Program Information Document (PID)

Concept Stage | Date Prepared/Updated: 11-Dec-2018| Report No: PIDC25817

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Nepal	P168869	Programmatic Fiscal and Public Financial Management Development Policy Credit (II) (P168869)	P160792
Region	**Estimated Board Date**	**Practice Area (Lead)**	**Financing Instrument**
SOUTH ASIA	Mar 28, 2019	Macroeconomics, Trade and Investment	Development Policy Financing
Borrower(s)	**Implementing Agency**		
Government of Nepal	Ministry of Finance		

Proposed Development Objective(s)

(i) Establish a framework to move towards fiscal federalism and (ii) improve the policy framework for public financial management.

Financing (in US$, Millions)

SUMMARY

Total Financing	100.00

DETAILS

Total World Bank Group Financing	100.00
World Bank Lending	100.00

Decision

The review did authorize the preparation to continue

B. Introduction and Context

Country Context

1. Nepal today is at a historic juncture with the promulgation of a new constitution in 2015 and the subsequent transition to a federal state with three levels of government: federal, provincial, and local. Recent elections held in 2017 led to a new government that took office in February 2018. In addition, the move to a federal structure will help increase the Government of Nepal's (GoN) ability to deliver on greater inclusion to meet the needs of all citizens, reducing the

likelihood of domestic unrest and political instability. With federalism, the country now has seven provinces and 753 local governments (municipalities) that are responsible for managing funds, functions and functionaries which were previously done through the 75 District Development Committees under the unitary system. The new federal structure aims to bring services closer to the people and increase the effectiveness of the state in the delivery of basic social and infrastructure services. This DPC supports reforms that lay the foundation for the new federal state, by helping to establish the relevant arrangements for efficient and equitable service delivery.

2. Throughout the changes in the political landscape, macroeconomic policy has remained sound and supportive of stable growth rates. Increasingly, there has been a shift from remittance driven consumption-based growth to investment-led growth. This recent shift is reflected in growth rates over the past two fiscal years that have exceeded 6 percent. The higher level of growth is driven by investments to establish local government offices, as well as construction and post-earthquake housing reconstruction, a reduction in electricity load shedding which has helped expand industrial capacity, and record tourist arrivals. Higher public spending (due particularly to the federalism transition) has increased the consolidated fiscal deficit to 5.8 percent of GDP in FY2018 despite higher taxes from elevated imports coupled with close-to-targeted collection. The higher fiscal deficit has been financed partly by tapping government deposits and partly through domestic debt. As a result, the increase in public debt to 30.5 percent of GDP by end-FY2018 remains below the key threshold of 40 percent, with the country rated at low risk of debt distress. Current estimates are that federalism will cost approximately 10.1 percent of GDP between FY2019 and FY2021, (or a little over 3 percent per year). These federalism transition costs coupled with infrastructure and social services needs will require a significant amount of additional resources from both private and public sources. It is therefore imperative that the GoN implement reforms to strengthen fiscal and public financial management at decentralized levels to support the delivery of services needed to engage the private sector and crowd in additional resources to accelerate growth.

3. Nepal’s macroeconomic policy framework is adequate for development policy financing. Despite several severe shocks in the past, Nepal’s macroeconomic fundamentals have been sound: high growth in revenue, low debt to GDP ratio, a stable financial sector and comfortable reserves. Going forward, the government remains committed to macro-fiscal prudence, as evident in its decision to undertake reforms to expand its revenue base and improve tax administration, institute spending reviews, and maintain the peg with the Indian Rupee. After more than a decade, the country now has political and policy stability that will support growth. The key risks are on the fiscal and external front. The transition to a federal structure will increase government spending and keep the fiscal deficit high. Risks are mitigated, to an extent, by the fact that there is considerable donor support for this transition, both in terms of technical assistance and concessional financing. The external deficit is also likely to remain elevated. Reforms supported by the current DPC series will help improve spending efficiency to reduce fiscal risks, particularly during the federalism transition. It is complemented by planned reforms to improve the investment climate and competitiveness, which will support export growth and help maintain reserve adequacy. Nepal is also vulnerable to climatic shocks that could disrupt growth. This risk is mitigated by the actions supported under this operation to establish a disaster risk management center with related guidelines.

Relationship to CPF

4. The proposed operation is anchored in the Country Partnership Strategy (FY2019-2023) and aligned to: CPF Focus Area 1— Public Institutions through reforms that strengthen public expenditure management at all levels of government, to mitigate the PFM and fiduciary risks from the transition to federalism; and CPF Focus Area 3 – Inclusion and Resilience through reforms to address vertical and spatial inequities in service delivery as well as vulnerabilities to climate change and natural disasters. It is also consistent with the government’s own development strategy including its focus on inclusion and poverty reduction. Poverty has been on a declining trend with the poverty headcount ratio at $1.90 per day (2011 PPP) decreasing from 46.1 percent in 2003 to 15 percent in 2010. Nepal has also had impressive performance on

shared prosperity. From 2003 to 2010 consumption growth of the bottom 40 percent was 7.5 percent compared to 4 percent on average across all households.

5. The DPC series is complemented by other WBG instruments and activities of other development partners supporting various aspects of the federalism transition. An ongoing PFM multi-donor trust fund (MDTF) administered by the World Bank includes technical assistance on federalism transition support. These technical assistance programs are providing necessary implementation support to the reforms underpinning the Fiscal and PFM DPC series. In addition, the Integrated Public Financial Management Reform Project (IPFMR), effective since August 2018, supports implementation of key reforms linked to strengthening budget execution and systems for reporting under the new federal system. The reforms supported by this DPC series also complement the overall support to federalism being provided by Development Partners (DPs) through the MDTF. The MDTF is administered by the World Bank with funding from U.K. Department for International Development (DfID), Government of Norway, Australia DFAT, United States Agency for International Development (USAID), European Union and the government of the Swiss Confederation. There is also a ‘federalism donor working group’ comprising several DPs that meets regularly to harmonize the assistance to be provided to the government on federalism.

C. Proposed Development Objective(s)

6. The proposed development objectives are as follows: (i) Establish a framework to move towards fiscal federalism; and (ii) improve the policy framework for public financial management.

Key Results

7. The key results expected from the operation are as follows: i) public primary education spending by subnational governments (SNGs) done on a timely basis; ii) all three tiers of government submit expenditure reports to their respective Parliaments; iii) SNGs initiating spending with seven days of their annual budget approval increases from 0 to 50 percent; iv) SNGs receiving equalization and conditional grants and spending in accordance with climate resilient guidelines increases from 0 to 100 percent; v) gender based violence service referral cases closed increases from 0 to 80 percent; vi) SNGs reporting consolidated spending for FY2020 and publishing it on the FCGO website increases from 0 to 100 percent; vii) procedures manual for all local governments notified by end-FY2019; viii) SNGs reflecting climate change and gender considerations in their annual budget/development plans increases from 0 to 30 percent; ix) expenditure reports (including SNGs) submitted to Parliament per Fiscal Responsibility and Budget Management Bills of individual subnational governments; x) Federal Capital expenditure in the last trimester reduced from 75 to 65 percent; xi) Federal Audit irregularities reduced by 40 percent in the 2019 Office of Auditor General report; xii) increase in Funds allocated to Disaster Management; and xiii) data on 90 percent of Federal and State tax collections available on a real-time basis (FY2019).

D. Concept Description

8. The DPC supports reforms under two pillars. Pillar 1 supports a framework to establish fiscal federalism through an umbrella legislation to be enacted at the federal level that will guide budget execution and ensure fiscal discipline and accountability for all three levels of government. This legislation would also define the broad framework for subnational governments (both provincial and local governments) to develop their own legislations. It also supports the development of a framework for the calculation and devolution of grants to subnational governments (SNGs) as well as mechanisms to improve services that address gender-based violence. Pillar 2 supports reforms to strengthen the policy framework for public financial management at the subnational levels. This is to be achieved through legislation and regulations that

govern the budget cycle and promotes transparency and accountability to citizens, guides implementation of the MTEF and strengthens expenditure control, and the development of a revenue management information system. The pillar also supports reforms to establish a disaster management system to help mitigate the fiscal costs of disasters.

9. The Government of Nepal has set out ambitious social and infrastructure programs and the new constitution (2015) has enshrined equality, economic prosperity and justice as foundations for Nepal's development. The current Periodic Plan (i.e. 14th Plan) aims to achieve middle income status by 2030 and outlines an ambitious investment program. This periodic plan guides the annual development policy directives and strategic directions of the annual budget. The ongoing exercise to prepare the next five-year (15th) Periodic Plan (to be launched in FY2020) is expected to give high focus to maximizing finance for development in addition to ongoing priorities highlighted in the current 14th Periodic Plan. Some of the key areas that the government's plan prioritizes include investment in connectivity and infrastructure, improvements in human capital and strengthening of service delivery. Improved public financial management is identified as a cross cutting area to help achieve these objectives and is the focus of the current operation. The Government's second-generation PFM Reform Program (PFMRP II) draws from the 2015 PEFA. The PFMRP II aims to achieve 8 outcomes which are derived from critical dimensions of the PEFA Framework and covers all key areas of the PFM cycle. The current work program of the MDTF, World Bank and other development partners support the areas identified in the PFMRP II.

E. Poverty and Social Impacts and Environmental Aspects

Poverty and Social Impacts

10. The overall objective of the DPC are aligned with the World Bank Group's twin goals of ending extreme poverty and boosting shared prosperity. Most of the prior actions under this operation are expected to have positive distributional and social impacts such as improved access to public services for the poor as service providers are brought closer to the people, including special grants to implement projects that tackle regional disparities or uplift marginalized communities and groups. The overall poverty effect of transition of civil servants from central to lower tiers of government is likely to be marginal given that mitigating measures are in place, including no planned lay-off and voluntary retirement benefits for those who prefer to resign, and that the civil servants account for a very small share of the population and tend to be mostly in the middle and upper quintiles of the income distribution. Establishing the Disaster Risk Reduction and Management, if appropriately linked with budgeting and investment plans, could have positive effects on the poor and the most vulnerable, currently suffering from increasing climate hazardous events. Gender aspects are also reflected in actions designed to support victims of gender-based violence. This aspect is expected to have positive distributional effects on poverty and gender.

Environmental Impacts

11. Prior actions supported by this operation are expected to have **climate co-benefits** of at least 11 percent (estimated) at concept stage and will be reviewed again during appraisal stage. Environmental and climate change aspects are captured through a prior action that supports the issuance of climate change guidelines in the use of grant transfers. Further environmental effects may arise from application of these guidelines to the budget more broadly. The potential for this will be examined during preparation. It is expected that implementation of the guidelines will lead to improved environmental effects by ensuring that projects and programs are designed to support climate adaptation and mitigation thereby mitigating fiscal risks arising from natural disasters.

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APPROVAL

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