Overview of revenue mobilization: FY 2021/22

Abstract
Understanding revenues and resources in Nepal's budget is critical because it determines the resource envelope for expenditures which in turn are a major determinant of many development outcomes, especially for children. This note highlights the key revenue sources in Nepal as declared in the 2021/22 budget and makes comparisons with the recent past. The data are primarily from Redbooks (Ministry of Finance, various years)

[1] *This product has been financed by the European Union*

Contents

Highlights

- For fiscal year (FY) 2021/22 the revenue available in Nepal's consolidated budget is expected to be Nepalese Rupee (NPR) 1,024.9 billion. This figure is derived by subtracting revenue sharing for Provincial and Local Governments (PGLGs) of NPR 126.7 billion (mandated by the constitution) from the gross revenues of Nepal: NPR 1,151.6 billion. In other words, 11 per cent of the gross revenues leave the federal consolidated budget towards the consolidated budgets of Provincial Governments and Local Governments (PGLGs).
- The major sources of revenues (Figure 1) are expected to accrue from taxes on income, capital gains and profits which are a direct tax on entities (24%), VAT (26%), taxes on foreign trade of which import taxes (and duties) comprise the majority (23%) and excise duty (15%).
- Projected expenditures are expected to be NPR 1,647.6 billion while domestic revenues as described above from different taxes and other revenues comprise 62% of this figure. Therefore, there remains a financing gap (deficit) of NPR 622.7 billion (38% of projected expenditures) that must be 'financially managed' through internal or domestic loans from banks and the private sector, as well as external loans and external grants from bilateral and multilateral partners.
- The extent that domestic revenue performance is hampered because of the ongoing Covid-19 pandemic and the extent that Nepal's ability at leveraging debt is adversely affected would determine realized revenue flows and hence expenditures. Nepal's budget relies extensively on foreign sources on two fronts. First, on the domestic revenues front, it plans to raise 23
- 75% of budgeted expenditures are expected to be financed from domestic revenues which are mainly from taxes. To the extent there is a shortfall in domestic tax revenues – recurrent expenditures could be at risk of being underfunded. Similarly, there is a high dependence on capital and financial management expenditures on loans – both internal and foreign and to the extent these targets are not realized, these two expenditure headings would have to be curtailed.
- It is not clear that Nepal,s budget has struck an optimal balance between domestic and foreign sources of debt and loans. On the one hand, excessive domestic borrowing may crowd out private investment – a critical factor for Nepal's economic recovery. On the other hand, all sources of debt carry the obligation of future debt repayment. At present, Nepal's non-votable expenditures comprise primarily of its debt obligations – amounting to 8% of forecast expenditures which is nearly as much as the health budget.

1. Recent trends

For fiscal year (FY) 2021/22 the revenue available in Nepal's consolidated budget is expected to be Nepalese Rupees (NPR) 1,024.9 billion. This figure is derived by subtracting the compulsory revenue sharing for Provincial and Local Governments (PGLGs) of NPR 126.7 billion from the total gross revenues expected in FY 2021/22: NPR 1,151.6 billion. In other words, 11 per cent of the gross revenues leave the federal consolidated budget towards the consolidated budgets of Provincial Governments and Local Governments (PGLGs).

These revenue sharing agreements are mandated by the constitution of Nepal (Article 59 Clause 8) and refer to 30% of VAT plus excise taxes as well as 50% of royalty revenues to be passed on to the PGLGs consolidated fund – allocated to each government entity through a formula driven approach. The gross revenue target for the FY 2021/22 is nearly 1/5th higher (19%) than FY 2020/21 revised estimate of NPR 959.7 billion.

The major sources of revenues are expected to accrue from taxes on income, capital gains and profits which are a direct tax on entities (24%), VAT (27%), taxes on foreign trade of which import taxes (and duties) comprise the majority (23%) and excise duty (15%). These four tax categories consisting of direct and indirect taxes constitute more than 87% of the revenues received. Thus their performance is critical to achieving revenue targets which eventually determine expenditures. Secondary effects from Covid-19 on business, trading, economic activity and foreign trade could affect revenue targets adversely.

Another 2% comes from rent and royalties. Other revenues such as capital revenues, revenues from administrative fees, fines and penalties and income from bonuses comprise 10% of domestic revenues. Many of these taxes such as excise taxes (also known as a 'sin tax' as they are primarily levied on goods concerned harmful such as tobacco and alcohol) are paid on an unit of good (rather than ad-valorem or on the price) and hence becomes an indirect tax and tends to shift the tax burden to the consumer. Similarly, high import taxes can raise the cost of production and affect the competitiveness of the domestic economy as well as the price of the final goods produced.

Table 1. Major Sources of Revenue: FY 2021/22

Source of tax revenues	**NPR Bill.**	**% of total**
VAT	306	27
Income, profit and capital gains	274	24
Foreign trade	260	23
Excise Duty	173	15
Infrastructure & vehicle use	51	4
Rent and Royalties	24	2
Others	65	6
Total Rev.	**1,151.6**	
Revenue sharing (PGLG)	-126.7	11
Total Revenues	1,024.9	
Total Expenditures	1,647.5	
Resource Gap	**622.7**	

1.1 Financial management of the deficit

Projected expenditures are expected to be NPR 1647.6 billion while domestic revenues as described above from different taxes and other revenues amounts to NPR 1,024.9 billion - 62% of expenditures. Therefore, there remains a financing gap (deficit) of NPR 622.7 (38% of projected expenditures) that must be 'financially managed' through internal (domestic) loans from banks and the private sector, as well as external loans and external grants from bilateral and multilateral partners. The proposed budget plans to finance this deficit primarily through loans: foreign loans from multilateral and bilateral partners (50%), domestic loans (40%) & foreign grants from multilateral and bilateral partners (10%). The overall financing structure for the consolidated budget is shown in Figure 1 below.

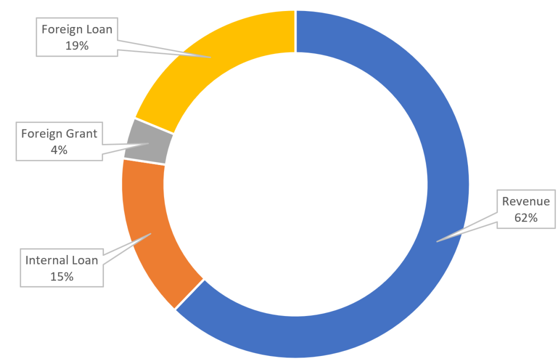

Figure 1. Financing the consolidated budget: FY 2021/22

1.2 Financing of heading-wise expenditures

The extent that domestic revenue performance is hampered because of the ongoing Covid-19 pandemic and the extent that Nepal's ability at leveraging debt is adversely affected would determine realized revenue flows (and hence expenditures). Detailed revenue sources for expenditure headings are available from recent Red Books. As per FY 2021/22 the budget and revenue sources for aggregated headings are shown in Table 2.

- Domestic revenues (Dom. Rev) are expected to finance 75% of recurrent expenditures[1] In addition, domestic revenues are earmarked to finance 37% of capital expenditures and 51% of financial management expenditures (mainly investment in public enterprises and corporations). Overall, domestic revenues are only able to cover 62% of budgeted expenditures.
- There is a high reliance on domestic loans (Loans-D)) for all expenditure headings except Financial Management. They are expected to finance 1/5th of capital expenditures in the budget and a slightly lower amount for recurrent expenditures.
- For both capital expenditures as well as financial management, there is a high reliance on foreign grants and loans (Grants/Loans-F): they are expected to finance more than 40% of budgeted expenditures for capital and financial management. They are also expected to finance close to 10% of recurrent expenditures.

[1] which comprise about 61% of total budgeted expenditures for FY 2021/22.

Table 2. Heading-wise Exp & Financing (%): FY 2021/22

Heading	NPR Bill.	Domestic Revenues	Domestic Loans	Foreign Grants/Loans
Recurrent	1,004.3	75%	16%	9%
Capital	435.2	51%	2%	43%
Fin. Mgmt	207.9	51%	2%	46%
Total	**1,647.6**	**62%**	**15%**	**23%**

There is reason for concern. Experience from very recent years has shown that some of these revenue sources, including grants and loans, can fall short as they depend on a variety of factors that are at co-risk from the ongoing Covid-19 pandemic.

1.3 Grants and loans

As shown previously, grants and especially loans are expected to finance a significant share of FY 2021/22 expenditures. The aggregated data for multilateral and bilateral grants and loans are summarized in Table 3. Bilateral grants dominate grant receipts for Nepal while multilateral loans dominate loans taken by Nepal. The data reveal some interesting plans for grants and loans:

Table 3. Sources of foreign grants & loans: FY 2021/22

Entity	Grants	Loans	% Grants	% Loans
Multilateral	16.5	238.1	26	77
Bilateral	36.3	61.1	57	20
Basket Funds	10.6	10.0	17	3
Total	**63.3**	**309.2**	**100**	**100**

- Considering grants first – bilateral donors have the highest share. Detailed breakdowns of the data suggest that the major multilateral donors are projected to be the World Bank (NPR 3.7 billion), ADB (NPR 3.6 billion), the consortium of donors providing grants for SSDP (NPR 2.7 billion), the UN (NPR 2.0 billion), IFAD (NPR 1.8 billion) and the EU (NPR 1.7 billion).
- Two bilateral grant donors – namely India (NPR 10. billion) and the USA[2] (NPR 8.4 billion) are projected to donate more grants than all the multilateral agencies combined. The third highest source of bilateral grants is expected to be from China (NPR 8.1 billion).
- In terms of loans multilateral creditors have the highest share. The major multilateral creditors are estimated to be the ADB (NPR 113.5 billion), the World Bank (NPR 84.1 billion), the consortium of creditors for SSDP (NPR 5.9 billion) and IFAD (NPR 5.3 billion). Among bilateral creditors India (NPR 19.7 billion), the European Investment Bank (NPR 10.6 billion) and China (NPR 9.6 billion) figure prominently.

[2] Millennium Challenge Corporation.

2. Issues

- **Reliance on foreign sources:** Nepal's budget relies extensively on foreign sources on two fronts. First, on the domestic revenues front, it plans to raise 23% of its revenues from taxes on foreign trade, most of which are import taxes and duties – mostly from India and China. Secondly, it is going to rely strongly on grants from India, China and the USA. Furthermore, it is also heavily reliant on loans – typically from multilateral agencies. Since the global Covid-19 pandemic has caused global economic and financial uncertainty as well as changes in global geopolitics, there is a risk that targets for import taxes and duties as well as loans and grants may not materialize.
- **Underspending risk from revenue short falls**. 75% of budgeted expenditures are expected to be financed from domestic revenues which are mainly from taxes. To the extent there is a shortfall in domestic tax revenues – recurrent expenditures could be at risk of being underfunded. Similarly, there is a high dependence on capital and financial management expenditures on loans – both internal and foreign and to the extent these targets are not realized, these two expenditure headings would have to be curtailed.
- Overall **concern about leveraging debt and grants** as they are expected to finance more than 38% of the budget. Furthermore, expected domestic revenues would depend on economic conditions and other factors which are at risk from the ongoing Covid-19 pandemic.
- **Efficiency of domestic versus foreign loans**: It is not clear that Nepal's budget has struck an optimal balance between domestic and foreign sources of debt and loans. On the one hand, excessive domestic borrowing may crowd out private investment – a critical factor for Nepal's economic recovery. On the other hand, all sources of debt carry the obligation of future debt repayment. At present, Nepal's non-votable expenditures comprise primarily of its debt obligations – amounting to 8% of forecast expenditures.

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