# Fiscal Risk Statement and Strategies

Government of Nepal

**Ministry of Finance**

**30 July, 2025**

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## List of Abbreviations and Acronyms

| | |
|---|---|
| ADB | Asian Development Bank |
| BOT | Built-Operate-Transfer |
| BOOT | Built-Own-Operate-Transfer |
| EPAD | Economic Policy Analysis Division |
| FFCD | Fiscal Federalism Coordination Division |
| FPFA | Financial Procedures and Fiscal Accountability |
| FCGO | Financial Comptroller General Office |
| FDI | Foreign Direct Investment |
| FPS | Fiscal Policy Statement |
| FRAT | Fiscal Risk Assessment Tool |
| FRM | Fiscal Risk Management |
| FY | Fiscal Year |
| GoN | Government of Nepal |
| IBN | Investment Board of Nepal |
| IMF | International Monetary Fund |
| LG | Local Government |
| MOF | Ministry of Finance |
| MTEF | Medium-Term Expenditure Framework |
| NNRFC | National Natural Resources and Fiscal Commission |
| NPC | National Planning Commission |
| NDRRMA | National Disaster Risk Reduction and Management Authority |
| NRB | Nepal Rastra Bank |
| NSO | National Statistics Office |
| OAG | Office of the Auditor General |
| OECD | Organization for Economic Cooperation and Development |
| PEFA | Public Expenditure and Financial Accountability |
| PPP | Public-Private Partnership |
| PPPIA | Public-Private Partnership Investment Act |
| PFM | Public Financial Management |
| SNG | Sub-National Government |
| SPFMDSDP | Strengthening Public Financial Management and Devolved Service Delivery Program |

## Executive Summary

**Fiscal risks are factors that can cause fiscal outcomes (such as - government revenues, expenditures, or debt levels) to deviate from forecasts.** These risks arise from macroeconomic factors such as volatility in growth, inflation, interest and exchange rates, and exposure to external shocks. They also include specific risks such as natural disasters, contingent liabilities from government guarantees, potential fiscal pressures from public-private partnerships (PPPs), losses in public enterprises, and fiscal challenges at the subnational government level due to weak controls and rising deficits. Additionally, institutional risks, including significant forecasting errors, further compound fiscal uncertainty. Addressing these risks is critical for ensuring fiscal resilience and sustaining long-term economic stability.

**Effective Fiscal Risk Management entails the identification, assessment, mitigation and disclosure of fiscal risks**. This report analyses the various sources of fiscal risks and includes a **Fiscal Risk Heatmap** that classifies risks in terms of 'Fiscal Impact' (as Low, Medium, High) and 'Likelihood' (Remote, Possible and Probable). This assessment/ quantification of fiscal risks follows the use of IMF's Fiscal Risk Assessment Tool (FRAT), historical and quantitative analyses, current stock of knowledge, prior reports and studies by the government and International Organizations as well as expert judgement.

### Macroeconomic Risks

***Volatility in GDP growth***
GDP growth in Nepal has been volatile over the past 15 years, with repeated shocks—including the 2015 earthquake, the transition to federalism, and the COVID-19 pandemic—resulting in large swings in fiscal outcomes. Growth volatility (standard deviation of 2.7 percentage points around a mean of 4percent) materially affects revenues and expenditures. IMF sensitivity analysis indicates that a one standard deviation decline in GDP growth could reduce revenues by 0.7percent of GDP, increase the fiscal deficit by 0.8percent of GDP, and raise public debt by 3.2percent of GDP, underscoring the **medium magnitude and possible likelihood** of this risk.

***Inflation***
Nepal's inflation has averaged 6.9percent over the past 14 years with a 2.2percent standard deviation. High inflation may lead to the erosion of household purchasing power and increasing public spending obligations on wages, pensions, and subsidies. While moderate inflation supports revenue growth, high inflation has historically coincided with lower GDP growth and expenditure pressures, classifying inflation as a **medium-magnitude, possible-likelihood** risk.

***Volatility in Interest Rate***
Domestic borrowing costs (effective interest rate) have remained relatively stable, with an average interest rate of 4percent and standard deviation of 1percent. A one percentage point change in interest rates increases interest payments by NPR 1,315.6 crore (0.2percent of GDP). Treasury Bills, although volatile (standard deviation 2.5percent), have limited fiscal impact due to their small share of public debt. Overall, interest rate risk is assessed as **low magnitude with a possible likelihood**.

***Volatility in Exchange Rate***

The exchange rate has shown high volatility (average annual change 4.3percent, standard deviation 4.03percent), but external debt—largely concessional—has limited exposure to such fluctuations. Exchange rate risk is therefore considered **low magnitude and low likelihood**.

***Debt-Related Risks***

The Debt-to-GDP ratio has increased from 22.7percent in FY2016/17 to 42.7percent in FY2023/24, driven mainly by pandemic-related spending. However, ongoing fiscal consolidation and a medium-term debt management strategy are expected to stabilize public debt at about 50percent of GDP by FY2028/29. The IMF classifies Nepal's risk of debt distress as low, indicating a **low magnitude and remote likelihood** risk.

***Mitigation Strategies***

The Government of Nepal has initiated several mitigation measures, including prudent monetary policy, domestic revenue mobilization strategies, a medium-term expenditure framework, and internal and external borrowing limits. Future strategies could include sensitivity analysis, alternative scenario modelling, fiscal rules legislation, creation of fiscal buffers and stabilization funds to strengthen fiscal resilience.

**Forecast Errors:**

Revenue forecasting remains a significant challenge, with tax revenue forecasts deviating by an average of NPR 550 billion annually (7.2percent of GDP), similar to the volatility seen during the COVID-19 period. Overly optimistic assumptions, particularly regarding imports affecting customs duties and import VAT, have forced mid-year expenditure cuts, including reductions in capital spending. The magnitude and recurring nature of forecast errors make this a **high-impact, probable** fiscal risk. Mitigation measures focus on building fiscal buffers and improving forecasting capacity through better data, analytical tools, and independent review processes.

**Natural Disasters:**

Nepal's geographical vulnerabilities expose it to frequent floods and landslides and occasional high-impact earthquakes. Flood events occur almost every one to two years, causing average damages of around 1percent of GDP, making them a **low-magnitude but probable** risk. In contrast, major earthquakes are rare but catastrophic, as evidenced by the 2015 earthquake that caused damage equivalent to 22.8percent of GDP, making them a **high-magnitude, possible** risk. Mitigation actions include disaster early warning systems, dedicated disaster funds, contingency funds, disaster risk financing strategies, risk transfer mechanisms (including insurance), and strengthened infrastructure resilience.

**Sub-National Governments:**

The federal governance structure, with seven provinces and 753 local governments, poses emerging fiscal challenges due to high reliance on federal transfers, underspending, increasing arrears, weak revenue generation, and growing staffing costs. Despite these challenges, borrowing is well regulated under the Inter-Governmental Fiscal Arrangement Act (2017) and Public Debt Management Act (2022), resulting in **low-impact, low-likelihood** fiscal risk from sub-national governments. Mitigation strategies include the government's intention of establishing a Sub-National Fiscal Risk Monitoring System, adoption of SuTRA for standardized accounting, improved intergovernmental fiscal rules, periodic planning and budgeting reforms, and efforts to enhance own-source revenue potential.

**Government Guarantees:**
Outstanding government guarantees amount to NPR 51.6 billion (0.9percent of GDP), primarily linked to loans taken by Nepal Airlines Corporation (NAC) from Employment Provident Fund and Citizen Investment Trust. The fiscal impact of a potential guarantee call is estimated at NPR 7 billion annually (0.1percent of GDP) over the next three years, which is relatively **low and remote** to materialize soon. Nonetheless, fiscal risk reporting remains narrow, with broader contingent liabilities like credit schemes, deposit insurance, crop insurance, and PPPs remaining to be underreported. Mitigation measures include the ceiling on guarantees (1percent of GDP). Other strategies that the government may adopt are- introduction of a guarantee risk assessment framework, risk-based guarantee fees, enhanced disclosure of all contingent liabilities, regular monitoring of guaranteed entities, and creation of a contingency reserve buffer of 0.1–0.2percent of GDP.

**Public Enterprises (PEs):**
Nepal's 44 PEs account for assets equal to 51percent of GDP and liabilities of 33percent of GDP. While operating revenues averaged 11–12percent of GDP in recent years, several PEs continue to experience operational inefficiencies and losses. While the government has recently enjoyed net positive fiscal flows from PEs (NPR 102.5 billion over two years), this performance depends heavily on a few profitable entities. IMF's credit risk analysis rates NAC, NEA, and NWSC as high-risk entities, with the cost of restoring solvency estimated at NPR 60 billion (0.9percent of GDP). Thus, it accounts for a **medium-impact and possible-likelihood** risk. Mitigation strategies include restructuring loss-making and non-functional PEs, including PPP-based revival of seven defunct enterprises and unbundling of NEA; enhancing governance frameworks and performance-linked incentives; stress testing and scenario analysis; strengthening contingent liability monitoring through PDMO; and improving transparency via timely audits and digital reporting systems.

**Public-Private Partnerships**
Public-Private Partnerships (PPPs) have become an important instrument for mobilizing private finance and expertise to develop infrastructure and public services. Supported by the Public-Private Partnership and Investment Act (PPPIA) 2019, the government has strengthened its institutional arrangements through the Investment Board Nepal (IBN) and the creation of a Project Bank for transparent project selection and prioritization. Fiscal risks from PPPs remain **low in impact and remote in likelihood**. There have been no defaults or early terminations, and government support has been limited mainly to viability gap funding. However, challenges persist, including weak project structuring, limited technical capacity, low FDI inflows, incomplete disclosure of contingent liabilities, and the absence of a central registry of PPP commitments.

To manage these risks, the government has implemented a robust legal and regulatory framework, transparent procurement processes, risk-sharing guidelines, and regular monitoring by IBN and the PPP Committees. Going forward, additional measures are recommended, including establishing a central registry of PPP fiscal commitments, imposing ceilings on aggregate commitments, conducting sensitivity analyses, strengthening the Ministry of Finance's gatekeeping role, and introducing risk-based guarantee fees. These steps will help enhance fiscal transparency and reduce unanticipated liabilities from PPP arrangements.

**Thus, the Government of Nepal has made notable progress in strengthening fiscal risk management through robust legal and administrative frameworks, improved transparency, and enhanced oversight mechanisms**. While challenges remain, ongoing reforms and capacity building position the Government to manage emerging fiscal risks effectively, safeguard fiscal stability, and promote long-term growth.

# I. Introduction

Fiscal risks refer to the deviation of actual fiscal outcomes from expected outcomes due to various shocks or contingent events. Nepal's Constitution, 2015 establishes the regulatory foundation for fiscal risk management by mandating fiscal discipline, controlled public borrowing, and prudent deficit management across all government levels. It provides for contingency funds to address unforeseen shocks and empowers the National Natural Resources and Fiscal Commission (NNRFC) to recommend debt ceilings and guide revenue sharing among the three levels of the government, promoting fiscal stability.

The Government of Nepal (GoN) has pledged to implement a Fiscal Risk Management (FRM) system to identify potential threats to public finances and take measures to mitigate them. To support this effort, the government has already set up an institutional framework to oversee the fiscal risk management process. The primary goals of FRM include recognizing sources of risk, evaluating their scale and probability, exploring mitigation strategies, and ensuring close monitoring and transparent disclosure of these risks. By implementing FRM effectively, Nepal can safeguard its economy against unexpected fiscal shocks and create a more resilient fiscal environment.

The Government of Nepal has made strides towards effective Fiscal Risk Management by developing a fiscal risk registry in 2023 with an aim of expanding its scope and including all major fiscal risks that Nepal may face. These risks may arise from volatility in GDP and related shocks, natural disasters, weak financial performance of public enterprises and public-private partnerships, subnational fiscal pressures or the realization of government guarantees. Nepal is undergoing a significant transformation in its public financial management landscape, and its commitment to Fiscal Risk Management marks its growing emphasis on fiscal transparency and resilience.

The conventional view on public finances assigns macroeconomic management as the sole responsibility of the Federal Government, thereby confining fiscal risk exposure—and its mitigation and management—to the federal level and its budgetary operations. However, the Government of Nepal's commitment to decentralization reflects a broader vision—one that acknowledges the growing fiscal responsibilities of Subnational Governments (SNGs) and underscores the need for a comprehensive SNG fiscal risk monitoring framework. Another significant milestone in this direction has been the establishment of the Fiscal Risk Coordination Committee within the Ministry of Finance. This committee brings together key stakeholders, including representatives from the National Planning Commission (NPC), Investment Board Nepal (IBN), the National Disaster Risk Reduction and Management Authority (NDRRMA), Nepal Rastra Bank (NRB), the Public Debt Management Office (PDMO), the Financial Comptroller General Office (FCGO), National Statistics Office (NSO), Deposit and Credit Guarantee Fund (DCGF) and others—ensuring a cross-sectoral and coordinated approach to the identification, analysis, and management of fiscal risks across all levels of government.

## Fiscal Strengthening for a Sustainable Future

Nepal stands at a pivotal juncture in its pursuit of long-term fiscal sustainability and resilience. Guided by the findings of the 2024 Public Expenditure and Financial Accountability (PEFA) Assessment Report, the government is preparing and implementing a comprehensive Public Financial Management (PFM) Reform Strategy. The Medium-Term Debt Management Strategy (MTDS) 2023/24–2025/26, underscores the commitment to maintaining debt at prudent and sustainable levels. A ceiling on domestic borrowing—set at 5.5 percent of GDP by the National Natural Resources and Fiscal Commission (NNRFC)—will be strictly observed, while external borrowing will be targeted towards long-term, concessional sources. The government also intends to utilize project-specific bonds and restructure domestic debt to better manage cost and mitigate refinancing risks.

Strengthening the fiscal foundation of subnational governments (SNGs) remains a key priority. Efforts are focused on enhancing their internal revenue mobilization and reinforcing the legal and institutional frameworks governing debt management. At the same time, a comprehensive review of intergovernmental fiscal transfers is underway to ensure that allocations are objective, equitable, and reflective of fiscal realities across levels of government.

To address fiscal liabilities from certain public enterprises, Nepal is implementing restructuring measures and pursuing strategic partnerships through Public-Private Partnerships (PPPs). These efforts aim to improve operational efficiency, reduce the fiscal burden, and stimulate private sector participation in critical infrastructure and service delivery.

Public investment outcomes are also being strengthened through bold reforms in capital project implementation. This includes revising legal frameworks, streamlining procedures, and introducing performance-based criteria to enhance efficiency and accountability.

On the revenue front, Nepal is moving towards a performance-based revenue administration system. Initiatives such as e-assessment, faceless audits, mandatory e-billing, and the deployment of AI-driven compliance tools are being rolled out to improve transparency, reduce risks, and build trust in the tax system. Complementing these efforts, the formulation of a new Customs Act and the reduction of customs and excise duties on industrial raw materials are designed to boost trade and industrial growth, thereby supporting revenue stability.

The Government of Nepal is also committed to regularly monitoring fiscal risks and adopting market-based approaches, including insurance solutions, to strengthen overall fiscal resilience. Together, these initiatives represent a bold and coherent vision for fiscal risk management—one that recognizes and responds to macroeconomic volatility, institutional inefficiencies, debt vulnerabilities, natural disaster, subnational fiscal dynamics, and liabilities from public enterprises. The government's emphasis on coordination, systematization, and transparency is more than just a reform agenda—it is a reaffirmation of Nepal's unwavering commitment to building a resilient and sustainable fiscal future.

# Sources of Fiscal Risk, Identification and Quantification

### Sources of Fiscal Risks

Fiscal risks faced by Nepal can be broadly grouped into macroeconomic, specific, and institutional risks, in line with IMF's classification.

From a macroeconomic perspective, Nepal is exposed to risks arising from volatility in growth rate, inflationary pressures, and volatility in interest and exchange rates, all of which can directly influence expenditures, revenues and debt. Moreover, external shocks, such as global economic slowdowns or commodity price swings, can adversely impact growth and fiscal health.

In terms of specific risks, natural disasters, including earthquakes, floods, and landslides, present risks given their potential to cause widespread damage to infrastructure and livelihoods, resulting in significant fiscal burdens. Government guarantees create contingent liabilities that may materialize and impose unforeseen fiscal costs. Public-private partnerships (PPPs), while important for infrastructure development, carry the potential for cost overruns, delays, or failures, adding to fiscal pressure. Inefficiencies and financial losses in public enterprises can necessitate government bailouts or ongoing subsidies, straining public finances. In addition, subnational levels governments may pose fiscal challenges due to weak fiscal controls, rising fiscal deficit, increasing reliance on federal transfers, limited PFM capacity, and unmonitored liabilities.

On the institutional side, forecasting errors in revenue and expenditure projections can lead to budget execution challenges, potentially widening fiscal deficits or creating funding shortfalls.

### Nepal's Fiscal Risk Landscape (Heatmap Representation)

The Fiscal Risk Matrix[1] visually categorizes potential fiscal risks based on their **fiscal impact** (Low, Medium, High) and **likelihood of realization** (Remote, Possible, Probable). Accordingly, the various sources of risks have been categorized as follows:

***Figure 1:*** **Fiscal Risk Matrix**

Fiscal Risk Matrix

| Fiscal Impact | Remote | Possible | Probable |
|---|---|---|---|
| High | | • Earthquakes | • Forecast Errors |
| Medium | | • Volatility in Growth Rate<br>• Volatility in Inflation Rate<br>• Risks from Public Enterprises | |
| Low | • Government Guarantees<br>• Sub-National Governments/ Risks from Lower-Level governments<br>• Debt-related risks<br>• Risks from Public-Private Partnerships<br>• Volatility in Exchange Rate | • Volatility in Interest Rate | • Floods and Landslides |
| | **Likelihood of Realization** | | |

1. *Fiscal Impact: Defined as marginal impact of risk realization on fiscal deficit.*
2. *Likelihood of Realization: likelihood of risk exposure over the medium-term*

# II. Macroeconomic Risks

Macroeconomic variables such as real GDP growth rate, inflation, interest rates, and exchange rates have a direct and significant influence on a country's fiscal position. Fluctuations in real GDP growth rate affect both government revenues and expenditures by altering the tax base and demand for public services. Similarly, changes in the inflation rate impact revenue collections and spending requirements, particularly for wages and social benefits. Interest rate movements influence the cost of interest payments, while exchange rate fluctuations affect the repayment burden of external debt and the cost of imported goods and services procured by the government. Together, these factors represent key sources of macroeconomic risk that can shape fiscal outcomes and budgetary stability.

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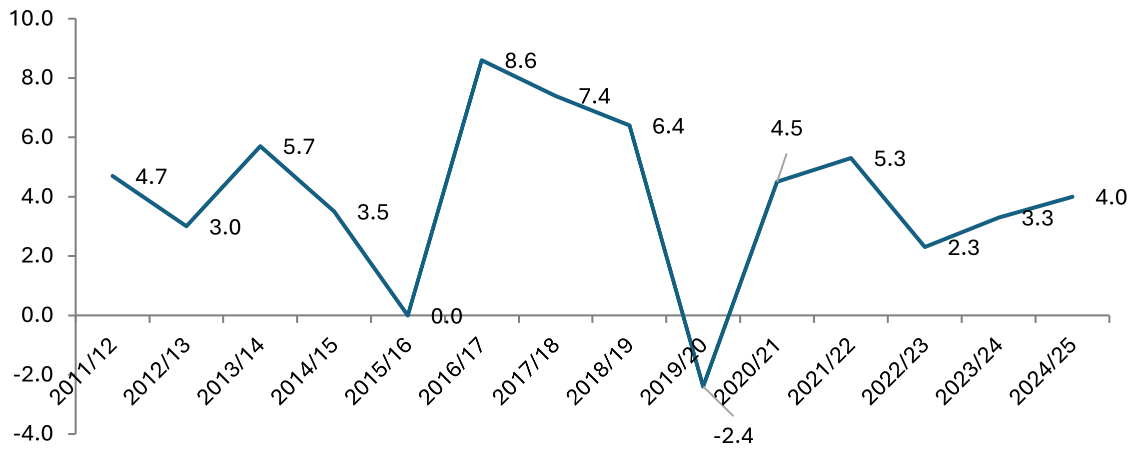
[1]*The Fiscal Risk Matrix categorizes fiscal risks in terms of magnitude – low (<1 percent of GDP), medium (1-5 percent of the GDP) and high (>5 percent of GDP) and likelihood as- remote (<10 percent probability), possible (10-40 percent probability) and probable (>40 percent probability). These thresholds have been assigned, to suit Nepal's fiscal context.*

## 2.1 Fiscal Risks from Volatility in GDP Growth

**Trends in GDP Growth**

Since the severe disruption caused by the Covid-19 pandemic in FY20, the country's growth rate has recovered but with considerable volatility. The economy evinced strong recovery in FY22 after rallying in FY21 from a contraction suffered in FY20. While the GDP contracted by 2.4 percent in FY20, it recovered to 4.5 percent in FY21 and further accelerated to 5.3 percent in FY22 (Fig. 2). Improvement in consumption demand and investment in post Covid-19 period were the main drivers of the recovery process. While surging domestic demand fueled imports to the country, foreign exchange earnings through remittances could not keep pace with it. The economy experienced a slowdown in FY23 with the GDP growth moderating to about 2 percent due to import restrictions and monetary tightening. From the slump in FY23, the GDP growth improved in FY24 to 3.3 percent, driven mainly by service sector growth. Rise in tourism related economic activities, surge in hydropower generation and agriculture contributed to recovery of growth process.

***Figure 2: Real GDP Growth Rate***




**Source**: Ministry of Finance, 2025

### Volatility in Real GDP

The observed volatility in the past 15 years, necessitates the estimation of the standard deviation (2.7) from the mean of 4 percent Real GDP growth rate. The standard deviation of 2.7 percent on a mean of 4 percent implies that Nepal's real GDP growth can fluctuate between 1.3 percent and 6.7 percent (one standard deviation band) in a typical year. This variability suggests that the ***magnitude of fiscal risks is potentially medium***.

Moreover, in the past 15 years, there have been 3-4 shock years[2], especially in FY 2015-16, FY 2016-17, FY 2017-18 (lesser in magnitude) and FY 2019-20. Nepal faced major shocks in FY 2015-16 due to the devastating earthquake, causing severe economic and fiscal disruption. In FY 2016-17 and FY 2017-18, transition to federalism and internal restructuring led to a sharp increase in government spending and fiscal widening fiscal deficit[3], with the burden of transition costs estimated at 3-4percent

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[2] Shock years = 1.5 * average absolute deviation

[3] International Monetary Fund. (2019, February 17). *IMF Executive Board concludes 2019 Article IV consultation with Nepal* (Press Release No. 19/45). International Monetary Fund.

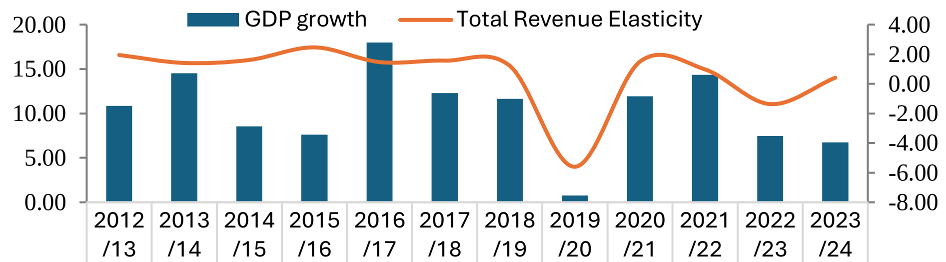
of the GDP[4]. In FY 2019-20, the COVID-19 pandemic triggered economic contraction and increased public spending needs. Thus, the repeated occurrence of these shocks over the past 15 years, ***the likelihood of this risk materializing is possible*** (between 10-40 percent).

## Effect on Revenue and Expenditure:

Aggregate revenue elasticity based on GDP and total revenue growth for the period from FY 2012-13 to FY 2023-24 was estimated to be 1.25. It suggests that for the whole period 1 percent GDP growth results in 1.25 percent growth in total revenue.

The annual estimates of revenue elasticity (measured as the percentage change in revenue relative to the percentage change in GDP) exhibit volatility, with a standard deviation of 2.09. In the year FY 2019–20 and FY 2022–23, revenue elasticity turned negative to -5.6 and -1.37, respectively, coinciding with a slowdown in GDP growth. This indicates that declines in GDP growth led to a disproportionately lower decrease—in revenue. The revenue elasticity declined as compared to the previous year in 2019-20 by 4.39 and in FY FY 2022-23 the decline in revenue elasticity as compared to the previous year was 0.40.

***Figure 3: Nominal GDP Growth rate and Revenue Elasticity***




| | 2012/13 | 2013/14 | 2014/15 | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 | 2022/23 | 2023/24 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| GDP growth | 10.86 | 14.53 | 8.56 | 7.62 | 17.98 | 12.31 | 11.66 | 0.77 | 11.93 | 14.34 | 7.47 | 6.74 |
| Total Revenue Elasticity | 1.95 | 1.41 | 1.61 | 2.46 | 1.47 | 1.57 | 1.21 | -5.60 | 1.50 | 0.97 | -1.37 | 0.41 |

Source: Ministry of Finance, 2025. Author's calculation.

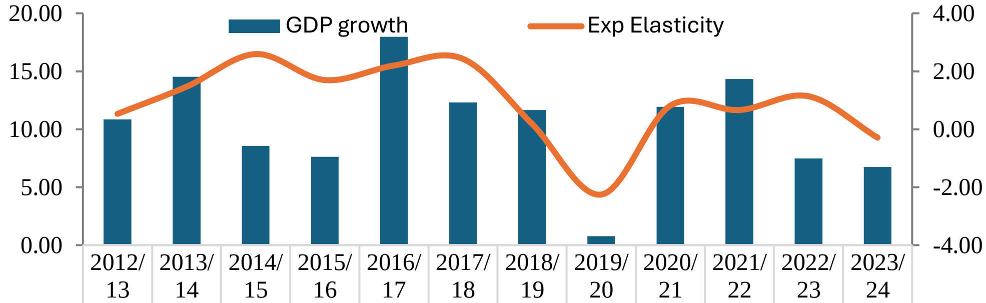
## Expenditure Elasticity

Expenditure elasticity results based on GDP and total expenditure growth for the period from FY 2012-13 to FY 2023-24 was estimated to be 1.31. It suggests that for the whole period 1 percent GDP growth results in 1.32 percent growth in total expenditure.

Annual expenditure elasticity, however, shows volatility with a standard deviation of 1.29. In two years, FY 2019-20 and FY 2023-24, the expenditure elasticity turned negative to -2.25 and -0.29, respectively, following a drop in GDP growth, suggesting a disproportionate decline in expenditure. In FY 2019-20 the decline in expenditure elasticity as compared to the previous year was 2.07 and in FY 2023-24, it was 0.85.

[4] Dahal, S., Rana, S., Bajracharya, R. D., & Cosic, D. (2018, April). *The challenging path ahead: Federalism in Nepal* (Report No. 125235). World Bank.

*Figure 4: Expenditure Elasticity*




| | 2012/13 | 2013/14 | 2014/15 | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 | 2022/23 | 2023/24 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| GDP growth | 10.86 | 14.53 | 8.56 | 7.62 | 17.98 | 12.31 | 11.66 | 0.77 | 11.93 | 14.34 | 7.47 | 6.74 |
| Exp Elasticity | 0.53 | 1.47 | 2.59 | 1.70 | 2.20 | 2.43 | 0.18 | -2.25 | 0.81 | 0.66 | 1.14 | -0.29 |

Source: Ministry of Finance, 2025 and Author's Calculation

***IMF's Sensitivity Analysis***

The IMF considered historical data for 4 decades and estimated the standard deviation for real GDP Growth at 2.4 percent and an average of 4.2 percent. A sensitivity analysis, applying a one standard deviation shock to the baseline forecast of GDP growth in 2025/26 (in terms of reducing growth from 5.5 percent to 3.1 percent) resulted in the following, by the end of the forecast period in 2027/28 (in the absence of any spending adjustment):

- A fall in revenues of 0.7 percent of GDP
- A 0.8 percent of GDP higher fiscal balance/ deficit
- A debt-to-GDP ratio that would be 3.2 percentage points higher than the baseline level.

On the other hand, sensitivity analysis of higher inflation indicates a relatively benign outcome, where revenues increase more rapidly than expenditures, leading to a reduced fiscal deficit and a decline in the debt stock.

In conclusion, Nepal's fiscal position is notably sensitive to fluctuations in GDP growth, as reflected by its growth volatility. Changes in GDP can materially influence revenue collections, public spending, and in turn, debt dynamics. This indicated that the fiscal risk from volatility in GDP is significant enough to be classified as a **medium magnitude** risk. Given the recurrence of such events in the past 15 years, the chance of similar growth disruptions materializing in the foreseeable future remains **possible**, rather than remote. This underscores the need for cautious fiscal planning and risk management.

## 2.2. Inflation

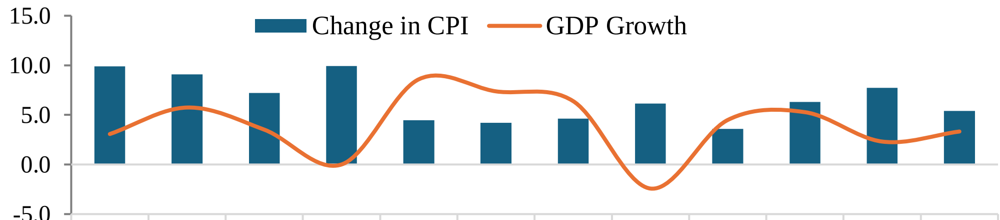
The impact of inflation on GDP is intricate, influenced by numerous interrelated factors. Due to its significance in shaping economic policy, the inflation-growth nexus has been the subject of extensive analysis and ongoing debate in the field of monetary economics. Empirical studies suggest that elevated and unpredictable inflation tends to hinder GDP growth by distorting resources allocation, diminishing purchasing power and increasing market uncertainty. These negative effects become particularly pronounced when inflation surpasses a certain threshold. Conversely, when inflation remains at moderate levels, it may sometimes correlate with stronger economic expansion.[5]

[5] Bruno, M., & Easterly, W. (1998). Inflation crises and long-run growth. *Journal of Monetary Economics, 41*
Khan M.S and A.S. Senhadji. 2001, Threshold Effects in the Relationship Between Inflation and Growth", IMF Staff Papers, 48(1), 1-21

For the past 14 years, the average inflation rate is 6.9, with a standard deviation of 2.2. The relatively high average suggests persistent inflationary pressures, which can erode household purchasing power and increase public sector wage and social spending commitments. With a standard deviation of 2.2 percent, annual inflation could reasonably fluctuate between 4.7 percent and 9.1 percent in a typical year.

In two years, 2015-16 and 2019-20, the real GDP growth declined considerably. Change in consumer price index in these two years remained high as compared to the previous years (Figure 5). In 2025-26 the change (negative) in real GDP growth as compared to the previous year was 3.51 percent, in 2019-20 at 8.8 percent. Thus, an average change in CPI of 2 percent was corresponded by an average fall in the GDP of around 6 percent, in these two years. Thus, it could be inferred that inflation may have a ***medium fiscal impact***. Such variability complicates expenditure planning and dampens economic activity. In the given period, there have been 2-3 shocks in inflation leading to a ***possible likelihood*** (around 20 percent).

**Figure 5: Inflation volatility**




| | 2012/13 | 2013/14 | 2014/15 | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 | 2022/23 | 2023/24 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Change in CPI | 9.9 | 9.1 | 7.2 | 9.9 | 4.5 | 4.2 | 4.6 | 6.2 | 3.6 | 6.3 | 7.7 | 5.4 |
| GDP Growth | 3.07 | 5.74 | 3.51 | 0.00 | 8.59 | 7.37 | 6.39 | -2.42 | 4.49 | 5.28 | 2.31 | 3.33 |

Source: Ministry of Finance, 2025 and Author's Calculation

High inflation may exert upward pressure on government spending by increasing the costs of wages, pensions, subsidies, social protection programs, and capital projects. At the same time, inflation may boost nominal tax revenues, particularly from VAT and excise duties. Fiscal outcomes ultimately rely on whether revenues increase enough to offset higher spending

## 2.3. Interest Rate

### Composition and Ownership of Domestic Debt, Bonds and Treasury Bills

Total **domestic debt stands at NPR.1,31,558 crore**. (1 crore = 10 million). The development bonds are the dominant component, accounting for 71 percent of the total domestic debt (Fig. 6). The treasury bills account for about **28 percent,** primarily used for short-term government financing and **citizens saving bonds** account for **1 percent**, aimed at encouraging public participation in debt financing. **Special bonds** stand at **0.3 percent,** according to the Economic Survey 2024-25. The effective interest rate (domestic) is used here as a representative indicator to capture the cost of public debt servicing[6]. This measure reflects the actual interest burden on government debt and provides insight into how borrowing costs impact fiscal sustainability. Further, T-Bill rate is also used to support the analysis.

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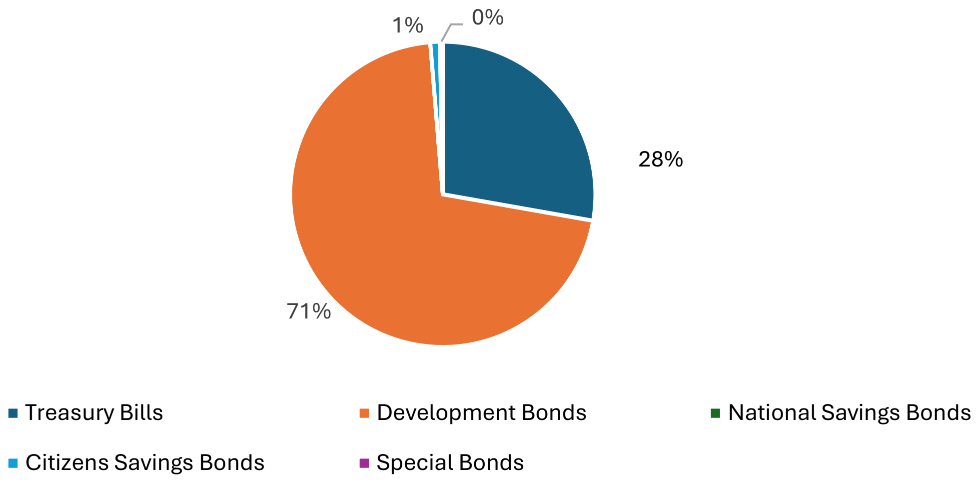
Del Canto, F., J. Grigsby, E. Qian, and C. Walsh. 2023. "Are Inflationary Shocks Regressive? A Feasible Set Approach." NBER Working Paper

Hodges, D. 2006. "Inflation and Growth in South Africa", Cambridge Journal of Economics, 20(2): 163-180

[6] The effective interest rate represents the average cost of servicing public debt and is calculated by dividing the total interest payments made in a given year by the stock of outstanding debt from the previous year.

**Figure 6: Composition of Domestic Debt and Ownership of Bonds and Treasury Bills**



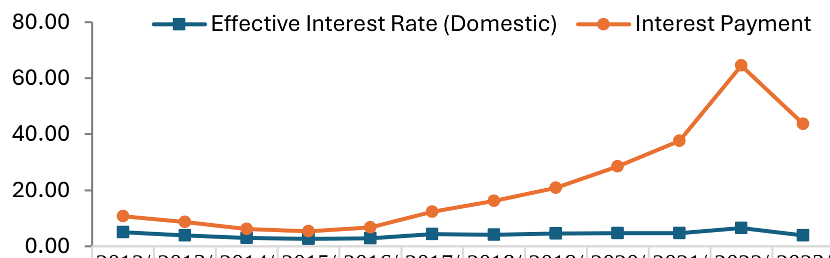

Source: Economic Survey 2024 -25

## Effective Interest Rate

After remaining stable until FY 2018–19, the effective interest rate (domestic) began to rise between FY 2019–20 and FY 2022–23. Correspondingly, interest payments increased significantly—from NPR 20.8 billion in FY 2019–20 to NPR 64.5 billion in FY 2022–23 (Figure 7). However, with a decline in the effective interest rate in FY 2023–24, interest payments also registered a decrease.

The **average domestic interest rate stands at 4 percent with a standard deviation of 1 percent**, indicating relatively stable borrowing costs with moderate potential variability. This suggests that in most years, the effective interest rate is likely to fluctuate within the range of **3 to 5 percent**, reflecting predictable debt servicing conditions. A 1 percentage point increase in the average domestic interest rate—within this expected variation—would raise annual interest payments by approximately NPR 1,315.6 crore. When compared to GDP, this translates to a fiscal impact of just around **0.2 percent of GDP**. This indicates that while changes in domestic interest rates can influence debt servicing costs, the overall **magnitude of fiscal risk remains low**, as the potential fiscal impact is limited. Moreover, in the past 12 years, there have been considerable deviations in 3-4 years, making it a ***possible-likelihood*** risk (around 33 percent probability).

***Figure 7: Interest payment and effective interest rate (domestic)***



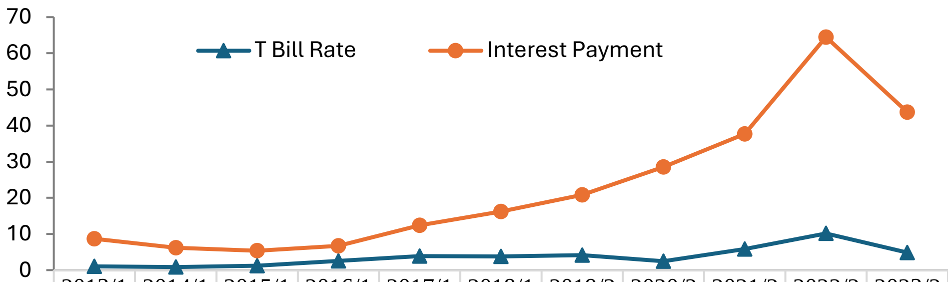

| | 2012/13 | 2013/14 | 2014/15 | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 | 2022/23 | 2023/24 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Effective Interest Rate (Domestic) | 5.01 | 3.93 | 3.01 | 2.66 | 2.83 | 4.36 | 4.14 | 4.59 | 4.65 | 4.69 | 6.53 | 3.88 |
| Interest Payment | 10.7 | 8.7 | 6.2 | 5.4 | 6.8 | 12.4 | 16.2 | 20.8 | 28.6 | 37.7 | 64.5 | 43.7 |

Source: Ministry of Finance, 2025 and Author's Calculation

**T-Bills (364 days)**

The interest payments and T-bill (364 days) rate follow a similar trend of rising payment during FY 2019-20 to FY 2022-23 in response to rise in T-bill rate. The 364-day Treasury Bills (T-Bills) carry an average interest rate of **3.7 percent**, with a high standard deviation of **2.5 percent**, indicating considerable volatility in short-term borrowing costs. T-Bills account for 28 percent of the total domestic debt, amounting to around NPR 36,836.24 crore. A 1 percentage point increase in T-Bill rates would raise the government's annual interest payments by approximately NPR 368.36 crore, which is about **0.06 percent of GDP**. Even if rates rise by a full standard deviation (2.5 percent), the additional interest cost would be around NPR 920.91 crore, or roughly **0.15 percent of GDP**. This shows that while T-Bill rates are volatile, their overall impact on Nepal's fiscal position is relatively **low in magnitude**, given their limited share in total public debt. However, in the past 12 years, significant deviations from the average absolute deviation have been observed in three years, making it a risk with a ***possible likelihood*** *(around 25 percent).*

***Figure 8: Interest payment and T Bill (364 days) Rate***



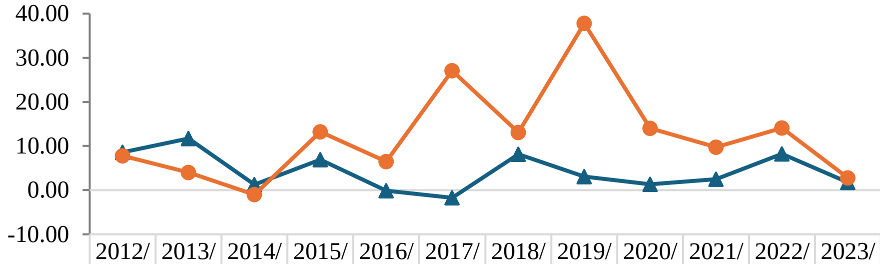

| | 2013/14 | 2014/15 | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 | 2022/23 | 2023/24 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| T Bill Rate | 1.02 | 0.84 | 1.25 | 2.52 | 3.92 | 3.81 | 4.16 | 2.49 | 5.82 | 10.14 | 4.83 |
| Interest Payment | 8.7 | 6.2 | 5.4 | 6.8 | 12.4 | 16.2 | 20.8 | 28.6 | 37.7 | 64.5 | 43.7 |

Source: Ministry of Finance, 2025 and Author's Calculation

## 2.4. Exchange Rate Volatility

The average exchange rate against the US dollar has shown high volatility (average change of 4.30 percent with a standard deviation of 4.03 percent) in the past 15-year period. However, the correlation of outstanding foreign debt to exchange rate volatility (Fig. 9) suggests that the outstanding foreign debt does not seem to be affected by a change in exchange rate. This is because Nepal's external borrowing decisions are primarily driven by expenditure requirements rather than short-term exchange rate movements. Moreover, a substantial share of Nepal's external debt is sourced from multilateral and bilateral development partners on **concessional terms**, with long maturities and low fixed interest rates. These concessional loans mitigate the immediate fiscal burden arising from exchange rate fluctuations, as the cost of servicing external debt remains relatively stable even during periods of exchange rate volatility. Consequently, exchange rate movements currently pose a **low magnitude fiscal risk**. Moreover, historical stability in external debt servicing, along with concessional financing, reduces the probability that exchange rate shocks will translate into fiscal distress, making it a **low likelihood** fiscal risk.

***Figure 9: Foreign Debt and Exchange rate change***




| | 2012/13 | 2013/14 | 2014/15 | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 | 2020/21 | 2021/22 | 2022/23 | 2023/24 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| % Change in Exchange rate | 8.56 | 11.71 | 1.26 | 6.90 | -0.13 | -1.73 | 8.15 | 3.04 | 1.34 | 2.52 | 8.20 | 1.75 |
| % Change in Outstanding Foreign Debt | 7.79 | 4.02 | -1.01 | 13.25 | 6.48 | 27.10 | 13.06 | 37.79 | 14.03 | 9.75 | 14.08 | 2.78 |

% Change in Exchange rate    % Change in Outstanding Foreign Debt

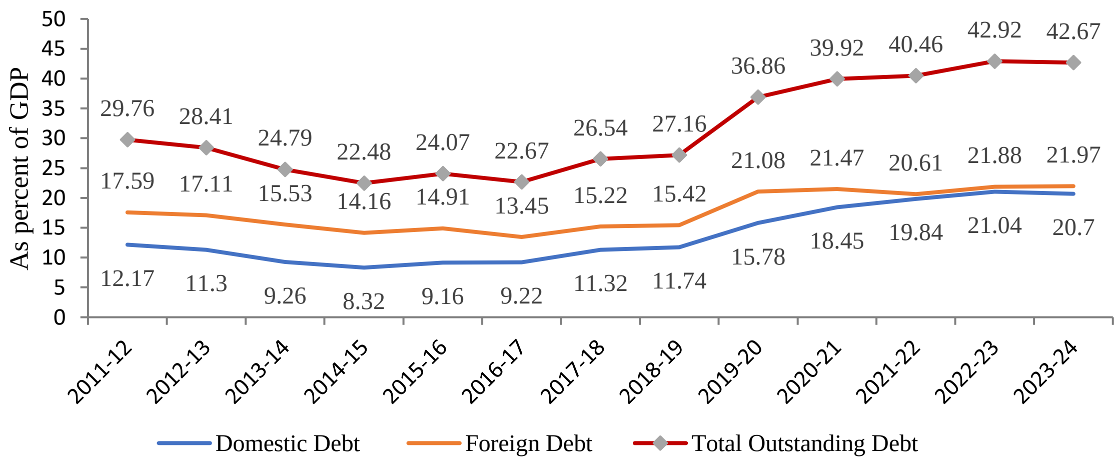
Source: Ministry of Finance, 2025 and Author's Calculation

## 2.5. Debt-Related Risks

### Public Debt trend of Nepal

In FY 2011-12, the outstanding debt was 29.76 percent of GDP and declined to 22.67 percent in FY 2016-17 (Figure 10). Then it steadily increased, reaching 39.92 percent in FY 2020-21, primarily due to the COVID-19 pandemic. Thereafter it continued to rise to 42.67 percent in FY 2023-24. External debt also declined from 17.59 percent of GDP in FY 2011-12 to 13.45 percent in FY 2016-17. Then it increased to 21.97 percent in FY 2023-24, recording 8.52 percentage points rise. The domestic debt fell from 12.17 percent in FY 2011-12 to 8.32 percent in FY 2014-15. Thereafter it steadily rose to 20.70 percent in 2023-24. Notably, the share of domestic debt increased from 40.7 percent in 2016-17 to 48.51 percent in 2023-24.

***Figure 10:*** **External and Domestic Outstanding Debt**




Source: Ministry of Finance,2025 and Author's Calculation.

### Debt Outlook

The ongoing fiscal consolidation efforts are projected to stabilize public debt at around 50 percent of GDP by FY2028/29, ensuring medium-term debt sustainability, which serves as the central fiscal anchor of the program. According to the Debt Sustainability Analysis (by IMF) of June 2024, both public and external debts are currently assessed to carry a low risk of debt distress. The debt trajectory, while rising in recent years, remains within manageable thresholds supported by strong institutional mechanisms and macroeconomic frameworks. The government's commitment to fiscal consolidation, alongside adherence to a medium-term debt strategy, signals proactive debt management aimed at ensuring sustainability without compromising growth. Thus, debt is categorized as a ***low impact and remote fiscal risk***.

**Management and Mitigation Strategies**

There are several management and mitigation measures being adopted by the Government of Nepal. A few are discussed below:

**Monetary Policy for Fiscal Resilience:** To mitigate macroeconomic risks, the Government of Nepal, through the Nepal Rastra Bank (NRB), has implemented several risk mitigation measures. Monetary policy remains appropriately accommodative, balancing inflation and financial stability. The NRB has absorbed excess liquidity — averaging 36 percent of GDP—through the Standing Deposit Facility (SDF) in 2024-25, while steadily reducing lending rates and enhancing access to the interest rate corridor (IRC). Structural reforms are underway to improve monetary policy implementation, including aligning open market operations with the reserve maintenance period and separating policy formulation from execution.

**Limits to internal and external borrowing:** Nepal has implemented borrowing limits for internal and external debt. For instance, the National Natural Resources and Fiscal Commission (NNRFC) has set internal borrowing limits for the federal government at 5.5 percent of GDP for the current fiscal year.

**Domestic Revenue Mobilization Strategy:** The government released a Debt and Revenue Management Strategy (DRMS) in 2024 aimed at expanding the tax base by streamlining tax concessions and enhancing compliance over the medium term. These measures align with expert recommendations and are expected to guide the formulation of the upcoming fiscal budgets.

**Fiscal Planning and Medium-Term Expenditure Framework:** The Government of Nepal (GoN) prepares a Medium -Term Expenditure Framework (MTEF) to improve budget credibility, execution, and fiscal discipline. It also aims at expenditure prioritization towards capital formation, service delivery, and social protection, improving resilience against macroeconomic shocks.

**Shift from import-based to production-based taxation**: Nepal has recognized the need to gradually shift from an import-based to a production-based taxation system as part of its broader strategy to improve domestic revenue mobilization and reduce fiscal vulnerabilities**.**

**Other mitigation strategies**

Several other mitigation and management strategies may be adopted by the Government of Nepal to respond to macroeconomic shocks/ risks. These are discussed below:

**Sensitivity Analysis/ Alternative scenario modelling:** As a response to an observation of the PEFA Report 2024, the GoN may incorporate a sensitivity analysis in its MTEF, to capture the fiscal impact of slight changes in important parameters/ fiscal indicators. Moreover, there exist no statutory obligations for the government to report on macroeconomic risks or undertake alternative scenario modelling. Thus, this may be taken up by the government to improve risk analysis. Moreover, the EPAD may focus on increasing capacity for undertaking sensitivity analysis.

**Fiscal Buffers/ headroom:** Incorporating fiscal space into budget planning is a widely used approach to cushion the effects of macroeconomic shocks. It allows the government to respond effectively to macroeconomic shocks without undermining long-term fiscal stability. The optimal size of this buffer can be guided by macroeconomic risk assessments/ analyses.

**Fiscal Rules Legislation:** A Fiscal Rules Legislation may be enacted to ensure fiscal discipline by setting legal limits on deficits, debt, and spending, at the federal and sub-national levels, enhancing long-term macro-economic stability.

**Stabilization Funds:** Nepal could establish stabilization funds to buffer against revenue shortfalls during economic downturns or external shocks, ensuring fiscal space without abrupt expenditure cuts. Such funds can smooth public spending across business cycles and reduce the need for pro-cyclical borrowing.

# III. Forecast Errors

Historical analysis conducted by the IMF, shows persistent challenges in revenue forecasting, particularly for tax revenues and donor grants. In recent years, tax revenue forecast errors averaged NPR 550 billion annually (7.2percent of GDP), similar to errors during the COVID-19 period and far larger than in earlier years. These errors, driven partly by lower imports (affecting customs duties and import VAT) and overly ambitious forecasts, have forced in-year fiscal adjustments, including scaling back capital spending. Grant revenue forecasts have also been overly optimistic, with actual receipts averaging only half of budgeted amounts (average optimism bias of about 1.2percent of GDP), especially after the 2015 earthquake when donor pledge significantly increased. However, its impact on fiscal deficit is limited because majority of the grants are project-specific which means that associated spending typically adjusts downwards when grants are not disbursed. Grant-related fiscal risk has declined as grants now form a smaller share of the budget and GDP. Given the scale of recent forecast errors and their recurring nature, this risk is considered high impact and probable fiscal risk.

**Management and Mitigation Strategies:**

**Building fiscal buffers into planning** is key to managing macroeconomic shocks, allowing flexibility to respond without jeopardizing fiscal sustainability.

**Strengthening forecasting capacity** through better data, analytical tools, and independent forecast reviews to reduce optimism bias and improve revenue predictability.

# IV. Risks arising from Natural Disasters

The geographical landscape of Nepal makes it highly vulnerable to a range of natural disasters. The country frequently experiences devastating events such as earthquakes, landslides, floods etc. particularly during the monsoon season. These hazards severely impact the livelihoods of communities, especially in rural and mountainous regions, where agriculture forms the backbone of the local economy. Nepal’s vulnerability to floods is exacerbated by limited adaptive capacity and low resilience of public infrastructure, including when compared to regional peers. The recurring nature of these disasters imposes significant economic losses and places a substantial burden on public finances. The Government of Nepal must frequently mobilize resources on an emergency basis for rescue operations, relief distribution, rehabilitation of affected populations, and restoration of damaged infrastructure. These demands strain fiscal space and highlight the critical need for comprehensive disaster risk management and resilient infrastructure development.

The most recent, September 2024 floods severely disrupted Nepal's economic recovery, causing population displacement, income losses, and supply chain disruptions. Flood damage to farmland, livestock, and infrastructure reduced productive capacity and pushed inflation from 3.9 to 6.1percent by December 2024 due to rising food and transport costs. A snapshot of the economic impact of the major natural disasters faced by Nepal till now is given below:

***Table 1:*** **Economic Impact of Natural Disasters**

| S.N. | Incidents | Total Economic Damage | |
|---|---|---|---|
| | | In million USD | As percentage of preceding year's GDP |
| **1** | ***Major floods/landslides*** | | |
| **1.1** | 2017 Aug | 595 | 2 |
| **1.2** | 2019 Jul | 204 | 0.6 |
| **1.3** | 2020 Jun-Sep | 100 | 0.3 |
| **1.4** | 2024 Sep | 420 | 1 |
| **2** | ***Major Earthquakes*** | | |
| **2.1** | 2015 Apr | 5174 | 22.8 |
| **2.2.** | 2023 Nov | 100 | 0.2 |

***Source****: IMF Country Report 25/26, March 2025*

Over the past decade, Nepal has experienced repeated natural disasters, particularly ***floods and landslides***, which have occurred almost every one to two years, which makes it a ***probable*** event. Events in 2017, 2019, 2020, and 2024 resulted in economic damages ranging from USD 100 million to USD 595 million, accounting for 0.3 to 2 percent of the preceding year's GDP. While these figures indicate significant disruption, the average magnitude/ impact on GDP is around 0.95 percent of the GDP, which makes it a ***low magnitude (<1 percent of GDP)*** risk.

In contrast, ***earthquakes*** are less frequent but potentially catastrophic, as seen in the April 2015 earthquake, which caused USD 5.17 billion in damage—22.8 percent of GDP. However, the more recent 2023 earthquake resulted in comparatively limited damage (USD 100 million or 0.2 percent of GDP), suggesting improved resilience and preparedness. Thus, the fiscal impact of discrete events like earthquakes, is uncertain and difficult to measure. However, the average impact on GDP of the two earthquakes in the past decade stands at 11.5 percent, which leads to a categorization of ***high magnitude-possible risk***.

## Management and Mitigation Strategies

For managing and mitigating risks from natural disasters, Government of Nepal has employed a multi-pronged strategy which entails effective identification (with early warning systems), mitigation (via risk transfer instruments like insurance) and provisioning via budgetary provisions. Few of them are discussed below:

**Early Warning System:** The budget speech for FY 2025-26 suggests that an early warning system for disasters will be developed to minimize damages. Capacity development of agencies involved in disaster management and response will be emphasized, along with the strengthening of disaster-resilient infrastructure and protection systems.

**Disaster risk financing strategy:** With World Bank support, Nepal is developing a comprehensive risk layering approach for natural hazard cost mitigation and establishing the framework for improved disaster risk financing.

**Natural Disaster Funds:** The Government operates a multi-tiered disaster financing system through dedicated funds at the federal, provincial, and local levels. At the federal level, the Prime Minister's Disaster Relief Fund is used exclusively for post-disaster response and can transfer resources to subnational governments. The NDRRMA Fund, also at the federal level, has a broader mandate—financing pre- and post-disaster activities, including risk reduction—guided by the National Disaster Management Fund Operating Guidelines.

At the provincial level, all seven provinces maintain disaster management funds, though most use them solely for post-disaster response, contrary to the recommended 70 percent allocation for risk reduction and 30 percent for response as outlined in the Disaster Risk Reduction and Management Act, 2017. At the local level, around 60 percent of municipalities have established disaster management funds, but only 20 percent have adopted operational guidelines. While these local funds are intended to follow the same 70:30 allocation principle, actual practices vary widely, and many rely on financial support from provincial and federal sources.

**Contingency Fund:** There exist constitutional provisions for the establishment of Federal and State Contingency Funds to meet unforeseen expenditures such as natural disasters or emergencies, enabling the government to respond to fiscal shocks without disturbing planned budgets.

**Budgetary Reallocations:** At present, in-year reallocation of unspent capital project budgets is commonly carried out after disasters to make resources available for disaster response.

**Risk Transfer Mechanisms:** As a risk mitigation measure against natural disasters, Government of Nepal plans to enhance the scope and accessibility of insurance services across all regions, including rural areas. This includes the implementation of crop and livestock insurance schemes to safeguard agricultural livelihoods.

**Budgetary Provisioning:** The budget speech for FY 2025-26 highlights the provisions made in the budget for the management of flood, inundation, and river erosion risks, though the implementation of river control programs in major rivers such as the Mahakali, Karnali, Narayani, Koshi, and others. Reconstruction and rehabilitation of irrigation systems in areas affected by natural disasters and earthquakes will be expedited. For this purpose, an allocation of *NPR 5.59 billion* has been made.

Additionally, reconstruction and rehabilitation efforts will be carried out for private residences, educational institutions, public infrastructure, and archaeological and cultural heritage sites affected by disasters such as earthquakes. To support these initiatives, a budgetary provision of NPR 18.5 billion has been allocated.

**Other mitigation strategies:**

Nepal can further enhance disaster risk mitigation and management by:

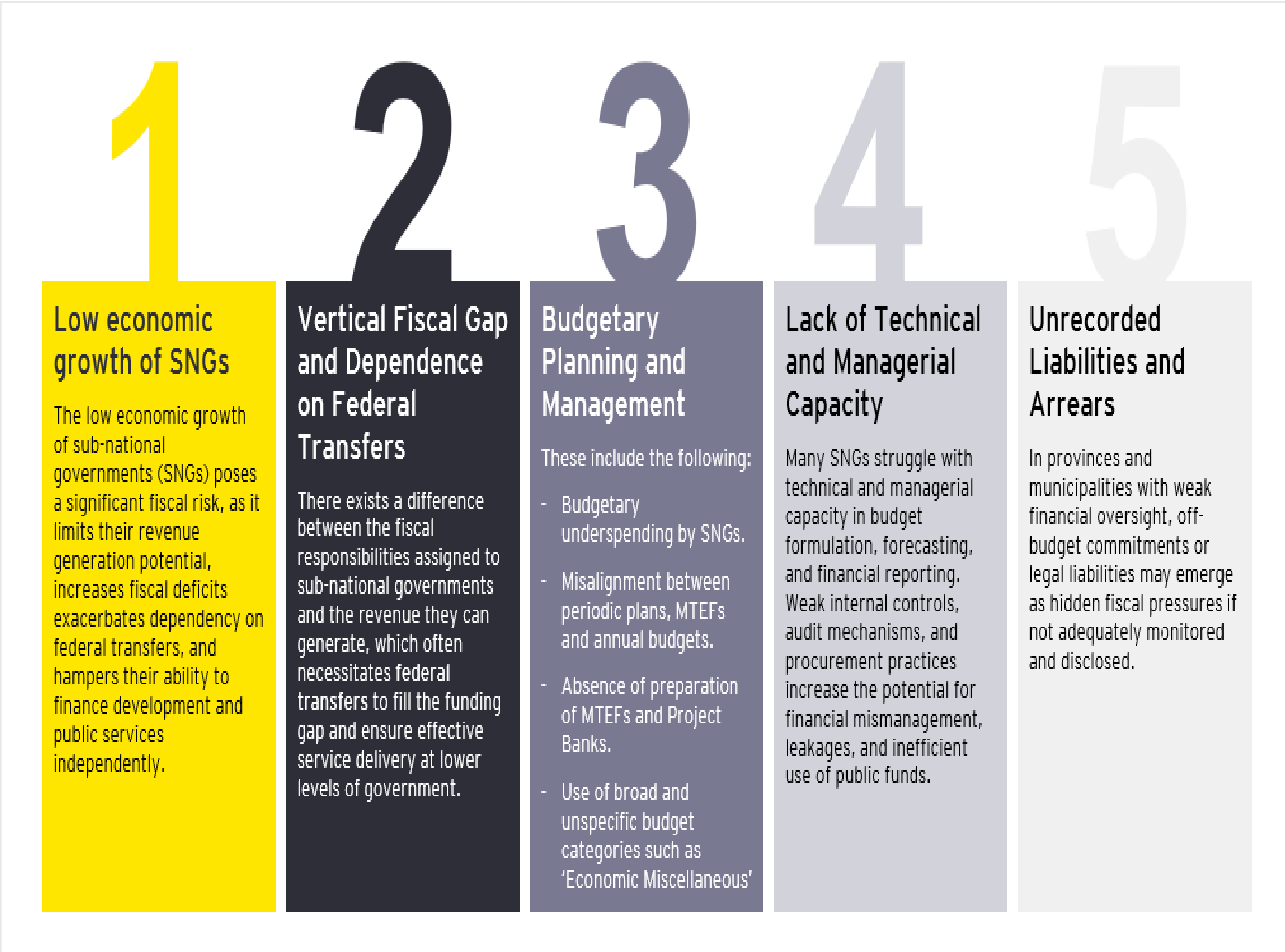
- Strengthening risk mapping and enforcing land-use zoning to avoid development in hazard-prone areas.
- Capacity building for local governments for the preparation of risk reduction plans with proper fund allocation, may be undertaken.
- Expanding disaster insurance coverage and promoting nature-based solutions like riverbank stabilization can further reduce risks.

- Establishing dedicated disaster financing instruments-such as catastrophe bonds will ensure timely resources for effective disaster response and recovery.
- Macroeconomic modelling can support informed responses by simulating the impact of natural hazards. The Ministry of Finance's MFMod can be utilized to assess the macro-fiscal effects of disasters of varying severity, helping to determine suitable sizes for contingency funds and fiscal buffers for medium-likelihood events like floods.

# V. Risks arising from Sub-National Governments

Nepal transitioned to a federal system of governance with the promulgation of the Constitution in 2015, establishing three tiers of government: federal, provincial, and local. The sub-national governments—comprising 7 provincial and 753 local governments (including metropolitan cities, sub-metropolitan cities, municipalities, and rural municipalities)—play a pivotal role in delivering public services, promoting local development, and ensuring participatory governance. In the context of Nepal, risks from subnational governments (SNGs) may be realized due to the following:

***Figure 11:* Causes for risks arising from subnational governments**




The process of intergovernmental transfers has led to a rise in Federal Government expenditure, impacting debt and deficit. This was more pronounced in the pandemic affected FY20. The post-Covid19 fiscal management shows that low revenue collection necessitated, limiting recurrent expenditure and transfers to subnational government.

Usually, subnational government finances rely heavily on intergovernmental transfers and revenue sharing from the central government. While provincial and local governments maintain relatively low debt levels, they face fiscal risks such as underspending, difficulties in aligning budgets with development priorities, and the need for stronger institutional development. Enhancing fiscal risk management at the subnational level is essential, requiring capacity-building initiatives and more efficient financial planning. The Federal Government also plays a vital role in mitigating risks and providing necessary support to ensure fiscal stability across all levels of governance.

**Fiscal Challenges in Subnational Governments**

- In FY23, provinces experienced their slowest economic growth since FY20. Economic growth slowed in all provinces, with the largest provincial economy, Bagmati, experiencing the lowest growth rate, mainly due to the contraction of wholesale and retail trade.
- Provincial governments recorded a consolidated fiscal balance deficit of 0.3 percent of GDP in FY23, the first time since the implementation of fiscal federalism began in FY19.
- Only 8 percent of own spending by provinces was financed by own revenue, and this vertical fiscal gap (VFG) increased marginally in FY23.
- Subnational governments are primarily funded through multiple intergovernmental transfers and revenue sharing, accounting for 8-9 percent of GDP annually.
- Unspent budgets and rising arrears at the SNG level highlight weak PFM capacity and increase fiscal risk. In FY2023/24, arrears reached NPR 2.7 billion for provinces and NPR 7.3 billion for LGs—around 3.6 percent of their recurrent spending. More notably, provinces underspent 35 percent of their budgets, up from 34 percent the previous year, leading to a surplus of NPR 69.83 billion. This reflects broader challenges in budgeting, public investment, and financial reporting. Moreover, budget credibility is undermined by lack of alignment between periodic development plans, medium-term expenditure frameworks (MTEF), and budgets.
- Own-source revenue collection for SNGs has stagnated.
- The transition to a federal governance structure has led to an increase of staff at SNG level to operationalize new functions, which puts pressure on SNG budgets and increases fiscal risk. Morevoer, SNGs are not fully accounting for long-term non-salary costs like pensions, despite rising staffing levels. This under-provisioning poses a growing fiscal risk, potentially shifting the burden to the federal government.
- While most local governments adhered to legal requirements for annual budgets and budget spending delegation, progress in preparing periodic development plans and MTEFs remains limited.
- Local governments continue to face challenges in fully adhering to the prescribed budget calendar. In many instances, annual budgets are prepared within compressed timeframes and often on an ad-hoc basis, which can compromise the quality of planning and investment decisions. Notably, in the fiscal year 2024/25, 56 out of 753 local governments were unable to present their annual budgets to their respective legislative bodies within the stipulated timeline.

The fiscal risks arising from Sub-National Governments is assessed as **low in impact and likelihood** due to well-regulated SNG borrowing under the Inter-Government Fiscal Arrangements Act (2017) and Public Debt Management Act (2022), domestic borrowing limits placed under NNRFC Act, stable federal transfers and ongoing fiscal reforms, no provincial debt and low LG debt etc.

**Management and Mitigation Strategies**

Nepal is currently undertaking several measures to strengthen public financial management at the sub-national level, which is intended to manage and mitigate risks from SNGs. These are discussed below:

**Sub-National Government Fiscal Risk monitoring system:** The Government is currently developing a Subnational Fiscal Risk Monitoring System, intended to standardize the reporting and oversight of fiscal risks emanating from provincial and local governments. This includes financial and debt reporting frameworks and oversight mechanisms.

**Public Debt Management Regulation:** Under the Public Debt Management Act (2022), four key institutions—the Public Debt Management Office (PDMO), Ministry of Finance, Nepal Rastra Bank (NRB), and the National Natural Resources and Fiscal Commission (NNRFC)—collaborated to shape a clear regulatory framework and institutional structure for internal borrowing by provincial and local governments (PLGs). This collaborative effort led to the formal adoption of the Public Debt Management Regulation on March 14, 2024, which clearly outlines the responsibilities and roles of each of these institutions in managing subnational debt.

**Enhancing PFM Practices at the Local Level:** Local governments are making significant progress in planning, budgeting and accounting practices, aiming to strengthen fiscal discipline and enhance service delivery. These include:

- A growing number of local governments are now preparing periodic development plans, Medium-Term Expenditure Frameworks (MTEFs), and annual programs.
- Almost all local governments have formed the required budget preparation committees, as stipulated by law.
- Thematic budget ceilings are increasingly being determined based on legal guidelines, ensuring better alignment with strategic priorities.
- Most local governments have delegated spending authority in accordance with legal requirements, contributing to more efficient fiscal operations.
- Local governments are also preparing Project Banks to ensure rational public investment.
- Nearly all local governments have adopted the Sub-National Treasury Regulatory Application (SuTRA), which standardizes accounting and treasury functions. This has led to broad compliance with accounting standards, thereby supporting better financial reporting.

**Improving Own-Source Revenue Mobilization by tapping potential of Natural Resources:** The government is currently supporting local governments in increasing their own-source revenues and reducing their dependence on federal transfers, through tapping the revenue potential of natural resources. This aims to improve fiscal autonomy and resilience.

**Enhancing Intergovernmental fiscal rules:** The Government is working to institutionalize intergovernmental fiscal discipline through: Clear debt reporting obligations for provincial and local governments, enforcement of borrowing limits under the Intergovernmental Fiscal Arrangement Act (2017), and design of fiscal responsibility rules for SNGs, in line with medium-term budgeting principles.

**Other Mitigation Strategies:** Other mitigation strategies that the government may undertake is to:

- Ensure the central government's budget is properly adjusted to reflect any future devolution of policy responsibilities and financial resources to SNGs. *Lead for this effort may be taken by* Fiscal Federalism Coordination Division (*FFCD) as well as* Budget and Program Division (*BPD).*

- Expand the financial reporting framework for SNGs to include the calculation and disclosure of long-term unfunded employee liabilities. Lead for this could be taken up by FCGO and FFCD.

# VI. Risks from Government Guarantees

Guarantees are legal commitments by the government to cover another entity's financial obligations, typically public sector borrowers. Nepal's total guaranteed debt includes NPR 51.6 billion (0.9 percent of GDP) in guarantees for loans from Employment Provident Fund (EPF) and the Citizen Investment Trust (CIT) to Nepal Airlines Corporation (NAC) for aircraft purchases in 2017. The increase from the original NPR 34 billion reflects NAC's failure to follow the repayment schedule and accumulated interest. While repayments are delayed, the guarantees haven't been triggered due to informal agreements by EPF and CIT to defer principal payments.
Although NAC's financial health is weak, the fiscal risk is currently low as both institutions continue to tolerate delays. However, if this change, the government may face annual debt servicing costs of around NPR 7 billion (0.1 percent of GDP) over the next three years.

Thus, in the event of a guarantee call or realization of risk, the ***magnitude*** of such a risk would be classified as ***low***. Moreover, table 5 suggests that the losses of Nepal Airlines Corporation have decreased substantially, which may minimize the likelihood of the materialization of this risk to ***remote.*** Therefore, with the given information on government guarantees, the risk emanating from them has been ranked as ***low impact and remote likelihood***.

More broadly, strengthening fiscal risk reporting, including guarantees, is essential to capture the full spectrum of potential government exposures. At present, there exists no explicit reporting obligation on all contingent liabilities. While the Public Debt Management Office (PDMO) publishes information on debt and guarantees, expanding the coverage to include deposit insurance, credit guarantee schemes, crop insurance, and public-private partnerships (PPPs) would provide a fuller picture of the government's potential fiscal exposures.

**Management and Mitigation Strategies**

**Caps/ Ceilings on guarantees:** To effectively mitigate and manage the risks arising from government guarantees, the Government of Nepal has implemented a direct control measure of setting a cap on issuing guarantees. The Public Debt Management Act mandates the capping of guarantees at 1percent of the GDP of the previous year, which considerable reduces the government's risk exposure.

**Other mitigation measures:**

To reduce fiscal risks arising from government guarantees, a '**Guarantee Risk Assessment Checklist'** may be introduced before approval, evaluating financial soundness, fall-back revenue streams, and impact of guarantee on higher-priority spending. Prior approval from the Ministry of Finance and PDMO, may be mandated. All issued guarantees may be published in an annual public report.

Moreover, introducing **risk-based guarantee fees** and setting aside budgetary provisions or creating a guarantee fund may cushion potential losses. Transparency may be enhanced by disclosing all guarantees in fiscal reports, while regular monitoring of guaranteed entities will help identify risks early. Additionally, limiting guarantees to priority sectors and enforcing strict oversight will further safeguard fiscal stability.

**Contingent Liability Reserve Buffer -** A designated budget line to cover realized contingent liabilities, starting with 0.1–0.2 percent of GDP may be established and replenished annually based on risk exposure. Disbursement and top-up rules shall be clearly defined to avoid disruption of core spending. Additionally, stabilization funds may be established for revenue smoothing during macroeconomic shocks.

# VII. Risks from Public Enterprises

According to the Annual Status Review Report of Public Enterprises 2024 by the Ministry of Finance, Government of Nepal, the country has 44 Public Enterprises (PEs). These enterprises primarily operate across key economic sectors, including industry, trade, services, social services, public utilities, and finance. In FY2020/21, PEs collectively held assets amounting to 51 percent of GDP, while their liabilities stood at 33 percent.

PEs have been established under various legal provisions and function under multiple ministries, including Finance, Industry, Commerce and Supplies, Agriculture and Livestock Development, Physical Infrastructure and Transport, Culture, Tourism and Civil Aviation, Forest and Environment, Urban Development, Energy, Water Resources and Irrigation, Education, Science and Technology, Communications and Information Technology, and Drinking Water.

### Contribution to GDP

The following table discusses the proportion of the operating revenue of the PEs to the GDP. This ratio stood at 11.57 percent in 2023-24, which marks a decline of 0.72 percentage points as compared to the previous year. In the last five years, this ratio is found to be at 11.23 percent, which suggests that a high proportion of the country's total economic output is generated by PEs, making it an important potential source of fiscal risk.

***Table 2:*** **Ratio of Operational Revenue to Gross Domestic Product (GDP) (Percentage)**

| Sector | 2019-20 | 2020-21 | 2021-22 | 2022-23 | 2023-24 |
|---|---|---|---|---|---|
| **Industrial** | 0.15 | 0.15 | 0.13 | 0.09 | 0.08 |
| **Commercial** | 5.62 | 5.53 | 7.06 | 7.24 | 6.55 |
| **Service** | 0.58 | 0.33 | 0.51 | 0.70 | 0.65 |
| **Social** | 0.06 | 0.06 | 0.06 | 0.07 | 0.05 |
| **Public Utility** | 2.65 | 2.47 | 2.55 | 2.55 | 2.64 |
| **Financial** | 1.89 | 1.16 | 1.35 | 1.64 | 1.59 |
| **Total Ratio of Operational Revenue to GDP** | 10.95 | 9.71 | 11.67 | 12.29 | 11.57 |

**Source**: Central Bureau of Statistics and Relevant Institutions

### Financial Performance

Before FY2018/19, aggregate profits of PEs were on the rise, but this trend was abruptly disrupted when the COVID-19 pandemic struck, causing a sharp decline in performance. Notably, even prior to the pandemic, PEs were experiencing a downward trend in Returns on Assets (ROAs), despite overall profit growth. This was largely driven by substantial asset expansion, particularly heavy investments in the electricity sector. Additionally, recent global price shocks have further strained PEs financially.

For instance, Nepal Oil Corporation (NOC) suffered losses equivalent to 1 percent of GDP in FY2021/22, as soaring fuel procurement costs were not fully passed on to domestic consumers through sales prices.

Among all the PEs, major PEs such as Nepal Oil Corporation (NOC) and Nepal Airlines Corporation (NAC) experienced significant financial deterioration due to the COVID-19 pandemic. In contrast, Nepal Electricity Authority (NEA) remained relatively resilient. Despite the pandemic's economic challenges, NEA's financial position was not severely affected, partly due to government policies supporting electricity consumption, which helped stabilize its revenue streams.

Table 3 below suggests that all (except Deposit and Credit Guarantee Fund) of the top five PEs generating highest profit over the last five years experienced a slump in their net profit/ loss in FY 20/21 and 21/22. Table 5 suggests that Nepal Airline Corporation has been able to significantly reduce its net losses in FY 2022-23, as compared to the previous year. The net losses incurred by Nepal Food Corporation have been consistently increasing over the past five years.

***Table 3:*** **Status of Net Profit/Loss of the Top Five Public Enterprises Generating Highest Profit Over the Last Five Fiscal Years**

| S.N. | Public Enterprises | FY 2018/19 | FY 2019/20 | FY 2020/21 | FY 2021/22 | FY 2022/23 |
|---|---|---|---|---|---|---|
| **1** | Nepal Oil Corporation Ltd. | 87,536.00 | 1,29,148.00 | (4,302.00) | (3,81,888.76) | 1,18,229.78 |
| **2** | Nepal Electricity Authority | 98,125.00 | 110,385.00 | 60,994.00 | 1,33,746.71 | 94,055.82 |
| **3** | Nepal Telecom | 97,576.00 | 97,490.00 | 71,294.00 | 84,707.00 | 89,201.55 |
| **4** | Citizen Investment Trust | 27,687.00 | 27,929.00 | 22,509.69 | 31,042.26 | 38,570.25 |
| **5** | Deposit and Credit Guarantee Fund | 13,863 | 18,711 | 21,509 | 30,150 | 38,063.79 |

***Source:*** *Annual Performance Review of Public Enterprises 2025 - Yellow Book, Ministry of Finance*

***Table 4:*** **Status of Net Profit/Loss of the Top Five Public Enterprises with the Highest Losses Over the Last Five Fiscal Years**

| S.N. | Public Enterprise | FY 2018/19 | FY 2019/20 | FY 2020/21 | FY 2021/22 | FY 2022/23 |
|---|---|---|---|---|---|---|
| **1** | Nepal Airlines Corporation | 2,017.00 | (19,654.00) | (38,983.00) | (36,630.00) | (6529.39) |
| **2** | Nepal Food Corporation | (616.00) | (1,255.00) | (3,569.00) | (3,637.00) | (5,469.19) |
| **3** | Dairy Development Corporation | 485.00 | (201.00) | (1,581.00) | 1,671.00 | 4,842.28 |
| **4** | Udayapur Cement Industry Ltd. | (1,024.00) | (1,963.00) | (3,336.00) | (3,060.00) | (3,628.88) |
| **5** | Nepal Television | (1,126.00) | (1,262.00) | (2,063.00) | (1,909.00) | (3,512.67) |

***Source:*** *Annual Performance Review of Public Enterprises 2025 - Yellow Book, Ministry of Finance*

Table 5 compares key statistics for Public Enterprises for FY 2022-23 and FY 2023-24. It is evident that a key source of concern is the sizeable accumulation of losses. Although, the net loss from loss-making enterprises has drastically reduced, the number of such enterprises remains relatively high at 15. On the other hand, the total accumulated profits across PEs saw a 16.68 percent increase, but this positive development may not enough to offset the risks posed by systemic inefficiencies and continued dependency on government support.

Compounding the risk are the unfunded liabilities, which grew by 11.63 percent, and the potential liabilities, which rose significantly by 44.8 percent. These figures represent substantial contingent liabilities that, if realized, could require significant fiscal outlays by the government, directly impacting fiscal sustainability. Moreover, the lack of transparency and weak oversight mechanisms exacerbate the fiscal risk. Only 20 out of 42 institutions completed audits in FY 2023–24, a decline from the previous year. Moreover, Outstanding amount yet to be cleared in records has increased for equity investment (45.35 percent) and reduced slightly for debt investment (-4.35 percent). These gaps suggest that financial data from many PEs may be unreliable, hindering effective fiscal monitoring and decision-making. The continuing existence of 3 non-business/ closed enterprises also poses a concern.

***Table 5:*** **A summary of the Key Financial Indicators of Public Enterprises**

| S. N. | Overview of operational and financial status of Public Enterprises | FY 2022-23 (Rs. In Lakh) | FY 2023-24 (Rs. In Lakh) | Change (in percentage ) |
|---|---|---|---|---|
| **1** | Reserve Fund | 3305128 | 5077967 | 53.60 |
| **2** | Total government investment | 6181646 | 6611064 | 6.15 |
| | Equity investment | 3289275 | 3797216 | 15.44 |
| | Debt Investment | 2892371 | 2813858 | -2.71 |
| **3** | Total Operating Income | 5754355 | 6610129 | 14.87 |
| **4** | Total operating Expense | 4988655 | 6748166 | 35.32 |
| **5** | Administrative Expenses (Including Employee Expenses) | 354647 | 439018 | 23.79 |
| **6** | Unfunded liabilities | 473600 | 528702 | 11.63 |
| **7** | Potential Liabilities | 12429125 | 18001259 | 44.83 |
| **8** | Market Capitalization (7 enterprises) | 5546333 | 5646745 | 1.81 |
| **9** | No. of Enterprises that have completed audits | 21 | 20 | -4.86 |
| **10** | No. of Profit-Making Enterprises | 25 | 26 | 4 |
| **11** | No. of Loss-Making Enterprises | 17 | 15 | -11.76 |
| **12** | No. of closed/ non-business Enterprises | 2 | 3 | 50 |
| **13** | No. of Enterprises with accumulated profits | 20 | 22 | 10 |
| **14** | No. of Enterprises with accumulated losses | 19 | 18 | -10.53 |
| **15** | No. of Institutions with accumulated profits/ losses | 5 | 5 | 0 |
| **16** | Operating Grant | 29736 | 32180 | 8.22 |
| **17** | Outstanding amount yet to be cleared in records | | | |
| | Equity investment | 188338 | 273757 | 45.35 |
| | Debt Investment | 283768 | 271506 | -4.32 |
| **18** | No. of Public Enterprises in Existence | 44 | 44 | |
| **19** | No. of Public Enterprises in Operation | 42 | 42 | |
| **20** | Public Enterprises used to prepare financial Statements | 42 | 42 | |

**Source:** Annual Performance Review of Public Enterprises 2024/25 - Yellow Book, Ministry of Finance

Moreover, six major PEs dominate the sector, accounting for 98 percent of total non-financial PEs liabilities. These include:

- Nepal Electricity Authority (NEA)
- Nepal Oil Corporation (NOC)
- Nepal Telecommunications Company Limited (NTCL)
- Nepal Airlines Corporation (NAC)
- Civil Aviation Authority of Nepal (CAAN)
- Nepal Water Supply Corporation (NWSC)

These enterprises have shown a notable turnaround in financial performance of PEs since FY2022/23, led by NEA, NOC, and NTCL; three major revenue contributors accounting for 90 percent of the PE turnover. While overall financial performance has improved, several Public Enterprises (PEs) still present considerable fiscal risks and require ongoing oversight. The Nepal Oil Corporation (NOC), in particular, has experienced earnings volatility and remains vulnerable to external shocks, especially shifts in global oil prices. High debt levels—most notably in Nepal Airlines Corporation (NAC), Nepal Electricity Authority (NEA), and Nepal Water Supply Corporation (NWSC)—alongside weak or negative equity positions, point to deeper structural issues.

Government transactions with PEs in FY2023 and FY2024 reflect a positive fiscal contribution. Inflows to the government—mainly from taxes and dividends—averaged NPR 147.5 billion over the two years, with over 96 percent coming from three profitable PEs: NOC, NTCL, and the CAAN. Outflows, including grants, equity injections and net lending, were significantly lower, averaging NPR 45 billion. During this period, only NOC received a grant, and equity support was limited to NOC and CAAN. Net lending made up around 77 percent of total outflows. Consequently, the net fiscal balance was strongly positive, averaging NPR 102.5 billion across the two years. This reflects a more fiscally balanced relationship between the government and PEs, although it remains reliant on the sustained performance of a few key entities.

**A Credit Risk Analysis conducted by IMF**, places Nepal Airlines Corporation (NAC), Nepal Electricity Authority (NEA), and Nepal Water Supply Corporation (NWSC) in Category 4 (high risk) on a five-point scale, with all other PEs rated low risk. These three entities show varying levels of fiscal stress:

- NAC is in severe financial distress, with persistent losses, extreme leverage, negative equity, and a current ratio of 0.7—indicating technical insolvency.
- NWSC suffers from structural inefficiencies, poor cost recovery, and delayed receivables/payables, resulting in unsustainable debt and chronic reliance on unpaid supplier dues.
- NEA, though marginally profitable, faces liquidity issues due to weak working capital management, high leverage (debt-to-EBITDA of 13.8), and continued non-operating losses, limiting financial flexibility.

The estimated cost to restore solvency for NAC, NWSC, and NEA is estimated to be approximately NPR 60 billion (0.9 percent of GDP), sufficient to reduce their debt-to-equity ratios to moderate levels. The likelihood of this fiscal risk materializing is assessed as possible, by IMF.

Taken together, it can be drawn that while the immediate fiscal impact of public enterprises remains medium, there is a possible likelihood that these risks could materialize in the near future, if not managed proactively. The combination of operational inefficiencies, rising liabilities, and weak transparency frameworks positions public enterprises as a latent fiscal risk that could potentially escalate.

**Management and Mitigation Strategies**

**Enhancing Institutional Governance and Financial performance of PE's**

The Government has taken several initiatives for improving institutional governance and financial performance of PEs, like-

- Enhancing the autonomy of public institutions in resource management, pricing and overall management, controlling the potential liabilities of the public corporations, and performance evaluation.
- The Government intends to limit the establishment of new public corporations and follow comprehensive assessment process.
- Initiatives have been taken to establish appropriate management framework by making a detailed analysis of the current economic, financial and business conditions in the privatization process.
- A team of experts, led by a former senior public official, is currently developing a comprehensive PE reform agenda aimed at tackling issues across the full portfolio of public enterprises.
- The official adoption of principles, criteria, and conditions to promote efficiency in public investments in PEs.
- Introduction of a performance-linked incentive system for PE employees, restricting financial rewards for entities with negative retained earnings or delayed audit submissions.
- Deployment of a dynamic management information system for strengthening oversight capacity of MoF.

**Restructuring Public Enterprises:** Few Public Enterprises represent a major fiscal risk due to sustained losses, weak governance, and operational inefficiencies. To mitigate this, the Government is implementing PE restructuring through Public-Private Partnerships (PPPs) and strategic equity partnerships. To mitigate fiscal risks from loss-making PEs, the Government of Nepal is restructuring seven defunct public enterprises through Public-Private Partnerships (PPPs). Under the Public-Private Partnership and Investment Act, 2019, a high-level committee is assessing their viability, aiming to reduce fiscal burdens, enhance efficiency, and attract private investment for sustainable operations.

**Monitoring, analysis and disclosure of contingent liabilities of Public Enterprises:** The PDMO aims at effectively identifying, compiling, and analyzing contingent liabilities from Public Enterprises, that could impact public finances. It will estimate the potential costs, assess the likelihood of these liabilities materializing, analyze risks by sector and conduct risk-rating. This helps provide clear, risk-based disclosures and informs the Ministry of Finance's strategies to manage and mitigate fiscal risks effectively.

**Individual PE Level:** At the individual PE level: (i) the government intends to identify an international strategic partner to enhance Nepal Airlines Corporation's (NAC) performance and transition it into a public company; (ii) it also plans to unbundle Nepal Electricity Authority's (NEA) generation, transmission, and distribution functions to improve efficiency and transparency.

**Audit of Public Enterprises:** The Government of Nepal, through the Office of the Auditor General is actively working to expedite the audit of Public Enterprises and Provincial Local Governments (PLGs). By ensuring timely and comprehensive audits, the government aims to enhance transparency, accountability, and financial discipline in these entities, which is crucial for identifying fiscal risks early and promoting sound public financial management—thereby safeguarding fiscal sustainability.

**Other Mitigation Strategies:** Additional mitigation and management measures that the government may take up, include:

*Identification and quantification:*

- Conduct Stress Testing or Scenario Analysis: Assess the fiscal impact of adverse scenarios, such as revenue shortfalls or market shocks, on PEs and potential government liabilities.
- Monitor Financial Performance of PEs: Regularly review key financial indicators (profitability, liquidity, solvency) to identify early signs of distress or inefficiency.
- Quantify Explicit Exposures: Measure and disclose direct government support to PEs, such as guarantees, subsidies, or capital injections, to understand the full extent of fiscal obligations.

*Reforms in PE Reporting and Governance:*

- Annual submission of audited financials, contingent liabilities, and risk mitigation plans (for high-risk PEs) to the PDMO, may be mandated.
- A secure digital portal for PE reporting to enable real-time tracking and performance comparisons, may be launched.
- A PE Risk Scorecard assessing financial health, compliance, and exposure to contingent liabilities to inform guarantee approvals, budget support decisions, and intensity of monitoring.

# VIII. Risks from Public-Private Partnerships

Public-Private Partnerships (PPPs) have emerged as a reliable alternative to traditional public financing, especially in infrastructure and public services like transportation, energy, water supply, and urban development. By leveraging private resources, PPPs enable the government to redirect public funds toward social sectors, aiming for cost-effective and timely service delivery. Public-Private Partnerships (PPPs) are regarded as essential, as the private sector provides finance, technology, and innovation to drive infrastructure development and fulfil financial needs for achieving Sustainable Development Goals (SDGs).

A structured policy framework has evolved over the years, beginning with sectoral policies such as the 1992 Hydropower Policy and 1999 BOT Road Policy, culminating in the comprehensive **PPP Policy of 2015**. This policy emphasizes project identification, procurement transparency, risk sharing, private sector participation, and institutional capacity building. It outlines principles for eligibility, procurement, land acquisition, and monitoring. The **Public-Private Partnership and Investment Act (PPPIA), 2019**, further strengthened the legal environment by enhancing the mandate of the Investment Board Nepal (IBN) to manage large-scale PPP and foreign direct investment (FDI) projects. The Act has mandated the IBN to develop, manage and facilitate large-scale projects above Rs. 6 billion and 200 MW (and above) energy projects in PPP and direct private investment. According to the PPPIA, the IBN has to carry out the functions of identifying projects, selecting a developer for the project to be implemented, and carrying out functions including monitoring and facilitation. The IBN carries studies and research on public-private partnership and investments.

The enactment of PPPIA, 2019 has led to noticeable improvements, providing greater legal clarity, administrative objectivity, and enhanced transparency in the processing of Public-Private Partnerships (PPPs). These advancements have been further reinforced by capacity-building initiatives supported by donors and multilateral agencies. The establishment of a Project Bank at NPC for screening, appraisal, selection, and prioritization, has further strengthened the overall process.

*Table 6:* **PPP projects under the Investment Board of Nepal (2024/25)**

| S.N. | PROJECT | Project cost | Development Modality |
|---|---|---|---|
| | **Under Implementation Phase** | | |
| **1** | Arun-3 Hydroelectric Project | NPR 144 Bn. | PPP-BOOT |
| **2** | Lower Arun Hydroelectric Project | NPR 92.68 Bn. | PPP-BOOT |
| **3** | Upper Karnali Hydroelectric Project | USD 1,049.9 Mn. | PPP-BOOT |
| **4** | Upper Trishuli-1 Hydroelectric Project | USD 647.40 Mn. | PPP-BOOT |
| | **Under Study Phase** | | |
| **5** | Upper Marsyangdi-2 Hydroelectric Project | NPR 78.65 Bn. | PPP-BOOT |
| **6** | West Seti Hydroelectric Project and SR-62 Hydroelectric Project | USD 1320 Mn. +USD 800 Mn. | PPP-BOOT |
| **7** | Solar Energy Project (250 MWp) 3 at Kohalpur and Banganga | USD 189.5 Mn. | PPP |
| **8** | Birethanti-Muktinath Cable Car Project | USD 439.34 Mn. | PPP/ Private Investment |
| | **Projects under Initial Phase** | | |
| **9** | Tamor Storage Hydroelectric Project | USD 1200 Mn. | PPP-BOOT |
| **10** | Solar Energy Project (350 MW), Doti and Dadeldhura | NPR 22.4 Bn | PPP |
| **11** | Grid-Connected Solar PV Plus Battery Project | USD 200 Mn. | PPP |
| **12** | Khaptad Integrated Tourism Project | NA | PPP-BOOT |
| **13** | Chemical Fertiliser Plant Project | USD 714 Mn. | PPP |
| **14** | Kathmandu Bus Rapid Transit Project | USD 153.32 Mn. | PPP |
| **15** | Nijgadh International Airport Project | USD 3.45 Bn. | PPP |
| | **Projects under Negotiation Phase** | | |
| **16** | China-Nepal Friendship Industrial Park Project | NPR 64.9 Bn. | PPP |

**Source:** IBN's Annual Report 2024/25

## Issues and Challenges

The implementation of public–private partnerships (PPPs) face several challenges, including complex project structuring and risk-return alignment, weak procurement systems, low FDI attraction, inadequate regulatory clarity and dispute resolution mechanisms, and limited institutional capacity for PPP oversight and monitoring.

Despite legal provisions and commitment shown by the Government, clarity regarding roles and functions of different stakeholders still unaddressed, due to which the vision for PPP has not been achieved yet. There is need to mainstream of PPP projects in periodic and sectoral plans.

While the office of IBN has made efforts, capacity building in the PPP process still remains a challenge. A lack of government expertise in project development, administration, and monitoring may hinder the effective implementation of PPPs. This includes challenges in retaining legal and regulatory expertise and training human resources.

## Fiscal Risks from PPP Projects

PPPs in Nepal introduce both direct and contingent fiscal risks, particularly when governments provide guarantees or assume liabilities embedded in contractual arrangements. The PEFA 2024 report notes some disclosure of contingent liabilities (e.g., guarantees to Nepal Airlines); however, many PPP-related fiscal risks remain off-budget and unreported, creating fiscal opacity.

Key fiscal risks stem from:

- Hidden contingent liabilities embedded in PPP contracts,
- Absence of a centralized and systematic PPP fiscal risk assessment framework,
- Inconsistent reporting in budget documents, and
- Limited technical capacity within the government to appraise and manage fiscal exposure.

**Direct Liabilities:**
For already approved PPP projects, no direct budgetary support has been extended thus far, although some have benefited from revenue concessions. However, the FY2025/26 budget includes provisions for direct financial assistance to infrastructure projects in priority sectors, with implementation anticipated to begin in the same fiscal year. The Ministry of Finance, in coordination with the Investment Board Nepal (IBN) and the National Planning Commission (NPC), is currently conducting further assessments to identify specific projects that may necessitate such support.

**Contingent Liabilities:**
At present, there is no centralized registry capturing contingent liabilities arising from PPPs, which heightens the fiscal risk exposure of the government. To address this, the Ministry of Finance, in partnership with the Investment Board Nepal (IBN), intends to carry out project-level probabilistic or scenario-based analysis to estimate potential contingent liability flows, considering the growing PPP portfolio.

However, fiscal risks from **Public-Private Partnerships (PPPs)** are assessed as ***low in magnitude and remote in likelihood*** due to the small size of operational PPP Project (04). Moreover, the PPP framework is still developing, with cautious project selection and limited government guarantees or support, mainly in the form of viability gap funding. Lastly, there have been no cases of PPP project failures or early terminations to date, and no substantial contingent liabilities are anticipated in the medium term. As a result, the likelihood of major fiscal impact from PPP-related defaults remains low.

**Management and Mitigation Strategies:**

The Government of Nepal has employed several measures to effectively manage and mitigate risks from PPPs. These include:

**Legal and Regulatory Framework**

- The **Public-Private Partnership and Investment Act 2019** (PPPIA) and its accompanying 2020 Regulation establish a comprehensive PPP framework covering risk-sharing, transparency, environmental compliance, structured bidding, and dispute resolution.
- Defined procedures ensure competitive, transparent procurement, reducing corruption and favouritism.

**Institutional Oversight and Technical Capacity**

- The PPPIA Act mandates regular monitoring and evaluation of PPP projects by the Public Private Partnership and Investment Committee (PPPIC) and other relevant authorities to ensure compliance with contractual obligations and performance standards.

**Risk-Sharing and Financial Instruments**

- Risk allocation guidelines ensure that each party bears the risks it is best able to manage, with government support structured transparently.
- **Viability Gap Funding (VGF)** and credit enhancements support financially viable projects, though full implementation is ongoing.

- Discussions are underway with development partners and the World Bank to establish a **Fiscal Commitments & Contingent Liabilities (FCCL) framework** to limit and manage government exposure on PPPs.

**Transparency, Monitoring & Reporting**

- All PPP proposals require risk assessments, Environmental Impact Assessments, financial modelling, and public disclosure through PPPIC.
- Regular reporting to parliament and stakeholders, along with mandated progress updates and financial audits, enhances accountability.

**Other mitigation strategies**

The Government could adopt the following additional mitigation strategies to further strengthen the management of fiscal risks from PPP projects:

- **Conduct Sensitivity Analysis for PPP Projects**: Assess the impact of key variables such as demand, cost overruns, and interest rates on project viability and government exposure.
- **Maintain a Central Registry of PPP Commitments**: Establish and regularly update a comprehensive database of all PPP-related fiscal commitments, guarantees, and contingent liabilities.
- **Set Ceilings on PPP Commitments:** Impose clear quantitative limits on the total value of PPP commitments relative to GDP or public debt to prevent excessive fiscal exposure.
- **Ensure the Gatekeeper Role of the Ministry of Finance** (MoF): Empower the MoF to review and approve all PPP proposals, especially those involving government guarantees or fiscal commitments.
- **Charge Risk-Based Guarantee Fees**: Introduce fees for PPP guarantees based on project-specific risk profiles to discourage unnecessary or high-risk commitments.

These measures would improve risk identification, enhance fiscal transparency, and reduce the likelihood of unanticipated government liabilities from PPP arrangements.

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