ECONOMIC ANALYSIS[1]

A. Development Context

1. Nepal's economic growth averaged 3.8% per year during FY2002–FY2010, declining slightly to 3.6% per year during FY2011–FY2016. This was slower than the average growth of 4.8% per year recorded during FY1991–FY2000. The service sector, with a share of nearly 50% of gross domestic product (GDP), has become the pillar of Nepal's economy. Agriculture accounts for nearly one-third of the GDP, while industry accounts for the remainder though its share has declined. Manufacturing's share of GDP declined from 9.5% in the mid-1990s to 6.5% in 2015. The low and declining share of manufacturing in Nepal's GDP has happened at a much earlier stage of development and at lower levels of per capita income than in other countries.

2. The trade balance in small and low-income economies such as Nepal tends to be negative because of their high dependence on imports. Nepal's trade deficit has increased as import growth has outpaced exports—more than doubling from 13.8% in FY2000 to 30.3% in FY2016. The ratio of goods exports to GDP has also declined from 15.4% in FY2000 to 5.1% in FY2014.[2] The decline in export–GDP ratio is also a reflection of the declining share of manufacturing in GDP. This is likely to create challenges for Nepal in its endeavor to realize its vision of middle-income status by 2030 as manufacturing plays a key role in generating productivity gains, creating backward and forward linkages with other sectors of the economy, attracting labor out of agriculture and the rural sector into modern and urban sectors, and creating decent jobs. Various government plans and strategies have recognized the role of manufacturing and exports in generating sustained growth.[3]

3. Remittances are the single most important source of foreign exchange earnings for Nepal. Since 2000, remittances have played an important role in stabilizing the current account balance. They have been crucial to poverty reduction, and in sustaining Nepal's consumption- service-led growth model. However, remittances have led to real exchange rate appreciation, resulting in a loss of competitiveness that adversely affects the prospects of the tradable sector. Heavy dependence on a single source of foreign exchange also exposes the economy to external shocks. In the long term, and to achieve Nepal's development vision, the manufacturing sector will play an important role in diversifying Nepal's economic base and in creating diversified and sustained sources of foreign exchange earnings.

4. An enabling export environment will be critical in boosting the manufacturing sector, and customs play an important role in creating a business-friendly climate. Poor trade facilitation can affect manufacturers' competitiveness and their ability to export.[4] Nepal's current state of trade facilitation shows vast potential for improvement (footnote 1). Nepal's Department of Customs (DOC) needs to shift from its traditional role of revenue collection toward paperless, risk-based procedures. In doing so, the DOC can evolve into a modern agency, facilitating implementation of the government's economic policies to increase foreign direct investment and enhance export potential. Government sector strategies recognize the role of an enabling export environment in realizing Nepal's aspirations (footnote 3).[5] A guiding principle of the Customs Reform and

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[1] A more detailed analysis is in Nepal's Development Context and the Role of Trade Facilitation (accessible from the list of linked documents in Appendix 2).
[2] The export–GDP ratio in FY2015 was lower at 4.6% and in FY2016 at 3.3%. The lower ratio in FY2015 and FY2016 may have been partially due to the twin shocks that Nepal suffered in 2015.
[3] Government of Nepal, Ministry of Commerce. 2016. *Nepal Trade Integration Strategy 2016.* Kathmandu.
[4] International Trade Centre. 2016. *SME Competitiveness Outlook: Meeting the Standard for Trade*. Geneva.
[5] Government of Nepal. Ministry of Finance. DOC. *Customs Reform and Modernization Strategies and Action Plan (CRMSAP), 2013–2017.* Kathmandu.

Modernization Strategy and Action Plan (CRMSAP), 2017–2021 is to introduce customs procedures with economic impact (CPEI). The program's support for customs modernization and trade facilitation reforms is aligned with the government's vision of an enabling export environment to support sustained growth, to attain middle-income status by 2030. The program must be complemented by other supply-side initiatives for successful realization of the government's vision.

B. Development Financing Needs

5. For its stage of development, Nepal has substantial development financing needs. It faces an estimated infrastructure financing gap of 8%–12% of GDP annually until 2020.[6] Nepal's fiscal deficit has been small, averaging 1.2% during FY2003–FY2016, but the budget showed a slight surplus in FY2013, FY2014, and FY2016. Robust revenue mobilization but disappointing expenditure performance[7] resulted in a surplus of 1.4% of GDP in FY2016. Nepal's fiscal surplus reflects chronic problems associated with weak budget execution stemming from lack of capacity and procurement delays. The fiscal deficit for FY2017 is projected at 8.8% of GDP or NRs229.3 billion,[8] more than half of which is expected to be financed through foreign loans.

6. The DOC collects about 37% of total government revenue each year. Of the government's total revenue, 79.1% in FY2015 and 78.2% in FY2016 came from taxes.[9] Of the total tax revenue, 50.6% in FY2015 and 50.8% in FY2016 came from taxes on goods and services. Of the revenue from taxes on goods and services, 94.6% in FY2015 and 92.0% in FY 2016 came from value-added taxes on imports, import duties (excise), and taxes on international trade and transactions (about 94% of which was from import duties). Thus, nearly 37.8% of government revenues in FY2015 and 36.6% in FY2016 came from duties and taxes on imports and other international trade-related taxes and transaction charges.

7. The estimated implementation cost of the CRMSAP, 2017–2021 is $94 million. The World Trade Organization (WTO) has noted challenges in calculating the costs of complying with the Trade Facilitation Agreement (TFA) and, more broadly, for undertaking trade facilitation reforms.[10] Implementation of the fifth phase of the CRMSAP is aligned to the WTO TFA compliance schedule. A costing exercise undertaken for the implementation of the CRMSAP, 2017–2021, with which the program is aligned, estimates it to be about $94 million (footnote 6). The government has committed $52 million of its own resources, and the Asian Development Bank (ADB) will contribute $21 million through this program. Additionally, the World Bank will provide

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[6] L. Andrés, D. Biller, and M. Herrera Dappe. 2013. *Reducing Poverty by Closing South Asia's Infrastructure Gap*. Washington DC: World Bank. Quoted in ADB. Nepal Resident Mission (NRM). 2016. *Macroeconomic Update: Nepal*. 4 (2).

[7] Reasons for weak expenditure performance include (i) lack of project readiness; (ii) delays in project approval and budget release; (iii) delays in procurement; and (iv) overall weak project planning, implementation, and contract management capacity. In FY2016, trade and supply disruptions may also have affected capital spending. ADB. NRM. 2016. *Macroeconomic Update: Nepal*. 4 (2).

[8] The fiscal deficit for FY2017 is a "budget estimate." Historically, capital expenditure has fallen short of allocation because of inadequate project planning and implementation. Actual capital spending and the realized deficit will likely be smaller than projected in the budget. ADB. NRM. Economic Database; and ADB. 2017. *Asian Development Outlook: Transcending the Middle-Income Challenge.* Manila.

[9] Calculations are based on data reported in Government of Nepal, Ministry of Finance. 2016. *Budget Speech of Fiscal Year 2016/2017.* Kathmandu. Annex 2. Data for FY2016 is a revised estimate.

[10] For instance, the inception costs of customs automation alone may vary from $550,000 to $57 million, depending on the country. Estimation is difficult because trade facilitation reforms are often deeply connected to broader policy objectives, and the costs vary considerably depending on the type of measures and the country's level of economic development. WTO. 2015. *World Trade Report 2015—Speeding up Trade: Benefits and Challenges of Implementing the WTO Trade Facilitation Agreement.* Geneva. pp.116–124.

$16 million, leaving a funding gap of $5 million (footnote 6). If funding gaps remain after commitments from development partners, the government and additional assistance from Trade Facilitation Agreement Facility will fill them.[11]

8. The size of the program, set at $21 million, is consistent with the DOC's financing needs in recent years. For FY2017, the DOC has a budget of $19.88 million, including an ADB grant from an ongoing project and earlier tranche releases worth a combined $8.49 million.[12] The DOC's capital and recurrent expenditures in preceding years have risen from $9.60 million in FY2014 to $10.81 million in FY2016, with ADB project and program support accounting for a significant percentage.[13] The DOC, like the rest of the government, has low capacity to absorb funds. It is committed to meet annual budget expenditure targets, particularly to increase capital expenditures by enhancing its procurement capacity, which is a policy condition of the program.

C. Program Impact Assessment

9. Trade facilitation reforms can benefit Nepal's economy through various channels. The program supports exports and economic growth through customs reforms that lower the cost of exporting, enhance export competitiveness by lowering the cost of importing, and improve the business climate, thus attracting new investment. The reforms lower the entry barriers to export, helping to enter new export markets and export new products. Beneficiaries from the program include current and future businesses, especially small and medium-sized enterprises, informal traders, and women traders who will benefit from an improved trade facilitation environment. More exports and the ensuing growth of firms, and more investment are also expected to provide benefits through job creation, higher wages, and poverty reduction.

10. Nepal's exports are estimated to increase by 23.0% from the improvement in trade facilitation. A modeling exercise undertaken to quantify the impact of the improvement in trade facilitation on Nepal's trade shows a positive relationship between the Organisation for Economic Co-operation and Development (OECD) trade facilitation indicator (TFI) score and bilateral trade.[14] As the WTO TFA is enforceable, other countries (i.e., those importing from Nepal) are also expected to see an improvement in their TFA compliance, so the TFI scores of Nepal's importing partners are likely to increase as well. Nepal will thus benefit from an increase in its own TFI score as well as that of its trading partners. It is assumed that high-income countries will be fully TFA compliant and that they will achieve a TFI score of 2.0. For all other countries (excluding Nepal, which is assumed to have a TFI of 1.3 as targeted under the CRMSAP, 2017–2021), the TFI score is assumed to increase to the current average of high-income countries if their current overall TFI score (i.e., score pre-TFA compliance) is below that average. In this scenario, exports are assumed to increase by 23.0% and imports are expected to rise by 21.6%.[15]

11. Improvements in trade facilitation will lead to a reduction in importing and exporting costs. Like tariffs, nontariff measures add to the cost of goods. Nontariff measures increase the cost of

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[11] Development Coordination (accessible from the list of linked documents in Appendix 2).

[12] The budget allocation and expenditures are from the DOC sources. The ADB grants are from (i) ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Subregional Transport Enhancement Project*. Manila; and (ii) ADB. 2012. *Report and Recommendation of the President to the Board of Directors: South Asia Subregional Economic Cooperation Trade Facilitation Program.* Manila.

[13] According to the DOC's Budget Section, the shares of the two ADB grants (footnote 12) in the total expenditures are 15.9% (FY2014), 20.1% (FY2015), and 28.7% (FY2016).

[14] A gravity model was estimated for this exercise. Full details of the modeling exercise are in Estimated Gains in Trade from Improvement in Trade Facilitation (accessible from the list of linked documents in Appendix 2).

[15] Gains in trade from other more ambitious reform scenarios are discussed in Estimated Gains in Trade from Improvement in Trade Facilitation (accessible from the list of linked documents in Appendix 2).

importing intermediate goods and can make exports less competitive. Imported inputs play an important role in Nepal's exports. Nearly 90% of Nepal's exporters rely on imported input for their exports.[16] Footwear exporters, for example, import more than 20 raw materials (e.g., leather, glue, soles, and accessories). Access to imported inputs at competitive prices is one of the "problematic factors" faced by Nepal's exporters, and measures to reduce trading costs can help make imports cheaper.[17] Estimates show that full implementation of the TFA can lead to a 9.6%–23.1% decline in trading costs (footnote 10). A 9.6% decline in trading costs from TFA implementation is equivalent to a 21 percentage point decline (from 219% to 198%) in the ad valorem tariff equivalent of trade costs.[18] In addition, expedited processing minimizes potential losses caused by the delay in transit, and timely delivery makes firms more competitive. Lower trading costs, if passed on in the form of lower prices, increase the consumer surplus. In the case of developing economies and least developed countries like Nepal, imported intermediate inputs are typically of higher quality than domestic inputs. In Nepal, manufacturers using larger amounts and a variety of imported intermediary inputs have been shown to have higher exports, more destinations, and higher quality as measured by higher price (footnote 16). Improving access to imported inputs can thus help improve manufacturers' productivity as well as lead to higher quality products that together enhance exporters' performance.

12. Improvements in trade facilitation procedures can also help diversify export baskets and export markets. In addition to expanding the trade of existing products to existing markets, trade facilitation can lead to diversification into new products and markets. Estimates show that an improvement in trade facilitation leads to an average increase of 11.8%–12.8% in the number of products exported by destination for least developed countries (e.g., Nepal) and an increase of 14.1%–21.3% in the number of destinations by products.[19]

13. Trade facilitation can play an important role in integrating Nepal into regional and global production networks. With advances in transportation and information and communication technology, supply chains have fragmented across borders since the mid-1990s. Using new data that capture trade in value added, estimates show that an improvement in TFI by 0.1 (on a scale of 0 to 2, with 2 being the best) could increase domestic value added in final foreign demand by 1%–3% on average.[20]

14. Trade facilitation reforms and lower trade costs can signal an improved business climate and attract foreign direct investment (FDI). The WTO argues that the "resource-enhancing capacity of trade facilitation, through increased capital inflow, could help in mitigating the cost of investing resources in customs-related infrastructure".[21] Recent research shows that reducing trade costs by 1% between the source and host country leads to a 0.8% average increase in bilateral FDI inflows.[22] For countries in Asia and the Pacific where trading costs are higher than

[16] G. Arenas. 2016. From Evidence to Policy: Supporting Nepal's Trade Integration Strategy. Nepal Integration into Value Chains: Stylized Facts and Policy Options. *Policy Note 2.* Washington, DC: World Bank.

[17] World Economic Forum and Global Alliance for Trade Facilitation. 2016. *The Global Enabling Trade Report 2016.* Geneva. p.227.

[18] The calculation is as follows: 21 percentage point=219*(9.6/100).

[19] Details of the extent of improvement for which gains are estimated are in Nepal's Development Context and the Role of Trade Facilitation (accessible from the list of linked documents in Appendix 2).

[20] An improvement in TFI by 0.1 (on a scale of 0 to 2) could increase foreign value added in final domestic demand or gross exports by 1.5%–3.5%. E. Moïsé and S. Sorescu. 2015. Contribution of Trade Facilitation Measures to the Operation of Supply Chains. *OECD Trade Policy Papers*. No. 181. Paris: OECD.

[21] World Economic Forum and Global Alliance for Trade Facilitation. 2016. *The Global Enabling Trade Report 2016.* Geneva, p.95.

[22] Y. Duval and C. Utoktham. 2014. Impact of Trade Facilitation on Foreign Direct Investment. *Trade and Investment Working Paper Series*. No. 4. Bangkok: United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) Trade and Investment Division.

the developing country average, reducing the trade cost to the developing country average is estimated to increase bilateral FDI flows by 20% on average. For Nepal, lowering the trading cost to the developing country average is estimated to increase bilateral FDI flows by 24% on average.

15. Making it easier and less costly to trade may also make growth more inclusive. Cumbersome customs procedures and delays and uncertainty may affect the rural poor as they export products that tend to be perishable. A recent study using the World Bank's trading across borders indicators estimates that each additional document required for imports increases poverty incidence by 0.77 percentage points (based on $1.25-a-day purchasing power parity poverty line).[23] An additional day of import or export increases poverty by about 0.5 percentage points. Small firms are affected more by lack of streamlined and simplified procedures, making it difficult to export. Improved trade facilitation through automation and simplified documentation helps reduce corruption, making it easier for small, informal, and/or women traders who do not have the capacity to handle complex custom requirements. Minimizing face-to-face interactions such as electronic procedures and single windows, as promoted under the WTO TFA, can help reduce bias against female exporters (footnote 4).

16. A reduction in revenue losses is another source of benefits from improved trade facilitation. Nearly 37.8% of the government's revenues in FY2015 and 36.6% in FY2016 came from duties and taxes on imports and other international trade-related taxes and transaction charges.[24] Implementation of the TFA is likely to lower revenue losses through improved valuation systems, improved capacity, efficiency in the clearance process, and by preventing customs fraud.[25] It will also boost revenue collection on account of trade expansion and improved trader compliance.[26]

[23] C. Nguyen. 2013. Poverty, Inequality and Trade Facilitation in Low and Middle Income Countries. In R. Ratnayke, et al., eds. *Impacts of Trade Facilitation Measures on Poverty and Inclusive Growth*: *Case Studies from Asia*. Bangkok: UNESCAP.

[24] Percentages are calculated based on data reported in Government of Nepal. Ministry of Finance. 2016. *Budget Speech of Fiscal Year 2016/2017.* Kathmandu. Annex 2. Data for FY2016 are "revised estimates."

[25] In Taipei,China, following the establishment of the post-clearance audit, customs authorities recovered $26 million in evaded duties and fines for FY2010–FY2011, which was 10 times more than the cost of implementing the post-clearance audit. Government of Taipei,China. 2012. *Post-clearance Audit.* Paper submitted for the WTO Symposium on Trade Facilitation. 11–12 July. http://bit.ly/PostClearanceAudit_TaipeiChina.

[26] In New Zealand, as a result of improved trader compliance, more than 95% of import transactions were deemed compliant based on a risk assessment and could proceed without further intervention. This share stood at 99.8% in FY2016. New Zealand Customs Service. 2016. *New Zealand Customs Service Annual Report 2015/16.* Wellington; and T. Yasui. 2014. Background Paper for the World Customs Organization Revenue Conference. *World Customs Organization Research Paper No. 33*. Brussels. http://bit.ly/WCOResearchPaperNo33.