Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 02-Apr-2019 | Report No: PIDA26569
BASIC INFORMATION

A. Basic Project Data

<table>
<thead>
<tr>
<th>Country</th>
<th>Project ID</th>
<th>Project Name</th>
<th>Parent Project ID (if any)</th>
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<tbody>
<tr>
<td>Nepal</td>
<td>P168869</td>
<td>Programmatic Fiscal and Public Financial Management Development Policy Credit (II) (P168869)</td>
<td>P160792</td>
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<thead>
<tr>
<th>Region</th>
<th>Estimated Board Date</th>
<th>Practice Area (Lead)</th>
<th>Financing Instrument</th>
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<tbody>
<tr>
<td>SOUTH ASIA</td>
<td>13-Jun-2019</td>
<td>Macroeconomics, Trade and Investment</td>
<td>Development Policy Financing</td>
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<tr>
<th>Borrower(s)</th>
<th>Implementing Agency</th>
<th></th>
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<tbody>
<tr>
<td>Government of Nepal</td>
<td>Ministry of Finance</td>
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Proposed Development Objective(s)

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

Financing (in US$, Millions)

**SUMMARY**

<table>
<thead>
<tr>
<th>Total Financing</th>
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**DETAILS**

<table>
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<tr>
<th>Total World Bank Group Financing</th>
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<tbody>
<tr>
<td>World Bank Lending</td>
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Decision

The review did authorize the team to appraise and negotiate

B. Introduction and Context

Country Context

1. Nepal today is at a historic juncture with the promulgation of a new constitution in 2015 and the subsequent transition to a federal state with three levels of government: federal, provincial, and local. Elections were held in 2017 and a new government that took office in February 2018. The move to a federal structure will help increase the Government of Nepal’s (GoN) ability to deliver on greater inclusion to meet the needs of all citizens, reducing the likelihood of fragility
and political instability. With federalism, the country now has seven provinces and 753 local governments (municipalities) that are responsible for managing funds, functions and functionaries which were previously done through the 75 District Development Committees under the unitary system. The new federal structure aims to bring services closer to the people and increase the effectiveness of the state in the delivery of basic social and infrastructure services. This DPC supports reforms that lay the foundation for the new federal state, by helping to establish the relevant arrangements for efficient and equitable service delivery.

2. Throughout the changes in the political landscape, macroeconomic policy has remained adequate. In the past couple of years, there has been a shift from remittance driven consumption-based growth to investment-led growth. This recent shift is reflected in growth rates over the past two fiscal years that have exceeded 6 percent. The higher level of growth is driven by investments to establish local government offices, as well as construction and post-earthquake housing reconstruction, a reduction in electricity load shedding which has helped expand industrial capacity, and record tourist arrivals. Higher public spending (due particularly to the federalism transition) has increased the consolidated fiscal deficit to 5.7 percent of GDP in FY2018 despite higher taxes from elevated imports coupled with close-to-target tax collections. The higher fiscal deficit has been financed partly by tapping government deposits and partly through domestic and external debt. As a result, public debt increased to 30.3 percent of GDP by end-FY2018 but Nepal remains at low risk of debt distress. The costs related to the transition to federalism coupled with infrastructure and social services needs will require a significant amount of additional resources. It is therefore imperative that the GoN implement reforms to strengthen fiscal and public financial management at decentralized levels to support the delivery of services needed to engage the private sector and crowd in additional resources to accelerate growth.

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

Relationship to CPF

4. The proposed operation is anchored in the Country Partnership Framework (FY2019-2023) and aligned to the first and the third focus areas which include strengthening of public institutions and inclusion and resilience, respectively. The operation supports strengthening of public expenditure management at all levels of government to mitigate the PFM and fiduciary risks from the transition to federalism. It also supports reforms to address vertical and spatial inequities in service delivery as well as vulnerabilities to climate change and natural disasters. The DPC series is complemented by other WBG instruments and activities of other development partners supporting various aspects of the federalism transition. An ongoing PFM multi-donor trust fund (MDTF) administered by the World Bank includes technical assistance on federalism transition support. These technical assistance programs are providing necessary implementation support to the reforms underpinning the Fiscal and PFM DPC series. In addition, the Integrated Public Financial Management Reform Project
(IPFMR), effective since August 2018, supports implementation of key reforms linked to strengthening budget execution and systems for reporting under the new federal system.

C. Proposed Development Objective(s)

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

Key Results

6. Expected results from the operation are as follows: (i) The overarching legal framework to ensure fiscal discipline and financial procedures at all three levels of government has been adopted; (ii) gender responsive budgeting has been extended to the local levels; (iii) the local revenue base has been expanded; (iv) Increased transparency in local spending as evidenced by making the consolidated budget execution data available in the public domain; (v) more timely availability of revenue data; (vi) improved spending efficiency by reducing underspending and bunching of the budget; (vii) improved processes for incorporating DRM in local plans and procedures.

D. Project Description

7. The transition to federalism is an on-going and dynamic process. DPC1 focused on umbrella laws while DPC2 is operationalizing these laws and furthering fiscal federalism at the subnational level, with adaptations along the way, to meet the dynamic needs of the federalism transition process. The proposed operation is the second in a programmatic series of two operations to support the GoN in its efforts to develop a framework to move towards fiscal federalism and enhance the policy framework for public financial and revenue management. This operation, in the amount of $100 million, builds on reforms supported under the first Development Policy Credit (DPC1) in the programmatic series. DPC1 supported reforms to establish the legal frameworks to govern resource allocation across the three tiers of government and guide operations of local governments. It also supported measures to strengthen budget execution and PFM systems at the federal level. This operation builds on these reforms by supporting local government implementation of the legislations enacted under DPC1. It also draws from prior analytical work, ongoing Public Financial Management (PFM) activities and World Bank and other donor assistance to the government on fiscal devolution.

8. This DPC series supports reforms to advance the federalism agenda, under two pillars. Pillar 1 supports measures to establish fiscal federalism through various legislations, policies and regulations. An umbrella legislation, enacted at the federal level, will guide budget execution and improve the accounting and financial reporting framework. This legislation will form the basis of model laws to be adopted by local governments, to govern their budget processes. Amendments to the legislation governing local government fiscal relations and operations will clarify revenue assignment between provincial and local governments. Also, a framework for the calculation and devolution of grants has been established to ensure local plans and budgets are designed to address the needs of local populations, targeting the most vulnerable groups. Pillar 2 supports reforms to strengthen the policy framework for public financial management at the subnational levels. This is to be achieved through legislation and regulations that govern the budget cycle and promotes transparency and accountability to citizens, guides preparation of the Medium-Term Expenditure Framework (MTEF), strengthens expenditure control, and the development of a revenue collection system. These reforms also include gender responsive budgeting and measures to promote climate change. In view of Nepal’s vulnerability to climatic shocks, the pillar also supports reforms to improve disaster risk management and mitigate the fiscal costs of disasters.
9. The reforms supported by this DPC series also complement the overall support to federalism being provided by Development Partners (DPs) through the MDTF. The MDTF is administered by the World Bank with funding from U.K. Department for International Development (DFID), Government of Norway, Australia DFAT, United States Agency for International Development (USAID), European Union and the government of the Swiss Confederation. A World Bank-UNDP led Needs Assessment of Federalism including assessments at the federal, provincial and local level is being undertaken to assess capacity gaps. This is being done at the request of the Government. There is also a ‘federalism working group’ comprising several DPs that meets regularly to harmonize assistance to the government on federalism. Finally, the Bank team is closely coordinating with the Fund on PFM capacity building, the federalism agenda, and overall reforms to raise investment and accelerate growth. The last IMF Article IV Consultation with Nepal was discussed at the IMF Board on February 8, 2019.

E. Implementation

Institutional and Implementation Arrangements

10. The Ministry of Finance (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 technical assistance operations. Given the long history of budget support operations in Nepal, some institutional capacity 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.

F. Poverty and Social Impacts and Environmental Aspects

Poverty and Social Impacts

11. Most prior actions under the DPC are expected to have neutral or potentially positive poverty and distributional effects in the long run. Prior actions to strengthen budget execution for more effective service delivery; clarify tax jurisdiction for greater equity; improve gender responsive budgeting; and reduce risks from climate change (to which the poor are more vulnerable) are likely to have significant positive effects on the vulnerable. Improving budget processes at the local level are expected to improve service delivery for the poor; also reforms to clarify tax jurisdiction given that the tax bases are mostly tied to the nonpoor will support improved distributional effects. This could potentially have positive effects on poverty. Increasing allocation to gender-based programs, would also result in improved distributional effects tied to gender. Finally, climate change measures could help reduce the effects on the welfare of the poor. This includes measures for budget coding to capture spending tied to climate mitigation or adaptation through improved application of the Climate Change Financing Framework (CCFF) that covers the full budget planning and execution. Local level DRM policies and guidelines on how to incorporate climate change in local development plans will help strengthen local level response to DRM and help improve the management of climate change, and therefore protect the most vulnerable who are typically the most affected by natural disasters. The model laws adopted by the provincial and local governments will support increased local capacity for disaster risk management and help strengthen coordination of disaster risk and climate change management.

Environmental Aspects

12. Reforms supported by this operation could stimulate higher levels of investment (particularly at local government levels) which, if not mitigated could increase the risks of adverse effects on the environment. Nepal currently has different
laws and systems for reducing adverse environmental effects and enhancing positive effects (e.g., Environmental Protection Act (EPA 1997) and the related Environmental Protection Rules, the Protected Areas legislations, the National Parks and Wildlife Conservation Act). The country also recently adopted a Climate Change Financing Framework (CCFF) to ensure climate change and environmental sustainability are captured in local level development planning and budgeting. The CCFF outlines key reforms to integrate climate change and climate finance into planning and budgeting processes. The CCFF will ensure that funds are better targeted to reach the most vulnerable local population groups and improve effectiveness of existing climate finance through reforms to planning and budgeting guidelines and other tools for more informed decision-making. Since the move to a federal structure, the country’s climate budget has increased from 19 to 31 percent of the total budget. The goal is to spend 80 percent of climate budget allocation at the sub-national level. In addition to systems in place, an ongoing capacity building needs assessment (conducted in collaboration with donors) will help identify priorities for strengthening local governments’ functions including environmental assessments and the sustainable management of natural resources. A joint, donor funded mechanism is planned to fund identified capacity building measures.

13. Most reforms supported by this operation are expected to have potentially positive effects on the environment. The Federal Fiscal Procedures and Financial Responsibility Bill and local governments’ adoption of a Bill that governs the budget and ensures fiscal discipline and accountability for all three levels of government could lead to positive environmental effects through implementation of the Climate Change Financing Framework, which applies to the full budget and facilitates tracking of climate change spending. Amendment of the Intergovernmental Fiscal Arrangement Bill could help reduce carbon emissions through the Motor Vehicle tax. Including an indicator for forest cover in the revenue sharing formula between local and provincial governments could help reduce carbon emissions and increase forest cover (which are carbon sinks). Implementing MTEF guidance on how to integrate climate change considerations into planning and budgeting could help reduce the effects of CO2 emission from transport and industries, maintain forest areas, ensure access to sustainable energy, build resilience to disaster and climate extreme events, build resilient infrastructure, and promote inclusive and sustainable industrialization. Finally, implementation of the disaster management policy guidelines in the planning process of provincial and local governments will support 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. Strengthening the policy and institutional capacity for disaster risk management will facilitate mainstreaming of DRM and climate-change-adaptation policies and practices both at the national and sub-national level, leading to environmentally-friendly planning of essential infrastructure. Overall, the operation is expected to generate significant levels of climate co-benefits.

G. Risks and Mitigation

14. Overall, substantial risks to the operation stem largely from the level of capacity, as well as the political and stakeholder context. Jurisdictional overlap between the three tiers of government, lack of clarity and coherence between policies and devolved powers could undermine coordination across government agencies, impede reform implementation and disrupt service delivery. Resistance from some stakeholders that benefit from the current policies and status quo could further slow reforms. Weak institutional capacity and enforcement of rules and regulations, particularly at the local government level, form significant sources of fiduciary risks and fragility. Political and governance and stakeholder risks are mitigated by strong commitment of the Minister of Finance to ensure progress on the current programmatic series and a democratically elected government with a two-thirds majority in Parliament. Improved transparency and accountability arising from the reforms supported in this DPC will also help mitigate the stakeholder risks. This includes reforms to clarify tax jurisdiction. Institutional capacity risk is mitigated by the extensive development partner engagement to build institutional capacity including through the MDTF PFM trust fund and the Federalism Working Group (co-chaired by the World Bank) that is supporting capacity building of elected governments and their institutions. Capacity
building is further supported by reforms under this Fiscal and PFM DPC series; the Integrated Public Financial Management Project; and continuous dialog with the government. In the case of fiduciary risks, this DPC supports reforms to revamp the rules that govern budget implementation working closely with identified champions at the National Planning Commission, Financial Comptroller General’s Office, Public Procurement Monitoring Office and Office of the Auditor General. With the approval and implementation of the new fiscal procedure and financial responsibility law and internal control guidelines, increased accountability and transparency should lower fiduciary risks. Fiduciary risks are also mitigated through on-going institutional capacity strengthening activities through a multi-donor trust fund (MDTF), centered around the rules governing budget implementation.

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## APPROVAL

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### Approved By

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<th>Country Director:</th>
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<th>13-Feb-2019</th>
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