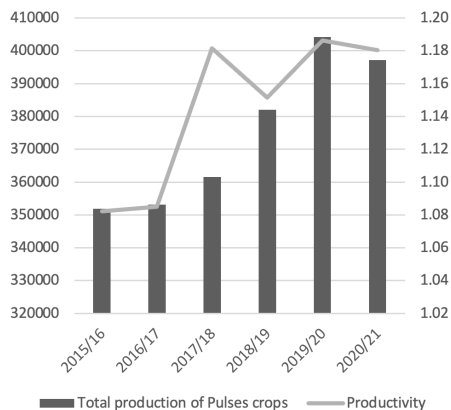
**Figure 7.6 Total earnings from tourist arrivals**



Source: Nepal Rastra Bank

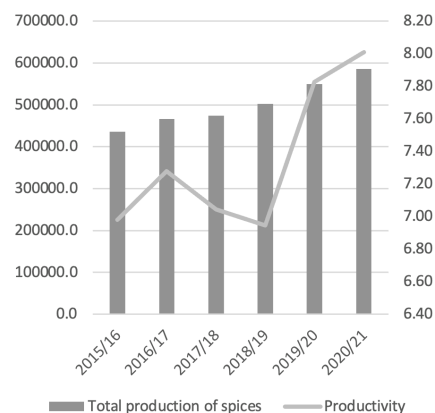
Since the start of the government tenure, the supply side has been driven by the primary and the tertiary sectors. Agriculture still contributes significantly to the GDP with its five-year contribution well above 20 percent. This has been helped by adequate rainfall and an increase in productivity for cash crops and spices albeit marginally. Although paddy production was affected by armyworms and inadequate rainfalls, overall production of pulse crops still recorded significant growth with an annual increase of productivity beginning from fiscal year 2017/18, as provinces and local governments played a major role in the agriculture sector through the establishment of agriculture facilitation centers and testing centers (Figure 7.7 and 7.8). Problems of unavailability of adequate fertilizers remain unresolved. Government import of fertilizers has been inadequate for fiscal years 2018/19, 2019/20, 2020/21. Fertilizer supply was also affected by increasing prices of nitrogen-based fertilizer owing first to the supply chain disruption caused by the pandemic and secondly by the Russia-Ukraine war that drove prices up. Additionally, fertilizer supply is largely regulated, with farmers depending on government subsidized fertilizers that are only allowed to be sold by farmer cooperatives which is expected to decrease production and productivity. Targeted policies to import the adequate number of fertilizers could boost agriculture productivity, at least to levels comparable to the south Asian average.

**Figure 7.7 Total production of pulse crops and productivity by fiscal year**



Source: Department of Agriculture

**Figure 7.8 Total production of Spices and productivity by fiscal year**



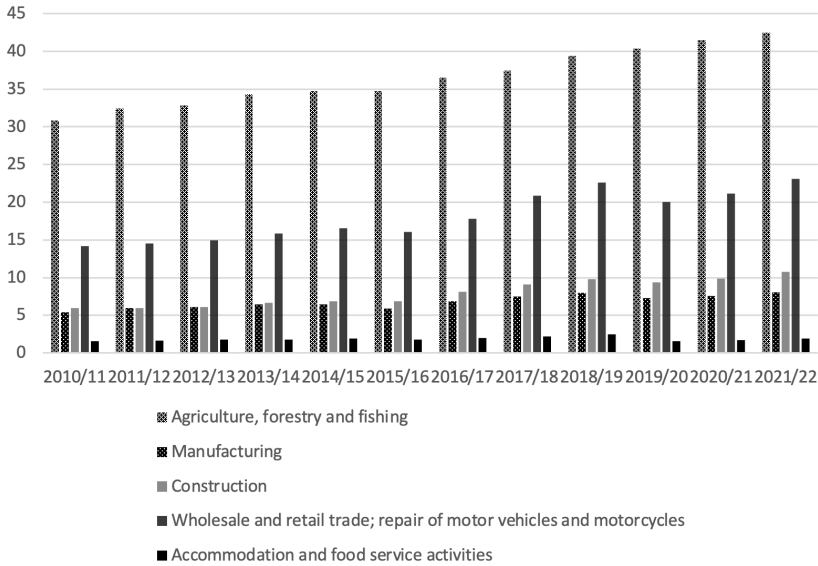
Source: Department of Agriculture

The secondary sector, more appropriately the industrial sector showed signs of increased activity in the fiscal year 2016/17 with an annual growth rate of 16 percent. This was largely driven by reconstruction post the earthquake and could not be sustained for a long period of time. From 2016/17 onwards, annual growth rate of the secondary sector exceeded both the primary and the tertiary sector fueled by both an increase in foreign investment in the manufacturing sector and domestic investment in the manufacturing sector. However, this soon came to a halt with covid-19. Government policies especially, those that made it mandatory for companies to keep paying wages made it more difficult.

Nepal's manufacturing sector has underperformed historically. Although, there is a high correlation between the growth of a country's manufacturing sector and its economic development, in Nepal's case, Manufacturing has not been at the forefront. The completion of election, the end of the civil war and relative political stability renewed the manufacturing sector, its contribution however remains marginal. Throughout the tenure of the current government gross value added by the manufacturing sector remained well below 9 percent of the total GDP (Figure 7.9). In comparison, the agriculture sector's contribution remained above 30 percent and the whole and retail trade above 15 percent. Nepal is also believed to be sinking into premature deindustrialization(See for instance Uddin (2016) and Kharel (2020)) as the share of manufacturing sector employment is highest in the informal sector while the contribution of service

sector to the GDP is growing steadily.

**Figure 7.9 Gross value added by key sectors.**



Source: CBS

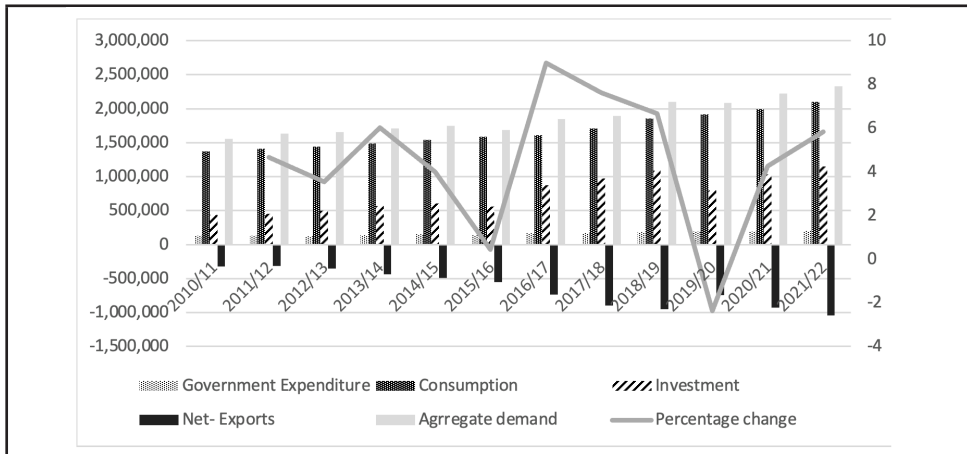
Although the growth in service sector particularly participation of labor force is seen as a normal phenomenon that most countries go through at higher stages of industrialization with technological advancement; any form of premature shift from manufacturing sector to the service sector is regarded as problematic given the inability of the service sector to sustain over a longer period (see for instance Rodrik, 2013, Rodrik, 2016, Singh and Dasgupta, 2009). The manufacturing sector experienced a negative growth rate of 9.03 percent during the pandemic. NRB survey indicated that it would take at least 7.9 months for the manufacturing sector to get back to its normal level. A follow up survey in 2021 indicated that only 49.04 percent of the manufacturing industries had come into operation. As of the third quarter of this fiscal year i.e. 2022/23, it was reported that the capacity utilization of Nepalese industries had dropped to 58 percent owing to inflationary pressure, import restrictions and increasing interest rates. Although regular power supply since fiscal year 2016/17 has helped the industrial sector, chronic issues with transportation costs, and unskilled labor remains a challenge. Nepal labor productivity at least for the manufacturing sector is the lowest in south Asia. It is hypothesized that shift effects i.e., shift in labor from manufacturing to service sector is driving

service sector productivity up, whereas manufacturing sector productivity is low. A note of caution however is that service sector is not reasonably regarded as a substitute for the manufacturing sector for sustained economic growth or even as a means for attaining unconditional convergence to catch up with the pace of developed nations.

On the demand side, growth has been driven by consumption and investment (Figure 7.10 and 7.11). Consumption was largely helped by remittance income. Remittance earnings remained above 20 percent of the GDP throughout the current tenure of the government, even during the year 2019/20, when it dropped by 16 percentage points (figure 7.12).

**Figure 7.10 Total Aggregate Demand and Composition by fiscal year**

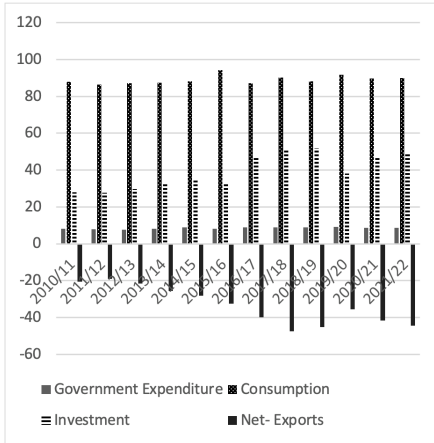
*Note: 2010/11 as base year*



Source: CBS

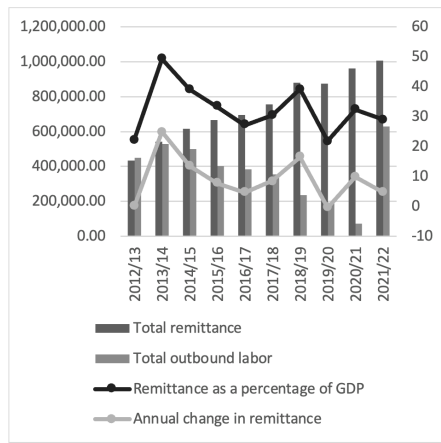
**Figure 7.11 Contribution to aggregate demand by fiscal year**

Note: 2010/11 as base year/statistical discrepancies are not shown



Source: CBS

**Figure 7.12 Total remittance and Outbound Labor by fiscal year**



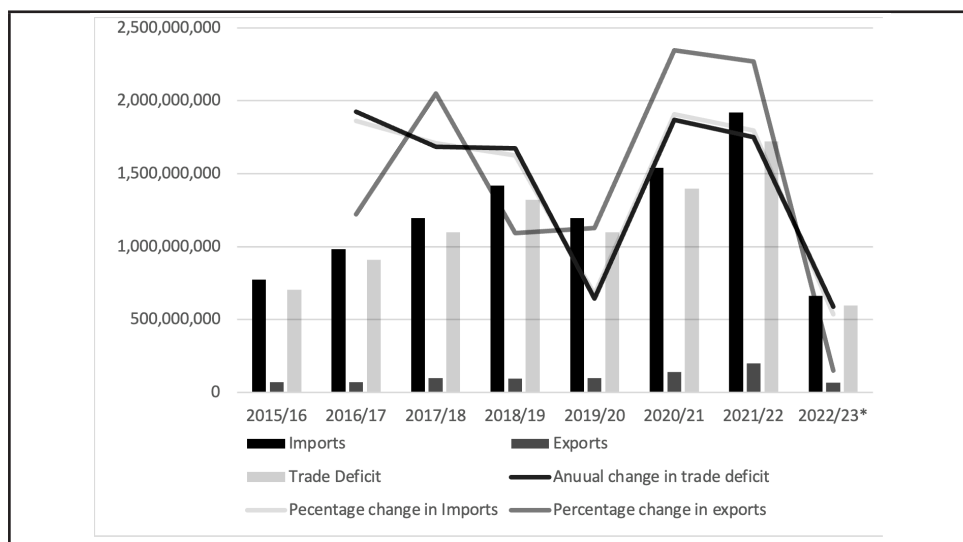
Source: CBS

Remittance earnings greatly helped push the consumption, as import of goods and service increased comfortably on a year-on-year basis dropping only in the fiscal year 2019/20 because of the pandemic. Pent-up demand eventually pushed imports figure higher in fiscal year 2020/21, which was also helped by an increase in remittance earnings in the same year. Total outbound labor had been on a declining trend, signifying better opportunities in Nepal as the country witnessed relatively moderate periods of political stability with a strong economic outlook and increase economic activity (Figure 3l). However, there was a spike in total outbound labor in the year 2021/22, an increase of 774 percent compared to previous years and an all-time high in a ten-year period. This spike was largely due to two factors, first restrictions on travel during the early half of 2020 that continued till the early of 2021 and lack of opportunities in Nepal itself.

Growing consumption helped by remittance earnings also influenced the current account, which remained at a deficit for all years within the current government tenure, widening by more than 10 percent for all fiscal year except for fiscal year 2019/20 (figure 7.13). The trade deficit declined in fiscal year 2019/20 by 16 percent because of the pandemic, eventually widening by 28 percent the next fiscal year as preventive measures were eased. Within the first five months of the current fiscal year, current account deficit figures declined significantly owing to import restrictions put in place to save dwindling foreign

exchange reserves.

**Figure 7.13 Net exports and trade deficit by fiscal year**



Source: CBS

### **Box Case 3: A worrying Trend of Remittance**

Nepal's historically low economic growth, at least during the conflict period, has fueled outmigration. Consequently, inward flow of remittance has increased consumption even contributing to a decline in poverty. At the same time, however, it has also led to a loss of competitiveness domestically. The pressure to create more productive employment opportunities or even foster an environment to create job opportunities at home has been steadily declining. Equally important is the fact that dependence on inward remittance earnings has contributed significantly to sustaining the agricultural sector which itself is mired by low-productivity. Here too, Nepal's dependence on remittance earnings to fuel consumption is troubling since remittance earnings is dependent on exogenous circumstances beyond Nepal's control. Then there is the specter of deglobalization and a marked backlash against foreign workers, which makes dependence on remittance driven consumption a perilous strategy. In-fact, the problems associated with remittance driven growth have been pointed out numerous times (See for instance Cosic, Dahal and Kitzmuller, 2017), yet concrete steps to create jobs domestically remain missing because of the very fact that a steady inward remittance earning provides little incentive to change the status quo. It is unlikely that the

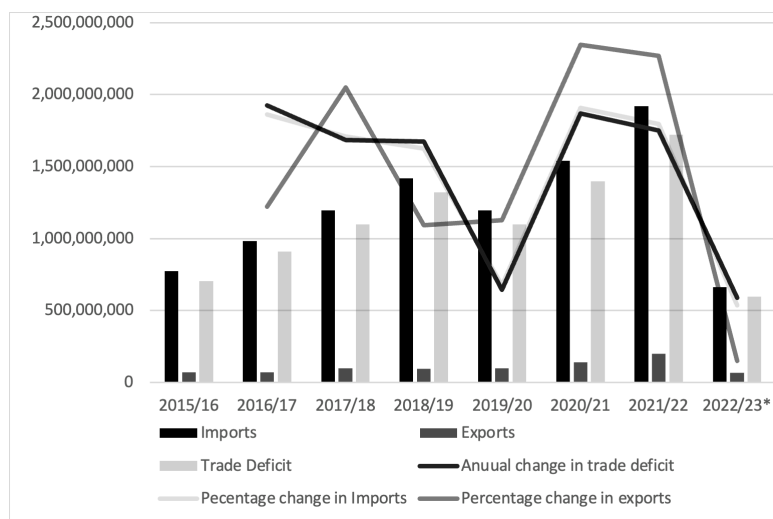
situation will change without an exogenous shock that decelerates the pace of remittance earning.

From fiscal year 2015/16 onwards, gross fixed capital formation has increased significantly. After experiencing a drop of 16 percent on a year-on-year basis in the fiscal year 2015/16, gross fixed capital formation, especially private sector gross fixed capital formation has played a significant role in increasing aggregate demand. The year 2015/16 was the year of two shocks i.e., an earthquake and a trade blockade, to that end, decrease in private sector investment in that period should not be surprising. Within the tenure of the current government, gross fixed capital formation, especially private sector led gross fixed capital formation contributed more than 40 percent of total investment, except in 2019/20 where it dropped to 38 percent. Monthly electricity demand which is usually a proxy for increased economic activity also increased signifying a favorable environment for investment which certainly helped increase private sector gross fixed capital formation. Additionally, an increase in foreign investment and the number of limited liability companies being registered on a yearly basis also point to an appetite for investment and a friendlier climate, which could be helped further by some policy changes.

Similarly, private sector gross fixed capital formation also showed signs of modest growth with the first two years (Fiscal year 2017/18, 2018/19) experiencing more than 15 percent annual growth, before the covid pandemic slowed it down. Recovery has been quicker with an annual growth of 7.6 percent in 2020/21 and 8.6 percent in 2021/22. Despite major political shifts during the time periods, private sector investment has been on an upward trajectory signaling a friendlier investment climate as well as a stable policy regime. A friendlier investment climate has been helped by Foreign Investment Legislation, Industrial enterprise legislation, Public Private Partnership, and Investment legislation and most importantly digitization of compliance requirements.

**Figure 7.14 Composition of Investment and percentage change in private sector investment by year**

Note: 2010/11 as base year



Source: CBS

Nepal's macroeconomic trend however has remained the same. When taking a comparative perspective, the trend is no different than it was in a 10-year time frame. Agriculture sector continues to be the predominant contributor to the GDP and the Manufacturing sector has failed to come to the fore front. Government policy aimed at promotion of the manufacturing sector has also not produced any significant results. Although it is not possible to isolate the effects of exogenous shocks on Nepal's failure to achieve a transition from agricultural to manufacturing based economy, the common sentiment is one of inadequate structural factor for transition.

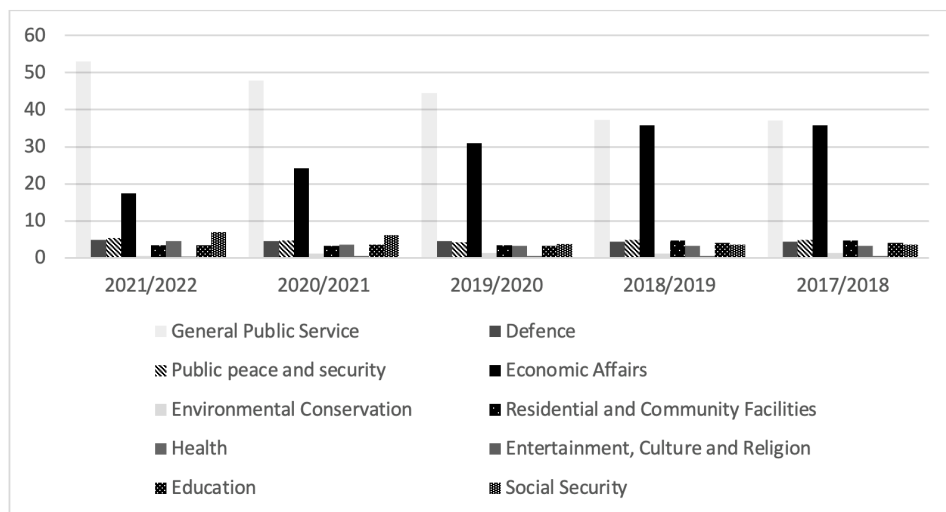
Some stylized facts appear when reviewing the last five years. Firstly, Nepal's growth is still dependent on the agriculture sector, as was the case, nearly two decades earlier. Secondly, there is a shift from the agricultural sector to the service sector, which has been helped by both remittance earnings and outward migration. While this shift is atypical it is not sustainable. Thirdly, Nepal's manufacturing sector was better nearly two decades early then it is now. There is however, a historical precedence that bold steps can be taken to change the structure of the economy. What is required, however, would be a focus on job creation, a stable policy regime and broad reforms.

## CHAPTER EIGHT

## Government Budgetary operations

Government spending was concentrated on public service throughout with more than 30 percent of the total budget being allocated. Although issues with efficiency in general public services still remains, The survey of Nepali people notes that on a year on year basis more people perceive government public service to have improved. As local governments execute more and more functions related to public services, both the cost and time for availing public services such as vital registration have decreased.

*Figure 8.1 Government spending by category*



Source: FCGO

Although, since fiscal year 2020/21, there is a significant increase in social security spending as payments are being made to both government covid-19 insurance program as well as the health insurance program and the contribution-based pension system for civil servants. Similarly, a strong focus on social protection is also seen in recent years through increased allocation of budget on unemployment benefits and old age schemes. Functional categorization of government expenditure does not reflect all forms of spending on social security

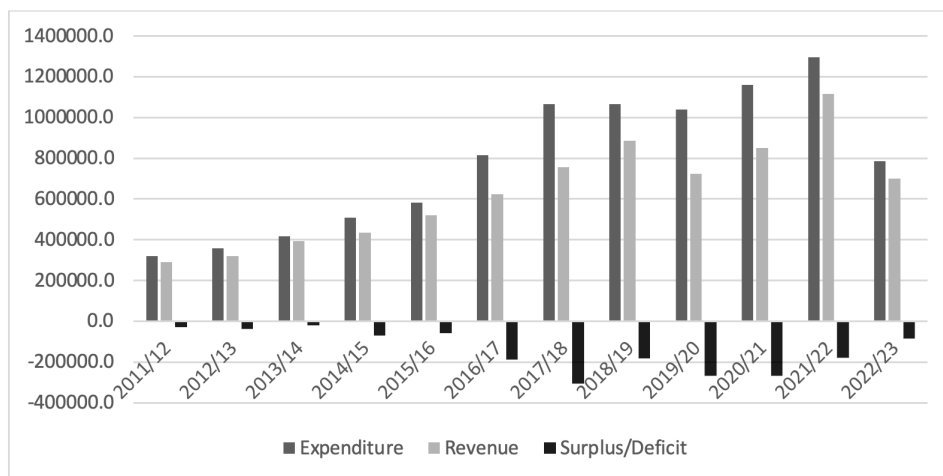
programs. Other spending that are by nature spending for social security may fall into categories such as economic affairs or residential and community facilities. In total there are 76 different social security programs that are run by the government of Nepal through different ministries. These programs are both contributions based, and non-contribution based. Most of the social security expenses come in the form of social security allowances paid to people over a certain age, people belonging to a certain ethnicity, people having disabilities, and single and widow allowance. With the country's transition into a developing nation, grants as a source of financing are limited. In the fiscal year 2020/21, Nepal government raised NRS 18 billion in loans to finance its social security programs. Over the five-year period, social security spending as a percentage of GDP has averaged four percent and social security spending as a percentage of government revenue has averaged 17 percent. Spending on social security is expected to increase in the coming years, as the minimum age for availing old age benefits has been lowered by two years. Identification of sources of financing for social security spending is required is Nepal is to pursue both its development endeavors as well as its focus on social protection. Additionally, the annual report of the office of the auditor general has suggested that there are beneficiaries that are availing themselves of the benefits under different programs. Reportedly, 170 local governments had registered the same people under different programs in addition to registering people that are already dead.

Economic affairs, which saw relatively ample amounts of spending, has decreased from fiscal year 2020/21 onwards largely due to increased spending in the health sector, insurance programs and social protection programs after the covid-19 pandemic highlighted the problems in the health sector. Similarly, economic affairs spending is mostly spendings on infrastructure. The budget structure and spending data does highlight increased spending on infrastructure and operation of special economic zone, yet low rates of capital spending (see sections below) and ineffectiveness of special economic zones and industrial clusters/villages showcase a need for rethinking things.

One thing to note however, is that spending for categories of general services and economic affairs is largely driven by administrative expenses which have picked up after the country has transitioned into a federal structure. Nepal's federal structure is still in its nascent stage, which effectively means that most functions have not been completely handed over, to that extent, the increase in administrative expenses of the federal government should not surprising. The reduction of administrative expenses, at least for the federal government, demands the completion of the transition process and commitment towards the same.

Throughout the tenure, fiscal deficit has been on a declining trend, as a result the debt to GDP ratio has been below 40 percent of the GDP throughout, with stronger focus on internal debt as opposed to foreign debt in recent years (Figure 8.2).

**Figure 8.2 Government expenditure/revenue by fiscal year**

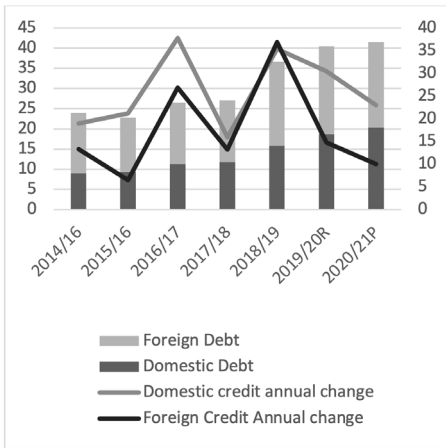


Source: FCGO

Additionally, low levels of spending and weak budget implementation together with an increase in revenue collection has also helped keep deficit figures below 3 percent of the GDP. Some improvements in the budgetary and public finance management system have also helped. Notable improvements undertaken during the tenure were the enactment of Financial Responsibility and Fiscal accountability act, limitation on the amount of virements to 10 percent of the budget, provision for Mid-Term Expenditure framework at all levels of government and the National Project Bank for national pride projects. The implementation of Financial procedure and fiscal accountability act from 2019 onwards, and improvements in the public finance management system are started show its effects, with a decrease in irregularities as well as 13 percentage point drop in the amount of virements in comparison to the fiscal year 2016/17.

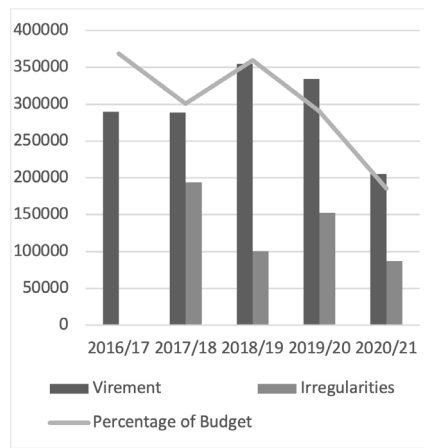
**Figure 8.3 Domestic debt and foreign debt as a percentage of GDP**

**Figure 8.3 Domestic debt and foreign debt as a percentage of GDP**



Source: FCGO

**Figure 8.4 Virements and Irregularities by fiscal year**

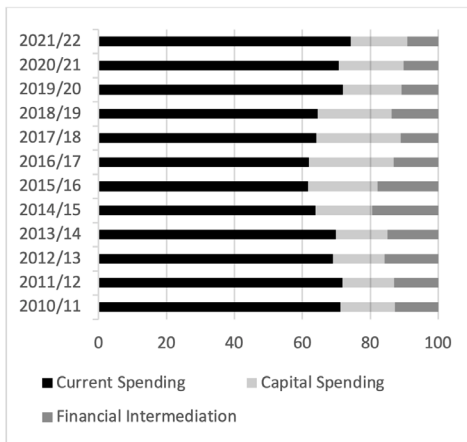


Source: FCGO

Issues relating to underspending of the budget, low capital spending, weak budget execution and bunching of spending during the final months of the fiscal year however remain. On average, current spending has accounted for 60 percent of the budget, whereas capital spending remains averaging 15 percent for the last five fiscal years. After witnessing a peak annual growth of 70 percent largely due to earthquake reconstruction, annual change in capital spending rates have remained subdued.

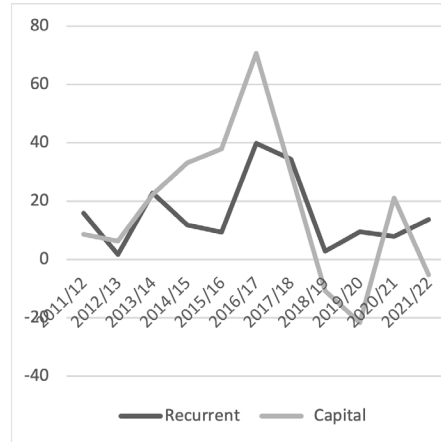
**Figure 8.5 Government expenditure by nature**

**Figure 8.5 Government expenditure by nature** Source: FCGO



Source: FCGO

**Figure 8.6 Average Trend of government spending by fiscal year**



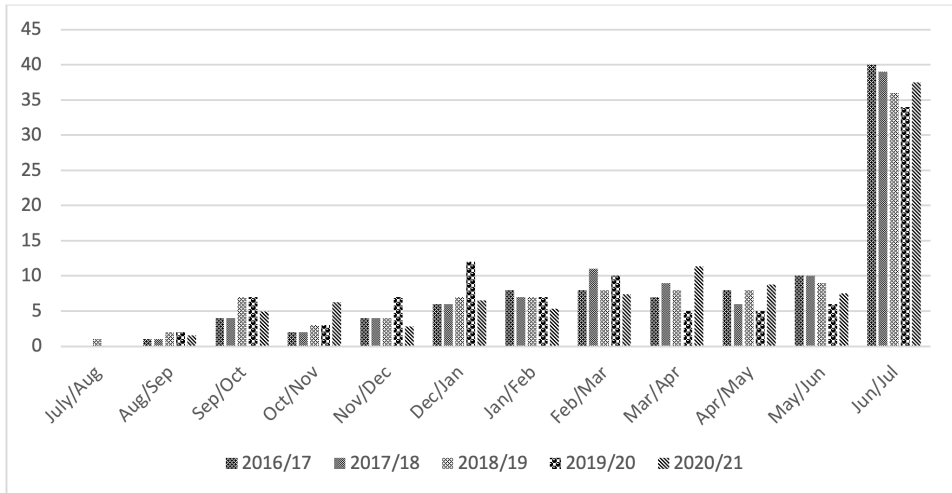
Source: FCGO

Weak capital expenditure pattern highlights problems in the public procurement system of Nepal. 60 percent of Nepal’s plans are implemented through public procurement system, which itself remains weak and is based on least cost bidding resulting in poor selection. Lack of technical capacity to prepare annual procurement plan and master procurement plan further exacerbates the problems of weak capital spending. Additionally, transparency issues in the current procurement system have also been highlighted, most notably through frequent amendments of the public procurement rules.

Nepal’s capital spending has mostly been carried out during the final month of the fiscal year. In fiscal years, 2018/19, 2019/20, 2020/21, 36%, 34% and 37% of capital spending was done in the months of June and July. This coincides with the delay in procurement process for works that require both national competitive bidding and International Competitive Bidding. Call for tenders for construction works predominantly take place in the month of January/February and February/March. The completion of the procurement process takes 60 days, which is the predominant reason for spending of the capital budget during the final months. Additional problems highlighted by the World bank (2020) regarding the procurement system include frequent transfer of government employees which makes accumulation of knowledge and institutional memory

harder, lack of plans and systems that generate data required for informed choices and delay in governmental transfers.

**Figure 8.7 Capital spending by month**



Source: FCGO

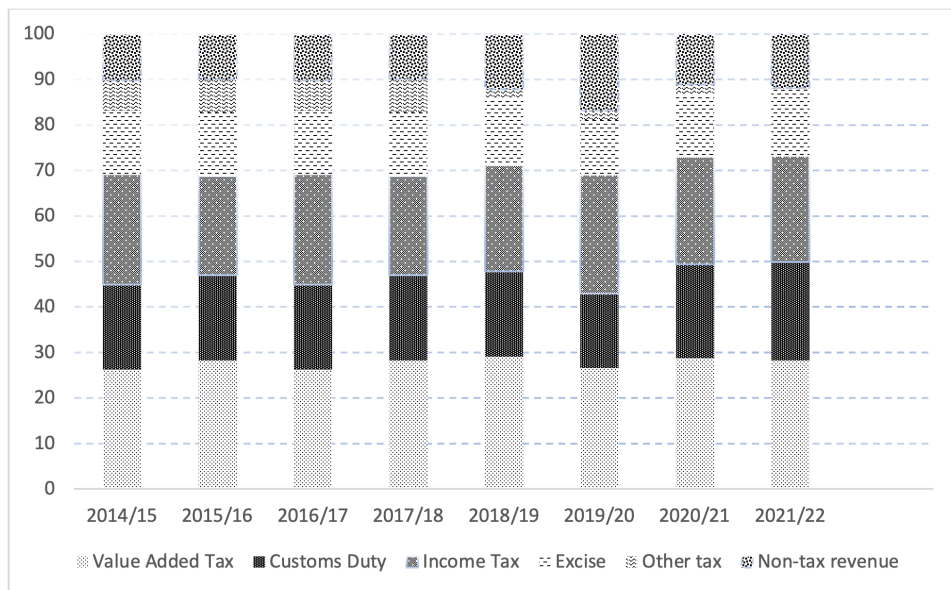
Government revenue has been dependent on indirect taxation. Customs and VAT comprised of 40 percent of the total revenue collected by the government, dipping only in the fiscal year 2019/20. Nepal has performed exceptionally well in collection of indirect taxes, after the end of the civil war and the implementation of existing indirect tax legislation more strictly. It is also worth noting that most of the indirect tax collection happens at border points highlighting the dependence on import duties to collect revenue. Dependence on import revenue showcases the future that became apparent in fiscal year 2019/20 when lockdown measures were imposed and again in the current fiscal year 2022/23, when measures aimed at protecting foreign exchange reserves were announced.

**Box Case 4: The case for effective public Investment Management system**

A standard approach to ascertain the relative strength of public investment management system is to focus on eight key areas i.e., Project screening, Project Appraisal processes, Existence of independent review process, Project Selection Processes, Project implementation processes, Project Adjustment Processes, Facility operation and Evaluation. In 2017, Cosic, Dahal and Kitzmuller reported that Nepal essentially does not have any of these features.

Except for the enactment of a new Financial Procedure and Fiscal Accountability act, which envisages the approval requirement of National Planning Commission for Multi-year projects, no significant changes have been made since. Although there are formal arrangements that state that before allocation of budget is to be made, it will be appraised and screened, realistically it rarely happens. Furthermore, there is very little parliamentary oversight over public investments. This signals that even formal institutions in Nepal are weak and informal institutions often take precedence over formal ones. In 2019, Nepal's transparency score in the Open Budget Survey was 41, higher than only Pakistan and Bangladesh. Although Nepal fared better in terms of Public Participation, its performance in Budget oversight was weak. In Nepal budget projects are not evaluated after their completion, neither are there any specific guidelines that detail out the methodology for project selection and screening (the closest thing to a guideline is the Multi-year Project implementation guidelines, 2020 and Budget Formulation Guideline, 2019, both are however not upto the global standards). The case for having a robust Public Investment Management system is strong in Nepal, although there are expectations that the National Project Bank will be able to fill this void, Nepal's history with plans and strategies makes its implementation questionable.

Revenue collection has been helped by an increase in the number of taxpayers which is evident from the increase in the number of permanent account holders. The digitization of services, especially income tax returns filing, and VAT filing has also helped with collection evidenced especially in the decline in number of non-filers at a steady rate. Personal Income tax and Corporate Income tax have also helped government revenue collection accounting for an average of 20 percent of the total revenue in the past five years.

**Figure 8.8 Revenue Structure by fiscal year**

Revenue collection has been helped by an increase in the number of taxpayers which is evident from the increase in the number of permanent account holders. The digitization of services, especially income tax returns filing, and VAT filing has also helped with collection evidenced especially in the decline in number of non-filers at a steady rate. Personal Income tax and Corporate Income tax have also helped government revenue collection accounting for an average of 20 percent of the total revenue in the past five years. Digitization of services such as Pan registration, tax return filing have no doubt helped but some minor issues still remain.

**Table 1: Selected details of PAN, VAT, and Income tax and VAT filers**

	2018/19	2019/20	2020/21
<b>Corporate Permanent Account Number</b>	194192	245561	284435
<b>Personal Permanent Account number</b>	982639	517610	718800
<b>Value Added Tax registration</b>	44638	37868	30956
<b>Excise Registration</b>	94292	103426	131127
<b>Withholder Permanent Account number</b>	4269	4893	8098

<b>Income Tax Filers</b>	50%	51%	55%
<b>Income Tax non-filers</b>	50%	49%	45%
<b>VAT non-filers</b>	38.46%	38.05%	33%

Source: Annual Report, IRD, Multiple Years

A recent world bank report suggests that import duties have a cascading effect with a simple average applied tariff rate of 10.2 percent making it among the world's most protected countries. More specifically, many sectors have a protection of more than 100 percent, which offers little incentive for export promotion, similarly, import duties on raw materials also means that very little incentive for efficient production within the country exists thus making it highly reliant on imports. The effects of which were more pronounced during the recent foreign reserve crisis.



## CHAPTER NINE

## Budget priorities and plans over the years

Nepal's budgetary plans and policies have remained similar over the years. Except perhaps, the addition of the subnational transfers as a separate heading, the trend of allocation of more amounts to recurrent expenditure continues. Capital expenditure as explained earlier has not seen any growth. Although the addition of subnational transfers as a separate heading reduces the amount of recurrent allocation, subnational transfers nonetheless are also mostly recurrent in nature. Indeed, a larger share of recurrent expenditure in comparison to capital expenditure itself is not the problem, yet lower budget execution rates for amounts allocated for capital spending signal structural problems that demand immediate resolve.

Additionally, the priorities of the government of Nepal have not changed over the years. Job creation, promotion of domestic industries, and a focus on social welfare have remained the objectives of the budget over the tenure of the government. This is not surprising, given the commitment of the Constitution of Nepal to socialism based on democratic norms. Yet, concrete plans and policies to realize the aspirations of prosperity and successful achievement of the objectives have always been missing. Except for the budget of fiscal years 2020/21 and 2021/22 (to a lesser degree), allocation of funds by ministry has remained similar, with the Ministry of Road Infrastructure and development receiving the highest share of the budget amount. Since fiscal year 2019/20, the budget size has been trimmed down through the government's mid-term budget review. Continuous decreases in the budget highlight problems in spending and budget execution.

Nepal's budget is informed by two key documents, first the five-year plan, and secondly Mid-term expenditure frameworks that are made for three years by all three levels of government. A recent world bank report suggests that the initial estimates for spending differ significantly from the final estimates in the budget. While capital spending estimates are lower than projected in the MTEF and the five-year plan, recurrent spending is higher highlighting the misalignment between plans.

As noted earlier, Nepal's capital expenditure is lumped during the final quarter of the fiscal year, no budget has taken any priority to address the structural

problems. Moreover, each successive budget has seen mixed reactions from the private sector. Except perhaps for the budget of fiscal year 2020/21, all budgets in Nepal for the tenure of the government have been labelled as either populist or missing the opportunity to accelerate the economy.

In terms of sector wise allocation of the budget and the plans and policies contained therein, Nepal's budget has remained somewhat similar. Column 7 of table 2 highlights repeated programs in some select sectors. In the education sector, free and compulsory education has been a program that has appeared in every successive budget. Social protection programs always include the formalization of the informal sector, yet very little has been done to ensure this. Similarly, revival of sick industries, digitization of land records and service delivery at the Land revenue office, integration of social security schemes, operationalization of existing special economic zones and those being built are all programs that have found continuation without any significant result.

More often than not, plans and policies specifically related to the industrial sector have failed because of the lack of adequate planning. For instance, in fiscal year 2020/21, the budget announced that a subsidy of 50 percent of minimum wage will be provided to those industries that run an apprenticeship program and guarantee employment for at least three months. On the backdrop of the industrial sector complaining about the lack of skilled laborers in the country, the program was appreciated as a step in the right direction. However, the program could not be implemented due to a lack of working procedure. When the program was announced, it was unclear as to which government department would run the program, to that end, a significant chunk of time was lost on planning the details of the program. Similarly, the implementation of duty drawback facility was affected by under allocation of funds to the program and even non-allocation in some instances. The start-up seed capital fund first announced in fiscal year 2020/21 could never be implemented in the said fiscal year because of a lack of working procedure. In fiscal year 2021/22, the same program was announced, yet the mistakes of the preceding year were not corrected completely. In the absence of proper working procedures for the implementation of programs in Nepal, several budgetary promises have not been fulfilled. The most affected sector by far is the industrial sector, which has failed to take off in the way it was imagined in the 15th five-year plan.

On the commerce side, plans to revisit bilateral arrangement and formulate new ones to boost exports have failed completely. Although not all failures can be attributed to government ineptitude, external shocks have had some effect on the ability to make bilateral arrangements, however, there has been no

concentrated effort to do so after the reopening of economies. Nepal's foreign affairs has always been lacking to the extent that making of bilateral arrangements have only been limited to signing of Memorandum of understanding during high profile visits both to and from Nepal, yet, concrete steps to materialize the memorandum of understanding have always been missing. Similarly, plans to identify goods in which Nepal has a comparative advantage has been talked about for five years in a row. The Nepal trade integration strategy, 2016 has already identified products in which Nepal has a comparative advantage, yet very little has been done to materialize the vision of the Trade Integration strategy except for perhaps the operation of an integrated check post at border points to facilitate smoother import and export.

On a yearly basis, the words import substitution and self-sufficiency is found in the budget document, indeed, there are even programs to materialize the goal such as the Make-in-Nepal Campaign, tax exemptions to industries that export certain percentage of their production, bonded warehouse facility for industries and revision to the current customs policy. However, none of these plans have been materialized. Instead, the budget and the finance act combined together have taken policies that incentivize import of finished goods rather than production within the country and even export. Anecdotal evidence suggests that a strong focus on increasing revenues is to blame. Nepal's predominant source of tax income comes from tariffs imposed on imports, to that end subsequent governments have been reluctant to reduce tariffs on raw materials used by Nepalese industries. The World bank (2016) estimates that nearly 90 percent of the industries that export goods use imported raw materials, which are taxed heavily than the final product itself. A higher rate of tariff on raw material discourages exports and even works against the goal of self-sufficiency. Nepal's budget for the past five years to that end has not been able to incorporate cross-sectoral policies to efficiently operate the programs mentioned in the yearly budget. Tariffs on Intermediate products required for production of cement putty, plastic industry, apparel industry form around 5 percent of the total excise revenue. The private sector has long suggested the government to gradually decrease the amount of import tariff on raw materials, however, no concrete steps have been taken in this regard. Instead, reports of apparent foul play for increase in tariffs for raw materials and decrease for finished products emerged in the beginning of last year, highlighting transparency issues in the preparation of the country's budget itself.

The agriculture sector has also received significant attention from the budget in the past five years. On average NPR 37.94 billion has been allocated to the agriculture sector alone, for comparison this is around 3.5 percent of the total

budget of Nepal. Yet, plans and policies for the agriculture sector have also failed to showcase any significant results. Each subsequent budget has highlighted the importance of timely fertilizer supply and shown commitment to address the problems, yet, every year, Nepal faces a fertilizer shortage. On average 800000 metric tons of fertilizer is needed in Nepal. Of the required amount only 1/3rd is imported through formal channels. Nepal heavily subsidizes fertilizer supply leaving little incentive for the private sector to participate. Additionally, the supply of subsidized fertilizer is the sole responsibility of Agriculture Input Corporation, a public enterprise which has failed on a year-on-year basis to supply the adequate amount of fertilizer. Farmers have regularly turned to informal sources for adequate amounts of fertilizers and have even decreased their acreage. Nepal has witnessed improvements in its per-hectare productivity; however, it is nowhere close to her south Asian counterparts. Adequate rainfall and irrigation facilities have helped, but fertilizer supply remains the most crucial problem that has not been addressed.

The poor performance of Agricultural Input Corporation is not entirely surprising given the state of public enterprises in Nepal. Of the 42 public enterprises in operation in Nepal 19 are operating at a loss, with an accumulated loss of NPR 38 billion, which itself is close to the amount of budget allocated to the agriculture sector. In fiscal year 2018/19, the budget document included a plan to formulate a new policy for the management and operation of public enterprises. The policy was never formulated and in fiscal year 2020/21 the same plan was proposed, the result remains the same. Plans to re-organize loss-making industries by involving the private sector have also not materialized. There are apparent resistance to the reorganization of public enterprises in Nepal especially from the trade unions that have prevented any policy to turnaround the state of public enterprises.

Additionally, the only sector to make consistent profit is the financial sector. There are 9 public enterprises in the financial sector. All nine enterprises have consistently made profits and have outperformed other public enterprises. This should not be surprising since the overall ownership of the government is lowest in the financial sector. Whereas in the social sector, public utility sector, industrial sector, service sector and commercial sector the ownership of government is above 90 percent, the financial sector has government ownership of 68 percent. Semi-privatization of the financial sector has greatly helped the sector as a whole to turn into a profit-making venture. Although Agricultural Input corporation is still operating at a profit, one thing to note is that the ability to turn a profit is dependent upon the monopoly powers for supply of fertilizers granted to the company.

The past five Mid-term Budget Reviews identify the same problems i.e. Projections of revenues based on an incremental basis rather than any data, determination of Budget ceiling on an ad-hoc basis, duality of infrastructure projects at the federal and Sub-national Level, Allocation of budget in projects which lack any initial plan, Lack of technical capacity to implement allocated budget, allocation to small and fringe projects based on political party determination. The solutions proposed to the problems are also similar. Proposed solutions often call for increased accountability and transparency measures, a greater focus on evidence-based planning and projection, investment in technical skills, a greater clarity on the roles of federal and sub-national government and a decrease in allocation of budget to fringe projects. Yet, in the past five years, very little has been done to adequately address the problems or even take any step towards the proposed solution. There are two reasons for this. First is a limited understanding of Nepal's policy making process. It is unclear how policies are made in Nepal, the structures that surround it and the incentives of the parties that are involved in it. Except for perhaps a few scholarly contributions, Nepal's policy making process still remains a topic that is yet to be explored in detail. Without an adequate understanding of the processes that drive policy-making any proposed solution is bound to fail. The second is resistance to change. Proposed solutions are resisted by two parties, the first is the bureaucracy which has been entrenched in its own way of doing things, the second are beneficiaries of budget allocation, generally political party cadres. Any proposed change therefore is not implemented. It should then not be surprising, that Nepal's economic outlook has always been balanced subject to the implementation of recommended changes.



Sector	2018/19	2019/20	2020/21	2021/22	2022/23	Repeated Programs
Education	An umbrella act will be enacted for the purpose of keeping uniformity in the establishment and management of the universities. Similarly, reform measures to be initiated to close the gap between private and public schools	President education reform project to be launched and replace the existing Education sector reform project. The program will be a multi-year program targeting secondary education. Likewise the structure of existing education subsidy to be made reform oriented.	Technical education to be promoted from the secondary level and at least one school dedicated to technical education will be established based on local specialty and needs. To establish technical schools Conditional grant will be provided for the establishment of technical school in the affiliation of Council for Technical Education and Vocational Training and under the management of the concerned local level.	Technical schools to be operated at all local levels to develop skilled human resources.	Curriculum will be designed based on market demand in order to link human capital with development and produced skilled labor.	<ol style="list-style-type: none"> <li>1. Free and Compulsory education upto the secondary level</li> <li>2. Schools will be made disable friendly</li> <li>3. Nepal will be declared literate Nepal</li> <li>4. An umbrella act will be established to maintain consistency in the operation and management of university</li> </ol>

Social Protection	Individuals involved in unorganized sector like farmers, laborers and self-employed persons will also be gradually streamlined in current social security programs. Additionally, provinces will be allocated funds to operate social security programs	Distribution of National identification cards based on Household survey in order to target social security schemes at the those below poverty line while also integrating all social security programs being run by various ministries	Expand Contribution based social security program of the government and incentivize more industries to participate in the scheme.		Provisions to enlist workers involved in foreign employment in the contribution based social security fund	<ol style="list-style-type: none"> <li>1. Bring informal sector into the Government's social security programs</li> <li>2. Integration of social security programs run by the government</li> <li>3. Operation of targeted social security programs based on select indicators</li> </ol>
Labor and employment	Establishment of Employment Information Center and Foreign employment center in all provinces. Additionally, partnerships to be made with foreign aid companies to manage domestic employment; provide free of cost short term training in order to supply skilled labor as per market demand.	Establish partnership with local governments to initiate unemployment programs and skill development programs.	To generate employment, the government will invest equity in Start-ups, additionally the Prime-Minister's Unemployment program will be expanded to all three tiers of the government	The Contributory Pension Fund Act will be amended to include professors, teachers and other civil servants in this system. Likewise, the scope of Social Security Fund will be extended to include self-employed persons, labors from unorganized sectors as well as contract and wage-based labors.	The government will give continuation to Prime-Minister's employment program with some modification. Additionally, records of all skills trained persons of the country will be managed and a coordination committee will be formed under the leadership of Labor, Employment and Social Security Minister to coordinate with different sectors that have been carrying out employment-related programs to reduce repetition and make the programs more effective.	<ol style="list-style-type: none"> <li>1. Establishment of Foreign employment centers in all provinces</li> <li>2. Effective implementation of the Prime-Minister's Employment Program</li> <li>3. Modifications to be made to existing programs to reduce the number of same beneficiaries that are targeted under different programs.</li> </ol>

Land Management	The government will initiate discussion on Land use bill in order to prohibit the use of agricultural land for residential purposes	Land Bank will be established and new law realting to leasing of public and private land will be enacted	Existing Policies will be changed to facilitate leasing of land by industries above the current threshold.	At least fifty branches of Bhumi Bank to be established in each province with co-financing of the Government of Nepal and local level. Similarly, unutilized private, government, public and reclaimed land will be provided on lease to individuals, groups or organizations for commercial farming and processing of agricultural product.	For the protection and administration of government, public, communal, and guthi lands, detailed digital records with maps will be created and sent to the appropriate local level. In the next fiscal year, an online service delivery system based on geo-information technology will be implemented in 126 survey offices. The Land Revenue Office's services will be integrated by upgrading the geo-information records management system.	<ol style="list-style-type: none"> <li>1. Digitization of land records and improving service delivery at Land Revenue offices</li> <li>2. Land to the landless program will be initiated and implemented by identification of landless people</li> <li>3. Laws relating to leasing of public and private land will be made</li> </ol>
Industry	The process of Industry registration will be simplified, and foreign direct investment will be promoted. Similarly, a feasibility study to establish at least one industrial zone, economic zone and special economic zone in each province in coordination with the provinces and partnership with public and private sectors will be carried out.	An export house will be established for taking small and cottage industries' products to international markets; products of cooperatives will also be included. Branding will be done through international quality certification, labelling and trademark for establishing an identity in the international market for Nepali goods such as carpets, pashmina, tea, coffee and handicrafts.	Subsidy equivalent of 50 percent of the minimum wage will be provided to industries that provided apprenticeship program to new employees and guarantees them employment for a minimum of two years.	Made in Nepal and Make in Nepal campaigns to be launched in collaboration with the private sector for mass production, marketing, use and export promotion of domestic goods. Similarly, The companies producing and assembling the world's top 10 brand of electric vehicles will be attracted to set up industries in Nepal.	The minimum limit for foreign investment will be reviewed and adjusted at Rs. 20 million. To attract foreign investment, an arrangement will be made to approve foreign investment up to Rs. 100 million through an automated system, similarly, Country Development and Prosperity Special Campaign Decade, 2079-2089 will be carried out and the Prime Minister's Nepali Production and Consumption Growth Program will be launched in order to increase Nepali production, create jobs, and expand export-oriented trade. Rs. 3.45 billion has been allocated for this program.	<ol style="list-style-type: none"> <li>1. Plans will be undertaken to revive sick industries in Nepal.</li> <li>2. Existing Special economic zones and industrial pockets will be fully operationalized by ensuring adequate structural factors are existent.</li> <li>3. At least one Industrial zone will be established in each province</li> </ol>

Transport Management	Various programs including the establishment of data center, use of embossed number in vehicles and preparation of smart card will be carried out in order to strengthen transport management.	Vehicle fitness testing centres will be established in all seven provincial capitals and periodic fitness tests of vehicles will be made mandatory.	Issuance of driving licenses will be done through electronic means	In order to increase the use of electric vehicles, 5 hundred charging stations, terminal buildings and other infrastructures will be constructed in different places of the country including Kathmandu valley in participation with private sector.	Improvements will be made to the driving license examination system in order to ensure that driving licenses examination are conducted within one month of the application.	<ol style="list-style-type: none"> <li>1. Promotion of electric vehicles for public transportation</li> <li>2. Procedures for obtaining Licenses will be simplified</li> </ol>
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## CHAPTER TEN

## Conclusion and Recommendations

When taking a comparative perspective, the last five years of government are neither noteworthy nor entirely unremarkable. Although the tenure of the government started on the backdrop of a relatively stable and political environment, internal and external shocks as was the case with predecessor governments became apparent, especially during years 2 and 3. Nepal still has not managed to structurally transform its economy. It is still heavily reliant on the agriculture sector for both development and employment generation. The manufacturing sector has never been able to take off, it peaked prematurely yet could not sustain. In terms of a strictly perception-based outlook, the Nepalese economy has remained the same in the last five years. Nepal economic update, released by the World Bank has always forecasted a balanced growth, our treasury position is highly reliant on taxes on imports, our economy driven by remittance and our debt positions remain comfortable at 40 percent of the GDP. Major indicators of governance, have all reported that Nepal has performed fairly. Our rankings have neither improved significantly nor worsened drastically. From a strictly rule-of-law perspective, except for a few propositions in controversial bills, government emphasis on protection of the rights enshrined by the constitution of Nepal has remained similar. It would, however, be a grave error to conclude that no efforts have been made to limit rights. There have been several instances, yet a strong civil society which has been helped remarkably by the presence of multilateral institutions and international government organizations has meant that such efforts have not come into fruition. Although, our performance of government effectiveness is some of the poorest in south Asia and the word, civil and political rights in Nepal remain strong.

Making the next leap to a developed economy and realizing the plans of the five-year plan, require significant investment, yet private sector investment although in an increasing trend in recent years is not sufficient for an optimistic growth of 7-8 percent. Similarly, GDP has been dependent on the agriculture sector, which till date is the largest employment provider. Despite signs of a sectoral overhaul in fiscal year 2016/17, the secondary sector has since not been able to reach desired rates of growth. The service sector or the tertiary sector although contributing significantly to the GDP of Nepal, is not a substitute for the manufacturing sector. Evidence from literature has often suggested that in the absence of proper value chains that link the local service industry to the

global service industry, growth in the service sector cannot be sustained. Nepal currently lacks such linkages.

Similarly, the demand side of Nepal's economy has been driven by consumption and investment. Government expenditure only accounts for a small part. Consumption has been driven by remittance earning which have fueled imports and widened Nepal's trade deficit. Investment on the other hand has been driven by private sector gross capital formation which signals a favorable environment for businesses in Nepal. In order to continue the trend of increasing private sector investment, a suitable environment must be created.

Recovery from the pandemic was both helped by an expansionary fiscal policy and a reactionary monetary policy. However, in the absence of continued measures of support, some sectors have not been able to recover completely. The manufacturing sector currently operates at 40 percent of its capacity and the tourism sector has not been able to recover completely from the effects. Recovery could not be sustained due to increasing global prices brought by the Russia-Ukraine war and low levels of spending and budget execution on part of the Government of Nepal.

Perennial problems remain in terms of Nepal's budgetary operations. Although in recent years, Nepal government's revenue collection has improved significantly, revenue collection is still reliant on custom points which itself is not a good sign. Nepal lacks a mix of good revenue base. In recent years however, personal income tax collection and corporate income tax collection have gone up. With an increased focus on formalization and a mandatory provision to have a permanent account number, income tax collection has improved significantly in recent years. This was also helped by digitization of taxation services. Although a few issues remain, it is expected that revenue collection will remain modest in coming years.

Budget execution rates have remained similar over the years, however. Capital spending remains low and for the past three years, the size of the budget has had to be brought down, highlighting optimistic budget making processes. Additionally, there are significant differences between the initial estimate of a project and the final cost as highlighted by the difference between the Mid-term expenditure Framework, five-year plan and the yearly budget.

There are, however, some signs of change already that could potentially change the direction of public fiscal management in coming years. As we institutionalize the practice of National project banks and learn from economies that have implemented them, infrastructure development in coming years will

likely speed up. On the other hand, however, there are currently no plans to change the current modality of procurement i.e. from Substantively Least Cost Evaluated bid to a more a Value for money approach. The National Project bank is modelled after the latter concept and thus likely to succeed in better evaluation of projects, yet its implementation is still questionable. To that end, a detailed evaluation of the current procurement system is needed. A shift from the current Least cost method of selection to a more robust system which considers quality and cost equally is needed.

Similarly, there is also an apparent focus on digitization of services. This was particularly helped by the Covid-19 pandemic and measures taken to control the virus spread. Although the Inland Revenue Department had already, taken steps to digitize its services, post pandemic, other government agencies have followed as well. Both the Company Registrar's office and the Department of Industries now provide digital services. Other agencies are soon to follow, there is however the question of whether effective infrastructure can be built on to provide digital services. The National Identity card distribution and Passport certification are two services that have suffered from lack of adequate digital infrastructure despite a vision for digitization. Bureaucratic transition to that end is equally necessary. In the current state, frequent transfer of employees has been cited as the predominant problem, additionally, a centralist mindset within the current bureaucratic structure is also found which is further exacerbated by a slow transition process to complete federal state.

Nepal has also had a long history of extractive institutions and rent seeking behavior, as noted earlier this has continued in the current context as well. As Wagle (2019), notes, Nepal's experience with private sector led growth is still in its nascent stage and it still must identify areas in which it has a comparative advantage. Furthermore, being a landlocked country aggravates the cost of trading and doing business. Similarly, Nepal's policy is also geared towards import of finished goods rather than production. Factor inputs have higher tariff rates than finished goods, this creates an environment of trading rather than production. Overall, a decrease in tariff rates, at least for raw materials while simultaneously working to reduce the dependency on tariff led revenue collection is a requirement.

## Policy Recommendations

Dependence on the Agriculture sector and the large share of labor in the sector means that productivity of the sector must be increased. This requires not just adequate facilities of irrigation but also a focus on improving farmer's knowledge

of new technology. Provincial and local governments are uniquely situated to bridge the gap. The use of Agricultural Knowledge center at the provincial level must be strengthened to improve productivity.

Financial constraints within the agriculture sector are also equally to blame. Although government policy stipulates that a certain percentage of lending must be to the agriculture sector, anecdotal evidence suggests that the priority sector lending program has rarely reached its beneficiary. Instead, the focus should be hybrid financial instruments that move away from the current Land-Mortgage based system of lending.

Nepal's agriculture productivity has been dependent on exogenous factors, however fertilizer availability is an endogenous factor that can be improved. The focus should be an effective fertilizer input forecast. Additionally, moving away from the current subsidized fertilizer program to a more need-based subsidy program with a focus on Private-sector led delivery using E-Vouchers. Lessons for smart subsidies can be learned from countries such as Senegal and Nigeria.

The manufacturing sector is mired by issues of productivity. Ideally improvement in productivity comes from incentives for firms to innovate or adopt new skills. The current Technology transfer arrangement outlined in the Foreign Investment laws and regulations are not conducive to imitation. Additionally, labor market participants in Nepal lack the adequate skills required. There is a possibility for sub-national governments to work closely with the private sector in order to change the design of technical and vocational education to better suit the demands of Nepal's manufacturing Industries.

Factor Inputs in Nepal are also high, leading to a bias towards importing finished goods. Nepal is uniquely positioned in the sense that it has a large working population, wages are also similarly cheaper, yet other factor inputs are expensive. Input tariffs to that end must be revised to accommodate production within the country.

Consequently, however, Nepal also must work on diversifying its sources of revenue. Reduction in input tariffs means that the government will lose a large share of its revenue from border points. This needs to be offset by a change in the current Value added Tax system, which is based on a lump-sum rate. Differentiating rates along with changes to the Zero-VAT schedule and VAT-Exempt schedule could be a strategy to offset losses. More essentially, the need is more a more robust revenue mix.

Although underspending of the budget has meant that the country's fiscal

deficit has remained below 3 percent of the GDP, changes must be made to the current processes of budget formulation. The need of the hour is a budget preparation guideline that focuses on project selection and project appraisal.

At the same time ex-post evaluation by an independent reviewer is also essential. Nepal does not have a fiscal commission. Although, National Natural Resources and Fiscal commission is a constitutional body, its roles are limited to making recommendations for grants and transfers to the subnational government. Its functioning can be reimaged to include an independent review of projects and their evaluation. This, however, must be taken on a quarterly basis. Projects that subsequently are evaluated poorly by the commission should be penalized with lesser disbursement of funds.

A pre-budget discussion takes place in the Finance Committee of the House of Representatives; however, its recommendations are rarely followed. Strengthening parliamentary oversight over the budget making process is key to establishing a transparent budgetary process and limiting allocation to fringe projects. Formal rules, however, must be complemented with implementation which seems to be lacking in the current scenario.

Nepal's procurement system is also outdated. It does not follow the global standards of Value for money instead opting for the least cost method of appraisal. A new procurement legislation is required, however, at the federal level the new procurement legislation should only detail out the general principles, subnational governments should be allowed to frame their own procurement legislation allowing sub-national governments to learn from the experiences of others.

Inter-agency co-ordination during the budget making process is also absent. A joint committee mechanism to decide on the priorities of the budget and any prospective projects led by the National Planning Commission or the Ministry of Finance could be a mechanism to strengthen inter and intra agency coordination.

Budget document in Nepal is highly optimistic. It often contains plans and policies that have been repeated. A major reason for this is the lack of either allocation of funds to projects as stated in the document or a lack of working procedures to implement a particular project. To that end, a review of past projects mentioned in the budget document must be undertaken before the budget for the next fiscal year is presented. Ex-post evaluation of projects should be complemented by evaluation of plans and policies as well.

Underspending of the budget is also a result of a lack of incentives at the bureaucratic level. There is currently no mechanism to reward and punish civil servants. Although performance contracts have been adopted for high-level executives, for lower levels, the practice of self-evaluation is still the norm. To that end, Nepal needs to make changes to its bureaucratic structure, by focusing more on job description and incentivizing performance.

Nepal still adopts a Cash-basis of accounting. This allows more room for corruption and misappropriation of funds. Similarly, cash-basis is also a reason for resource unavailability during the first quarter of the fiscal year when revenue collection is relatively weaker. Instead a shift to accrual based accounting measures along with debt issuance moving forward would mean that projects can be started as soon as the budget is endorsed.

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