
NEPAL

2024

January

Components: Revenue

Module: RM I – Tax Policy

PROJECT SUMMARY**COUNTRY:** Nepal**LEAD DEPARTMENT:** Fiscal Affairs Department**REGION:** Asia & Pacific**PROGRAM ID:** (To be filled out by Secretariat)**PLANNED DATES:** February 2024 – April 2027**FUNDING PROGRAM TITLE:** GPFP Nepal**PROJECT MANAGERS:****RM I/TAX POLICY:** Li Liu – T2**PROJECT LEAD MANAGER:** Li Liu –T2**ESTIMATED BUDGET:** \$359,986**BUDGET FOR ENDORSEMENT:** \$325,418 (through FY25)

Contents

Project Summary.....	2
I. Project Purpose.....	4
II. Background	5
III. Project Level Description	6
A. Project Scope	6
Table 1. Summary of Objectives Covered by the Proposal.....	6
B. Country Engagement	6
C. Delivery Modalities	6
D. Coordination / Cooperation	7
IV. Risk Assessment and Mitigation	8
V. CD Delivery Plan Country Level.....	9
Table 2. Summary of Indicative CD Delivery	9
Table 3. First Year Workplan.....	9
VI. Program Financials.....	9
ANNEX I. REVENUE MODULE I - TAX POLICY	10
A. Program Objectives.....	10
B. Expected Results (outcomes)	10
C. Targeted Logical Framework – TAX POLICY	11

*NEPAL***I. PROJECT PURPOSE**

The country's authorities have expressed interest in a new capacity development (CD) project to continue FAD's supported reforms to tax policy for stronger revenue mobilization. Authorities started formulation of a comprehensive fiscal consolidation program, to ensure debt sustainability while creating fiscal space to support an ambitious reform agenda for poverty reduction and sustained growth. Reforming design of the tax system is key to achieving the expected results. However, the tax-to-GDP ratio in the country has dropped substantially from 20.7 percent in 2021 to 16 percent this year and is far from sufficient to meet these development needs.

This CD Project (FY24-26) will focus on combining tax policy advice and building capacity in tax expenditure reporting, assessment, and rationalization. It would build on the success of existing engagement, notably a FY23 FAD mission on domestic revenue mobilization and its subsequent integration as part of the Extended Credit Facility program, consolidate their achievements, and provide continuity to activities initiated under those missions.

This two-year CD Project has been discussed with the authorities, and the medium-term objectives and outcomes were agreed upon. The estimated budget for the project is \$359,986, but endorsement is requested for \$325,418 through FY25. Endorsement for future plans will be requested at a later date as funding for the program is secured and reform plans gain traction.

II. BACKGROUND

Nepal's tax to GDP ratio has experienced a substantial drop from 20.7 percent in 2021 to 16 percent in 2023, mainly driven by recent economic slowdown and lower imports. In January 2022, staff-level agreement on an Extended Credit Facility Arrangement was reached, foreseeing the primary balance to increase by 2.8 percentage points over the next three years. As spending pressures to protect the poor remain high, much of the consolidation will need to come from tax increases. Priorities areas, including tax expenditure reporting and assessment, have been included as structural benchmarks to achieve gradual fiscal consolidation. The project aims to provide support in this area: conducting tax expenditure assessment (TEA), establishing tax expenditure reporting, and delivering training for tax expenditure costing and evaluation. The support will be closely coordinated with ongoing assistance on revenue administration, currently funded by the JSA, to ensure mutually reinforcing reforms.

Tax expenditure rationalization, a first step for stronger domestic revenue mobilization, is also critical in supporting Nepal's transition to a green, resilient, and inclusive development (GRID) path. Nepal adopted the GRID approach in 2021, as a fundamental shift of the development agenda to a longer-term strategy that considers the interdependence between people, the environment and the economy, and prioritizes the sustainability of public and private sector-led development initiatives (green), adaptation to risks and uncertainties (resilient), and a reduction of disparities in opportunities and outcomes (inclusive). The GRID framework aims to achieve lasting economic growth without aggravating inequality and compromising environmental sustainability and calls for an upgrade of the tax system to reduce economic distortions that undermine investment and growth, while mitigating the impact of climate change and enhancing resilience.

III. PROJECT LEVEL DESCRIPTION

A. Project Scope

Against this background, this CD Project is aligned with the government's priorities and the IMF program which aims to improve the design of tax system, enhance tax transparency, and strengthen revenue collection. This project will include in-depth analysis of Nepal's tax expenditures (TEs) in all major taxes to identify improvements to streamline and rationalize TE, as well as tax policy institution building by advising on reporting and evaluation of tax expenditures.

- Tax expenditure costing: this activity will review the current system of TEs, and their fiscal costs in Nepal, as part of the TE policy framework to prioritize and rationalize them and identify options to reduce forgone revenues.
- Tax expenditure evaluation: this activity will undertake in-depth assessments of major TEs, including their effectiveness in achieving the economic objectives. The objectives for the TE policy reform will combine a revenue raising target while balancing the efficiency and equity impact.
- Tax expenditure workshop: this activity will provide training on comprehensive tax expenditure assessment and report, which is essential to enhance capacity to better monitor the Nepal's tax system performance and form policy proposals for its improvement.

Table 1. Summary of Objectives Covered by the Proposal

Component	Module	Objective
Revenue	RM I – Tax Policy	• Improve Tax Policy Design • Strengthen Policy Monitoring, Evaluation, and Institutions

B. Country Engagement

Nepal has achieved successful progress benefiting from a previous FAD mission on revenue mobilization as well as continuing engagement with FAD through the ECF program. The tax policy mission in FY23 provided a general review of tax policy to support Nepal's domestic revenue mobilization strategy and identified a series of reforms in strengthening the design of tax policy. Several key recommendations have been incorporated as fiscal conditionalities in the ECF program. Establishing a sound TE policy framework, including TE assessment and rationalization, and building institutional capacity in this area, is welcomed by the authorities as part of multi-year effort to strengthen revenue collection and upgrade the tax system in Nepal.

C. Delivery Modalities

The CD delivery will mainly be in-person activities due to the low capacity of the country, necessitating a more hands-on approach. Virtual deliveries will be used to provide efficiencies to on the ground support, including pre-engagement meetings and post follow-up meetings. The following CD activities will be delivered as a package:

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- **Headquarters-led (HQ) missions and staff visits** to provide strategic recommendations, primarily through a combination of diagnostic and technical advice, and to conduct regular follow-ups, assess progress, and adjust implementation plans.
- **Short-term expert (STX) visits** to help implement the recommendations delivered by the HQ missions; a limited number of STXs will be assigned to provide specialized assistance and training in specific areas of tax expenditure assessment.
- **In-person workshops** to build capacity in tax expenditure assessment and reporting, and new/emerging policy issues with a view to embedding the policy advice provided as part of HQ-led missions. These may be delivered as stand-alone activities or part of HQ-led missions.

D. Coordination / Cooperation

A scoping mission is expected by the authorities in February 2024. It will focus on establishing benchmark and available data for TEA and following up on further areas to assist the authorities in formulating the domestic revenue mobilization strategy. The Inland Revenue Department and Department of Customs are currently receiving FAD CD on tax administration through the SARTTAC and through a separate JSA-funded CD project in customs. Appropriate linkages with the existing CD programs are defined using the IMF's result-based management (RBM) framework. When designing specific country-based activities and workplans, this CD Project will seek to define the emerging challenges in an integrated and coordinated manner.

The project will coordinate with other development partners, notably the World Bank, to seek synergies and maximize impact of CD deliveries. Currently the World Bank is providing CD support to the Ministry of Finance to improve their VAT, including through eliminating excessive exemptions. Project managers will seek collaboration with the other CD providers in the respective areas to ensure regular exchange of information and discuss areas of support. The IMF Resident Representative assists FAD by setting up meetings with donors during major CD deliveries in the country, and this practice will continue. The authorities will be advised on the need to coordinate the various CD providers to seek synergies and improve cooperation among the IMF and other development partners.

IV. RISK ASSESSMENT AND MITIGATION

Program risks based on the assessed probability and impact on the achievement of the expected results.

General or Module	Description	Probability	Impact	Mitigation Measures
External climate/conditions				
Frequent and/or severe natural disasters; Abrupt global slowdown or recession in major trading partners	Risk that external events create a more challenging environment to implement reforms.	Low	Medium	Ensure sufficient flexibility in program execution and allow for ability to adjust activities in the case of adverse events.
Political Support				
Political instability	The political cycle generates governance instabilities, restricting policy making and delivery.	Low	Medium	Secure policy continuity if political instability occurs. Ensure transparency, accountability, and inclusion in policy implementation. Engage regularly with ministers and senior management to ensure government ownership of reforms.
Management and Technical Staff Support and Commitment				
Tax Policy (RM I)	Low commitment of management and staff in finance ministry and revenue authority to adopt and implement TE policy framework.	Medium	Medium	Engage with senior management and technical staff pro-actively and explain their role in driving reforms. Ensure frequent engagement to maintain momentum and rekindle commitment where needed.
Resource Adequacy				
Tax Policy (RM I)	Insufficient technical capacity and human resources necessary to implement TE reforms are limited.	Medium	High	Ensure CD plans include sufficient capacity building and training elements and prioritize CD to priority or highest risk areas where resources are limited, in line with country engagement strategy.
Other risks				
Tax Policy (RM I)	Multiple donors are providing technical assistance on strengthening revenue mobilization. Overlaps may arise as a result	Low	Low	Under the leadership of the country team take an active role in engaging with other donors to ensure support is well coordinated.

V. CD DELIVERY PLAN COUNTRY LEVEL

Table 2. Summary of Indicative CD Delivery

CD Modalities (Remote or Field-based CD)	Total for FY24	Total for FY25	Total for FY26	Grand Total
RM I / Tax Policy				
HQ-led CD mission	1	1	-	2
STX visits	1	-	-	1
Staff or other visit	-	-	1	1
Interactive Learning (in-person workshop)	-	1	-	1

Table 3. First Year Workplan

Timing	CD Delivery		Proposed Topics of CD
FY24 – Q4	STX (FB)	1 STX	TEA benchmarking and data collection
FY24 – Q4	HQ Mission (FB)	1 staff, 2 STX	Tax Expenditure Assessment: Indirect Tax
FY25 – Q1	Workshop (FB)	1 staff, 2 STX	Tax Expenditure Assessment: Direct Tax and Workshop on Tax Expenditure Assessment and Evaluation
FY25 – Q2	HQ Mission (FB)	1 staff, 2 STX	Tax Policy Framework

VI. PROGRAM FINANCIALS

	FY24 Q4	FY25	FY26	TOTAL (USD)
Direct Delivery	162,057	142,072	32,306	336,435
Module RM I - Tax Policy	162,057	142,072	32,306	336,435
Module RM II - Revenue Administration	0	0	0	0
Module SM I - Spending Policy	0	0	0	0
Module SM II - Managing Public Finances	0	0	0	0
Subtotal	162,057	142,072	32,306	336,435
Trust fund management fee (7%)	11,344	9,945	2,261	23,550
TOTAL	173,401	152,017	34,567	359,986

The estimated budget for the project is \$359,986, but endorsement is requested for \$325,418 through FY25. Endorsement for future plans will be requested at a later date as funding for the program is secured and reform plans gain traction.

ANNEX I. REVENUE MODULE I - TAX POLICY

A. Program Objectives

The objective of the program is to help Nepal to establish a tax expenditure policy, as a first step to strengthening its medium-term revenue mobilization. FAD will actively support the authorities in all aspects of TE policy framework, starting with quantitative assessment of TE cost and benefit, followed by a plan for TE rationalization and governance, together with a training workshop to help building institutional capacity.

In particular, CD activities will focus on:

- Tax expenditure assessment and evaluation in VAT.
- Rationalize and streamline tax expenditure in VAT.
- Tax expenditure assessment and evaluation in direct taxes.
- Rationalizing and streamlining tax expenditures in direct taxes.
- Support in developing and adopting a Tax Expenditure Policy (TEP) for the design, governance, and enforcement of TEs.
- Training in TE assessment and evaluation.

B. Expected Results (outcomes)

This CD Project is expected to benefit the Nepali public finance in a number of areas:

- Increased tax revenue quantity (tax revenue increases on account of rationalized tax expenditures and adoption of laws implementing this policy).
- Improved economic efficiency (economic distortions stemming from various tax expenditures are reduced on account of improved tax design as implemented by new laws).
- Increased transparency (a sound TE policy framework will enhance the transparency of fiscal management, and improve the design of tax policy)
- Increased institutional capacity (authorities' ability to model and evaluate tax expenditures, adding to improved capacity in general forecasting and modeling of tax policy)

C. Targeted Logical Framework – TAX POLICY

Objective	
Improve Tax Policy Design	
Outcomes	Indicators
Increased/decreased revenue quantity	Revenue change
	Laws implementing amendments to raise revenue are passed
Increased economic efficiency by minimizing economic distortions or addressing externalities or market failures	Adopt legislation that reduces economic distortions
Objective	
Strengthen Policy Monitoring, Evaluation, and Institutions	
Outcomes	Indicators
Improved structures (e.g., tax policy units) or capacity (e.g., models and tools) related to tax policy advice and analysis.	Improved models to evaluate tax policy adopted
Improved transparency and outreach	Tax expenditures are published