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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR

A PROPOSED

DEVELOPMENT POLICY CREDIT

IN THE AMOUNT OF SDR 137.3 MILLION (US$200 MILLION EQUIVALENT)

TO

NEPAL

FOR THE

FIRST PROGRAMMATIC FISCAL AND PUBLIC FINANCIAL MANAGEMENT DEVELOPMENT POLICY CREDIT

February 20, 2018

Macroeconomics Trade and Investment and Governance Global Practices
South Asia Region

NEPAL—GOVERNMENT FISCAL YEAR
July 16 – July 15

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of January 25, 2018)

Currency Unit: Nepalese Rupee
US$1.00 = NPR 101. 61

ABBREVIATIONS AND ACRONYMS

DPC	Development Policy Credit
CPS	Country Partnership Strategy
DPO	Development Policy Operation
FRBMB	Fiscal Responsibility and Budget Management Bill
GDP	Gross Domestic Product
GoN	Government of Nepal
GBV	Gender-based Violence
GRS	Grievance Redress Service
IMF	International Monetary Fund
IT	Information Technology
LMBIS	Line Ministry Budget Information System
MDTF	Multi-Donor Trust Fund
MIS	Management Information System
MoF	Ministry of Finance
MTEF	Medium-term Expenditure Framework
NNRFC	National Natural Resource and Fiscal Commission
NRB	Nepal Rastra Bank
NWC	National Women Commission
OAG	Office of the Auditor General
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PFMIS	Public Financial Management Information System
PPMO	Public Procurement Monitoring Office
TSA	Treasury Single Account
WBG	World Bank Group

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NEPAL

FIRST PROGRAMMATIC FISCAL AND PUBLIC FINANCIAL MANAGEMENT

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SUMMARY OF PROPOSED CREDIT TO
NEPAL
FIRST PROGRAMMATIC FISCAL AND PUBLIC FINANCIAL MANAGEMENT POLICY CREDIT

Borrower	Government of Nepal	
Implementation Agency	Ministry of Finance (MoF)	
Financing Data	US$200 million financed from the World Bank's Risk Mitigation Resources (RMR) window	
Operation Type	First in a programmatic series of two Development Policy Credits; The Board date for the first operation is March 20, 2018.	
Pillars of the Operation and Program Development Objectives	The Fiscal and Public Financial Management Development Policy Credit supports the government in its efforts to: (i) Establish a framework to move towards fiscal federalism; and, (ii) Improve the policy framework for public financial management.	
Results Indicators (Baseline FY16 and target FY20 unless otherwise stated)	Expenditure on public primary education	Baseline: Undertaken by the federal government Target: Fully undertaken by the local governments
	Spending of all three tiers of the government is as per the Federal Financial Procedural Act (FFPA)	Baseline: Not applicable Target: Expenditure as per norms in the FFPA
	Spending of local governments as per Local Government Operations Act (LGO)	Baseline: NA Target: Expenditure as per the norms in the LGM Act
	Equalization grant in FY19 budget made as per the new equalization formula	Baseline: NA Target: To all local governments
	Share of service referrals (legal, health, police and shelter homes) on Gender Based Violence cases that are closed	Baseline: None Target: 80 percent
	Consolidated public expenditure data available in the public domain	Baseline: NA Target: FY20 budget
	Deviation between consolidated budget estimates and actual consolidated spending	Baseline: 15 percent (average of FY11-016) Target: 10 percent or less deviation
	Submission of annual public expenditure reports	Baseline: None Target: All expenditure reports submitted as per the Fiscal Responsibility and Budget Management Bill
	Proportion of capital expenditure undertaken in the last trimester	Baseline: 75 percent Target: 65 percent
	Audit irregularities reported by the OAG report	Baseline: Audit irregularities of Rs. 97.44 billion (OAG 2016 report) Target: 2019 OAG report with 40 percent reduction in the amount of irregularities reported compared to the 2016 OAG report
	Funds allocated to the Disaster Management Fund	Baseline: Zero Target: TBD
	Availability of information on tax collections	Baseline: Data on 90 percent of tax collections available with a lag of two months. Target: Data on 90 percent of tax collections available on a real-time basis
Overall risk rating	Substantial	
Climate and disaster risks	No	
Operation ID	P160792	

IDA PROGRAM DOCUMENT FOR A PROPOSED FIRST DEVELOPMENT POLICY CREDIT TO NEPAL

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed operation will support the Government of Nepal (GoN) in its efforts to establish a framework to move towards fiscal federalism and improve public financial management.** This operation builds on prior analytical work, ongoing Public Financial Management (PFM) activities and assistance to the government in fiscal devolution. The main development challenges faced by the country include fragility stemming from limited government capacity, political instability, as well as natural disaster related risks. The country had nine governments over the past 10 years and was hit by three large exogenous shocks in the past three years: earthquake (2015), trade blockade with India (2016) and floods (2017).[1] These shocks have adversely impacted the government's fiscal stance, among others.[2] The proposed operation for US$200 million is the first in a programmatic series of two operations and is being fully financed from the Risk Mitigation Resources (RMR) window of the World Bank. The main risks to the operation arise from political vulnerabilities, stakeholder risks and weak institutional capacity.

2. **Nepal is at a historic juncture where it is establishing a federal democratic republic based on the 2015 Constitution.** The impetus for transitioning to a federal state has been the inability of the centralized government to deliver on greater inclusion and meeting the needs of all its people. Nepal is establishing a federal state structure comprising federal, state, and local governments. Seven states have been established. District offices and their sub offices (approximately 3,400 Village Development Councils) have been replaced by 753 local governments. Funds, functions and functionaries hitherto managed through the 75 District Development Committees are moving to state and local governments. Elections for all three tiers of the government were completed relatively smoothly in 2017. The new elected government has been established in February 2018, ushering in the federal democratic republic state that brings to a closure the 2006 Comprehensive Peace Agreement[3].

3. **This Development Policy Credit (DPC) series is a key component of the World Bank's support to federalism.** The World Bank is committed to support Nepal in establishing a federal state, through activities at the strategic, policy and operational levels. At the strategic level, the focus will be on maintaining consensus to transition to a federal state by engaging with political leaders, opinion leaders and the public at large. At the policy level, the focus will be to support the government in aligning the country's economic, social, environmental, and other policies with the new federal state system. At the operational level, the focus will be on the establishment of sound public institutions. This DPC series supports the fiscal and Public Financial Management (PFM) aspects of the transition, which are core to the functioning of the new federal state.

4. **With a focus on the fiscal and PFM aspects, this DPC series lays down the foundation for the new federal state, and will help mitigate the country's elevated risk of fragility and conflict.** Limited state presence in the provision of adequate basic services in education, health, drinking water and connectivity – roads, electricity and telecommunication – were recorded grievances during the conflict period.[4] The new constitution addresses the provision of basic services through the devolution of

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[1] The trade blockade was an international trade embargo that lasted more than four months (from September 2015 through January 2016) and affected economic activity across the board.

[2] Gross domestic borrowing of 3 percent of GDP.

[3] The peace agreement ended the Maoist armed conflict that started in 1996.

[4] Bank's Conflict Stock Taking Exercise – 2003.

functions, functionaries and funds to local governments. This will be done by establishing sound decentralization arrangements that will enable the new government to deliver services efficiently and equitably across the country. If resources do not flow smoothly to the subnational levels, local governments would not have the means to carry out its functions and deliver basic services. Fiscal decentralization needs to be complemented with the strengthening of public financial management systems to strengthen accountability in the use of resources. This operation supports two of the five primary recommendations of the 2017 Nepal Risk and Resilience Assessment,[5] which are: transition to federalism and sub-national governance support; and support to address persistent horizontal and spatial inequalities. Given the importance of the First Programmatic Fiscal and Public Financial Management DPC to setting the foundation for fiscal transfer and strengthening public financial management that is necessary for the functioning of the new federal structure, the operation proposes to utilize financing from the IDA Risk Mitigation Regime.

5. **The transition to fiscal federalism is a major undertaking especially given the limited government capacity, which, if not properly addressed, can bring about significant fiscal risks.** The move to federalism is a mammoth task. It requires administrative restructuring, an increase in public investment and in the number of civil servants at the local level, a redesign of public service delivery, and significant demands on the PFM systems. The proposed operation will support the government in some of these critical areas through the adoption of the Intergovernmental Fiscal Arrangement Act, the establishment of the National Natural Resources and Fiscal Commission, the adoption of the Fiscal Responsibility and Budget Management Bill (FRBMB), the strengthening of PFM systems, improvements in budget execution and reforms to improve revenue collection. The passage of these Acts sets the rules of fiscal federalism, which will contribute to better provision of services to underserved regions and sections of the population. These reforms will address some of the risks associated with fragility and vulnerability in terms of access to services. These reforms are anchored in the government's own development strategy and are consistent with the Performance and Learning Review (February 2017) that adjusts World Bank Group (WBG) engagement to focus more on support to federalism, as well as economic stability and jobs, and disaster preparedness. To address the issue of limited government capacity, a capacity building needs assessment is being supported by the donors in partnership with the government. In addition, in the short term, the on-going capacity building activities are supporting local governments to deliver basic services. In the medium to long term, a joint, donor funded mechanism is planned to fund identified capacity building measures.

6. **Despite fragility, poverty has been on a declining trend.** The proportion of Nepalese households living in poverty (as measured by the international extreme poverty line) fell from 46 percent in 1996 to 15 percent in 2011.[6] 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. The key drivers of improvement in the twin goals included an increase in the amount and the number of households receiving remittances, an increase in labor income derived from wage and non-wage employment, and changes in the demographic structure with a lowering of the dependency ratio.

2. MACROECONOMIC FRAMEWORK

7. **Nepal's growth averaged 4.3 percent during 2005-15.** In 2016, Nepal experienced its slowest growth in 14 years as output growth, which had already fallen to 3.3 percent in FY2015 after the

[5] 2017 Nepal Risk and Resilience Assessment.
[6] Based on International US$1.90 (2011 PPP) per day per capita, Nepal Systemic Country Diagnostic 2017.

earthquake, was dragged down further to 0.4 percent because of a disruption in cross-border trade with India. Agriculture continues to play a large role in the economy contributing to one third of value-added, but its share in the economy is declining. The service sector has grown in importance accounting for more than half of total value-added, while industry/manufacturing sector has declined. Exports continue to struggle while imports are high and fueled by remittances. Inflation was in single digits for most of the past decade, with the peg of the Nepalese rupee to the Indian rupee providing a nominal anchor. Fiscal balances remained healthy owing to strong revenue growth and under execution on the spending side. As a result, the public debt level is sustainable.

2.1 RECENT ECONOMIC DEVELOPMENTS

8. **Following two challenging years, output growth in Nepal rebounded strongly in FY2017, reaching 7.5 percent (year-on-year).** On the supply side, all three sectors grew at above-trend rates in FY2017. Rice production reached a record high at 5.2 million tons, on the back of one of the best monsoons in recent years, boosting agricultural output. With record addition of hydropower capacity and continuing earthquake reconstruction activities, the industry sector expanded briskly. Growth in the service sector was aided by wholesale/ retail trade and the hotels subsector's rapid return to normalization after the shocks of the previous two years. Tourist arrivals rebounded strongly and reached a record high in FY2017. On the demand side, gross investment contributed the most to headline growth. Gross fixed capital formation is estimated at 25 percent of gross domestic product (GDP) in FY2017, with both private and public investment rebounding strongly. Consumption, however, eased with a slowdown in remittances.

9. **The high single digit inflation of the last two years (induced by external shocks), moderated sharply in early 2017 and reached 4.5 percent, the lowest in a decade.** Due to the moderating inflation rate in India and improving supply side constraints, the inflation rate slowed down further to 4.2 percent (y/y) in December 2017. The Nepalese rupee is pegged to the Indian rupee at the rate of 1.6 Nepalese Rupees to 1 Indian Rupee (India is the largest trade partner) and, thus, inflation follows the price movements of the nominal anchor. The real effective exchange rate appreciated by 3.05 percent between July 2016 and July 2017, adversely impacting export competitiveness.

10. **The trade deficit widened to 34.4 percent of GDP in FY2017, driven by a surge in reconstruction related imports.** Imports increased to a record high of 43.6 percent of GDP, primarily driven by industrial supplies, capital goods, and fuel imports; but, consumption and food imports slowed. Exports have further declined to about 9.2 percent of GDP (from a five-year average of 10.7 percent of GDP) because Nepal's exports never fully recovered from the two external shocks (earthquake and trade disruption with India). There is the possibility that exports demand may have further been dampened by the demonetization and the introduction of the Goods and Services Tax in India.[7]

11. **The growth rate of remittances, which financed almost all imports in previous years, has slowed down.** The volume of remittance inflows is still large at US$6.5 billion in FY2017, but growth remains low (much below the double-digit growth of the past). Remittances declined to about 27 percent of GDP in FY2017 from 30 percent in FY2016 (Table 1). The main destinations for Nepali migrants are countries in the Gulf (Qatar, Saudi Arabia, United Arab Emirates) and Malaysia. Following the oil price slump in 2014

[7] India reformed their indirect taxation system through the introduction of the Goods and Services Tax (GST) in July 2017. The GST replaces and subsumes 17 central and state taxes. It reduces rates on over 50 percent of items, with many essential items exempt from tax, and charges standard rates of 5 percent, 12 percent, 18 percent and 28 percent.

and subsequent austerity measures in host countries, the demand for migrant workers from Nepal has softened.

12. **Consequently, the current account balance has reversed from a surplus to a small deficit.** Slower growth of remittances and a surging trade deficit have begun to put pressure on the current account. The trade deficit reached a historic high of US$8.4 billion in FY2017. With remittance inflows of only US$6.5 billion, this was insufficient to offset the trade deficit. Consequently, the current account has moved to a deficit of 0.4 percent of GDP compared to a surplus that averaged 5 percent of GDP in the last five years. Foreign reserves accumulation is high (US$10.5 billion) covering 9.8 months of prospective merchandise and services imports. Despite some pick up in FY2017, foreign direct investment continues to remain low at 0.5 percent of GDP.

13. **Following a surge during the first half of FY2017, credit growth is moderating while the slower deposit growth continues.** Deposit mobilization eased due to the slowdown in incoming remittances. This led to a squeeze on the availability of loanable funds in banks in mid-FY2017. The Credit to Core Capital and Deposit ratio of the banks (capped at 80 percent) reached 78.1 percent by December 2017. The Nepal Rastra Bank (NRB) responded by introducing temporary restrictions on bank lending, which slowed credit growth from a peak of 31.9 percent (y/y) in February 2017 to 18.1 percent (y/y) in July 2017.

14. **The banking sector remains adequately capitalized and stable, even as slower deposit growth continues.** The capital position of banks has improved significantly owing to the retention of earnings, issuance of rights shares and mergers to meet the new capital requirement of NPR 8 billion. The Capital Adequacy Ratio stood at 14.72 percent as of FY2017 compared to 12.12 percent in the previous year. The nonperforming loan ratio is the lowest in Nepal's banking history at 1.54 percent of the total loan portfolio. Loan loss provisions are more than adequate to cover the impaired assets

Table 1. Macroeconomic Indicators

	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21
	Actuals				Est.	Projections			
Real economy	(Percentage change, unless otherwise stated)								
Nominal GDP, current prices (NPR, billions)	1,695	1,965	2,130	2,247	2,599	2,884	3,240	3,613	4,024
Real GDP growth (at market prices)	4.1	6.0	3.3	0.4	7.5	4.6	4.5	4.2	4.1
Real GDP growth (at factor prices)	3.8	5.7	3.0	0.0	6.9	4.6	4.5	4.2	4.1
Contributions to GDP growth:									
Agriculture (percentage points)	0.4	1.6	0.4	0.0	1.8	0.9	1.0	1.0	1.0
Industry (percentage points)	0.4	1.1	0.2	-1.0	1.6	0.8	0.5	0.5	0.5
Services (percentage points)	2.9	3.0	2.4	1.0	3.5	3.0	3.0	2.7	2.7
Consumer prices (period average)	9.9	9.0	7.2	9.9	4.5	5.5	6.5	7.5	7.5
Fiscal sector	(As percentage of GDP, unless otherwise indicated)								
Total revenue and grants	19.5	20.6	20.8	23.2	26.1	26.6	26.7	27.0	27.0
Expenditures	19.0	20.0	21.9	23.7	29.3	30.9	31.3	31.5	31.5

	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21
	Actuals				Est.	Projections			
Net incurrence of liabilities	-0.2	-0.2	-0.9	2.4	3.1	4.3	4.6	4.6	4.5
Foreign	-0.1	0.1	-0.7	0.7	1.2	1.6	1.8	1.9	2.0
Domestic	-0.1	-0.3	-0.2	1.7	1.9	2.7	2.8	2.7	2.5
Total public debt	32.2	28.2	25.6	28.0	27.6	29.4	31.0	32.6	33.9
Domestic	12.5	10.5	9.5	10.7	11.1	12.8	14.2	15.4	16.4
External	19.7	17.7	16.1	17.3	16.5	16.6	16.8	17.1	17.6
Monetary sector	(Percentage change, unless otherwise indicated)								
Broad money	16.4	19.1	19.9	19.5	15.5	….	….	….	….
Domestic credit	17.2	12.7	15.6	18.1	20.2	….	….	….	….
Private sector credit	20.2	18.3	19.4	23.2	18.0	….	….	….	….
Balance of payments	(As percentage of GDP, unless otherwise indicated)								
Current account balance	3.4	4.6	5.1	6.2	-0.4	-2.0	-2.8	-3.2	-3.4
Exports of goods and services	10.7	11.5	11.6	9.5	9.2	9.8	9.7	9.6	9.5
Imports of goods and services	37.5	40.8	41.5	39.4	43.6	43.9	44.0	44.2	44.4
Remittances (as percentage of GDP)	25.6	27.7	29.0	29.6	26.8	26.3	26.5	26.6	26.9
Gross official reserves ($, millions, eop)	5,150	5,828	7,067	8,340	8,730	8,689	8,271	7,677	6,923
Gross official reserves (in months of prospective imports of goods and services)	7.9	8.4	10.1	10.9	9.8	8.6	7.3	6.0	5.0
Rupees per U. S. dollar (period average)	88.0	98.2	99.5	106.4	106.2	…	…	…	…
Memorandum items:									
Nominal GDP, current prices (US$, billion)	19.3	20.0	21.4	21.1	…	…	…	…	…
Population, million	28.0	28.3	28.7	29.0	…	…	…	…	…
GDP per capita, US$ current	689	706	747	729	…	…	…	…	…

15. **Annual revenue growth is robust, but government spending has picked up significantly resulting in a higher fiscal deficit**. In FY2017, the revenue target was met because of a one-off improvement in the collection of outstanding taxes (telecommunication), but revenue collection continues to be reliant on trade taxes. Public spending has picked up significantly as both recurrent and capital spending increased. Recurrent spending increased to 19.9 percent of GDP (up from a 5-year average of 15 percent) particularly due to an increase in civil service wages, fund transfers to local governments, and increased social security spending. Capital spending reached 7.9 percent of GDP in FY 2017 (up from a five-year average of 4 percent of GDP) due to post-earthquake reconstruction activities. After five years of broadly balanced budgets, the fiscal deficit reached 3.3 percent of GDP in FY2017. (Table 2)

Table 2. Fiscal Indicators

	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21
	Actual				Est.	Projections			
	(As percentage of GDP, unless otherwise indicated)								
Total Revenue and Grants	**19.5**	**20.6**	**20.8**	**23.2**	**26.1**	**26.6**	**26.7**	**27.0**	**27.0**
Total revenue	17.6	18.8	19.3	21.6	24.8	25.3	25.5	25.9	26.0
Tax revenue	15.3	15.9	16.7	18.7	22.1	22.8	22.8	22.9	22.9
Nontax revenue	2.2	2.6	2.3	2.7	2.7	2.5	2.7	3.0	3.0
Grants	2.1	2.1	1.8	1.8	1.3	1.3	1.2	1.1	1.0
Total Expenditure (includes on-lending)	**19.0**	**20.0**	**21.9**	**23.7**	**29.3**	**30.9**	**31.3**	**31.5**	**31.5**
Current expenditure	14.6	15.5	15.9	16.5	19.9	20.6	21.1	21.4	21.7
Capital expenditure	3.2	3.4	4.2	5.4	7.9	8.7	8.7	8.7	8.4
Overall balance (excluding grants)	-0.2	-0.1	-0.8	-0.4	-2.9	-4.0	-4.3	-4.2	-4.2
Overall balance (including grants)	1.7	1.8	0.8	1.3	-1.7	-2.8	-3.1	-3.2	-3.2
Fiscal Balance (including on-lending)	**0.5**	**0.6**	**-1.1**	**-0.4**	**-3.3**	**-4.3**	**-4.6**	**-4.6**	**-4.5**
Net financial transactions	-1.5	-1.3	-2.7	0.7	1.5	2.8	3.1	3.2	3.2
Net acquisition of financial assets (includes on-lending)	1.2	1.1	1.8	1.7	1.6	1.6	1.5	1.4	1.4
Net incurrence of liabilities (financing needs)	-0.2	-0.2	-0.9	2.4	3.1	4.3	4.6	4.6	4.5
Foreign	-0.1	0.1	-0.7	0.7	1.2	1.6	1.8	1.9	2.0
Domestic	-0.1	-0.3	-0.2	1.7	1.9	2.7	2.8	2.7	2.5

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

16. **Economic activity, which was expected to progress well in FY2018, was set back by the worst flooding in decades.** Severe floods at the start of FY2018, the third major shock in three consecutive calendar years, have caused significant disruption and damage, especially in the southern plains of Nepal that are the main food producing areas of the country. As a result, the growth rate for FY2018 is expected to decline to 4.6 percent. Over the medium-term, growth will remain moderate, in line with the potential, averaging 4.4 percent in the forecast period. By 2021, output growth will be close to its potential rate of 4 percent. While agriculture will be affected in FY2018, it is expected to grow thereafter in line with its historical average growth rate. Construction is likely to remain strong, driven by post-earthquake and post-flood reconstruction activities. However, the remaining sectors could be affected by uncertainty stemming from the transition to the new federal structure. Remittances could also slow down further. Inflation, particularly food inflation, is expected to rise temporarily in the first half of FY2018 because of the recent floods in Nepal and India, but is expected to remain below the Central Bank’s target of 7.5 percent. Over the medium-term, inflation is likely to be around the Central Bank’s target of 7.5 percent.

17. **The current account deficit is expected to widen, as import growth remains strong, exports remain subdued, and remittances growth rate remains low.** Exports were adversely impacted by the earthquake and the trade disruption with India, and have not recovered since. In addition, an appreciation

in the real effective exchange rate[8] has made Nepali exports less competitive, dampening recovery. The decline in the outflow of migrant workers is likely to continue due to lower demand in Gulf countries, impacting remittance inflows. Imports growth is likely to remain strong, driven by reconstruction activities and infrastructure projects such as the Pokhara International Airport, as well as the Babai Irrigation and the Melamchi Drinking Water Project. The persistence of a large trade deficit and a continued slowdown in the growth rate of remittances is likely to increase the current account deficit, which will be financed primarily by long term borrowing and a drawdown of international reserves (Table 3). By 2021, the current account deficit is expected to increase to 3.4 percent of GDP and international reserves are likely to cover only 5 months of imports (Table 1). There are negligible portfolio investments in the country and despite some expected increase in FDI (due to foreign investments in large infrastructure projects), it will continue to remain low (Table 4). The central bank has maintained the currency peg with India, its largest trading partner, for the last two decades and is expected to continue to maintain the peg with the Indian Rupee.

Table 3. BOP Financing Requirements and Sources (in US$)

	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
Financing requirements	**1,153**	**-263**	**-715**	**-1,039**	**-1,298**	**-1,497**
Current Account deficits	1,320	-95	-536	-855	-1,109	-1,305
Debt amortization	-167	-168	-179	-184	-189	-192
Financing Sources	**-1,153**	**263**	**715**	**1,039**	**1,298**	**1,497**
FDI and portfolio investment (net)	56	127	129	143	162	208
Long term borrowing	338	589	258	362	461	574
Others (trade credits, currency deposits, misc items etc)	100	129	187	116	81	34
Changes in reserves (minus sign indicates increase)	-1,647	-583	142	418	594	682

18. **Government expenditure is expected to increase over the medium-term primarily because of the implementation of fiscal federalism. However, there is considerable uncertainty around the outlook.** Government spending as a percent of GDP jumped by 5.6 percentage points in FY2017, primarily driven by a higher wage bill, larger transfers to local government to implement federalism, and earthquake-related cash assistance and reconstruction activities. The transfers to the local government increased to 3 percent of GDP in FY2017 from a five-year average of 2 percent. This is expected to further increase to 4.3 percent of GDP in FY2018 and reach 6.4 percent of GDP by 2021. In the next three years (2019-2021), on average, total expenditure is likely to grow by 3.4 percent of GDP per year (Annex 5), because of the implementation of the federal structure. While there is considerable uncertainty on the scope and pace of the implementation of fiscal federalism, higher spending is likely because of: i) the establishment cost for state and local governments; (ii) increased infrastructure spending by state and local governments; and, (iii) additional fund transfers for decentralized service delivery.

19. **The consolidated wage bill is not expected to change significantly.** The wage bill at the central level will decline with the decentralization of service delivery,[9] as central level civil servants get reassigned to sub national governments. Concurrently, with the devolution of service provision to state and local governments, the civil service bill will increase at the sub national levels. Initial estimates of the number of civil servants to be transferred from the federal government to the state and local governments are at

[8] 3.05 percent Real Effective Exchange Rate Appreciation between July 2016 and July 2017.

[9] The number of federal level ministries is proposed to be reduced from 32 to 15.

2,000 and 20,000 respectively. The reassignment of central level civil servants to the subnational governments (along with an offer of voluntary retirement packages to those who are not willing to be reassigned) has started, and the outcome is being monitored.

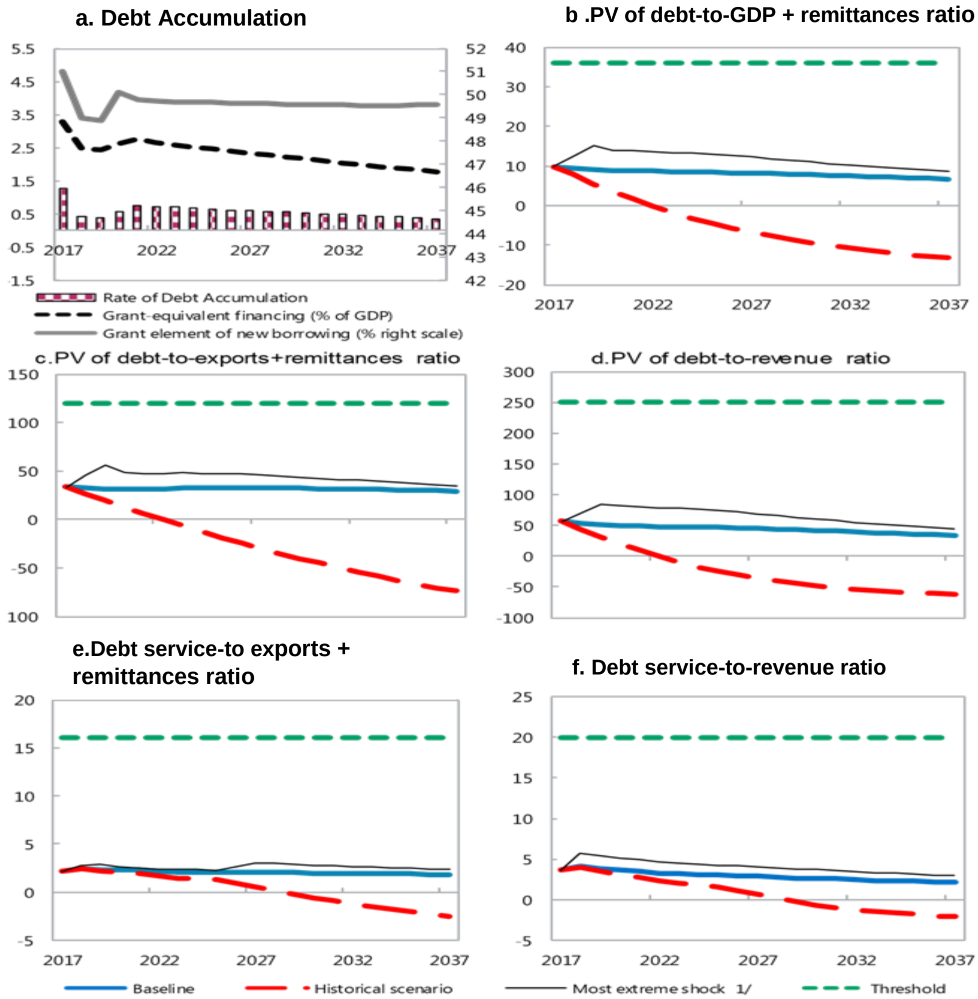
20. **Revenue collection is expected to grow with an increase in trade taxes related to import growth.** Non-tax revenues are also expected to increase because of dividends from institutions (such as Nepal Telecom) and royalties from new hydropower projects (such as *Upper Tamakoshi).* However, expenditure growth is likely to outpace the increase in revenue collection, resulting in a wider fiscal deficit of 4-5 percent of GDP in the forecasted period. The higher deficit will be financed by higher domestic and international borrowing. The availability of concessional financing from international donors is expected to continue and possibly increase, as the government transitions to a federal structure.

21. **The stock of public debt is low at 27.6 percent of GDP in FY2017 and the risk of debt distress is expected to remain low.** Public debt, as a share of GDP, has fallen dramatically from around 64 percent in 2002 to 27.6 percent in FY2017. While prudent fiscal management by the government played a part in early 2000, it is largely the result of revenue collection - annual growth rate of 0.5 percent of GDP - and persistent under execution of capital expenditure in the later years that has resulted in lower levels of borrowing. The Joint World Bank- International Monetary Fund (IMF) Debt Sustainability Analysis (2017) has maintained the "low" risk rating of debt distress. The baseline macroeconomic projections underlying this DSA assume a pickup in government spending and an increase in deficit levels over the medium term. However, Nepal's risk of debt distress is expected to remain low in view of the continued high level of concessionality of official borrowing and limited scaling up of capital spending due to weak implementation capacity. In addition, the government remains committed to fiscal prudence and recently formed a high level Public Expenditure Review Commission (PERC) to carry out a spending review and suggest measures to cut down on spending, particularly in light of federalism. Under the baseline scenario and stress tests, the indicators of the public external debt stock and public debt service ratios remain well below the policy-dependent indicative thresholds (figure below). The Economic Affairs and Policy Analysis Division (EAPAD) at the Ministry of Finance (MoF) is responsible for overall debt management in Nepal. The EAPAD performs the middle office function of setting the targets and objectives of public debt policy. A Medium-Term Debt Management Strategy (MTDMS)[10] awaits cabinet approval, and a dedicated public debt management unit consolidating all debt management functions is being established at the MoF.

22. **The higher federalism related expenditures will be managed by a combination of revenue, domestic borrowing and donor funding.** Therefore, indicators of public external debt stock and public debt service ratios remain within the policy-dependent indicative thresholds even under stress tests, due to continued high level of concessional borrowing.

[10] World Bank provided technical support.

Figure 1. Indicators of Public/Publicly Guaranteed External Debt under Alternative Scenarios, FY 2017-37



The most extreme stress test is the test that yields the highest ratio on or before 2026. In figure b. it corresponds to a Combination shock; in c. to a Combination shock; in d. to a Combination shock; in e. to a Combination shock and in figure f. to a One-time depreciation shock.

Source: World Bank/IMF Debt Sustainability Analysis.

23. **The macroeconomic policy framework is adequate for this operation**. Despite several severe shocks in the past (conflict, unstable governments, earthquakes, trade disruptions), Nepal's macroeconomic fundamentals have been sound: high growth in revenue, healthy fiscal balance, low debt to GDP ratio, stable financial sector and comfortable external balance. Going forward, the government remains committed to macro-fiscal prudence, as evident in its decision to undertake a spending review and continued maintenance of the peg with the Indian Rupee. The key risks are on the political, growth and fiscal fronts. The political environment remains fluid, as the term of the existing government—sworn in in July 2017 as part of the power-sharing agreement among the coalition partners—has come to an end and a new government will be formed in early 2018. The transition to a federal structure could result in

political and policy uncertainty which could impact growth. These risks are mitigated, in part, by the fact that elections have been completed on schedule and the new government is likely to be in place very soon. In addition, fiscal federalism could increase government spending significantly, raising the fiscal deficit above the projected 4-5 percent of GDP. 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. Over the medium-term, as the transition period is completed, a well-functioning federal structure will help support stability and growth.

2.3 IMF Relations

24. **The IMF does not have an ongoing program in Nepal, and the 2017 Article IV consultations concluded in March 2017.** The Bank and the IMF coordinate closely on financial sector strengthening (under follow up assistance to the joint Financial Sector Assessment Program, statistical and PFM capacity building and, more recently, on the federalism agenda.

3. THE GOVERNMENT'S PROGRAM

25. **The current three-year 14th Periodic Plan and the Socio-Economic Development Strategy (2030) aim to achieve graduation from least developed country status by 2022 and transition to middle-income status by 2030.** The periodic plan guides the annual budget, while the 2030 Strategy is a guide to achieving longer-term goals. Some of the key areas that these strategies prioritize include job creation, urban development, investment in connectivity and infrastructure, improvements in human capital, strengthening of public service delivery, and improved PFM. The proposed operation supports the government's efforts in some of these areas, including strengthened public service delivery (through the move to a federal structure) and improvements in PFM.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

26. **The proposed operation supports the government's transition from a centralized to a federal structure and reforms that enhance PFM.** The operation is fully consistent with the government's three-year periodic plan and the 2030 Strategy. It is the first in a programmatic series of two operations and is organized under two pillars: (i) establish a framework to move towards federalism, and (ii) improve the policy framework for PFM.

27. **The transition to a federal state in Nepal is an ambitious agenda and the WBG, along with other development partners, will be supporting the government in fulfilling this ambition.** The donor community provided numerous technical experts that have advised parliamentarians, political parties, civil society organizations, media and citizens on various aspects of federalism. The WBG also provided expert advice and training in various areas to senior government officials. Some of these officials were directly involved in drafting federalism related legislation. Adoption of some of these legislative frameworks is being supported by the current DPC series and these frameworks incorporate key lessons learned from other countries. As an example, in the Nepali fiscal federalism context, the design of fiscal transfers includes the following lessons learned from other countries: (i) Effective and efficient revenue collection is achieved through centralization of revenue collection efforts on major tax sources; (ii) Adequacy of funding for sub-national governments is ensured through predictable, formula-based allocations; and (iii) Adequate provisions for prudent debt management in a decentralized system of

government is crucial. This partnership between the donor community and the government[11] will support the authorities as they progress on the federalism agenda, including the fulfilment of the triggers for the second operation in this programmatic series. Capacity building is a crucial element of the joint federalism engagement agenda.

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1: Establish a framework to move towards fiscal federalism

Implementation of Fiscal Arrangement in the Federated Context

Prior Action 1: To implement fiscal federalism the Parliament has approved the Intergovernmental Fiscal Arrangement Act which provides the legal framework for resource allocation among the three tiers of government.	**Trigger 1:** The Parliament has approved the Federal Financial Procedures Bill which provides guidance on budget execution.

28. **Nepal has embarked on an ambitious compact between the state and citizens to move from a unitary to a federal government system.** While the expected benefits of this reform are significant, in the short term, this shift is a daunting task for a low-income country like Nepal with fragmented politics and weak institutions. Adoption of new legislation; creation of new institutions, systems and processes; and finalization of methodology for transfer of funds to local governments pose many challenges and will put further strain on the government, whose implementation capacity is already stretched.

29. **One of the key objectives of this transition is to increase efficiency and expansion of the delivery of basic services.** Local governments will deliver basic services like education, health, local transport, and water and sanitation. Until now all these services were provided by the central government through line ministries, which resulted in limited access to basic services in certain parts of the country, such as far and mid-western regions and inner Terai, in part due to challenges related to the geography of the country. The quality of service provision had also deteriorated over the years, for example, unavailability of medicine and trained staff, teachers' absenteeism, lack of sufficient maintenance funds leading to breakdown of existing water supply systems, and local roads access limited to the dry season only.

30. **For the provision of these services, resources will be allocated to local governments according to an established framework**. The Parliament has approved the Inter-Governmental Fiscal Arrangement Act[12] (*prior action 1*), which specifies the framework for PFM, including resource allocation between the central, state and local government. It establishes fiscal policies that guide the PFM systems, including the fund transfer channels from the central government to the local governments, namely: a) equalization grants, which is the transfer of resources to the state and local governments based on population and development status; (b) complementary grants, which is the transfer of funds to state and local governments to implement infrastructure projects; (c) conditional grants, which is the transfer of funds to state and local governments to support projects in accordance with national policy and programs; and, (d) special grants, which is the transfer of funds to state and local governments to support any special project related to the supply of services, emergency needs and activities related to national development priorities. The exact cost of fiscal federalism is still unknown, as the government is still deciding on the

[11] A government-donor federalism team, jointly chaired by the Swiss Development Corporation and the WBG, has been formed to provide technical assistance to the government to implement federalism.
[12] WBG supported through PFM Multi-Donor Trust Fund (MDTF).

finer details of functions (concurrent ones) that will be devolved and the federal civil servants who will be assigned to the state and local governments. Given the existing information, the current cumulative estimated cost of federalism is approximately 10.1 percent of GDP running up to 2021 (i.e. from FY 2019 to FY 2021).[13]

31. **To govern the budget execution of all three levels going forward, Nepal is preparing "The Federal Financial Procedures" Law (*trigger 1*).** This law will formalize budget planning and execution activities that were earlier functioning through budget directives. These directives governed procedures like budget planning, fund allocation, recording and reporting. The Federal Financial Procedures Law will include formalization of the committee responsible for fixing the budget ceiling, the three-year periodic plan, coverage and content of the budget virement, internal controls and reporting. It will also provide state and local governments with the basis to frame their financial procedures. Until this Bill is approved by the Parliament and respective local government councils, interim budget directives have been issued to facilitate local government spending. Once the law comes into effect, these interim directives will cease to exist.

Functioning of Local Governments in the Federal Context

Prior Action 2: The Parliament has approved the Local Government Operations Act - 2017, which will govern the operation and management of local governments.	**Trigger 2:** Local governments have (i) Established the Local Consolidated Fund; and (ii) issued regulations to authorize the Chief Administrative Office to initiate spending within seven days of approval of the annual budget by the local assembly.

32. **The powers of the local level governments have been outlined in the Constitution of Nepal in the spirit of cooperativeness, co-existence and coordination among the federal, state and local level.** To implement the new constitution, the Local Government Operations (LGO) Act (*prior action 2*) defines functions, duties and rights of local governments; establishes assembly meetings and working systems; outlines procedures related to management of local assembly; provides guidance on the formulation and implementation of local development plans; earmarks the fiscal jurisdiction of local governments and provides the local financial working procedures. This act will primarily govern the operation of the local governments.

33. **In the future, all funds for the local government are to be deposited into the Local Consolidated Fund (*trigger 2*) from where all expenditures will be channeled**. A functional Local Consolidated Fund will enable the municipalities to manage their fiscal affairs, especially on the expenditure side and bring an end to the current practice of off-budget activities that have lowered the accountability of funds use. In addition, the ability to initiate the execution of budgeted amounts within a week of annual budget approval will allow local governments to perform their service delivery functions efficiently and in a timely manner.

Operationalization of the Fiscal Commission

Prior Action 3: The Parliament has approved the National Natural Resources and Fiscal Commission Bill which will govern federal transfers to state and local governments.	**Trigger 3:** The National Natural Resources and Fiscal Commission has (i) adopted the framework for the calculation and devolution of two grants (equalization and conditional) and has made the formula for the equalization grant public; and (ii) issued climate resilient

[13] Preliminary estimates of the MoF, Ministry of General Administration and Ministry of Federal Affairs and Local Development.

	infrastructure investment guidelines to the sub national governments

34. **Implementation of the 2015 constitution will be assisted by eleven commissions[14] which will provide further guidance on the broad framework adopted in the constitution.** The National Natural Resource and Fiscal Commission (NNRFC) [15] [16] is one of the eleven commissions to guide the fiscal and financial devolution under the arrangements of the federated state, which has three tiers of independent governments. The NNRFC is empowered to provide policy guidance in the design of natural resources mobilization,[17] revenue[18] and grant[19] sharing between all three tiers of the government. Nepal's ecology is fragile with one of the youngest mountain ranges in the world. Past infrastructure investments, especially those undertaken by the local authorities in the road sector, were land slide prone and resulted in a loss to both human lives and pristine vegetation. Under a federal structure, further damage to the fragile ecology by infrastructure investment can be lowered through NNRFS' investment guidelines to the sub-national governments. The NNRFS is also the focal body that will arbitrate on benefit sharing amongst the different tiers of the government. The NNRFC will provide the 2019 fiscal year budget ceiling as well as the transfers to the local governments.

35. **Going forward, in addition to providing fiscal policy guidance to the government on the budget, the NNRFC will also determine the norms for the calculation and distribution of fiscal grants to the local governments and investment guidelines to the sub-national governments that are climate resilient**. The NNRFC will develop the formula to implement the two fund transfer channels[20] (*trigger 3*), namely: (a) equalization grants; and (b) conditional grants. These transfers are expected to lead to a more balanced development across states and regions, and to support and uplift underserved regions and groups. To ensure transparency, the NNRFC will also make public the equalization and conditional grant formulas. In addition, through the natural resource mobilization framework, the NNRFC will incentivize investment by all tiers of the government in infrastructure that is climate resilient by awarding investment projects that adopt measures to minimize risks from floods, landslides and glacier outburst.

Response Mechanism for Gender-based Violence

Prior Action 4: The National Women Commission has adopted an integrated platform that provides a comprehensive response system and	**Trigger 4:** National Women Commission has (i) established a 24 hour Helpline manned by trained staff; (ii) established a case processing system to track service provision; and,

[14] National Women Commission (NWC); National Dalit Commission; National Inclusion Commission; Adibashi Janajati Commission; Madhesi Commission; Tharu Commission; Muslim Commission; Commission for the Investigation of Abuse of Authority; Public Service Commissions; Election Commissions; National Human Rights Commission; and National Natural Resources and Fiscal Commission.

[15] Through Cabinet's formation order (August 30th), NRFC is to be formed post-election.

[16] Nepal is a hydro power rich country and royalty from this natural resource could potentially be an important revenue source for some local governments.

[17] Resource Mobilization Indicators: revenue situation and revenue raising capacities; investment capacity; proportions of benefit sharing; utilization of proportion of benefit; condition of infrastructure and requirement; and economic condition and geographical structure.

[18] Revenue Sharing Indicators: population and its composition; area; human development index; expenditure requirement; efforts towards revenue collections; infrastructure development; and, special conditions.

[19] Grant Sharing Indicators: Revenue status; Need; Service provided to the citizens; status of infrastructure development; human development index; sustainable development; status of economic, social and other discrimination; and availability of education, safe drinking water and others.

[20] MoF is responsible for two channels namely 1) special grant and 2) complementary grant.

coordinates and expands access to services for Gender Based Violence cases.	(iii) issued protocols and guidelines for survivor support, case prioritization and service access.

36. **While fiscal federalism will help address one part of Nepal's exclusion story (people living in remote areas and places far from Kathmandu), the other group that has been systematically excluded is women.** All forms of exclusion entail a cost to the economy. There are still significant gender disparities in Nepal. The adult literacy rate at 72 percent for men is significantly higher than the 49 percent for women (2011). Similarly, while 34 percent of male workers have a salaried formal job, only 12 percent of women have a similar job. In fiscal year 2008, the MOF formally introduced a gender responsive budget system requiring sectoral ministries to categorize their program budget on the extent to which they are responsive to gender equality.[21] Taking forward the nation's inclusive agenda, the constitution mandates that one-third of federal and state parliamentarians should be women, while municipal councils must have at least two women in the ward council[22], in addition, to having either the executive or the deputy as a woman for all elected government local institutions.

37. **Nepal has a large prevalence of intimate partner violence, many married women report having experienced emotional and physical violence from their spouse.** Women are also at the risk of child marriage and trafficking. Past efforts, typically disjointed and sporadic, have made some but insufficient inroads in addressing these issues. A new response mechanism for gender-based violence (GBV) through an integrated support model for survivors will be operationalized. This integrated model encompasses access to shelter, health care, psychosocial support, legal aid and improved service delivery. It will contribute to the government's broader objective of promoting gender equality and justice, thereby empowering nearly 50 percent of the society.

38. **For the integrated model to be effective, the next step will be the establishment of a 24-hour Helpline Service (*trigger 4*) at the NWC as a response to GBV.** Digitalizing the recording, reporting and referral system of the NWC[23] and tracking of GBV cases through an on-line Case Management Process/System will ensure a monitorable response mechanism. Such a mechanism will be critical for ensuring a survivor-centric approach for victims from the time of registering their call to the time their case is dealt with and closed. This measure is anchored in the NWC Act (2017), the Domestic Violence Act (Crime and Punishment) 2009, and the National Action Plan on GBV (2010). Under the National Action Plan, the issue of involvement of men and boys in the prevention of GBV will be explored.

39. **Expected results under Pillar 1 are**: (i): Public primary education expenditures fully undertaken by local governments; (ii) Spending of all three tiers of the government in accordance with the Federal Financial Procedural Act; (iii) Spending of local governments as per the Local Government Operations Act; (iv) Equalization grant in the FY19 budget made as per the newly adopted equalization formula; and (v) Share of service referrals (legal, health, police and shelter homes) on GBV cases are closed.

Pillar 2: *Improve the policy framework for public financial management*

Strengthening of Public Financial Management Systems

[21] Gender Responsive Budget 2018: 70 percent of the budget gender supportive, 23 percent directly gender supportive.
[22] At the minimum, there are nine wards in every urban/rural municipalities,
[23] NWC is a constitutional body formed in 2002 with the mandate to work for the protection and promotion of the rights and interests of women to effectively include them in the mainstream development by providing gender justice.

Prior Action 5: To strengthen public financial management systems, the MoF has: (i) integrated all public financial management systems onto one platform - Public Financial Management Information System and (ii) provided access to the PFMIS to all federal ministries.	Trigger 5: To strengthen state and local governments' public financial management, (i) the Local Governments have adopted the Local Finance Procedures Bill and its directives and the Local Administrative Revenue Bill and its procedural directives; and (ii) to increase transparency and support citizens' engagement the government has instituted a system of public disclosure of local government expenditure reports by making them available on the website of the Financial Comptroller General's Office.

40. **The country has made impressive strides to improve PFM, but systemic weaknesses exist that impair policy decisions.** The Public Expenditure and Financial Accountability (PEFA) - II (2015) concluded that while the basic building blocks of PFM are in place, improvements are required in the following areas: composition of expenditure out-turns compared to original approved budget; extent of unreported government operations, transparency of intergovernmental fiscal relations; effectiveness in collection of tax payments; predictability in the funds for commitment of expenditure budgets, and others. As a first step, timely information is required to make informed policy decisions. To achieve that, an information platform that integrates multiple budget management systems into a single platform – the PFMIS – has been created (*prior action 5*). It integrates: (a) Line Ministry Budget Information System, (b) Budget Management Information System (MIS), (c) Treasury Single Account (TSA), (d) Financial Management Information System, and (e) Revenue Management Information System.[24] Going forward, all federal ministries will be provided access to the PFMIS to enable informed policy dialogue with the MoF and their respective divisions and departments.

41. **With the creation of a fiscal federal structure, transparency on public expenditure will require that reforms that made expenditure information public at the federal level will be extended to the state and local level (*trigger 5*)**. The central government's expenditure reports are already available on the Financial Comptroller General's Office website. The availability of local government expenditure reports will support transparency, and greater accountability of funds use. In addition, the availability of government spending data for public consumption will facilitate citizen engagement at all levels of the government, especially at the local level.

Budget Formulation and Execution

Prior Action 6: To strengthen budget realism: (i) the Recipient has issued guidance to the federal ministries to guide their preparation of the draft three-year MTEFs for the FY 2019 budget cycle; and (ii) the National Natural Resources and Fiscal Commission has issued its circular to the local governments to guide their preparation of the annual budgets, to be part of the Local Government Development Plan.	Trigger 6: To ensure budget realism at the local level, the local governments' council has mandated the preparation of a 3-year MTEF in line with the Local Government Development Plan. Trigger 7: The Cabinet has endorsed and submitted to Parliament the Fiscal Responsibility and Budget Management Bill (FRBMB) to ensure fiscal discipline and increase accountability.

[24] Systems under development and not fully rolled out are not covered, such as assets management, pension management, and personnel information systems, among others.

42. **Nepal was the first country in the South Asia region to implement Medium-term Expenditure Frameworks (MTEFs),[25] which was then discontinued**. In the absence of MTEFs since 2014, unrealism in the budget has increased (measured by the deviation of actual spending from planned outlays). The average budget deviation between FY11-FY14 and FY15-FY17 increased from 17 percent to 23 percent.[26] With an anticipated increase in public expenditure in support of fiscal federalism, the reinstatement of MTEFs at the federal level will help ensure prudent fiscal and budget management (*prior action 6*).

43. **In addition, while the federal government's annual budget is anchored in the national development plan, the same is not true for the local governments due to the absence of local plans**. The Intergovernmental Fiscal Arrangement Act and Local Government Operations Act (*Prior Actions 1 and 2*, respectively) mandate the preparation of Local Government Development Plans on the policy side, which will guide both the local budgets as well as the local MTEFs. A next step will be the preparation of the local level MTEFs, anchored in those Local Government Development Plans. The NNRFC has issued circulars to all local governments to guide their preparation of the annual budgets to be part of the Local Government Development Plan. Mainstreaming this circular, in conjunction with donor supported capacity building activities, will be the corner stone and a platform to improve local government budget planning. Going forward, the preparation of local MTEFs will help with the formulation of realistic local government budgets staying under approved budget ceilings and, thereby, strengthen budget execution and its efficiency. *Trigger 6* will mandate the preparation of local MTEFs.

44. **Finally, in addition to the above reforms to support better budget preparation, an overarching legislation to govern fiscal policy will be necessary to ensure fiscal prudence.** The FRBMB will encompass rules that govern fiscal discipline, guide annual budget formulation, and ensure effective execution of fiscal policies (*trigger 7*). It will also guide PFM institutional arrangements and reporting systems to the parliament to strengthen accountability and governance. In 2015, two clauses of the proposed FRBMB (namely, early submission of budget for parliamentary discussion and approval of next budget before the end of the fiscal year) were enshrined in the Constitution. This mandates that PFM actors implement the approved budget on the first day of the new fiscal year (in FY18) and ends the practice of using budget submission to the parliament as a political negotiation process.

Improving Budget Execution and Controls

Prior Action 7: To improve budget execution, the MoF has: (i) issued a decree which requires all new aid funded and national priority projects to have secured project filter clearance for issuance of budgetary funds; (ii) adopted the System for Automatic Spending Authorization and Program Approval for all spending units which will assist in budget execution from day one of new fiscal year; and (iii) adopted a system of payments by account payee only to expedite payments.	**Trigger 8:** To strengthen expenditure control: (i) the Financial Comptroller General Office has adopted the new internal control guidelines (2018); and, (ii) the cabinet has submitted the 2018 Audit Bill to the Parliament for approval.

45. **Last trimester bunching (75 percent of capital expenditure) and under execution of the capital budget (average 20 percent unspent) is common in Nepal**. Some of the factors that explain under-

[25] In 2003.
[26] Includes both recurrent and capital spending.

execution include: (i) lack of a project readiness filter leading to budget allocation but no release;[27] (ii) project approval in the last quarter of the year; and, (iii) lack of enforcement of multi-year procurement planning.[28] To increase capital budget execution, the government has created the requirement that all new aid funded and national priority projects will need to obtain project filter clearance, which certifies that they have adhered to the pre-requisites for project implementation. If a project does not have this clearance, only a limited amount of resources will be allocated to such projects. In addition, to increase the overall budget execution, the MoF has operationalized automatic spending authorization and funds transferred directly to vendor's account. This has made funds available from the very first day of the new fiscal year for budget implementation. As of now, even if line ministry budgets are approved, the MoF approval for spending is a perquisite and few payments are done through account payee checks or directly credited into vendor accounts. These reforms will do away with the current time-consuming program/ project approval processes and improve budget execution arrangements, while strengthening the role of the MoF in budget execution monitoring activities.

46. **In addition, to improve budget execution, it is critical to strengthen expenditure controls.** Audit observations[29] are expected to further increase with expanded local governments' spending units under the current internal control guidelines. The Office of Auditor General (OAG) reported audit irregularities to the tune of NPR 97.44 billion (OAG 2016 Report). Most of the irregularities are centered on financial procedures for the recovery of advances (26 percent of audit observations), non-compliance with financial procedures (31 percent) and the inability to recover funds (42 percent). To strengthen expenditure controls going forward, new internal control guidelines and an Audit Bill will be submitted to the parliament for approval (*trigger 8*). The adoption of the new internal control guidelines by the Financial Comptroller General's Office will help strengthen the procedures pertaining to payment requests, document control and the timely settlement of advances, among others. In addition to strengthening other audit functions,[30] the approval of the 2018 Audit Bill will support the establishment of audit offices in all 7 states, regularize performance audits and enforce the recovery of irregularities within a given timeframe.

Strengthening Disaster Risk Management and Building Climate Resilience

Prior Action 8: The Parliament has approved Disaster Risk Reduction and Management Act - 2017, which will govern coordination and management of all activities pertaining to disaster management, disaster risk reduction, disaster recuperation and disaster response as well as monitoring and mitigation measures on climate change and global warming.	**Trigger 9:** To strengthen disaster management response and initiate disaster risk reduction actions, the federal government has (i) established the National Disaster Risk Reduction and Management Centre; (ii) approved the disaster management national policy and plan; and (iii) issued disaster management policy guidelines to state and local governments, taking current risk profile and future climate change into consideration

47. **Nepal is one of the most disaster and climate vulnerable countries in the world and this puts a big strain on the government's budget.** An estimated 80 percent of the geographic area in Nepal is at risk from multiple natural hazards. These natural risks take an enormous toll on people and livelihoods, and

[27] Examples include: (i) Transmission project fund budgeted but in absence of permission for forest trees clearance, budget not released; (ii) Based on preliminary estimates of a proposed project, budget appropriation made; but, in absence of detail feasibility report that has procurement plans, budget not released; (iii) budget appropriated for land purchase, but in absence of land purchase directive, budget not released.
[28] 2014 PFM Gap Analysis.
[29] Audit observation is when Office of Auditor General flags a financial rule that may have been side step in financial transaction.
[30] On-going Strengthening of OAG through MDTF.

put a strain on the government's budget given reconstruction related activities, among others. Every year, monsoon rainfall causes floods and the country is exposed to high risks from landslides and Glacier Lake Outburst Floods (GLOFs). Glacier thinning and retreat in the Himalayas has resulted in the inherently unstable process of formation of new glacial lakes and the enlargement of existing ones. Recent surveys indicate that many glacial lakes in the country are expanding at a considerable rate, increasing the risk of sudden outbursts. These disasters have had considerable fiscal implications that are expected to be exacerbated by future climate change. A post-disaster needs assessment carried out after the 2015 earthquakes estimated about US$6.6 billion in disaster recovery needs. Similarly, the recovery cost of the 2017 flood is estimated at US$700 million. Much of this has been met from public-sector financing, particularly for the housing reconstruction subsidy. Hence, for Nepal to continue to make progress on its key development indicators, it is critical to invest in efforts aimed at post-disaster reconstruction efforts, early warning preparedness, and long-term climate resilience. The Disaster Risk Reduction and Management (DRRM) Act is expected to reduce the risk and manage the disaster response after it occurs, particularly because of better coordination among the various public sector entities. Additionally, the act also requires the government to set up a separate disaster fund, which can only be spent for recovery activities following a disaster. Cognizant of the topographical fragility of the country, the constitution has made a provision for fiscal transfers to local governments of under 'special grants' to address local specific disaster response fund requirements.

48. **Policies and institutional arrangements for disaster response and mitigation measures are there, but coordination could be strengthened.** The establishment of the National Disaster Risk Reduction and Management Council (*trigger 9*) will be an apex body of the government for all issues related to disaster risk reduction and management, as well as mainstreaming climate resilience. The council will support the adoption of policies and guidelines on disaster risk reduction and management for all three tiers of the government. The main thrust of these policies will be an integrated approach with all sectors in terms of disaster risk reduction, disaster counteractions and disaster recovery taking potential future climate change into consideration. Additionally, it will define the roles of all agencies and institutions of public, private, non-governmental sectors and will require such agencies and institutions to include disaster management and climate resilience components in their respective policies, plans and programs. For instance, to further strengthen its commitment to climate change, the government recently approved the World Bank funded Forest Investment Plan, which will include climate adaptation. As noted earlier, NNFRC investment guidelines to sub-national governments will support climate change related activities.

Strengthening of Revenue Management Information System

Prior Action 9: The MoF has established the Revenue Management Information System at the federal level to provide real time information on revenue collections.	**Trigger 10:** The MoF has established the Revenue Management Information System at the state and local level to provide revenue collection information.

49. **So far, concessional financing and revenue growth have funded increases in public expenditure.** To finance increased spending arising from fiscal federalism, measures are being undertaken to strengthen tax administration. An electronic platform to monitor revenue collection of major tax streams on a real-time basis is now operational (*prior action 9*). This will serve as a database for tax collections, which will enable evidence based research, analysis and policy making.

50. **The constitution has devolved revenues to both state[31] and local[32] governments.** Elected local government officials will collect these revenues that have been assigned to them. Also, one of the parameters governing federal transfers to the local units is own revenue collections. Hence, it will be critical to gather information on local government revenue collections, which will be enabled by the establishment of the RMIS at the state and local level (*trigger 10*). This database will support more effective local level tax policies and administration and partly determine the amount of grants allocated to local units.

51. **Expected results under Pillar 2 are:** (i) Consolidated budget execution data available in the public domain; (ii) Deviation between consolidated budget estimates and actual total spending reduced; (iii) Public expenditure reports of all tiers of government submitted to the Parliament as per FRBMB; (iv) Proportion of capital expenditure undertaken in the last trimester reduced; (v) Reduction in the audit irregularities reported by the OAG; (vi) Disaster Management Fund established and funds allocated; (vii) and Information on 90 percent of tax collections available on a real time basis.

52. **The design of the proposed DPC operation is underpinned by extensive analytical work.** The details for the first operation are presented below (Table 44).

Table 4. Development Policy Operation (DPO) Prior Actions and Analytical Underpinnings

Proposed Prior Action	Status	Analytical underpinnings
	Pillar I	
Prior Action 1: To implement fiscal federalism the Parliament has approved the Intergovernmental Fiscal Arrangement Act which provides the legal framework for resource allocation among the three tiers of government.	Completed	• PFM Gap Analysis 2015; • MTEF Gap Analysis 2015; • NLSS 2003; • Census 2011; • Federal Fiscal Act, Institution and Social Security; • Intergovernmental Fiscal Transfers.[33]
Prior Action 2: The Parliament has approved Local Government Operations Act - 2017, which will govern the operation and management of local governments.	Completed	• Note on Fiscal Responsibility and Budget Management. • Policy and Advisory Technical Assistance for Strengthening Subnational Public Management 2017; • Note on Local Level Expenditure – 2017; • Report on Unbundling/Detailing List of Exclusive and Concurrent Powers of the Federation, the State and the Local Level Provisioned.
Prior Action 3: The Parliament has approved the National Natural Resources and Fiscal Commission Act which will govern federal transfers to state and local governments.	Completed	• Note on revenue rights; • Note on Institutional set up for fiscal transfer; • Note on Formula-based Budget; Allocation Framework in the Federal Context of Nepal.

[31] Revenue assignment state government: land and house registration tax; vehicle tax; entertainment tax; advertisement tax; tax on tourism and agriculture income; service charges and penalties.
[32] Revenue assignment local governments: local tax property tax, house rent tax, fee on registration of houses and land, vehicle tax); service fee, tourism fee; advertisement tax; business tax; land revenue; fines, entertainment tax.
[33] Rup Khadga.

Proposed Prior Action	Status	Analytical underpinnings
Prior Action 4: The National Women Commission has adopted an integrated platform that provides a comprehensive response system and coordinates and expands access to services for Gender Based Violence cases.	Completed	• National Action Plan on gender based violence; • Nation Women Commission Act (2002); • Domestic Violence Act (Crime and Punishment) 2009.
	Pillar II	
Prior Action 5: To strengthen public financial management systems, the MoF has: (i) integrated all public financial management systems onto one platform - Public Financial Management Information System and (ii) provided access to the PFMIS to all federal ministries.	Completed	• PFM Gap Analysis 2015; • MTEF Gap Analysis 2015.
Prior Action 6: To strengthen budget realism: (i) the Recipient has issued guidance to the federal ministries to guide their preparation of the draft three-year MTEFs for the FY 2019 budget cycle; and (ii) the National Natural Resources and Fiscal Commission has issued its circular to the local governments to guide their preparation of the annual budgets, to be part of the Local Government Development Plan.	Completed	• Note on Fiscal Responsibility and Budget Management.
Prior Action 7: To improve budget execution, the MoF has: (i) issued a decree which requires all new aid funded and national priority projects to have secured project filter clearance for issuance of budgetary funds; (ii) adopted the System for Automatic Spending Authorization and Program Approval for all spending units which will assist in budget execution from day one of new fiscal year; and (iii) adopted a system of payments by account payee only to expedite payments.	Completed	• Nepal Project Performance Review(s); • PFM Gap Analysis 2015.
Prior Action 8: The Parliament has approved Disaster Risk Reduction and Management Act -2017, which will govern coordination and management of all activities pertaining to disaster management, disaster risk reduction, disaster recuperation and disaster response as well as monitoring and mitigation measures on climate change and global warming.	Completed	• National Strategy for Disaster Risk Management -2009; • Disaster Response Framework - 2013; • Post Disaster Need Assessment, 2015.
Prior Action 9: The MoF has established the Revenue Management Information System at the federal level to provide real time information on revenue collections.	Completed	• PFM Gap Analysis 2015.

4.3 LINK TO CPF, OTHER BANK OPERATIONS, AND THE WBG STRATEGY

53. **This operation is one component of the broader support the World Bank is providing to the government in the transition to federalism.** This operation focuses only on the PFM and fiscal part of the transition to federalism. The WBG will have a much broader engagement on the federalism agenda with the GoN. A new Country Partnership Framework (CPF), currently under preparation for delivery by June 2018, will support the GoN in transitioning to a federal state. The CPF proposes three broad areas of focus: (i) institutions and governance; (ii) growth and employment; and (iii) inclusion and resilience. This DPC series will support various aspects of these focus areas, particularly the first and the third one. This DPC series is also linked to the CPS Performance and Learning Review (PLR).[34] The latter highlighted the

[34] 2017 February.

importance of fragility, limited government capacity, and the need to maintain fiscal sustainability, especially through the transition into a federal state, as critical areas for future WBG engagement. The Systematic Country Diagnostic (SCD)[35] also identified a smooth transition to federalism as one of the priority areas in the country's overall development context.

54. **Support for transition to federalism and subnational governance is one of the four pillars of support proposed by the Nepal Risk and Resilience Assessment (June 2017) to tackle the elevated risk of fragility and conflict.** An implementation note to use Risk Mitigation Resources for this operation will be circulated to the World Bank's Executive Board.

55. **This operation is central to achieving improvements in implementation capacity, accountability and transparency at the federal, state and local levels.** A strong fiscal devolution framework and PFM system provide the foundations for achieving and sustaining the activities under the three focus areas of the CPF. This operation directly supports areas of the fiscal devolution framework and PFM identified in the CPF, such as passing laws and procedures to underpin well-functioning local governments, enhancing budget controls, upgrading the Financial Management Information System (FMIS), strengthening the budgetary process, and enhancing openness and public awareness to build the foundations for increased accountability.[36] In addition, this operation, and more broadly this series, will be a cornerstone of the World Bank's engagement on fiscal federalism,[37] as outlined in the CPF under preparation.

56. **This DPC complements the work of the PFM MDTF and the recently initiated work on fiscal federalism.** The PFM MDTF is an ongoing engagement between the government and the development partners, and is managed by the World Bank. It supports PFM reform activities to strengthen the performance, transparency and accountability in PFM in Nepal. The policy dialogue underlying the proposed operation was greatly facilitated by activities of the PFM MDTF and the 2015 PEFA Assessment. In addition, the World Bank is also leading the donor coordination committee to support the government in the implementation of fiscal federalism. This includes supporting activities to align the country's economic, social, environmental and other policies with the new federal state systems, and activities to develop sound civil administration systems and ensure continuation of service delivery with minimum disruptions for the 7 states and 753 local government units.

57. **This operation supports the WBG's twin goals of eliminating extreme poverty and boosting shared prosperity through improved public service delivery and strengthened fiscal management**. The 2015 Constitution devolved the provision of basic services such as healthcare, primary education, local roads, local drinking water and sanitation, and social assistance to the local governments. The policy reforms supported by this operation help the government in its efforts to provide local governments with the operating framework and resources needed for effective service delivery. The reforms also support greater citizen engagement to enhance accountability of local governments. These efforts will strengthen public service delivery and help the poor and bottom 40 percent who depend more on public services. More effective PFM and an increase in tax revenues will help the government increase its investment in physical and human capital. This will also help the poor and support economic growth.

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[35] 2017 November (draft)

[36] CPS for Nepal FY2014–FY2018.

[37] CPF 2018 (PCN).

4.4 CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

58. **The government has undertaken broad-based consultations with all relevant stakeholders on the reforms supported by this operation.** This is particularly relevant for measures that address disaster management and GBV, where extensive public consultations and outreach activities were held by the government. The main gender related issues that were raised by stakeholders included (i) non-reporting of cases due to stigma, (ii) risk of revictimization of the survivors as they recounted their incident in multiple institutions when accessing services, (iii) poor documentation of follow up actions, and (iv) inadequate quality of support services. In disaster management, the key issues raised included the need to: (i) ensure hazard-resistant reconstruction of the assets damaged from recent disasters to avoid creating new risks; (ii) strengthen disaster preparedness and early warning systems at various levels of the government and societies; (iii) establish and operationalize the institutional set-up envisaged under the recently enacted Disaster Risk Reduction and Management Act 2017; and (iv) explore disaster risk financing and insurance options in the Nepalese context to prevent diverting planned development funds to unplanned disaster recovery. In the case of other reforms, the consultations included the main stakeholders, largely within the government. Most suggestions from stakeholders were incorporated into the reforms supported by the government. In addition, the WBG team has engaged with civil society organizations (CSOs) and has continued the dialogue through sectoral work, especially in the areas of PFM and public audits.

59. **Government reforms on fiscal and expenditure management are an on-going activity supported by development partners through a PFM MDTF.** The MDTF, managed by the World Bank, is supported and funded by U.K. Department for International Development, Government of Norway, Australia DFAT, United States Agency for International Development (USAID), European Union and the government of the Swiss Confederation. It supports fiscal and expenditure management reform activities that have led to improvements in PEFA scores. The MDTF members and the government hold meetings regularly to share information and discuss PFM reform support. This series complements the ongoing PFM reform program.

60. **Development partners are also supporting federalism under an umbrella platform**. There is a 'federalism working group' comprising several development partners that meets regularly to harmonize the assistance to be provided to the government. The reforms supported by this series complement the overall support on federalism that is being provided to the government.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

61. **Overall, the reforms supported by this operation are likely to have positive or neutral effects on the poor and those at the bottom 40 percent of the welfare distribution.** With funds and functions devolved to local governments, access to public services for the poor is expected to improve with the government getting closer to the population. During the current fiscal year (FY18), the federal government has transferred 26 percent of its annual budget to subnational governments. These transfers will enable the local governments to implement social security programs, and provide education and health services. Furthermore, going forward, the special grant channel can provide funds to the subnational governments to implement special projects that aim to balance development across States and local levels, or to develop and uplift marginalized communities and groups.

62. **The establishment of a framework and procedures for the transfer of resources from the federal government to the subnational governments (Pillar One) will help ensure accountability and equitable distribution of resources across the subnational governments**. Therefore, these reforms are expected to have positive distributional effects. In addition, the Integrated Platform of Comprehensive Response System which coordinates and expands access to services for GBV victims, is expected to have positive distributional effects on poverty and gender. This reform will strengthen the institutional capacity of the NWC and is expected to result in increased access to justice, capability, accountability, and inclusion through referral services, such as legal, health (psychosocial), police and shelter-homes.

63. **The transition to federalism will lead to the sizable transfer of civil servants from the central government to state or local governments.** It is critical, therefore, for the federal government to carefully monitor the process and ensure a smooth transition. However, the effect of this civil service reorganization on the poor and those at the bottom 40 percent of the welfare distribution is expected to be marginal, if any. First, no civil servant is expected to be laid off, and those who prefer to resign are offered a package of voluntary retirement benefits. Further, civil servants and their family members account for a very small share of the population. According to the 2014/15 Annual Household Survey, only 8 percent of the population belongs to households where at least one person works in government offices or public corporations. Of those, only one fifth of them (or 1.5 percent of the total population) belong to the bottom 40 percent.

64. **Prior actions under pillar two "Improve the policy framework for public financial management" are expected to have distribution neutral or positive effects**. In the medium to long term, improved fiscal and financial management can boost government resources, which can be channeled to investments in human capital and other investments, in support of growth and poverty reduction. In addition, the Disaster Risk Reduction and Management can have positive effects on the poor and the most vulnerable. Natural disasters disproportionally impact the poor and the most vulnerable due to poor housing and by adversely impacting their livelihoods.

5.2 ENVIRONMENTAL ASPECTS

65. **Most reforms supported by this operation are expected to have potentially positive or neutral effects on the environment.** The Intergovernmental Fiscal Arrangement Act and the National Natural Resources and Fiscal Commission Act support devolution of resources to the local governments. Devolution of funds and functions to the local governments are opportunities to initiate fully funded environmental management activities that are location specific and just-in-time with community participation, which could help reverse deforestation, strengthen location specific land slide preventive measures, and enhance developmental activities that protect water sources and habitats.

66. **However, increased public investment at the local level, needed by the decentralized delivery model, can potentially affect natural resources, if risks are not mitigated**. Specifically, the absence of land use or territorial planning and weak enforcement of environmental impact assessment for investment project approval can potentially put pressure on natural resources. To mitigate these risks, Nepal currently has systems for reducing adverse impacts and enhancing positive effects regarding the environment through the Environmental Protection Act (EPA 1997) and the Environmental Protection Rules, the Protected Areas legislations, the National Parks and Wildlife Conservation Act and various other policies pertaining to environmental protection and conservation, and protecting biodiversity and ecosystems. There is also an abundance of legislation in place on land rights and land use, but most of the efforts of governmental bodies are focused on formulating policies and plans rather than implementing

them in practice. This includes Nepal's Land Use Policy 2015. In addition, and to strengthen local governments' functions, a capacity building needs assessment is being supported by the donors in partnership with the government. In addition, in the short term, the ongoing capacity building activities are supporting local government's capacity to deliver basic services. In medium to long term, a joint, donor funded mechanism is planned to fund identified capacity building measures.

67. **To further help mitigate this risk, the preparation of a three-year MTEF at the federal level starting from the FY2019 budget cycle and the preparation of the Local Government Development Plans will be used to promote environmentally friendly local development plans**. To meet this objective, the Bank is working with the federal government to develop guidelines for the formulation of local development plans and MTEFs. Capacity development for land use planning and policy and its subsequent implementation and enforcement at the local and state level will be crucial to manage and minimize trade-offs between economic growth and environmental sustainability. The on-going and planned engagements with the government including Nepal Environmental Sector Diagnostic; Nepal Forest Investment Plan Preparation Grant and the Nepal REDD Readiness Preparation Program - will assist the government to not only address some of these identified risks, but, also strengthen formulation of environmental policies, planning and its implementation.

68. **Prior Action 8 "The Parliament has approved Disaster Risk Reduction and Management Act - 2017" is expected to have positive effects on the environment and natural resources**. This act will govern coordination and management of all activities pertaining to disaster management, disaster risk reduction, disaster recuperation and disaster response as well as monitoring and mitigation measures on climate change and global warming. Strengthening the policy and institutional capacity for disaster risk management will offer the possibility to mainstream DRM and climate-change-adaptation policies and practices at the national level, leading to environmentally-friendly planning of essential infrastructure and development projects.

69. **The climate co-benefits of this operation (DPC1) are estimated at 11 percent.** The climate co-benefit calculated for each of the prior actions of DPC1 are 11 percent with the potential for increasing climate co-benefits in the follow-up operation in DPC2 as more mitigation co-benefits and adaption co-benefits are assigned to completed actions of DPC2.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

70. **The government's PFM systems have improved.** The 2015 PEFA Assessment concluded that Nepal has made substantial progress in deepening the structures and processes of PFM, particularly in the use of Information Technology (IT) in PFM processes. As compared to the first PEFA Assessment (2007), the second assessment (2015) recorded improvements in 16 indicators. There are nonetheless areas the need continued improvement and this DPO is designed to strengthen PFM. For example, as in the previous audit reports, the 2016 Auditor General's Report highlights systemic weaknesses in internal control systems. The current DPO series is designed to strengthen PFM and support reform to reduce audit irregularities, include the expenditures of local governments in the TSA, integrate all three tiers of government's budget spending with the central financial management information system and adoption of prudent fiscal policies, among others. In addition, the upcoming integrated PFM project under the MDTF comprises a component on internal controls and internal audit to improve capacity in this key area.

71. **The government budget classified by functions, functionaries and charts of accounts is publicly available.** Budget information by geographical locations and monthly expenditure reports by functions are all available at Financial Comptroller General Office website. An integrated PFM information platform (budget execution) is operational and information is shared with the line ministries. All financial transactions have been unified under a single treasury.

72. **The Public Procurement Monitoring Office (PPMO) continues to improve transparency in public procurement processes by adopting international standards and IT.** The Public Procurement Act and Public Procurement Regulations, compliant with United Nations Commission on International Trade Law, provide an international standard procurement legal framework. Anchored in this Act and the supporting Regulations is the single e-GP (Electronic Government Procurement) portal which is facilitating the availability of standard bidding documents on-line of all common procurements to all interested parties and on-line procurement progress monitoring by the PPMO. This e-GP platform has drastically reduced paperwork, fostered transparency and competition and enabled faster remedial actions by the authorities. As part of the government's on-going procurement reform program, the Bank is supporting the government in preparing public procurement strategic framework, facilitating 3rd party IT security audit of the e-GP system and strengthening of PPMO.

73. **As per the 2017 IMF Staff Report and 2016 IMF Safeguards Report, Nepal's foreign exchange management and safeguards are adequate**. Since October 1997, the exchange arrangement of Nepal has been reclassified as pegged to a single currency unit. The Nepalese Rupee is pegged to the Indian rupee at a rate of 1.6 Nepalese Rupee to 1 Indian Rupee. All merchandise imports (except certain goods restricted for security reasons) are freely available through an open general license system, with foreign exchange provided through the banking system at the market exchange rate. Safeguards are found to be adequate by the updated safeguards assessment of the NRB completed by the IMF in 2016. It has however noted that that the NRB had made limited progress in improving its safeguards framework and addressing recommendations from the previous assessment (2011). In particular, the quality of the external audit continued to fall short of international standards and priority should be given to engaging an auditor with requisite experience. The legal framework should also be enhanced to strengthen the central bank's autonomy and governance arrangements. The assessment concluded that strong commitment from the NRB Board and management is essential to improve the internal audit function and reinforce controls in key areas, including foreign reserves management and currency operations.

74. **Disbursements.** The proposed operation is the first in a programmatic series of two DPCs. The credit proceeds will be made available to the Government upon approval of credit effectiveness. The government will submit a withdrawal application in the requested format to the World Bank once the credit has been approved and the World Bank has notified the credit effectiveness to the government. At the request of the MoF, the disbursement will be made into the treasury account of the government maintained at the NRB that forms part of the country's foreign exchange reserve which will later be transferred in local currency equivalent to the Government's consolidated fund (the General Fund). The Government will confirm to the World Bank, within 30 days, receipt of the proceeds and its credit in the Treasury account, including the date of receipt, the exchange rate applied to convert the credit proceeds into Nepalese rupees, and the name and number of the Government's bank account in which the funds have been deposited.

75. **Confirmation and eligible expenditure.** The MoF will provide to the Bank a confirmation that the amount of the operation has been credited to an account that is available to finance budget expenditures. If, after the proceeds are deposited in the government account, the proceeds of the operation are used

for ineligible purposes as defined in the Loan Agreement, the Bank will require the Government, upon notice from the Bank, refund an amount equal to the amount of said payment to the Bank. Amounts refunded to the Bank upon such request shall be cancelled.

76. **Reporting, auditing and closing date.** No audit will be required for the proposed operation as fund will be transferred to treasury and not to a dedicated account. The closing date of the proposed loan will be February 28, 2019. The Bank reserves the right to request an audit of the treasury foreign current account, if necessary.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

77. **The MoF is leading the effort in coordinating the overall implementation of the DPC.** MoF has experience and is conversant with World Bank policies and procedures through lending and TA operations. Given the long history of budget lending operations in Nepal, some institutional capacity and has been built up on data requirements and overall monitoring arrangements. Nepal has implemented the IMF's Enhanced General Data Dissemination System and data is generally available through the MOF website, the central Bank's website and the Statistical Agency. The World Bank team will continue to provide support to government in monitoring the reform progress and results.

78. **Grievance redressal.** Communities and individuals who believe that they are adversely affected by specific country policies supported by prior actions or tranche release conditions, under a World Bank DPO, may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, because of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate GRS, please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

79. **The proposed operation faces substantial risk,** with political and governance risks assessed as high, while institutional capacity, fiduciary, technical design and stakeholder risks are substantial**.**

80. **Political and Governance risks are rated as High.** Nepal's transition has been characterized by frequent government changes. The new constitution, however, bars change of the government before two and half years into the term of the new government. The country has constitutionally adopted a federal government system; however, it is currently facing the daunting task of smoothening the transition from the old unitary system to the new federal one. The new system takes effect in January 2018 and, in principle, provides opportunities to decentralize development benefits and make service delivery more effective and accountable. However, the risks of jurisdictional overlap between the three tiers of government, lack of clarity and coherence between policies and devolved powers, and duplication of efforts will remain high during the coming few years. Key aspects of the new system require further definition and may continue to be contested by different population groups.

81. **Technical design risks are substantial.** This operation supports a number of activities which require Parliamentary or Cabinet approval of bills. There could be potential delays in the passage of identified acts and bills. In addition, the move to fiscal federalism is a very big step on the part of the government and the transition could face some unexpected hurdles. These risks are somewhat mitigated by the fact that many of these policy reforms are a requirement for the three tiers of the government to function smoothly. In addition, the donor community is fully engaged in the process and could help the government as and when it hits a roadblock.

82. **Risks related to institutional capacity for implementation and sustainability, are substantial.** This operation supports the policies and activities that govern the fiscal relationships amongst the three tiers of government. Under a federal structure, new institutions and processes are to be established and will become operational in an environment where institutional capacity is already weak. The risks associated with the sustainability of the reforms are mitigated by the fact that the transition to fiscal federalism has already begun with the devolution of funds and functions, and, with the completion of the election in December, all three tiers of the governments will be in place. Towards continuity of services under a new federal arrangement; the government has initiated orientation programs for the elected members, funded trainings for existing staff and is in the process of hiring 30,000 new staff. To address the institutional capacity constraints, the Bank is leading the capacity needs identification exercise in coordination with donors with an expectation of implementing quick capacity building activities to strengthen the existing service delivery institutions, systems and processes.

83. **Weak implementation capacity and lax enforcement of rules and regulations have increased fiduciary risks.** With the approval and implementation of the new financial procedural act, increased accountability and transparency should lower fiduciary risks. Fiduciary risks are also mitigated through on-going institutional capacity strengthening activities funded through a MDTF centered around the rules governing budget implementation. The frequent procurement and financial management clinics that have been held for Bank funded project officials have yielded positive results and resulted in fewer 'audit observations'. These clinics have become a regular activity. The government is revising the PFM strategy in the federal context. Implementation of this strategy is expected to further assist in mitigating fiduciary risks. Strong leadership and commitment of the MoF to ensure progress on the current programmatic series also mitigates some of the risks.

84. **Stakeholder risks remain substantial.** These risks stem from vested interest groups – many political in nature - as this operation supports the process of transition to federalism and the devolution of power. These risks are mitigated by the fact that all three tiers of government have been democratically elected which shows that there is broad-based support for the transition to federalism in Nepal. These risks are mitigated, to an extent, by continuous dialog with the government and significant support from the donor community.

Table 5. Risks Indicator

Risk Categories	Rating (H, S, M or L)
1. Political and governance	H
2. Macroeconomic	M
3. Sector strategies and policies	M
4. Technical design of project or program	S
5. Institutional capacity for implementation and sustainability	S
6. Fiduciary	S

7. Environment and social	M
8. Stakeholders	S
Overall	**Substantial**

ANNEX 1: POLICY AND RESULTS MATRIX

Prior Actions under DPC1 (2018)	Triggers for DPC2 (2019)	RESULTS INDICATORS Baseline: FY2016 and Target: FY2020 (unless otherwise mentioned)
	Pillar One: Establish a framework to move towards fiscal federalism	
Prior Action 1: To implement fiscal federalism the Parliament has approved the Intergovernmental Fiscal Arrangement Act which provides the legal framework for resource allocation among the three tiers of government.	**Trigger 1:** The Parliament has approved the Federal Financial Procedures Bill which provides guidance on budget execution (Cabinet Approval/ CA-2017).	Expenditure on public primary education: Baseline: Undertaken by the federal government (FY2016) Target: Fully undertaken by the local governments (FY2019) Spending of all three tiers of the government is as per the Federal Financial Procedural Act: Baseline: Not applicable Target: Expenditure as per norms in the FFPA
Prior Action 2: The Parliament has approved the Local Government Operations Act - 2017, which will govern the operation and management of local governments.	**Trigger 2:** Local governments have (i) Established the Local Consolidated Fund; and (ii) issued regulations to authorize the Chief Administrative Office to initiate spending within seven days of approval of the annual budget by the local assembly.	Spending of local governments as per Local Government Operations Act. Baseline: Not applicable Target: Expenditure as per the norms in the LGM Act.
Prior Action 3: The Parliament has approved the National Natural Resources and Fiscal Commission Bill which will govern federal transfers to state and local governments.	**Trigger 3:** The National Natural Resources and Fiscal Commission has (i) adopted the framework for the calculation and devolution of two grants (equalization and conditional) and has made the formula for the equalization grant public; and (ii) issued climate resilient investment guidelines to the sub national governments.	Equalization grant in FY19 budget made as per the new equalization formula: Baseline: NA (FY16) Target: To all local governments
Prior Action 4: The National Women Commission has adopted an integrated platform that provides a comprehensive response system and coordinates and expands access to services for Gender Based Violence cases.	**Trigger 4:** National Women Commission has (i) established a 24 hour Helpline manned by trained staff; (ii) established a case processing system to track service provision; and, (iii) issued protocols and guidelines for survivor support, case prioritization and service access.	Share of service referrals (legal, health, police and shelter homes) on Gender Based Violence cases that are closed. Baseline: None Target: 80 percent

Prior Actions under DPC1 (2018)	Indicative Triggers for DPC2 (2019)	RESULTS INDICATORS Baseline: FY2016 and Target: FY2019 (unless otherwise mentioned)
Pillar Two: Improve the policy framework for public financial management		
Prior Action 5: To strengthen public financial management systems, the MoF has: (i) integrated all public financial management systems onto one platform - Public Financial Management Information System and (ii) provided access to the PFMIS to all federal ministries.	**Trigger 5:** To strengthen state and local governments' public financial management, (i) the Local Governments have adopted the Local Finance Procedures Bill and its directives and the Local Administrative Revenue Bill and its procedural directives; and (ii) to increase transparency and support citizens' engagement the government has instituted a system of public disclosure of local government expenditure reports by making them available on the website of the Financial Comptroller General's Office.	Consolidated public expenditure data available in the public domain. Baseline: NA Target: FY2020 budget
Prior Action 6: To strengthen budget realism: (i) the Recipient has issued guidance to the federal ministries to guide their preparation of the draft three-year MTEFs for the FY 2019 budget cycle; and (ii) the National Natural Resources and Fiscal Commission has issued its circular to the local governments to guide their preparation of the annual budgets, to be part of the Local Government Development Plan.	**Trigger 6:** To ensure budget realism at the local level, the local governments' council has mandated the preparation of a 3-year MTEF in line with the Local Government Development Plan. **Trigger 7:** The Cabinet has endorsed and submitted to Parliament the Fiscal Responsibility and Budget Management Bill (FRBMB) to ensure fiscal discipline and increase accountability.	Deviation between consolidated budget estimates and actual consolidated spending. Baseline: 15 percent (average of FY2011-2016) Target: 10 percent or lower deviation. Submission of annual public expenditure reports: Baseline: None Target: All expenditure reports submitted as per the FRBMB to the Parliament.
Prior Action 7: To improve budget execution, the MoF has: (i) issued a decree which requires all new aid funded and national priority projects to have secured project filter clearance for issuance of budgetary funds; (ii) adopted the System for Automatic Spending Authorization and Program Approval for all spending units which will assist in budget execution from day one of new fiscal year; and (iii) adopted a system of payments by account payee only to expedite payments.	**Trigger 8:** To strengthen expenditure control: (i) the Financial Comptroller General Office has adopted the new internal control guidelines (2018); and, (ii) the cabinet has submitted the 2018 Audit Bill to the Parliament for approval.	Proportion of capital expenditure undertaken in the last trimester: Baseline: 75 percent Target: 65 percent Audit irregularities reported by the OAG report: Baseline: Audit irregularities of Rs. 97.44 billion (OAG 2016 report). Target: 2019 OAG report with 40 percent reduction in the amount of irregularities

Prior Actions under DPC1 (2018)	Indicative Triggers for DPC2 (2019)	RESULTS INDICATORS Baseline: FY2016 and Target: FY2019 (unless otherwise mentioned)
Pillar Two: Improve the policy framework for public financial management		
		reported compared to the 2016 OAG report.
Prior Action 8: The Parliament has approved Disaster Risk Reduction and Management Act - 2017, which will govern coordination and management of all activities pertaining to disaster management, disaster risk reduction, disaster recuperation and disaster response as well as monitoring and mitigation measures on climate change and global warming.	**Trigger 9:** To strengthen disaster management response and initiate disaster risk reduction actions, the federal government has (i) established the National Disaster Risk Reduction and Management Center; (ii) approved the disaster management national policy and plan; and (iii) issued disaster management policy guidelines to state and local governments taking current risk profile and future climate change into consideration.	Funds allocated to the Disaster Management Fund: Baseline: Zero Target: TBD
Prior Action 9: The MoF has established the Revenue Management Information System at the federal level to provide real time information on revenue collections.	**Trigger 10:** The MoF has established the Revenue Management Information System at the state and local level to provide revenue collection information.	Availability of information on tax collections: Baseline: Data on 90 percent of tax collections available with a lag of two months. (FY2016) Target: Data on 90 percent of tax collections available on a real-time basis (FY2019)

ANNEX 2: LETTER OF DEVELOPMENT POLICY

November 24, 2017

Mr. Jim Jong Kim

President

The World Bank

1818 H Street N.W.

Washington DC 20433

United States of America

Dear Mr. Kim:

RE: Letter of Development Policy

The Government of Nepal is committed to pursuing and deepening reforms to ensure fiscal sustainability through improved public financial management. Nepal's new constitution, promulgated in 2015, has restructured the state into a federal system with three tiers of government — federal, state and local. The transition to federalism will require the devolution and reassignment of functions, funds and personnel to state and local governments. It is within this context that we are pursuing reforms to establish a framework to transition to fiscal federalism, and to further strengthen public financial management and revenue collection at all three tiers of the governments to ensure fiscal sustainability.

The Constitution of Nepal, in adopting a federal system, has devolved significant service delivery and resources to local governments. The transition of service delivery from the currently centralized system to local governments presents a challenge of transferring funds and resources to local governments to enable them to provide services. To meet these objectives, we have begun the process of formulating and adopting new rules and regulations that will guide the transition and govern fiscal federalism. To that end, the Government has initiated the following reforms to be completed in 2017-2018:

' The Inter-Governmental Fiscal Arrangement Act, which will facilitate and provide the framework for local governments' spending. This will allow local governments to provide basic services like education, health, local transport, and water and sanitation.

- The Federal Financial Procedural Act will provide the state and local governments the financial management framework that governs their fiscal procedures like budget planning, fund allocation, recording and reporting.

- The establishment of the National Natural Resource and Fiscal Commission (NNRFC), which will guide policy formulation related to fiscal devolution.

Our commitment to fiscal policy prudence and fiscal sustainability is enshrined in the Constitution as well as actions taken in the past. Two key aspects of fiscal policy prudence have been enshrined in the Constitution — early submission of budget for parliamentary discussion and approval of next year's budget prior to the end of the ongoing fiscal year. Nepal was the first country in South Asia to implement medium-term expenditure framework (MTEF) in 2003. Although the use of MTEF was discontinued in the intervening years, moving forward in a federal context, we are committed to reinstating and institutionalizing MTEF and deepening public financial management systems across all tiers of government to ensure fiscal sustainability. The following reforms have been initiated and due to be completed in 2017-2018:

- Integrate all public financial management systems into a single Public Financial Management Information system (PFMIS) and providing access to the PFMIS to all federal ministries.
- Mandate the preparation of Medium Term Expenditure Framework (MTEF) at the federal level for budget preparation, and adopt the Local Government Development Plan which will anchor local government budgets and local government MTEFs.
- To increase budget execution, the Government plans to institutionalize the need for all new aid funded and National Priority Projected to obtain project filter clearance which certifies that they have adhered to the pre-requisites for project implementation, and adopt automatic spending authorizations, which allows funds to be transferred directly to vendor's account.
- Establishment of the Revenue Management System at the federal level that will provide real time revenue data.

We intend to continue and deepen these reforms during 2018-2019 and the following years. Reform actions will include:

- Monitoring of expenditure and publicizing the reports of all tiers of government to ensure transparency and accountability of fund use.
- The National Natural Resource Commission adopts the framework for the calculation and devolution of equalization, matching, conditional and special grants to local governments, and makes the equalization formula public.
- Development and use of local level MTEFs.
- Strengthen state and local governments' public financial management through the adoption of the Local Financial Procedures Act, Local Administrative Revenue Bill, and Local Procurement Bill along with each of their respective procedural directives.

- Strengthen expenditure control through the adoption of new internal control guidelines by the Financial Comptroller General's Office, and the approval of the 2017 Audit Bill which will support the establishment of audit offices in all 7 states, regularize performance audits and enforce recovery of irregularities in addition to strengthening other audit functions.
- Make contributory pensions mandatory for all civil servants hired on or after July 16th 2017 to lower the cost of unfunded pension liabilities.
- Endorse the fiscal responsibility and Budget Management Bill (FRBMB) to ensure fiscal discipline and increase accountability.
- Establishment of Revenue Management System at the state and local levels.
- Approval of the Single Tax Code Bill that will harmonize all tax codes.

We would also like to reaffirm our commitment supporting macroeconomic stability and growth. After two extremely challenging years for the economy hit by two consecutive exogenous shocks in the form of the devastating earthquakes of April/May 2015, and the economic blockade during 2015-2016, the economy rebounded successfully in 2016-2017. GDP growth was 7.5 percent, the highest in two decades. The reform actions outlined above will support economic growth and prosperity as federalism will create economic and employment opportunities across the country.

We deeply appreciate the support of the World Bank in the historic implementation of federalism in Nepal. We look forward to our continued successful partnership with the World Bank, including cooperation in the context of the proposed Development Policy Operation.

Sincerely,

Shanker Prasad Adhikari

Finance

ANNEX 3: IMF RELATIONS NOTE

Nepal—Assessment Letter for the World Bank
January 31, 2018

This note provides the IMF staff's assessment of Nepal's macroeconomic conditions, prospects, and policies. The assessment has been requested in relation to a proposed program loan to Nepal to be considered by the World Bank in March 2018.

Nepal's economy rebounded strongly following a slowdown caused by the 2015 earthquake and trade disruptions at the southern border. Real GDP growth reached 7.5 percent in 2016/17 (mid-July 2016 to mid-July 2017), up from 0.4 percent in 2015/16. The rebound was supported by a favorable monsoon season, accommodative monetary policy, and rising government spending. In recent months, high-frequency indicators suggest that the economy continues to expand steadily. Inflation averaged 3.2 percent in 2017, a multi-year low, on low food prices and favorable base effects related to the normalization of trade. Growth is projected to moderate to 5 percent in 2017/18 and inflation to rise to about 6 percent, as activity begins to run up against capacity constraints and food prices firm. In the baseline, growth then falls back to the historical average of about 4 percent per annum.

Nepal's external position remains strong but the current account has turned to a deficit following five years of surpluses, due to buoyant imports of goods and services and softening remittances. Exports of goods and services and FDI inflows remain low. International reserves reached a new high of US$9.4 billion (more than 9 months of prospective imports of goods and services) in 2017 but are projected to moderate to 7 months of imports in the medium term, a level still judged to be adequate.

Macroeconomic risks are broadly balanced. The rise in government spending toward the end of the previous fiscal year and the start of local government operations in the new fiscal year could provide stronger-than-projected support to growth. Key downside risks pertain to domestic political instability, the weak capital budget implementation capacity, financial sector vulnerabilities, and slowing remittances. Hasty implementation of a new federal framework as mandated under the constitution could strain government implementation capacity in the short term and could pose risks to public finances in the medium term if inter-governmental fiscal arrangements are not adequately balanced.

Fiscal policy should focus on improving public investment and managing prudent fiscal decentralization. Nepal's public debt remains low but the fiscal balance turned to a deficit in mid-2017, after recording surpluses in recent years. This resulted in part from a push to raise capital spending, which grew by 2.4 percent of GDP in FY2016/17. Nevertheless, capital expenditure tends to bunch at the end of the fiscal year, undermining expenditure quality. The fiscal position is projected to deteriorate further to a deficit of 3.4 percent of GDP in FY2017/18 with the implementation of fiscal decentralization. Going forward, fiscal policy should focus on higher and better-quality public investment and prudent implementation of fiscal decentralization through sustainable and well-balanced inter-governmental fiscal arrangements. There is also an urgent need to build public financial management capacity at the sub-national level.

The current monetary policy stance is broadly appropriate, provided the Nepal Rastra Bank persists with its efforts to implement the interest rate corridor and strengthen the monitoring of financial sector risks:

- Loose monetary conditions, along with a fourfold increase in paid-up capital required by the Nepal Rastra Bank (NRB), fueled a strong credit expansion to a 7-year high of 32 percent year-on-year in February 2017. Credit growth has since moderated, to 16 percent in December 2017, after the NRB phased out a temporary relaxation of the loan-to-deposit ratio ceiling and introduced a loan-to-value ceiling on car loans.
- With the fiscal stance becoming more expansionary, tighter monetary policy is needed to keep inflation and balance of payments pressures in check. The authorities have recognized the need to strengthen monetary management and have begun to follow through on their welcome intention to adopt an interest rate corridor, which has led to an increase and greater stability in interbank rates recently.
- Rapid credit growth and the buildup of macro-financial risks underscore the need to accelerate banking sector reforms. Building on the recent amendments to the regulatory framework, loan classification, provisioning, and banks' risk management practices should be upgraded.

Structural reforms will be essential to promote sustained high and inclusive growth, and to achieve the Sustainable Development Goals. Boosting potential growth requires improvements in competitiveness and the business climate. Efforts would need to focus on strengthening the government's policymaking and implementation capacity and creating a conducive environment for domestic and foreign investment, as well as accelerated implementation of donor-supported projects.

IMF Relations

- In the aftermath of the 2015 earthquakes, the IMF's Executive Board approved the disbursement, as direct budget support, of the equivalent of SDR35.65 million (22.7 percent of quota) under the Fund's Rapid Credit Facility on July 31, 2015.
- The 2017 Article IV Consultation was concluded by the IMF's Executive Board on March 27, 2017. The mission to conduct the 2018 Article IV Consultation has been postponed due to the parliamentary elections and formation of a new government.
- An IMF mission visited Nepal during July 11-14, 2017 to review macroeconomic developments and the outlook and discuss additional capacity building needs. IMF Deputy Managing Director Zhang visited Nepal during November 3-6, 2017 to discuss macroeconomic policies with the authorities.
- In recent years, the Fund has been providing technical assistance in the areas of tax administration, tax policy, public expenditure management, monetary policy operations, banking supervision, and macroeconomic statistics. Nepal is a member of the South Asia Regional Training and Technical Assistance Center (SARTTAC) in New Delhi. The joint IMF-World Bank FSAP was completed in mid-2014.

Table 1. Nepal: Selected Economic Indicators, 2014/15-2018/19[1]

Population (2015, est. million): 28.5
Quota: 156.9 million SDR
Main exports (2015): Textiles, food items, tourism
Key export markets (2015): India, U.S., Germany

	2014/15	2015/16	2016/17 Est.	2017/18 Proj.	2018/19 Proj.
Output					
Real GDP growth (percent)	3.3	0.4	7.5	5.0	3.8
Employment					
Unemployment (percent)	...	...	...	...	...
Prices					
Inflation (period average, percent)	7.2	9.9	4.5	6.0	5.8
Inflation (end-year, percent)	7.6	10.4	2.7	5.7	5.7
General government finances (percent of GDP)					
Total revenue and grants	20.8	23.4	26.3	23.8	23.8
Expenditure	20.1	22.0	27.7	27.2	27.0
Fiscal balance	0.7	1.4	-1.4	-3.4	-3.1
Public debt	25.0	27.3	27.2	27.7	28.8
Money and credit					
Broad money (percent change)	19.9	19.5	15.5	12.4	11.0
Domestic credit (percent change)	16.4	17.4	20.2	17.6	14.2
Credit to private sector (percent change)	19.4	23.2	18.0	15.7	13.0
Balance of payments					
Current account (percent of GDP)	5.0	6.3	-0.4	-2.2	-2.3
Trade balance (percent of GDP)	-31.2	-30.2	-34.5	-34.2	-33.6
Remittances (percent of GDP)	28.9	29.6	26.8	26.2	25.5
Reserves (months of prospective imports)	10.4	9.6	9.8	9.0	8.4
Public external debt (percent of GDP)	15.8	16.9	16.2	16.7	17.6
Exchange rate					
Exchange rate (Nepali rupees/US$; period average)	99.5	106.4	106.2	...	...
Real effective exchange rate (period average, y/y percent	7.7	6.0	3.4	...	...

[1] Fiscal year ends mid-July.

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	Significant positive or negative environment effects (yes/no/to be determined)	Significant poverty, social or distributional effects positive or negative (yes/no/to be determined)
Pillar I: Establish a framework to move towards fiscal federalism		
Prior Action 1: To implement fiscal federalism the Parliament has approved the Intergovernmental Fiscal Arrangement Act which provides the legal framework for resource allocation among the three tiers of government.	Potential positive effects. The Intergovernmental Fiscal Arrangement Act which provides the legal framework for resource allocation among the three tiers of government of decision making powers and resources to the local level could improve environmental/natural resource management in public sector institutions by allowing local governments to initiate location specific activities with community participation. Potential increase in public investment to support the decentralized delivery model could potentially have negative effects if risks are not mitigated. Capacity building support will mitigate this risk.	Positive distributional effect by establishing the framework for fiscal transfer to subnational government for service delivery
Prior Action 2: The Parliament has approved the Local Government Operations Act - 2017, which will govern the operation and management of local governments.	No	Positive distributional effect by establishing the governance mechanism for local governments to operate and provide services.
Prior Action 3: The Parliament has approved the National Natural Resources and Fiscal Commission Bill which will govern federal transfers to state and local governments.	Potential positive effects. Equitable distribution of resources based on a formula taking into account development status and population with the aim to encourage balances development across inter-state and inter-local level will enable local governments to implement fully funded location specific activities. However, if institutional capacity and environmental regulation enforcement is weak, then degradation can be a problem.	Positive distributional effect by establishing the framework for fiscal transfer to subnational government for service delivery.
Prior Action 4: The National Women Commission has adopted an integrated platform that provides a comprehensive response system and coordinates and expands access to services for Gender Based Violence cases.	No	Positive distributional effect by increasing access to gender based justice, accountability and inclusion.
Pillar II: Improve the policy framework for public financial management		

Prior Actions	Significant positive or negative environment effects (yes/no/to be determined)	Significant poverty, social or distributional effects positive or negative (yes/no/to be determined)
Prior Action 5: To strengthen public financial management systems, the MoF has: (i) integrated all public financial management systems onto one platform - Public Financial Management Information System and (ii) provided access to the PFMIS to all federal ministries.	No	Distribution neutral.
Prior Action 6: To strengthen budget realism: (i) the Recipient has issued guidance to the federal ministries to guide their preparation of the draft three-year MTEFs for the FY 2019 budget cycle; and (ii) the National Natural Resources and Fiscal Commission has issued its circular to the local governments to guide their preparation of the annual budgets, to be part of the Local Government Development Plan.	Potential positive effects. This prior action will provide an opportunity for local governments to develop local development plans taking into account location specific environmental considerations that are backed up by local MTEFs which ensures the availability of resources to implement the plans and fiscal sustainability.	Distribution neutral
Prior Action 7: To improve budget execution, the MoF has: (i) issued a decree which requires all new aid funded and national priority projects to have secured project filter clearance for issuance of budgetary funds; (ii) adopted the System for Automatic Spending Authorization and Program Approval for all spending units which will assist in budget execution from day one of new fiscal year; and (iii) adopted a system of payments by account payee only to expedite payments.	No	Distribution neutral
Prior Action 8: The Parliament has approved Disaster Risk Reduction and Management Act - 2017, which will govern coordination and management of all activities pertaining to disaster management, disaster risk reduction, disaster recuperation and disaster response as	Potential positive effects. Strengthening the policy and institutional capacity for disaster risk management will offers the possibility to mainstream DRM and climate-change-adaptation policies and practices at the national level, leading to environmentally-friendly planning of essential infrastructure and development projects.	Potential positive effects, as the poor and the most vulnerable are typically the most affected by natural disasters

Prior Actions	**Significant positive or negative environment effects (yes/no/to be determined)**	**Significant poverty, social or distributional effects positive or negative (yes/no/to be determined)**
well as monitoring and mitigation measures on climate change and global warming.		
Prior action 9: The MoF has established the Revenue Management Information System at the federal level to provide real time information on revenue collections.	No	Distribution neutral

ANNEX 5: ASSUMPTIONS FOR THE FISCAL IMPACT ANALYSIS ON FEDERALISM

As a result of the transition to fiscal federalism, government expenditure is expected to increase by an average of 3.4 percent of GDP annually in the forecasted period (2019 – 2021). While there is considerable uncertainty on the scope and pace of the implementation of fiscal federalism, higher spending is likely because of: i) establishment cost for state and local governments; (ii) increased infrastructure spending by state and local governments; and (iii) additional fund transfers for decentralized service delivery. The following assumptions have been made to estimate the cost of implementing fiscal federalism:

1) **Wage bill and voluntary retirement package:** It is assumed that there will be minimal impact on the overall general government wage bill because the wage bill at the central level is assumed to decline[38] as central level civil servants get reassigned to sub national governments. Initial estimates of the number of civil servants to be transferred from the federal government to the state and local governments are at 2,000 and 20,000 respectively. Reassignment of central level civil servants to the subnational level has started and the government has offered voluntary retirement service (VRS) to interested government employees. About 10,000 to 15,000 civil servants are expected to resign and make use of VRS and the cost is estimated at US$400 million over the next four years.

2) **Fiscal transfers to the sub-national level for service delivery and infrastructure:** This is one of the largest spending categories and is likely to increase to finance the decentralized service delivery and local infrastructure needs. From an average of 2 percent of GDP in the pre-federalism era (FY 2013-FY2016), the fiscal transfers to the sub-nationals are expected to increase to 6.4 percent of GDP by FY2021.

3) **Building and vehicles:** This spending category is also assumed to be large with additional buildings and vehicles required at the local and state levels for carrying out day to day activities. The additional cost in this category is assumed to be about 3 percent of GDP between FY2017-FY2021 at the local and state levels. Both costs for temporary and permanent structures have been included in the calculations. The standard per unit cost provided by the government has been used to derive the calculation.

Table A1: Impact of Transition to Federal Structure

(As percent of GDP)	**FY13**	**FY14**	**FY15**	**FY16**	**FY17**	**FY18**	**FY19**	**FY20**	**FY21**
Total Revenue	19.5	20.6	20.8	23.2	26.1	26.6	26.7	27.0	27.0
Total Expenditure at current trends with transition costs	19.0	20.0	21.9	23.7	29.3	30.9	31.3	31.5	31.5
Expenditure at current trends w/o transition cost						29.5	28.8	28.0	27.5
Expenditure for transition costs						1.5	2.5	3.6	4.0
Fiscal balance	**0.5**	**0.6**	**-1.1**	**-0.4**	**-3.3**	**-4.3**	**-4.6**	**-4.6**	**-4.5**

[38] The number of federal level ministries will be reduced from 32 to 15.