CSO Prospective and Recommendations on Upcoming Budget

2025/026

Tax And Fiscal Justice Alliance, Nepal

EDUCATIONOUTLOUD advocacy & social accountability

GPE Transforming Education

actionaid

To:
Hon. Bishnu Prasad Poudel
Minister of Finance
Government of Nepal

Cc:
Final Drafting Committee Representatives, FfD4

From:
TaxED Alliance · TAFJA Nepal · ActionAid International

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1.0 Current Global and Global South Context

The contemporary global landscape is characterized by heightened unpredictability and uncertainty, posing serious risks to the post-World War II rule-based international order. Interestingly, the ongoing rule based system which is unfair and unjustifiable from poor countries' perspectives has been established and led by the USA with special privilege to the USA due to, among others, dollar as a predominant international reserve currency. Likewise, USA being the largest shareholder has continuously used both IMF and World Bank to influence their lending policies in a way that could primarily serve USA's global interest. It is also noticeable that despite widening trade deficit in goods overtime, USA has registered surpluses in services trade for last several decades. Therefore, there is an apprehension that the USA under current president wants to consolidate further the single country global order. This is highly dangerous from the standpoint of establishing fair and justice based global system.

At present, the unilateral and erratic policy decisions by the United States-such as abrupt halts in foreign aid and sudden unprecedented hike in tariff- besides aggravating humanitarian crisis in many poor countries has created turbulence in the global stock markets and economies. Although the U.S. has paused proposed massive rise in tariff for 90 days (excluding China) keeping the newly imposed basic 10 percent tariffs to all countries intact, the economic volatility and threat of a global recession similar to the one experienced during 2008 and 2009 continue to loom. Compounding this instability is the U.S.'s withdrawal from key international organizations and agreements, including the World Health Organization (WHO), the United Nations Human Rights Council (UNHRC), and the Paris Climate Agreement to fund their ambitious defense program. If dollar appreciation, higher interest rates, and a decline in capital flows intensify, the pervasive adverse effects on vulnerable economies will be even larger and more damaging. Dollar shortages and balance-of-payments problems may become more acute, and the aggravation of the climate crisis could have spillover effects due to the U.S.

withdrawal from the Paris Climate Agreement. Above all, the lack of respect for the legitimate development rights of low-income countries will have a very adverse impact on the Sustainable Development Goals (SDGs). As a low-income country, Nepal will face severe consequences depending on the extent of the trade war and aid disruptions.

In such an alarming situation, various new initiatives at different global, regional and country levels are underway to minimize the likely severe adverse effect and rescues the economies. As called by the USA, ongoing bilateral initiatives are there at different levels to review tariffs and renegotiate with the USA amidst intensified trade war between China and the U.S.A. At the same time, efforts to prioritize regional trade and strengthen South-South cooperation are gaining momentum. The role of BRICS is also receiving increased attention, with a growing emphasis on enlarging its role. At the domestic level, countries are revising and reorienting policies on monetary, fiscal, industry, and trade fronts to promote self-reliance in development.

Strengthening true multilateralism through drastic reforms in the WTO and reviving the pending reform agenda of the Global Financial Architecture have received new attentions. The agenda now also includes fair trade, aid flows as per commitments, and establishing a more stable and predictable international exchange rate regime. The ultimate goal is to liberate countries from the current dominant system, though this may take time.

In such a turmoil prone and crisis imbedded dominant global system added by macroeconomic stresses and vulnerabilities in multiple fronts, preparation for the upcoming budget is going on. Therefore, upcoming budget faces big challenges and hence a major departure may be needed taking both external and internal experiences into account.

If negotiations are not made soon and threat of destroying rule based global trading system continues, developing countries in general and low-income countries in particular will face bigger challenges with a risk of deepening economic crisis amidst their vulnerabilities, both externally and internally. Notably, a basic 10 % tariff hike has already eroded the export competitiveness of these countries. This could trigger a chain effect, manifesting in low revenue/resource mobilization, and diminished saving and investment. Foreign employment and remittance inflows may also face adverse impacts, compounding the difficulties faced by these economies. Abrupt cuts in U.S. aid have exacerbated the humanitarian crisis in many nations, with vital projects and programs in health, education, and livelihoods suffering the most with significant setbacks. Nepal is a vivid example of this. Moreover, the likely reduction of U.S. support to multilateral development banks, especially their concessional lending windows, will affect critical areas such as health, education, and infrastructure development, given that the U.S. contributes around 25 to 30 percent of Official Development Assistance (ODA). In addition, countries like the UK and the Netherlands have already declared cuts in aid, and European countries are now diverting resources

2. Recommendations for Upcoming Budget

2.1 Major Challenges for Upcoming Budget

2.1.1 Economy/Macroeconomic Stresses

Recently some positive developments have taken place in the economy. A highly comfortable situation is seen in the external payments front amidst increased remittances inflows. More recently, a sharp rise in goods export has taken place along with moderate growth in imports, indicating some improvements from the slackness in the domestic economy. There have been continued expansion in the energy production. Revival in the tourism sector is also continuing. The IT sector development has also taken some pace. The interest rate has reached at one of the lowest levels as a result of plenty liquidity in the banking system. There are symptoms of some slowdown in prices as well. Largely, in some areas the progress on SDGs has been satisfactory to some extent.

However, the deepening problems in many critical fronts of the economy outstrip the positive developments especially from the standpoint of improving people's living conditions, sustaining quality growth and creating momentum towards prosperity of the nation. A quick review and analysis shows mounting economic/macroeconomic stresses posing challenges to the upcoming budget which are rooted in perpetuated structural and institutional problems to a greater extent. In our view, deficient policy direction and policy contradictions with committed objectives also in many respect are working as catalyst to such deepening problems.

Foremost is the low-quality growth amidst shallow structural change in the economy which portrays the fragile nature of the economy. Agriculture, a major production sector, remains almost stagnant. A phenomenon of deindustrialization is continuing. Hence, services sectors such as trade and finance have been the key drivers of economic transactions with little contribution to broad based economic growth and employment generation. Furthermore, there are poor linkages between the banking sector's lending to the private sector and overall growth, pointing to low investment in productive sectors. Worry is that the average growth rate is decelerating in recent years, from average growth rate of around 4 percent during 2010/11 to 2023/24 to 2.6 percent during last five fiscal years (2018/19 to 2023/24). There has also been negligible contribution by the Total Factor Productivity (TFP) in the growth which has been corroborated by the recent World Bank Development Update. The perpetuation in the inter-provincial socio-economic development gap is adding macroeconomic stresses immensely.

2. Recommendations for Upcoming Budget

Worryingly, the closure of enterprises and operation below production capacity is continuing as a result of trust deficit among investors. The poor investment, business, and operational environment aggravating such a problem. This is the primary reason for the excess liquidity in the banking system leading to rising non-performing assets (NPAs) in the banking system. The country faces a trade trap, marked by a widening trade deficit and escalating external vulnerabilities. The predominance of food and other consumable products in the import basket, along with a very narrow export base, low export competitiveness, and poor external market linkages, adds to the strain. The misalignment of the exchange rate with neighboring country is eroding not only export competitiveness but also affecting import substituting industries markedly. The high tariffs, and protectionism coupled with the threat of collapsing global trade rules may have added adverse effect.

Labor market vulnerabilities are also high, with larger unemployment rates in general and youth unemployment in particular. The National Living Standards Survey (NLSS) shows a low labor force participation rate of 37.1%, with the lowest female participation at 24.4%. More than 80% of the labor force is engaged in informal employment, primarily in unskilled jobs, and there is a significant wage gap between males and females. The unemployment rate stands at 12.6%, with male unemployment at 11.3% and female unemployment at 14.7%. Youth unemployment, especially among those age group of 15 to 24 is particularly high at 22.7%.

The country is facing a phenomenal rise in debt outstanding and debt servicing. Debt outstanding has already reached approximately 47% of GDP, and there has been a sharp increase in debt servicing. The current year's budget has allocated Rs. 402.8 billion for debt servicing, which includes Rs. 299.7 billion for principal payments and Rs. 103.1 billion for interest payments, against a targeted total revenue of Rs. 1419.3 billion. Such a mounting debt burden indicates the growing fiscal strain on the economy.

The widening gap between federal government revenue and expenditure is a major concern, exacerbated by shrinking revenue growth, uncertainty in aid, and a very adverse external environment. This has been further compounded by a larger gap between domestic savings and total investment. The predominance of the informal economy also poses a challenge, and efforts to move out of the gray list remain difficult.

Moreover, a significant portion of the population remains vulnerable, including those who have yet to receive full justice, such as highly exploited people from moneylenders, cooperative victims, disaster and earthquake victims, and those affected by environmental and climate crises. Gender inequality, landlessness, poverty, and youth unemployment are deepening vulnerability of these groups with both explicit and implicit pressures on macroeconomic front from the standpoint of addressing their problems and concerns. In sum, there are immense stresses in closing the gap between SDG achievements and the ongoing challenges, including the smooth transition to the graduation from least-developed country status.

2.1.2 Looming Fiscal Crisis: Causes and Likely Consequences

The macroeconomic stresses discussed above, to a greater extent, are rooted in looming crisis on the fiscal policy front. One of the key indicators of this is the deteriorating fiscal gap—the difference between government expenditure and revenue. This gap has widened from 6.1% of GDP in 2010/11 to 7.7% in 2022/23. During this period, total expenditure as a share of GDP rose from 18.9% to 26.6%, while revenue increased from 12.8% of GDP to 18.9%, indicating a growing imbalance.

More concern is the decline in the revenue-to-GDP ratio in recent years leading to increased reliance on internal borrowing. Internal borrowing rose from 2.7% of GDP to 4.8% during 2010/11 to 2022/23. Although the total expenditure as a share of GDP has decreased in recent years, this is mainly due to the shifting of budgetary responsibility from the federal government to the sub-national levels. For instance, a larger share of education budget has been shifted to the subnational governments.

As of April 9, the actual gap between revenue and expenditure has been recorded at Rs. 180.8 billion. Furthermore, in the first eight months of the current fiscal year, internal borrowing surged to Rs. 268.6 billion, up from Rs. 196.6 billion in the same period last year, according to Nepal Rastra Bank's eight-month statistics. These trends underline deepening fiscal vulnerabilities and indicate on the need of urgent attention.

More concern is the changing expenditure and revenue pattern. Between 2010/11 to 2022/23, current expenditure rose sharply from 13.4% to 18.5% of GDP, while capital expenditure increased only marginally from 3% to 4.4% of GDP. Financing component climbed from 2.4% to 3.6% of GDP. Notably, in the current year's budget, the share of financing has surpassed that of capital expenditure—a trend likely to intensify in the coming years due to fiscal pressures and rising debt obligations. Such imbalances reflect deeper structural problems in our public expenditure and financial management system.

More striking is the changing composition of total expenditure. The share allocated to public services surged from 18.9% in 2011/12 to 42.9% in 2022/23, while spending on social protection also rose substantially, from 3.6% to 14.4%. Conversely, the share of expenditure on economic affairs declined from 23.3% to 18.4%. Spending in key services sectors has declined phenomenally in recent years. Health sector spending fell from 7.8% to 4.2%, and the education sector experienced a sharper drop, from 21.0% in 2011/12 to 11.27% in 2022/23. This year's budget has further reduced education budget at 10.95%. This portrays a shift from public services, growth and development-oriented programs.

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The sub-national governments' overdependence on the federal government continues to pose structural challenges. Adding to the fiscal strain is the rise in debt outstanding and debt servicing more alarmingly in recent years. Total debt, which stood at Rs 540 billion in 2014/15, surged to Rs 2676.3 billion by last February, increasing by nearly fivefold in a decade. Such a rapid growth in debt has led to a significant rise in expenses on debt servicing. The situation is likely to worsen in the post-graduation period with a possibility of decline in concessional aid.

Sharp fall in grant assistance along with growing uncertainty about the concessional aid has increased the fiscal stress to greater extent. Grants have dropped from Rs 45 billion in 2010/11 to Rs 23.4 billion in 2022/23, with a clear downward trend. U.S. aid has already been halted, and uncertainty in it continues. There is also growing concern over a potential drastic reduction in Official Development Assistance (ODA) from the USA and other countries, particularly through multilateral donors, which could further aggravate the fiscal crisis.

The tax and revenue system is plagued with deep-rooted structural problems. Still there is predominance of indirect taxes at 62.3% in 2023/24. In this, share of VAT is predominant which is highly a regressive tax as it undermines the equity and ability-to-pay tax principles. Over 45% of tax revenue continues to be derived from international trade. The weak enforcement mechanisms, and the presence of a cascading tariff structure further amplifies inefficiencies. Meanwhile, the base of direct taxes remains low and is also impacted by similar cascading effects. Additionally, there is less effort to tap and harness government assets for more resource mobilization and optimal use of assets.

Another major concern lies in the tax regime's failure to incentivize investment and production. Frequent and adhoc changes in tax rates, rebates, and facilities—often influenced by ulterior motives—have hindered the genuine development and expansion of industries. This has facilitated rampant leakages, misuse, low compliance, and inducement to informal channels. Overall, the current tax and revenue system is constraining government to mobilize revenue taping the potentials, promoting investment in productive sectors, and fosterer more equitable development.

3. Upcoming Budget: Some Recommendations

Taking major deficiencies, constrains and challenges on the one hand and strengths, potentials/prospects on the other into account, the upcoming budget has to bring about certain breakthroughs in the budgetary objectives, strategies, policy direction, resource allocation principles and implementation system. As indicated above, the turmoil prone and crisis embedded dominant global system additionally calls for a such a departure. In this respect it has to be added based on global and out own experience that the budgetary system rooted in neo-liberal orthodoxy is one of the catalysts of looming crisis in the economy persistently.

Budgetary Objectives:
In aligning with SDGs, augmenting self-reliant development led higher growth and equitable prosperity should be the main objectives of the budget.

Major Strategies:
The accomplishment of objectives principally lies in the strategies that are adopted and pushed. Unlike continuity with business as usual approach, bringing about structural and institutional reforms including overhauling of fiscal system (both expenditure and revenue system) must be the principle strategies of the budget. Strategies also should insure that there is complete coherency in the policies for ensuing that policy direction is fully compatible with the above objectives.

As an integral part of the strategy, focus should be on enhancing productive capacity of the economy, raising overall and major sector productivity and boosting supply side of the economy. In this, priority should be given on quality education and healthcare (with gender equality), skill development (especially female participation), entrepreneurial capacity development, expansion in infrastructure, rapid growth in IT and internal as well as external market integration. Needles to add that unlike the past negligence, high priority has to be given on expansion in investment in education and health in massive way for improved quality public services which is key for productive capacity enhancement, without which sustainable growth and equitable prosperity is unthinkable.

Genuine transformation of key sectors should be equally high strategic priorities for sustaining higher growth and generating decent employment in a rapid way. Based on comparative advantages and potentials, agriculture, industry (manufacturing, construction and energy), tourism, and IT are transformative sectors which are also major drivers of growth. Unlike the past more concrete strategies have to be pursued that could help boosting these sectors. Robust strategies for moving from low productivity to higher productivity is a must. In this, a clear roadmap on the role of federal government and sub-national governments has to be clearly spelt out in the spirit of constitution. Present reluctance and ambiguities signifying the feudalistic behavior will continuously make the transformation agenda simply a propaganda tool.

3.1.1 Comprehensive Reform in Economic Policies

There is a need of economic policy reform in a comprehensive way covering industry, trade, investment and labor market apart from macroeconomic front. In this both immediate and long term policy packages will be needed for revival of the economy and boosting growth, employment and prosperity in a sustainable way. In that the climate related crisis has also to be addressed distinctly for sustainable growth and development.

In this respect some of the specific recommendations are as follows:

Restructuring Industrial Policy: Promote rapid industrialization by prioritizing agro-based, small-scale, and competitive industries, with special emphasis on the IT sector.

Revamping Trade and Exchange Rate Policies: Focus on trade creation, diversification, and export competitiveness while reviewing the exchange rate policy and addressing impacts of preferential trade losses.

Integrated Investment Policy: Encourage productive investment and FDI with clear strategies, including the establishment of a Rs 300 billion revolving fund under a PPP model to boost investor confidence and offset potential aid disruptions.

Employment-Generating Policy Framework: Formulate a comprehensive employment policy supported by targeted and effective job creation programs.

Introduce Transformative Macroeconomic/ Fiscal Policy Rules: First replace the shallow pro-cyclical fiscal balancing rule with a more transformative one which helps to identify the structural and institutional factors contributing to escalating unproductive expenses and paves the way to focus on maintaining fiscal balance without jeopardizing investment that raises productive capacity of the economy. As a part, it simultaneously paves the way to augment mobilization in revenue.

The other two critical aspects of fiscal rules are allocative efficiency of resources and operational efficiency associated with implementation of the budget. These principles should be strictly followed while selecting projects and programs and implementing the budget in a timely and effective manner. Indeed, there is a need of revamping of operational efficiency system in which priority on raising aid effectiveness is equally essential. New projects must come through the project bank scrutiny processes.

While devolving fiscal rules in such a way, efforts should also be made to ensure the sustainability of debt for which implementation of a robust debt management framework will be essential.

Introduce Systemic and Other Reforms in Budgetary System

Along with introduction of transformative fiscal rules, there is a need of replacing ongoing expenditure-centric budgetary system by **a performance-based budgetary system** in which **performance monitoring mechanisms** should be a part and parcel of this. This will require **complete restructuring of MTEF** as well. For efficiency and effectiveness ensuring high returns and productivity, such a bread based overhauling is must. In that public expenditure and public financial management improvement should be integral part of it. Under public financial management, cash based payment system has to be replaced by accrual system for larger improvement in this front.

- **Establish Realistic and Coherent Frameworks.** Move away from fragmented program labeling (gender-responsive, poverty reducing and environment related) towards integrated and realistic budgeting framework by keeping SDGs at the epicenter.
- **Reclassify Budget Structure**: Categorize the budget into clear segments such as administrative/security, social investment (human capital), core capital investments for higher productivity, sub-national transfers adhering to fiscal federalism, and sol protection.
- **Introduce Targeted Social Security Protection and Start Universal Minimum Income Program in a Pilot Basis:** Discard universal approach and adopt targeted social security program and ensure livelihood guarantees for vulnerable groups. In parallel, start a universal minimum income threshold program in a pilot basis that could guarantee social protection of highly vulnerable population.
- **Curtail Unproductive Spending in a Massive Way**: Reduce at least Rs 300 billion equivalent unproductive expenditures across all categories (current, capital and financing financing) and channel this amount toward human resource development, capital investment, and crisis mitigation.
- **Realistic Budget and Enhancing Budget Credibility:** Upcoming budgets should be realistic, predictable and implementable so that gap between estimates and actuals could be minimized. In that more focus should be not only on raising size of the capital budget markedly but also enhancing the absorptive capacity of the capital budget which will also facilitate raising absorptive capacity of aided projects considerably.
- **Strictly Follow Financial Procedure and Fiscal Responsibility Act and Other Budget Related Rules:** All fiscal mismanagement including public expenditure and public financial mismanagement should be strictly controlled through strong enforcement of rules. As a part reward and punishment system should be enforced effectively.
- **Governance Transformation**: Focus on transforming governance with an emphasis on transparency and accountability is highly essential. Both state and market capturing practices must be contained. As a part of this, **Ministers Accountability through a new act will be necessary to** ensure that they perform their responsibility in time with sincerity. Similarly, there is need of enhancing the effective role of the **Oversight Institutions**: Strengthen the role of oversight institutions, including civil society, in ensuring checks and balances is highly essential.

3.1.2 Advancing Domestic Resource Mobilization Strategies

A comprehensive reform of Nepal’s tax policy and administrative systems is imperative to achieve sustainable domestic resource mobilization. This reform should align with the broader objective of transitioning from donor- and vendor-driven financing models to self-reliant, predictable, and equitable revenue systems.

In this context, the Government of Nepal has introduced the Inland Revenue Mobilization Strategy 2024, a medium-term plan spanning Fiscal Years 2024/25 to 2028/29. This strategy aims to modernize the country's tax system and administration, enhance economic efficiency, and promote greater equity within the system. Key objectives include increasing revenue mobilization from domestic sources, encouraging voluntary taxpayer compliance, and strengthening the risk management capacity of tax and customs administrations. The strategy also emphasizes automating tax and customs systems to streamline processes and improve efficiency.

By implementing these reforms, Nepal seeks to reduce its reliance on external financing and establish a more resilient and equitable fiscal framework.

Key Problems in the Current Revenue System

- Highly regressive tax structure, with about 2/3 of total tax revenue from indirect taxes such as VAT, Excise and customs duties.
- Under-taxation of capital and wealth, while salaried individuals face relatively high effective tax rates.
- Legal ambiguities and conflicting provisions (e.g., Section 57 vs. Section 95Ka) create confusion, double taxation risks, and opportunities for misuse.
- Excessive administrative discretion, with long dispute resolution times, upfront payment barriers, and weak appellate accountability.
- Frequent ad hoc tax changes erode trust and hinder long-term investment.
- Limited contribution from global digital, financial, and corporate flows, and loss of revenue due to treaty abuse and illicit financial flows.
- Declining aid and growing debt highlight the urgency of building a resilient domestic revenue system.

Recommendations

1. **Reforming Tax Policies for Sustainable Development:**
- Shift from over-reliance on indirect taxes toward progressive direct taxes, especially on capital gains, property, inheritance, and high-net-worth individuals.
- Close loopholes and harmonize tax treatment across similar transactions, ensuring fairness and simplicity.

2. **Strengthening Democratic Oversight and Legislative Role:**
- Ensure the legislative body retains full authority over tax policy, rate changes, exemptions, and reforms.
- Stop bypassing Parliament through ordinances, budget directives, or administrative notices that undermine transparency and democratic accountability.
- Institutionalize mandatory parliamentary consultation and public hearings before introducing major tax policy changes.

3. **Enhancing Tax Administration Efficiency:**
- Simplify dispute resolution: abolish the 25% pre-deposit requirement before appeal; shorten timelines for tax reviews and audits.
- Enhance accountability of tax officers and reduce arbitrary discretion.
- Invest in digitization, data integration, and capacity-building to strengthen enforcement and reduce compliance costs.

4. **Implementing Progressive Tax Policies:**
- Enhance withholding tax (TDS) systems, especially in emerging sectors such as tech, e-commerce, and freelancing.
- Fully implement transfer pricing rules, ensuring multinational enterprises pay their fair share.
- Target undertaxed sectors and the informal economy through smart enforcement and incentives.

5. **Assert Nepal's Role in Global Tax Governance:**
- Support and engage in the push for a UN Tax Convention, to ensure fairer global rules and reclaim taxing rights from OECD-led regimes that favor richer countries.
- Collaborate with other developing countries to fight tax avoidance, treaty abuse, and illicit financial flows.

6. **Mobilize Public Assets for Revenue:**
- Activate underutilized public land, buildings, and enterprises through public-private partnerships (PPPs) or strategic leasing/sales.
- Ensure proceeds are used transparently for human capital development and infrastructure.

7. **Stabilize Policy for Investor Confidence:**
- Avoid frequent, non-transparent tax law changes; establish a medium-term tax policy roadmap through inclusive stakeholder engagement.
- Introduce sunset clauses for temporary tax incentives and evaluate them regularly for effectiveness.

Registered Event Attendees
of
Public Dialogue on Upcoming Budget and Financing for Development(FFD)
12 April 2025

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39	Jitendra Thapa	9864736136	Media Journal
40	Sanjaya K.C	9801226684	Co-Founder
41	Saru Dhakal	9851067509	Karobar Daily
42	Sudarsan Gautam	9844851745	Economist -TAFJA
43	Kriti Bhattrai	9765943797	Student
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45	Subin Kc	9851349957	Prakriti Pragya Nepal
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