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2081/82 Budget

SUGGESTIONS TO THE MINISTRY OF FINANCE - KEY MEASURES TO ADDRESS ECONOMIC CHALLENGES

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SECOND GENERATIONAL STRUCTURAL REFORM (SR2.0):

Nepal's 16th Five-Year Plan, spanning from fiscal year 2081/82 to 2085/86 (2024/25-2028/29), with the theme “Good Governance, Social Justice and Prosperity” has been approved by the cabinet and aims to achieve a target economic growth rate of 7.3%. Nepal’s average growth rate since the pandemic has been 2.7%, with a long-term average growth rate of 4.5%. To attain the ambitious target set by the 16th Five-Year Plan, Nepal must undergo a comprehensive structural transformation of its economy.

The foundational pillars for sustainable, resilient, and inclusive economic growth lie in prudent fiscal discipline and robust macroeconomic fundamentals. When these elements harmonize, resources are effectively allocated to the most productive sectors in the economy. Economic reform in Nepal demands a comprehensive overhaul of the current remittance-dependent and consumption-driven economic structure. Transforming the existing economic model to a more dynamic one that promotes knowledge, innovation, and production necessitates an enabling policy environment for the private sector to become the true engine of growth. A long-term and broad-based vision, as opposed to a short-term fix approach, is crucial to facilitate this transition. Below are some ideas addressing the structural challenges of the economy and ways to address it.

Fiscal Consolidation:

1) Size of the Budget: The recommendation for the size of the budget 2081/82 is no more than 28 % of GDP (NPR 1,800 billion) with a 90 % delivery target such that the utilization will be around NPR 1,600 billion. In the past seven years since the new constitution, the average size of the budget has been 35% of GDP and actual implementation has been 28% of GDP which is less than 80% delivery of the target.

2) Capital Expenditure: Since the formation of the new constitution less than 60% of the allocated budget for capital expenditure has been utilized. This shall be revised upward to at least 80% utilization of the allocated budget. Capital expenditure is important for Nepal to achieve the ambitious growth targets set in the 16th periodic plan and prevent falling into the low middle-income country trap. The capital expenditure should be revised upwards to at least 6% of GDP in the short term before raising it to a higher level in the medium term.

3) Fiscal Deficit shall be brought down to 3% of GDP from the 6.1% (average deficit since 2017) in the medium term to lower the burgeoning debt servicing obligation. Due to high fiscal deficit in recent years, the sovereign debt has risen above 40 percent from less than 23 percent in 2017.

Avenues of Funding:

1) Sovereign Wealth Fund (SWF): In the first nine months of this fiscal year, approximately 2.65 billion dollars in foreign currency reserves have been accrued, increasing the total reserves to over 14.36 billion dollars. In the past 19 months alone, the foreign exchange has increased by more than 5 billion dollars, an increase of more than 50 percent. Historically, the utilization of foreign exchange reserves has been restricted as a means of financing imports. To optimize these crucial state assets, a strategic framework should be established to direct them towards investments in productive infrastructure, thereby enhancing capital formation. This approach will address the issue of remittance inflows not contributing to capital accumulation. Implementing this mechanism will complement public capital expenditure and support broader economic policy objectives by providing an alternative source of public financing for productive infrastructure. Thus, SWF must be established as early as possible for the strategic use of the country’s foreign exchange reserves for the overall development of the country.

2) Revenue Management through professional Chartered Accountants: Current government challenges include failure to meet revenue targets due to a massive decline in imports and overall slowdown in the economy. This poses a serious threat to fiscal management due to ballooning public debt. To tackle this, the government can pragmatically hire at least one hundred tax professionals who can support in professionalizing the overall tax administration, expand tax base, contain pervasive tax evasion and ensure transparency and fairness of the tax system. Such a strategy can generate returns that are a thousand times greater than their combined salaries and benefits within the next five years.

3) Foreign Direct Investment (FDI) through Nepali Diaspora: An enabling environment must be created to boost FDI essential for technology transfer, expanding market outreach and upskilling and capacity development. The Nepali Diaspora represents a valuable resource for Nepal's development, offering expertise, capital, and networks that can contribute to economic growth and social progress. To leverage the potential of the Nepali Diaspora effectively, Nepal should adopt policies that encourage their active engagement in the country's development endeavors. This may include initiatives such as creating investment platforms specifically targeting the Nepali Diaspora, providing information and support services to facilitate their involvement in business ventures and philanthropic activities in Nepal. Moreover, fostering a sense of belonging and pride among the Nepali Diaspora can encourage them to contribute their skills, knowledge, and resources towards the country's development goals. Recognizing the Nepali Diaspora as strategic partners in Nepal's development journey and facilitating their meaningful participation can yield significant benefits in terms of technology transfer, market expansion, upskilling, and capacity development.

4) Reverse tax subsidy on electric vehicle (EV): The customs duty set by the Nepal government on EVs range from 10% to 80% depending on their capacity, which varies from 50kW to 300kW and above. This is significantly lower than the import tax on ICE cars, which stands at over 250%. The significant contrast in tax rates between electric vehicles and petrol cars creates an incentive for the adoption of electric vehicles, primarily benefiting a select group of individuals who may not necessarily require subsidies. Quantifying the loss in government revenue due to subsidized tax rates in EVs amounts to losing NPR 14 billion to 52 billion in FY 2023/24. Similarly, an additional NPR 18 billion worth of foreign exchange is lost when importing EVs for the same number of ICE vehicles. The government can raise EV duties from 25% (50-100 KW) to 45-50%, to level the custom duties with ICE to maintain a difference in import price. With the disproportionate duty privilege, Nepal, the least developed country, has outstripped Norway, one of the richest countries in the world to become the world's highest EV-adopting nation since 2023. Furthermore, opening the import of reconditioned cars of less than 5 years, Euro 6 standard with less than 100K km mileage is a good strategy for Nepal.

Revisiting existing policies

1) Allocative Efficiency: Macroeconomic policies (fiscal and monetary) and priorities determine the allocative efficiency of the economy. Despite reasonable capital formation in the past, economic growth has been low due to channelization of resources to less efficient and less productive sectors of the economy. The upcoming budget must take a major departure in channeling resources into the most productive sectors of the economy.

2) Credit policy alignment with long term nominal growth rate: Credit growth should be synchronized with the long-term average nominal GDP growth rate, aiming for a range of 12-13% in the medium term. Low credit growth, specifically less than 5%, in the last two consecutive years have had adverse effects of credit stagnation on economic dynamics. Low credit has impeded investment, consumption, and overall economic activity, leading to a slowdown or recessionary pressures. Inhibited aggregate demand has triggered a downward spiral of reduced production, income, and employment. Setting a target range for credit growth in line with nominal GDP growth in the medium term, promotes stability and resilience against external shocks and fosters an environment conducive to investment and consumption. Once the current structural challenges are addressed and the economy starts becoming more productive, the credit growth shall pick up gradually to drive economic growth.

3) Disproportionate focus on old age allowance: The current universalization of senior citizens allowance poses a fiscal burden to the country and is an example of misallocation of limited resources. The expenditure of current old age allowance (excluding old age allowance for Dalits, single women and senior citizens from Karnali) is roughly 70 billion NPR. This is equivalent to the size of the personal income tax collected in Nepal. There could be alternative ways to institutionalize public support to elderly, such as health insurance and redirecting investment in health infrastructure while prioriti-

-zing old/senior citizens. This could be a long-term investment to improve the overall health system of the country and minimize the mortality rate of elderly. The social security benefits should be targeted and focused on marginalized and poor households. Instead of investing in children, youth, poor, marginalized and farmers, a very large public resource has been wasted in paying allowances to elderly that disproportionately benefits middle class and upper-class individuals.

4) Escalating Land Prices: There is a stark difference in land prices in Nepal compared to major global and South Asian cities. Land in Nepal is often seen as an investment rather than a factor of production. This has led to extremely high land prices in Nepal, which is responsible for high credit growth and cost of doing business, rising import, capital flight, growing informal economy, tax evasion, outmigration, complacency, etc., thus discouraging its productive use. To promote sustainable development and address current economic challenges, it is crucial to implement measures that curb soaring land prices, encourage responsible land use, and deter speculative investments. This will foster an environment conducive to entrepreneurship and economic progress in Nepal. Ensuring all land transactions are done through banks and supported by a valid source of income might help lower land prices. Though the construction sector is very important for economic growth it can't be revived until land price comes down faster.

5) White Elephant projects: Large projects like Budhigandaki Hydropower and Pokhara International Airport generate meager annual returns relative to their capital cost. In contrast, projects like Sunkoshi Marine Diversion Multipurpose Project are likely to generate much higher economic returns in terms of electricity production and agriculture productivity, provided it is completed in time. The recommendation to the government is to conduct thorough research and planning before allocating taxpayer resources to large-scale infrastructure projects prioritizing projects with long-term economic benefits, exemplified by the failure of Bhairahawa and Pokhara International Airports and the never completing Melamchi Drinking Water Project. Undertaking costly public infra-projects such as Metro, China Nepal Railways, Trams, Tunnels, Koteshwor subway (by Japan), etc. would result into gross misallocation of resources.

Drivers of Growth

1**) Myths about Tourism and Hydro:** Nepal should look beyond Tourism and Hydro Power for economic growth and development. The maximum number of tourists that have entered Nepal so far is 1.2 million bringing USD 700 million in revenue in a year. At this pace, it is difficult to envisage the country benefiting from tourism. While domestic tourism has helped the sector in navigating through difficult times, Nepal badly needs foreign investment to expand its outreach to attract foreign tourists.

2) For hydropower, even if Nepal produces at full capacity and all electricity is exported to India by producing 40,000 megawatts of hydropower, only 9 to 10 billion dollars will be earned in a year. This will increase the per capita income by USD 300 to 350 raising the per capita income to USD 1,700 to 1,750. To become an upper middle-income country, per capita income should reach about USD 4,500. It is clear from this that the established commentary that the country will become rich by exporting hydropower is imaginary and far-fetched. Apart from this, to produce 40,000 megawatts of hydroelectric power, an investment of 80 billion dollars, twice the size of Nepal's GDP, is required.

3) Instead, the upcoming Fiscal Policy must prioritize growth drivers by setting the stage for Structural Reform 2.0 to elevate the economy to a higher growth trajectory.

- **Agriculture Transformation** through a "Whatever it Takes" approach to achieve import substitution, key to achieving trade balance in agriculture within a decade.
- **Digital Transformation** hrough an "Anything for Digital Transformation" strategy to achieve transition from labor export to service export within a decade.
- Higher **Value addition** in Industry
- Optimum Use of **Natural Resources** for export

Sectoral Priorities

1) Digital Infrastructure: Expanding the digital sector can spur economic growth through service exports and create employment opportunities for the youth. It is crucial to transition Nepal from a labor-exporting nation to a service-exporting one. Recognizing the pivotal role of the Nepali diaspora in digital service exports, the government should adopt policies that acknowledge and support their contributions. This includes fostering foreign investment through the diaspora and negotiating double tax exemption agreements with countries hosting significant numbers of Nepali expatriates, such as the United States.

2) Transmission Lines: While the private sector is ramping up investment in electricity production, the government must ensure timely construction of electricity transmission lines. Building the necessary infrastructure to enhance internal electricity production and consumption is imperative.

- **Universalization of electric cooking**: The government shall aim to promote electric cooking by providing incentives in cities and free induction stoves in rural areas, enhancing domestic electricity consumption and reducing reliance on LPG. With 97% household electricity access, the goal is to increase per capita consumption to 1,500 kWh by 2030. During monsoons, electricity supply exceeds demand (2,700 MW capacity vs. 1,750 MW peak demand). This initiative also reduces biofuel usage and aligns with emission reduction targets. The average induction stove costs NRs. 4,000, with a market potential of NRs. 26.8 billion for 6.7 million households, presenting opportunities for innovation and R&D in the electric stove industry. The emission reduction target could be increased to 60% by 2030 with this approach.

3) Irrigation is the most productive public infrastructure investment for Nepal. Given the excessive dependence on import for basic agricultural products, there is an urgent need to implement plans to irrigate 1.0 to 1.5 million hectares of land within a decade. Such investments could transform agriculture within this timeframe.

4) Fuel Storage: Nepal has always remained vulnerable to the shocks for the supply of fuel. Increasing fuel storage capacity to cover one week to three months of demand is therefore essential.

5) Promoting Cement Industry - Red brick to Cement block: Nepal has the natural resources to sustain the cement industry, and cement is one of the commodities in which Nepal is not just self-sufficient but also has a surplus. Approximately 1600 brick kilns are currently operational in Nepal, collectively producing around 5 billion bricks annually. As coal is used in the production of red bricks it is a double burden. Coal is imported using scarce forex and also pollutes the environment, raising health concerns. The transition to cement block is proposed to mitigate health risks, reduce environmental impact, bolster the domestic cement industry, and enhance foreign exchange reserves. Hence promoting the use of cement blocks over traditional bricks in Nepal can serve as a strategic move to promote domestic the cement industry and meet net zero goals.

New Initiatives for UpSkilling and Addressing Unemployment

1) Skilling Nepal Initiative: Nepal must adopt national level skilling measures to develop human capital for gradual transition into a Knowledge Economy. It includes STEEM (E represents English as a language) in school, Skill in College degrees, Training Centers in Madhesh and Lumbini to replace foreign migrant workers and Upskilling traditional artisans. Due to specific challenges arising from geopolitics, there is no alternative than transitioning into a knowledge economy.

2) Foreign Employment Opportunities for Marginalized Communities: To disrupt the vicious cycle of poverty, economic assistance must be provided to individuals seeking work but lacking the financial means to pursue overseas employment independently. This scheme seeks to address the socioeconomic aspects of poverty through timely interventions. The Government must provide foreign employment opportunities to low income and marginalized community households in collaboration with the local government, Bank and Financial Institutions (BFI) and the foreign employment agencies under the government bank guarantee scheme. Since remittance is the most effective means of addressing socio-economic conditions, cultural divides, and social discrimination in Nepal, the government must adopt this policy to break the inter-generational poverty trap. This is a nationwide recommendation but can be piloted with selected districts for the coming fiscal year. Migrant workers can pay back the loan amount within a certain period of seeking employment abroad.

3) IT and Innovation Park/District: Cyber and Innovation Park or District shall be set up in Kathmandu Valley in integration with an establishment of Nepal Institute of Technology (like the IITs of India). The SWF can be used to finance this project which has multiple economic returns. This measure is also important to signal that Nepal is ready for digital transformation and to be part of the global digital value chain. This investment will have a significant multiplier effect in crowding-in private investment and transitioning from a labor export to service economy.

4) Teaching Hospitals: The Doctor to Patient ratio in Kathmandu valley is at 1:850. In rural parts of the provinces, this is even more drastic at 1:150,000. Needless to say, the doctor count per population is substantially below WHO recommendations. There is an urgent need to set up at least one new Teaching Hospital within the next five years in each of the seven provinces in collaboration with the largest public hospitals in the provinces. Every year, the government is spending NPR 4.5 billion providing scholarships to medical students. Similarly, Nepal is losing large amounts of foreign exchange in medical studies abroad. Such measures will help produce enough healthcare professionals in the country, provide free medical service to the senior citizens and stem depletion of foreign exchange for medical studies abroad. This will also address Dr. Govinda KC's demands to a large extent.

Others

1) Public Financing of political parties: The state must consider funding political parties and elections. The gross misgovernance that is seen in the country is partly explained by the excessive reliance of political parties on cronies for funding, even for their day-to-day operations. In this regard, a very simple, transparent and equitable mechanism can be instituted for funding based on the number of proportionate votes received by political parties in the last national election. NRP 100 per vote would make it less than NPR 1 billion accounting for merely 0.07% of the total public expenditure. Though funding of political parties won't address the entire issues of governance, particularly corruption, it is expected to help improve their functioning, professionalizing management and gradually improving political governance in the country. At the minimum, it will help in reducing excessive reliance on cronies for political funding.