



Fiscal Federalism in Nepal

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**Ashesh Shrestha
Jai Venaik**

ABBREVIATIONS AND ACRONYMS

ADDCN	Association of District Development Committees in Nepal
CDO	Chief District Officer
DDC	District Development Committee
LBFC	Local Bodies Fiscal Commission
LSGA	Local Self- Governance Act
LSGR	Local Self- Governance Regulation
MUAN	Municipal Association of Nepal
NAVIN	National Association of Villages in Nepal
NNRFC	National Natural Resource and Fiscal Commission
UN	United Nations
VAT	Value Added Tax
VDC	Village Development Committee
MoF	Ministry of Finance
OPMCM	Office of the Prime Minister and Council of Ministers

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EXECUTIVE SUMMARY

With the transition from a unitary structure to a federal structure, there are many opportunities as well as challenges that lie ahead for Nepal. One of the biggest challenges that Nepal currently faces is the management of fiscal aspects of a federal structure. This paper attempts to study existing fiscal arrangement (assignment of expenditure and revenue rights among various orders of government) and intergovernmental fiscal transfers among various orders of government. Furthermore, this paper has attempted to study various principles of fiscal federalism and has also used series approach to compare six federations and their workings on the above-mentioned topic. Finally, the paper has identified various issues that need to be dealt with and has proposed some reforms to deal with these issues to help advance timely and balanced implementation of Federalism in the country. The paper has mainly identified the following issues:

1. Distortionary transfers of resources

A sound fiscal structure should be such that it prevents distortionary transfer of capital and labour from one sub-national jurisdiction to the other. However, the current federal structure and plans seem to have given no priority to this particular factor. Till date, government's plan does not include maintaining fiscal equity, which could lead to the distortionary movement of resources from the jurisdiction where the difference between benefits received and total tax payments by the citizens is lower to the jurisdiction where it is higher. This might lead to unequal growth and development.

2. Disregard to vertical fiscal imbalance

The current framework of fiscal federalism seems to have disregarded vertical fiscal imbalance and has primarily focused on horizontal fiscal imbalances. Horizontal fiscal imbalance addresses the difference in needs and revenue

generating capacity of sub-national governments of equal status, whereas vertical fiscal imbalance addresses such difference among the different orders of government. Mismatch between the expenditure responsibilities and the total revenue generation (including the funds received from revenue sharing and equalization grants) could affect ability of the sub-national governments in efficient and effective public service delivery.

3. Unavailability of the data for efficient fiscal transfers

Maintaining horizontal and vertical fiscal balance is one of the major concerns which determines the success of federalism. Similarly, another important factor to be considered as mentioned above is prevention of distortionary transfer of resources from one sub-national jurisdiction to another. However, we lack sufficient data to calculate vertical and horizontal fiscal imbalances. In order to calculate these, we need data related to revenue base of various sub-national jurisdiction and also the needs of the public goods and service of those jurisdictions. Unavailability of these statistics could lead to unscientific fiscal transfers and failure to solve the problem of fiscal imbalance and inequity.

4. Capacity of sub-national government

The sub-national governments lack institutional capacity to prioritise expenditure and raise revenue accordingly. Moreover, they also lack skilled human resource and capacity to make laws related to the powers and responsibilities assigned to them by the constitution. This could directly affect efficient public service delivery by the sub-national governments. Hence, we cannot expect smooth functioning of the government in terms of providing public services. Therefore, one of the priorities of sub-national governments should be invest on development of their human resource and institutional capacity. The federal government should also assist them in doing so.

5. Unwillingness of Federal government to give up power/ authority

Even after federalization and formation of all three levels of government whose responsibilities and rights have been mandated by the Constitution, the federal government still seems unwilling to give up powers which have

now been assigned to the lower levels of government. This view has been supported by the fact that the federal government still has not dissolved many of its department and agencies whose works have now been delegated to sub-national governments.

6. Local government lack clear understanding about their rights and responsibilities

Currently, local governments are not aware about their rights and responsibilities. There have been instances where they levied taxes under the headings which fall under the purview of federal government such as VAT, putting extra tax burden on the people. Similarly, lack of understanding of their roles under federal structure could also adversely affect production and delivery of public goods and services.

7. Income tax administration by the federal government could exclude micro enterprises

Most of the microenterprises in Nepal are either informal or semi-formal in nature. Many of them are operating their business without formal registration with all the concerned authorities. They are only registered with municipal government and are not registered with the federal tax authority. Since they are not registered with the federal tax authority (the one who is responsible for collection of income tax), the state has not been receiving the income tax revenue from them. Even in the federal structure, the authorities relating to income tax administration has been given to the federal government, and therefore, the problem of these enterprises falling outside the income tax bracket could still prevail in the new system.

1

INTRODUCTION

On the eve of the promulgation of the Constitution of Nepal, the then UN Secretary General, Mr. Ban-Ki-Moon noted that a Constitution is a living document and urged the political leaders to act in broader national interest with continued flexibility and inclusivity. Though this reference was made with respect to the clashes among the Madhesi and Tharu communities, its application is extended to all aspects of a Nepali citizen's life; pivotal of all is the economic aspect.

Leveraging Federalism: Economic Growth and Doing Business is an attempt to provide for a dialogue exploring the economic angle of the federal debate. This document is prepared by the Research Team at Samriddhi Foundation over a course of several months which included research, analysis and consultation, both formal and informal.

This paper is Part III in the series with Part I and II published before. As sound fiscal arrangement is one of the key determinant of success of federalism, this part specifically looks at the Fiscal Considerations for Federal Nepal. This paper first examines the revenue-expenditure assignments divided between the sub-national governments in Nepal, the intergovernmental transfer mechanisms and general architecture of the fiscal framework. Additionally, the paper uses series approach to compare six federations and their workings on the above-mentioned topic.

Special reference has been made in comparison to Brazil since it comes very close in its structural relevance of Nepal. Nepal comes very close to the independent model of a cooperative federal structure. All three orders of government (federal, state and local) enjoy autonomous powers and also coordinate their policies both horizontally and vertically. A chapter devoted to the comparison of Brazil with Nepal is included separately since Brazil is the only type of independent cooperative federation existing in the world today.

Finally, areas for reform and possible considerations are compiled to help advance the timely and balanced implementation of Federalism in the country.

2

FISCAL DECENTRALISATION IN NEPAL (PRE 2015)

Decentralisation with regards to Nepal, can be traced back to the 1960s, when two-tiered system of local government comprising of 75 district Panchayats in the intermediate level and municipal and village Panchayats at the lower level of local government was introduced for the first time (Devkota, 2014). But, it was only after the restoration of democracy in 1990, decentralisation and local governance took pace in Nepal (Dhungel, 2004). The genuine establishment of fiscal decentralisation in Nepal, however, was created only after the promulgation of Local Self- Governance Act (LSGA) of 1999 (Devkota, 2014). 1960 - 1990 was an era of party-less panchayat system, which introduced the Municipal Panchayat Act, 1962 and put it into force (Khanal, 2016). Under this act, the local level authorities of Nepal were divided into village, municipal and district Panchayats. The responsibility of these local bodies was to undertake development activities under the supervision of the central powers of the nation. The centralised political and fiscal structure epitomised both de-concentration and delegation approaches, however, the king remained the source of executive, legislative, and judicial powers (TAF, 2012). Thus, the decentralised policy framework back in 1962, was not introduced with the rationale of developing autonomous government foundations in Nepal, but its sole purpose was to expand central control over local politics. This structure was perceptibly an ineffectual type of governance as the monarch held all administrative powers.

Realizing the ineffectiveness in the governance structure, a need to reform

the centrally oriented framework was felt and thus the heads of district administration – representatives of central government – were annulled in 1965 and were supplanted by Chief District Officers (CDO) – secretaries of district panchayat. In addition, local development officers were also recruited later in the mid 1970s. In 1973, with the motive of supervising and coordinating district level departmental programs, the government delineated the nation into four and later on five development regions, each having assigned their headquarters with regional offices and directorates. In 1974, further step was initiated by dividing the country into 14 zones and 4 development regions.

A significant process of decentralization started in 1982 with the enforcement of Decentralization Act 1982 and its Regulation in 1984 (Devkota, 2014). This Act provided a clear framework by placing all district level line agencies under the umbrella of respective District Panchayat. However, even after this reform, fiscal decentralization and focus on local governance had not been accentuated.

The people's movement of 1990, marked the restoration of democracy in Nepal, bringing an end to the 30 years long Panchayat system of governance and introducing multi-party parliamentary governance (TAF, 2012). With the replacement of absolute monarchy by the constitutional monarchy, the concept of decentralization and local governance further evolved in Nepal. Democracy through extensive support by the people in the governance of the country, accomplished through decentralization was the primary motive of the then Constitution (Lamichhane, 2012). Under the 1990 Constitution, the king became the head of state, and the prime minister, chosen from among themselves by elected members of parliament, became the head of government. The government retained the three-tier local governance system, with the centre, village or municipalities and district level local governments. Three separate Acts, namely the District Development Committees (DDCs) Act, Village Development Committee (VDCs) Act, and Municipality (Muns) Act, were enacted (Devkota, 2014).

A decentralization commission was formed after 1994 by one of the coalition

governments, under the recommendation of whom, the LSGA, 1999 was enacted (TAF, 2012).

The proclamation of the LSGA in 1999 consolidated Nepal's local governance structure and can be described as the year in which fiscal decentralization was portrayed in a more operational form for the first time in the history of Nepal (Dhungel, 2004). This was seen as an extraordinary political change in the history of Nepal, as the act was accompanied by a legal concept of self-government and delegation of power to local authorities. This law delegated greater political, administrative and financial powers to local authorities for the effective management of development issues at local level.

To operationalize the provisions of the Act, the government framed Local Self-Governance Regulations (LSGR), 2000 and Local Authorities (Financial Administration), 2007 (Prasad, 2015). These laws and regulations provided local authorities various functions of social, economic, physical infrastructure development, poverty reduction and environmental management. It also empowered local governments for planning, financial management, coordination, monitoring and reporting.

These Acts and regulations also assigned to local bodies the freedom to raise their own revenues from different sources, most of which were defined by central government. On the basis of taxes that were fixed as per the LSGA, 1999 and LSGR, 2000, VDCs and municipalities were allowed to collect house tax, land tax, land revenue, local market/shop tax, vehicle tax, entertainment tax, advertisement tax, business means tax, commercial video tax, natural resource utilization tax, taxes on small infrastructures maintained by the VDC or municipalities and other taxes like collection and saving tax. The DDCs being the first tier of the government had the power to define tax bases and rate caps. They had the permit to collect tax on use of infrastructures constructed and maintained by them, tax on use of natural resources, tax on export from district, tax on re-usable goods and non-tax charges and fees for services.

LSGA also handed over the expenditure responsibility to the local level

among which 16 categories of expenditure were to be made by DDC and 11 categories by municipalities and VDCs. The expenditure permit for DDCs, VDCs and municipalities included agriculture, drinking water, sanitation, habitat development, hydropower, work and transport, land reform and land management (except VDC), development of women and helpless people, forest and environment, education and sport, wages for labour (except for municipalities), irrigation and soil erosion and river control, information and communication, language and culture, cottage industry, health services, tourism, physical development (except district), finance, legal and public safety.

Association of District Development Committees in Nepal (ADDCN), National Association of Villages in Nepal (NAVIN) and Municipal Association of Nepal (MUAN) were also created under the LSGA in order to smoothen out the functioning of the local bodies (Prasad, 2015).

By 2002, with the financial power in the hands of local government, other responsibilities relating to health, education, agriculture, livestock, rural infrastructure and postal service were also devolved to the local bodies.

To move ahead with fiscal decentralization, the government of Nepal established permanent Local Bodies Fiscal Commission (LBFC) in 2002 under the control and direct supervision of Ministry of Local Development (LSGA, 1999). One of the main objectives of this commission was to develop the fiscal transfer system from central government to local government that lacked transparency both in the vertical share and in the horizontal distribution.

As of July 2002, former King Gyanendra Shah dismissed the elected government, demanded residual authority, took executive powers and governed the country through several directly appointed Prime ministers (TAF, 2012). However, in November 2005, leaders of seven political parties in the dissolved parliament signed a 12-point deal with the CPN-Maoist, and together led the mass protest that forced the king to resign and thus the parliament was re-established.

The powers granted to the King in the 1990 Constitution of Nepal were gutted by the re-elected House of Representatives and the 2007 Interim Constitution was promulgated. This Constitution had the promise to transform the unitary state into a Federal Republic. It committed itself to an integrative, democratic, and progressive restructuring of the state, repealing its existing form of centralized and unified structure.

3

PRINCIPLES OF FISCAL FEDERALISM

The primary focus of economists is to study the method by which resources can be optimally allocated thus garnering an optimal outcome from the prescribed allocation. In pursuit of explaining the optimality condition, economists have studied and researched how the economic agents behave so as to optimise benefits. They have segregated the economy into private and public sector, and studied how economic agents in these sectors behave to optimise their objective function. Under the private sector, the economic agents have been further divided into producers and consumers and positive studies have been conducted as to how competing producers and consumers optimise their behaviour to accrue most favourable outcomes for themselves i.e. maximum profits to the producers and maximum utility to the consumers.

Whereas, under the public sector the objective is to promote the public interest and optimise public welfare. Promoting public interest may have multiple dimensions but the primary focus here is optimising the total production and supply of public goods and services subject to revenue constraints. However, unlike private sector, public sector is not characterised by competitive nature; and as there is a high possibility that the true preferences for public goods and services are not revealed by citizens, allocation of tax burden and delivery of public goods and services is not optimised. Furthermore, the behaviour of the public sector which would optimally fulfil the public interest is based on the assumption that it is the interest of the monolithic government to promote and fulfil public interest. But, in a less competitive political environment, it is more likely that people in the government work for their own interest than for promoting public interest in general (Buchanan, 1984).

A unitary government operating within a specified jurisdiction also faces an additional constraint, which impedes it from working efficiently. This particular constraint has been termed as 'Knowledge Problem' by the economists from Austrian tradition. It is not possible for the government operating from the centre to have knowledge about preferences for public goods and services of the people in every part of the country. Hence, the task of allocation of tax burden and expenditure assignment is not efficiently done (Hayek, 1945). The mismatch between tax allocation on citizens and expenditure assignment on public goods, could lead some people to pay more for the public goods and some people may just enjoy the public services without paying for it (become a free-rider). The knowledge problem also leads to disproportionate geographic allocation of fiscal resources in a centralised system.

These inefficiencies in a unitary system of governance where government finances are handled at central level, can be taken care of in a federal structure, where there are more than one tier(s) of government operating in overlapping areas (Tiebout, 1956). The federal structure is characterised by a central government and multiple number of sub-national governments governing separate precinct whose powers and functions are mandated by the constitution so as to avoid conflict between them and assure mutual co-operation.

Having multitude of sub-national governments in a level parallel to each other induces an important factor that can enhance efficiency, i.e. competition. Economists working in the field of public sector economics have claimed that federalism induces competition in the sub-national level(s) (Tiebout, 1956, Oates, 1972, Brennan and Buchanan, 1980). As firms in market compete for more customers and more revenue, in federal structure sub-national government compete for labour and capital so that they can increase their tax base to finance their expenditure. As the heading under which tax can be collected are allotted by the constitution and are same for the parallel sub-national governments, the only way to increase revenue is by attracting more people and more businesses.

Federal structure also ensures allocative efficiency. Allocative efficiency is achieved when public goods and services are supplied in accordance with the preferences of the citizens and the citizens are taxed according to the level of use of these goods and services. In the words of Alchian (1950), the government's revenue-expenditure pattern for goods and services is expected to adapt to consumers' preferences. Lindahl (1958) had proposed the provision of taxes for financing the public goods expenditure on the basis of revealed willingness/ preferences to pay for the benefits received. In a unitary system, the only way to know the preference of the people is to force them to reveal their preferences. In a democratic system, as the citizens cannot be forced to reveal their preferences, efficiency cannot be achieved like the one in the market (Samuelson, 1954 and Tiebout, 1956). However, in federal structure, Tiebout (1956) suggests that when there are multiple numbers of sub-national jurisdictions, say states, it reveals actual preferences of the consumers. Each sub-national government will lay their own distinct pattern of revenue and expenditure. Consumer (voters) as according to their set of preferences will reallocate themselves into various jurisdictional areas. Therefore, only those people will reside in a particular state whose preference match with the public goods and services provided by that state at the given level of price or tax.

But, for a fair competition, all states must be equal in terms of fiscal capacity. It would be very naïve to expect the states to compete with each other and produce efficient outcomes when there is difference in fiscal capacity among the states. The difference in fiscal capacity arises because of the variation in the capability to raise revenue. Furthermore, difference in the need for public goods and services also impedes competitive nature of federalism. Therefore, issues concerning fiscal inequalities and differences in needs should be addressed.

In order to address this issue Richard A. Musgrave seeks for the role of the central government. In his paper "Approaches to a Fiscal Theory of Federalism" published in 1961, he has provided various techniques of fiscal equalisation that central government can choose from depending upon the fiscal situations of the each states. For the present purpose of the study, we consider three approaches to fiscal transfers from the central government.

Equalisation when there is difference in fiscal capacities

The first approach is to equalise the fiscal capacities of each state. Equalisation of fiscal capacity means equalising the ratios of tax revenues to the tax base of each state. Central government, by using fiscal transfer as a tool, can equalise the ratios. Tax base, generally refers but is not confined to the total income generated by the citizens of each state. This approach solves the problem of existence of difference in the revenue generation capacity of the states caused due to difference in the tax base. However, this equalisation plan does not account for difference in needs for public goods and services. In terms of equation,

$$\frac{(t_1 \times B_1) + T_1}{B_1} = \frac{(t_2 \times B_2) + T_2}{B_2} = \frac{(t_3 \times B_3) + T_3}{B_3} = \dots = \frac{(t_n \times B_n) + T_n}{B_n}$$

Where, $i = 1, \dots, n$

t_i = tax rate in i^{th} state

B_i = tax base in i^{th} state

T_i = transfer from central government to i^{th} state

Equalisation when there is difference in needs

This approach neglects the difference in fiscal capacities of the state and hence difference in tax base are completely disregarded. It is only concerned with difference in needs of the states. When tax base is considered to be equal in all the states, the equalisation principle would be to equate the ratio of total revenue to the index of need for all the state.

$$\frac{(t_1 \times B) + T_1}{I_1} = \frac{(t_2 \times B) + T_2}{I_2} = \frac{(t_3 \times B) + T_3}{I_3} = \dots = \frac{(t_n \times B) + T_n}{I_n}$$

Where,

I_i = index of need of i^{th} state

B = Tax base which is assumed to be equal for all the states

Equalisation when there is difference in both fiscal capacities and needs

Unlike the previous two models, this model incorporates both the differences in fiscal capacities and need of the states. In this case, the equalization principle would basically be to transfer funds in such a way that funds are transferred from high income - low need state to low income- high need state. The optimal situation can be reached by equating the ratio of tax base to index of need for all the states.

$$\frac{B_1}{I_1} = \frac{B_2}{I_2} = \frac{B_3}{I_3} = \dots = \frac{B_n}{I_n}$$

In the second and third approach, major challenge would be to calculate the index of need for public goods and services for all the states. In order to calculate index of need, detail statistics on demographics, existing supply of various public goods and services, economic potential etcetera of all the states are required. An example cited by Musgrave is that the need for the educational expenditure in a state would be determined by the number of children of school going age in that state. An aggregation of all the needs for public goods and services will give the index of need of that state. Among these three approaches, the third one is considered more comprehensive and realistic.

Apart from balancing the needs and revenues of the state, Buchanan (1950) has identified another important function of the central government. Buchanan basically argues that, central government should prevent distortionary transfer of resources from one state to another. Distortionary transfer occurs when there is horizontal inequity (unequal treatment of equals). The federal government is responsible for maintaining horizontal equity (equal treatment of equals). Citizens with a certain level of productivity (expressed in terms of level of income as per Buchanan) must be treated equally (in fiscal sense) with the citizens of the same level of productivity in any other state by the federal government. Here, equal treatment in fiscal sense does not mean equalising tax burden, but means equalising the fiscal residuum. Fiscal residuum refers to the expenditure benefits over tax payments. It is the total tax payment minus the total value of benefits received in the form of public goods and services. In order to explain this clearly, we use Buchanan's model presented by him in his paper.

Before presenting his model, Buchanan has made certain assumptions:

1. There exists a federal government say, X and two state governments, A and B.
2. The total population is six divided into 3 in each state. A-1, A-2 and A-3 reside in state A, and B-1, B-2 and B-3 reside in state B.
3. A-1 and A-2 are skilled workers, and A-3 is an unskilled worker in state A. B-1 is a skilled worker, and B-2 and B-3 are skilled workers in state B.
4. Skilled workers earn \$10000 per year, whereas an unskilled worker earns \$1000 per year.
5. Central government imposes progressive tax. 10 percent to high income earners and 5 percent to low income earners.
6. Both states impose 10 percent proportional tax.

Citizen	Total taxes collected by federal government X (\$)	Total taxes collected by state government A or B (\$)	Total (\$)
A-1	1000	1000	2000
A-2	1000	1000	2000
A-3	50	100	150
B-1	1000	1000	2000
B-2	50	100	150
B-3	50	100	150

Here, we have only considered tax paid by the citizens to federal and state governments and completely neglected expenditure benefits received from them. We can see that, if tax payment is only accounted for, the fiscal system is completely equitable. A person earning equal amount of money in both the states, is also making equal tax payment. But, accounting for both sides of the fiscal account, the inequities can be found evident.

In addition to above assumptions, it is assumed that the federal and state

governments make expenditure on public goods and services such that all the citizens in a particular state benefit equally. The federal government distributes the total amount collected from taxes equally among all the citizens in the country and the state governments distribute the tax revenue equally among the citizens of its state.

Citizen	Total taxes (\$)	Total benefits (\$)	Fiscal residuum (\$)
A-1	2000	1225	775
A-2	2000	1225	775
A-3	150	1225	-1075
B-1	2000	925	1075
B-2	150	925	-775
B-3	150	925	-775

As seen in the table, total taxes collected from high income citizens (A-1 and A-2 in state A, and B-1 in state B) is equal. But, the total benefits received by A-1 and A-2 is higher than that received by B-1. Fiscal residuum of A-1 and A-2 is \$775, which is lower than fiscal residuum of B-1, which is \$1075. Likewise, the total benefits received by A-3 is \$1225, which is higher than the one received by B-2 and B-3. This clearly shows the existence of horizontal inequity.

In order to maintain horizontal equity in the above setting, Buchanan proposes a transfer of total amount of \$200 from high income citizens in state A to high income citizen in state B. This would increase the fiscal residuum of A-1 and A-2 to \$885 and reduce the fiscal residuum of B-1 to \$885, thus equating their fiscal residua. Similarly, a transfer of \$200 from A-3 to B-2 and B-3 would also equate the fiscal residuum of low income individuals. Thus, a net transfer of \$400 is to be made from A to B. Hence, equalising fiscal residuum for the equals living in both the states would prevent distortionary transfer of both human and non-human resources to the state with least fiscal pressure. Therefore, Buchanan suggests that the entire fiscal structure should be as neutral as possible in geographical sense and the federal government has to play a vital role in maintaining such neutrality.

4

FISCAL ARCHITECTURE OF FEDERAL NEPAL (2015)

The Fiscal Architecture of Federal Nepal is constitutionally guaranteed with three orders of government at the central (federal), provincial (state) and community (local) levels. Thus, as of now, Nepal consists of one federal government for the entire nation, seven state governments and, seven hundred fifty three local governments.

The transformation of the Nepalese State Structure as enumerated in the Part 5 of the Constitution of Nepal provides for the framework for sharing of resources, roles and responsibilities, for each level of government: Federal, State and, Local. Article 59 grants autonomy to the corresponding order of government in terms of power with respect to formulation of policy, legislation, budgeting and implementation within their respective jurisdictions.

Thus, the federal, state and the local governments are autonomous in decision making with respect to their powers which are enumerated in the associated schedules of the Constitution wherein,

Schedule 5: Federal Power

Schedule 6: State Power

Schedule 7: Federal & State Power (Concurrent)

Schedule 8: Local Power

Schedule 9: Federal, State and Local Power (Concurrent)

4.1 Role of the Federal Government

The Federal Government is initially tasked with formulating legislation required for the working of the governments at all three levels. Specifically for fiscal considerations, this is mandated for timelines of budget submissions by sub-national governments (state and local) (Article 59 (3)) and, a Federal Act on the distribution of revenues with regard to national policies, national requirements, autonomy of the State and Local levels, services to be rendered by the State and the Local level to the people and financial powers granted to them, capacity to collect revenues, potentiality and use of revenues, assistance to be made in development works, reduction of regional imbalances, poverty and inequality, end of deprivation and assistance to be made in the performance of contingent works and fulfilment of temporary needs (Article 60 (8)).

Article 59 (6) empowers the federal government to obtain necessary foreign assistance and loans required to maintain macro-economic stability. Additionally, the federal government is also tasked with the responsibility of providing legislation for management of budget deficits and other measures of maintaining fiscal discipline (Article 69 (7)).

Though autonomous in character, the Federal Government (also known as Government of Nepal) has overriding powers pursuant to formulation of necessary policies, standards and legislation on matters of concurrency (Schedule 7 and 9) as well as matters under the state government's purview (Article 59 (2), Article 60 (1)). Furthermore, the Federal Government also has powers over any residual matters that do not yet form a part of the constitution (Article 60 (1)).

4.2 Distribution of Sources of Revenue

Provisions in the Constitution mandate an equitable distribution of revenue collected by the three orders of governments (Article 60 (2)) as well as an equitable distribution of benefits derived from the use of natural resources

(Article 59 (4)). Further to this, the local communities have a priority on investment in their respective areas and the federal, state and local governments have been mandated to take due cognisance of the same taking in account the nature and size of such investment. This gives local community members or local groups a priority on investment in natural resources of their respective areas (Article 59 (5)).

Article 60 (3) tasks the responsibility of determining the amount of fiscal transfers to sub-national governments by the federal government to the National Natural Resources and Fiscal Commission (NNRFC), a constitutionally empowered commission which is independent of all the orders of government. The basis of these transfers is outlined on the need of expenditure and revenue capacity, in an equitable, balanced and, transparent manner (Article 60 (7)). Similarly, provisions for transfer of funds from the state governments to associated local governments are also pursuant to the need of expenditure and revenue capacity of each (Article 60 (5)).

Finally, the federal government was tasked to formulate provisions for conditional grants, complementary grants or special grants from the federal consolidated fund to sub-national governments (Article 60 (6)).

4.3 National Natural Resources and Fiscal Commission

The National Natural Resources and Fiscal Commission, as per Article 250-251, is the constitutional body which is both empowered and authorised by the Constitution to advise the Government of Nepal (federal government) on revenue distribution to sub-national governments, both state and local (Article 60 (3)). The following are key points with respect to the functions, duties and powers of the commission wherein, the commission will:

- i. Decide the basis and modalities for distribution of revenues between the federal, state and local governments which also includes sharing of revenues garnered through royalties of natural resources while taking due cognisance of the environmental assessment impact. (Sub-clause (a),(d))

- ii. Make recommendations on equalisation grants and prepare parameters which will be used to calculate conditional grants from the federal government to state and local governments and, from state government to local governments (Sub-clause (b), (c)).
- iii. Take measures to meet expenditures of different orders of governments which also includes measures to improve and reform revenue collection (Sub-clause (e)).
- iv. Additionally, recommend ceilings for sub-national governments' internal loan policy while also analysing macroeconomic indicators (Sub-clause (f)).
- v. Further, the commission is also tasked to make suggestions on dispute resolution between the orders of government (both vertically and horizontally) (Sub-clause (i)).
- vi. The basis for revenue sharing as enshrined in the NNRFC Act 2017 is given as follows:
 - Population data
 - Area
 - Human development index
 - Need of expenses
 - Effort in revenue generation
 - Infrastructure development
 - Specific condition

As of May 2018, the National Natural Resources and Fiscal Commission is set up with an acting head appointed by the Government of Nepal, no further appointments have been made as of now.

4.4 Inter-governmental Fiscal Arrangements Act

The federal law entitled, 'Intergovernmental Fiscal Arrangements Act, 2017' provides for the necessary provisions specifically dealing with revenue rights, revenue sharing, grants, loans, budget arrangements, public expenditure and fiscal discipline for all three orders of government. A summary of the characteristic features of the act are outlined as follows:

- i. The Act provides for the revenue rights for all three orders of government which includes rights of both tax and non-tax revenues (discussed later). These revenue rights are subject to conditions following national economic policies, transportation of goods and services, capital and labour markets, the neighbouring state or local level governments. This partially inhibits states/ local governments to pursue differentiated taxation policies maintaining a level of synchrony in the system.
- ii. The Act outlines the criteria of the rate of non-tax revenues to be determined by taking the cost of goods or services, operation and, maintenance cost at the base. The criteria is applicable to all three levels of government.
- iii. Provisions for a single tax administration for shared taxes are listed between any two levels of governments amongst the three orders of government wherein;¹
 - Motor vehicle tax to be collected by state government for both state and local governments
 - Building and land registration fee to be collected by local government for both state and local governments
 - Advertisement tax to be collected by the local government for both state and local governments
 - Entertainment tax to be collected by the local government for both state and local governments

¹ the same would be deposited in the associated consolidated fund minus upto two percent accounting for administrative costs

iv. The act mandates the sharing of revenues from value added tax (VAT) and excise duty collected from domestic products to be divided in the following manner; the same is deposited via creation of separate funds for state and local levels on a monthly basis:

- 70% Federal Government
- 15% State Governments (7)
- 15% Local Governments (753)

v. Similarly, royalty from natural resources would be divided amongst the three orders of government in the following manner:

- 50% Federal Government
- 25% State Governments (7)
- 25% Local Governments (753)

vi. The Act further mentions the following for the provisions of grants as a means of inter-governmental fiscal transfers:

- Fiscal Equalisation Grants: from federal to state and local and, from state to local dependent upon their respective need for expenditure and revenue capacity.
- Conditional Grants: project based grants given from federal government to state/local governments and from state government to respective local governments .
- Complementary Grants: grants specifically for infrastructure development in concerned state or local jurisdictions from federal to state and local and from state to local while taking in account the following criteria:
 - Feasibility of the project
 - Project cost
 - Outputs/ benefits

- Financial and Human resources required for the project
- Need and priority

- Special Grants: these grants are targeted for specific purposes limited to basic services like education, health and drinking water, balanced development in inter-state or inter-local levels or, uplift economically, socially marginalised communities from federal to state and local or from state to local governments.

vii. Fiscal Equalisation and Conditional Grants are subject to criteria laid down by the National Natural Resources and Fiscal Commission which is yet to submit their recommendations to the Federal Government for these transfers to take place.

viii. Only the Federal Government has the explicit authority to obtain foreign assistance (grants) and loans for maintaining macroeconomic stability in the country. State and Local Governments cannot obtain foreign assistance (grants) or loans without prior consent of the federal government.

ix. The Act limits the areas under which foreign assistance can be sought; these are:

- Physical Infrastructure (construction, maintenance and renovation)
- Education, health and human development
- Domestic production and productivity growth
- Disaster management
- Development/ transfer of science and technology
- Environment protection and climate change
- Public Private Partnership Investments
- Areas beyond the capacity of public, private, cooperative and community sector as determined by the Federal Government

x. All orders of government have the right to obtain internal loans

within limits set again by the National Natural Resources and Fiscal Commission but States and Local Governments need consent from the Federal Government before doing so.

- xi. Only Federal and State governments are allowed by law to raise internal loans by issuing government bonds.
- xii. The Federal Government, themselves, have the authority to provide loans to the sub-national governments (both state and local).
- xiii. The Act mandates submission of Public Expenditure statements including recurrent, capital, and fiscal arrangements annually and simultaneously also prepare mid-term expenditure frameworks. Along with these statements, projection of income and expenditure and, revenue proposals are also mandated to be prepared and presented periodically.
- xiv. Clauses on maintaining fiscal discipline by State and Local governments in accordance with economic and financial policies of the Federal Government, targeted use of grants and transparency are also mandated by the act.
- xv. The Act provides for an Intergovernmental Fiscal Council which is tasked with maintaining coordination among the three orders of government for effective functioning of policy. This council comprises of Minister of Finance from the Federal and State levels along with representatives of the Local Governments as well as financial experts and the secretary of the ministry of finance.
- xvi. Additionally, the Federal Government is empowered to give directives to State Council of Ministers and Local level representatives and these directives are binding on them without fail.
- xvii. And finally, the Federal Government also has the powers to form and enforce standards which deem fit to implement the act.

5

ALLOCATION OF RESPONSIBILITIES

The Revenue and Expenditure Assignments form the bedrock of a fiscal structure analysis. A detailed review of the these assignments indicates further areas of consideration in gaps (both horizontal and vertical) which then is indicative of the transfer mechanism required to balance the revenue-expenditure finances. The literature on fiscal federalism argues that finance should follow function. In other words, assigning responsibilities for spending, including the exercise of regulatory functions, must precede the assignment of responsibilities for taxation because tax assignment is generally guided by the spending requirements of the different orders of government and cannot be determined in advance (Shah, 2007).

5.1 Expenditure Assignment

An Expenditure Assignment is understood as the domain of a policy area on which an order of government (federal, state or, local) is responsible and authorised by the constitution to spend on. For example, local roads via Item No. 11 of Schedule 8 rests exclusively within the local government sphere hence only the local government is authorised to decide how local roads in a given local municipality would be provided for, managed or, financed. Organising them theoretically on the basis of the subsidiarity principle², the distribution of powers in a representative assignment of expenditure responsibilities are given in the table below;

² The principle of subsidiarity holds that a larger and greater body should not exercise functions which can be carried out efficiently by one smaller.

Table 1: Representative Assignment of Expenditures

Function	Policy standards	Provision and administration	Production and distribution	Comments
Interregional and international conflict resolution	N	N	N,P	Benefits and costs international in scope
Protection of fundamental rights	N	N	N,P	Has national and global dimensions
External trade	N	N,S	P	Benefits and costs international in scope
Telecommunications	N	P	P	Has national and global dimensions
Financial transactions	N	P	P	Has national and global dimensions
Environment	N,S,L	N,S,L	N,S,L,P	Externalities of global, national, state, and local scope
Foreign direct investment	N,L	L	P	Local infrastructure critical

Defence	N	N	N,P	Benefits and costs national in scope
Foreign affairs	N	N	N	Benefits and costs national in scope

Sources: Anwar Shah, *The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economies* (Washington, DC: World Bank, 1994); Anwar Shah, "Fiscal Decentralisation in Transition Economies and Developing Countries," in *Federalism in a Changing World: Learning from Each Other*, ed. R. Blindenbacher and A. Koller, 432–60 (Montreal and Kingston: McGill-Queen's University Press, 2003).

Note: N= national government, S= state or provincial government, L= local government, ICB= independent central bank, and P= nongovernmental sectors or civil society

However, there is no one example of a federation that corroborates with the above design. Nepal in its expenditure assignment heavily retains a central framework wherein, the Federal Government is responsible for all major macroeconomic management including common national spheres of defence, international relations, international trade. Additionally, the federal government is also responsible for large scale development projects in hydropower, infrastructure (highways and airports) etc. The federal government also shares responsibilities with states (Schedule 7) and states and local governments (Schedule 9). Furthermore, residual powers are responsibility of the Federal Government (Article 58). Similarly, the constitution mandates a full listing of these division of powers for the state, which includes operations of banks, state police etc. and local governments which includes basic education, basic health, sanitation etc. The division of powers is presented in two formats;

5.1.1 Exclusive Powers

Powers are exclusively allocated to an order of government, for which, they control all aspects of policy as well as financial decisions. An example of the same is explained above. These are vested in the constitution of Nepal in Schedules 5, 6 and, 8 wherein,

Schedule 5: Exclusive powers of the Federal Government (Government of Nepal)

Schedule 6: Exclusive powers of the State Government(s)

Schedule 8: Exclusive powers of the Local Government(s)

Responsibilities of the issues of national and international importance, such as defence, foreign affairs, international trade, immigration and citizenship are under the purview of the Federal Government. Moreover, the responsibilities of monetary policies, exchange policies and fiscal policies also lie with the central government. Exclusive responsibilities of state government include land management, maintaining records of land, mineral exploration and management, province-level electricity, irrigation and drinking water supply service, transportation, trade within the state, state universities, higher education, libraries and museums. The main exclusive responsibilities of local governments involve activities related to basic health, sanitation, local market management, local road, rural road, agriculture road, irrigation etc.

5.1.2 Joint Control/ Concurrent Power

Powers which are jointly held by two or more orders of governments are termed as joint powers. In cases of concurrency, a detailed division of roles and responsibilities is generally available to make clear demarcations over the kind and type of authority (or aspect of power) a jurisdiction has over a policy domain area. For example, standardisation in policy for skill training and providers might be of a federal authority but regulation or management of the same skill training providers might fall under the state governments' purview.

Thus, expenditures are also differentiated as policy is based on the same division. The Constitution of Nepal stipulates two lists of concurrency, Schedules 7, 9 wherein,

Schedule 7: Shared power between Federal and State Governments
Schedule 9: Shared power between Federal, State and, Local Governments

The concurrent powers of the central, state and local governments include education, sports, newspapers/magazines, health, agriculture, cooperative, electricity, irrigation, mines and minerals, disaster management, social security and poverty alleviation, squatter management, personal incidents, birth, death, marriage and statistics, archaeology, tourism, drinking water supply, sanitation, and motor vehicle licensing centre. Similarly, tourism, drinking water supply, sanitation, law relating to family affairs, property acquisition, land acquisition and rights over it, planning, family planning and population management, social security and employment, functions relating to rights of labourers and labor disputes, poverty alleviation and industrialisation, casino, lottery, motion pictures, cinema hall, sports, scientific research, development of science and technology and human resources, forests, mountains, forest conservation areas spreading inter-provinces, water use, land policies and laws relating to thereof, employment, unemployment assistance etc. fall under the concurrent powers of the central and state governments.

A detailed overview of the these subjects is given in the 'Cabinet Unbundling Report Office of the Prime Minister and Council of Ministers (OPMCM)'. An adapted version of the representative assignments is given below;

Table 2: Assignment of Expenditure Responsibilities among various ties of government in Nepal

Function	Policy standards	Provision and administration	Production and distribution
Interregional and international conflict resolution	N	N	N, International Agencies
Protection of fundamental rights	Constitution	Supreme Court	N,P
External trade	N	N	N,P
Telecommunications	N	N,S,L	N,S,L,P
Financial transactions	N	N,S	N,S,P
Environment	N	N,S,L	N,S,L,P
Foreign direct investment	N	N,S,L	N,S,L,P
Defence	N	N	N
Foreign affairs	N	N	N
Monetary policy, currency, and banking	N	N,S	N,S,P
Interstate commerce	Constitution	N	N,S,L,P
Immigration	N	N	N
Transfer Payments	N	N,S	N,S
Criminal and Civil Law	N,S,L	N,S,L	N,S,L
Industrial policy	N,S	N,S	N,S,L,P
Regulation	N,S,L	N,S,L	N,S,L
Fiscal Policy	N	N	N

Natural Resources	N	N,S,L	N,S,L,P
Education, Health and Social Welfare	N	N,S,L,P	N,S,L,P
Highways	N,S	N,S	N,S,P
Parks and Recreation	L	L	L,P
Police	N,S,L	N,S,L	N,S,L
Water, Sewage, Refuse and Fire Protection	L	L	L

Note: N= national government, S= state or provincial government, L= local government, and P= nongovernmental sectors or civil society

While there are several responsibilities in the parliamentary list, it is unclear as to which activities should be performed by which particular levels of government. It must be made clear by laws. In general, the central government has to be responsible for determining policies and standards. The governments' responsibilities should govern governments on the implementation of these policies and the local governments are obliged to take care of them. For example, it is necessary to formulate plans of social security programs, but because the central government cannot afford the beneficiaries of the social security programs, it is necessary to implement them at the local level. In the image of the education, the central government can better cope with the educational norms and curriculum development on education, while government reforms can make the Higher Education Act true. Unlike local governments, they can work more efficiently with primary education. On street vendors, the central government can manage inter-provincial road networks by managing the governments and local governments to administer the road under their respective responsibilities.

A clear boundary line has to be drawn into the relationships and responsibilities of the governments of different levels. Or, it is likely to confuse the roles of different governments, to demand them and to assume responsibility for another, to reduce jobs and to increase the cost of unnecessary improvement. For this reason, certain provisions must be made to ensure efficiency and accountability, by which the responsibility of every level is clear.

6

REVENUE ASSIGNMENT

The other major component of a fiscal framework is the assignment of revenue, through taxation and other surcharges (such as fines, penalties etc). These sources of revenue are constitutionally guaranteed thus affirming to the autonomous control by all levels of government (federal, state or, local). As per Structure of State and Distribution of State Power (Part 5, Constitution of Nepal) revenue rights (or assignments) are delineated to the three orders of government both exclusively and in shared format (or concurrent powers).

Further, the Inter-government Fiscal Arrangements Act, 2017 specifically details out the revenue rights of the three orders of governments as well as the revenue sharing mechanism. The revenue rights of the three orders of governments can be studied as follows;

FEDERAL GOVERNMENT

A. Tax

- i. Customs Duty
- ii. Excise- Duty
- iii. Value- Added Tax (VAT),
- iv. Corporate Income Tax
- v. Individual Income Tax
- vi. Remuneration Tax

B. Non-tax

- i. Passport fee
- ii. Visa fee
- iii. Tourism fee
- iv. Service Charge/fee,
- v. Gambling/lottery, Casino
- vi. Penalty and fine

C. Other tax and non-tax revenue to be levied in accordance with Federal laws and other prevailing laws.**STATE GOVERNMENTS****A. Tax**

- i. House and land registration fee
- ii. Motor vehicle tax
- iii. Entertainment tax
- iv. Advertisement tax
- v. Agro- income tax

B. Non-tax

- i. Service Charge/fee
- ii. Tourism fee
- iii. Penalty and Fine

C. Other tax and non- tax revenue to be levied in accordance with State laws and other prevailing laws related to the matters falling under State's domain.

LOCAL GOVERNMENTS

A. Tax

- i. Wealth tax
- ii. House rent tax
- iii. House land registration fee
- iv. Motor vehicle tax
- v. Land tax (Land revenue)
- vi. Entertainment tax
- vii. Advertisement tax
- viii. Business tax

B. Non-tax

- i. Service Charge/fee
- ii. Tourism fee
- iii. Penalty and fine

C. Other tax and non-tax revenue to be levied in accordance with Local laws and other prevailing laws related to the matters falling under Local Level's domain.

7

INTERGOVERNMENTAL TRANSFERS

Fiscal imbalance correction, both horizontal and vertical (discussed in the Principles of Fiscal Federalism chapter), forms the basis and the reasoning behind using tools of Inter-governmental transfer to equalise balance sheets and provide for sufficient finances to carry out the plans decided by a level of jurisdiction. These instruments have an important bearing on the efficiency, equity and, accountability in a federal system.

Broadly, fiscal imbalances (or mismatched revenues) are addressed by two mechanisms: revenue sharing and tax-base sharing. Tax-base sharing means that two or more orders of government levy rates on a common base. Tax-base determination usually rests with the national or state government, with the state and local governments levying supplementary rates on the same base. Tax collection is by one order of government, generally the national government in market economies and the local government in centrally planned economies, with proceeds shared downward or upward depending on revenue yields. Tax-base sharing is quite common in mature federations and almost non-existent in newer federations in developing countries.

Nepal follows a dual transfer system: revenue sharing mechanism which distributes VAT and Excise Duty as well as royalty from natural resources, and inter-governmental transfers which consists of grants given conditionally and unconditionally.

7.1 Revenue Sharing

Under revenue sharing mechanism one order of government has unconditional access to a specified share of revenues collected by another order. Revenue-sharing agreements typically specify how revenues are to be shared among the federal government and the state and local governments, with complex criteria for allocation and for the eligibility and use of funds. Such limitations run counter to the underlying rationale of unconditionality. Revenue sharing mechanisms are quite common in developing countries. They often address multiple objectives, such as bridging the fiscal gap, promoting fiscal equalisation and regional development, and stimulating tax efforts by state and local governments (Shah, 2007).

Revenue sharing in Nepal is mandated by the Constitution, National Natural Resources and Fiscal Commission Act, 2017 and the Intergovernmental Fiscal Arrangements Act, 2017. Value Added Tax (VAT) and Excise Duty in a 14:3:3 ratio or 70-15-15 percent sharing for Federal, State and Local governments respectively. The Budget of 2018/19 distributes these in the following manner:

Table 3: Sharing of VAT and Excise Duty among three orders of government for the fiscal year 2018/19

Total collection (in 000)		Percentage (sharing)			Distribution (in 000)		
		F	S	L	F	S (7)	L (753)
VAT	284691000	70	70	15	199283700	42703650	42703650
Excise	134957100	70	70	15	94469970	20243565	20243565
Total	419648100					62947215	62947215

Note: F= federal government, S= state government and L= local government

The above numbers are total amounts set aside for distribution amongst seven states and seven hundred fifty-three local governments. The parameters and

weightage for further disbursement of funds to each state and each local government is as follows:

- 70% Population
- 15% Total Area of the corresponding jurisdiction
- 05% Human Development Index (HDI)
- 10% Low Development Indicators (Need for Infrastructure and Other Expenditures)

Similarly, royalty from natural resources are also disbursed between the three orders of government in the ratio 2:1:1 or in percent sharing as 50-25-25 percent share for Federal, Concerned State and Concerned Local government(s) respectively. As per Budget 2018/19 the following distribution in terms of money allocated is as follows;

Table 4: Sharing of Royalty from natural resources among three orders of government for the fiscal year 2018/19

Total collection		Percentage (sharing)		
		FEDERAL	STATE	LOCAL
Mountaineering	1661500000	50	25	25
Water resources	2333100000	50	25	25
Forest	2860000000	50	25	25
Mines and Minerals	157300000	50	25	25
Charges for consumption of electricity	1600000	50	25	25

However, these transfers are made to the concerned state/local government depending upon the share of each in each of the above headers.

7.2 Intergovernmental Transfers

Intergovernmental transfers, by theory, are the dominant source of revenues for sub-national governments in most developing countries. The design of these transfers is of critical importance for efficiency and equity of local service provision and fiscal health of subnational governments. Five broad economic arguments for central-state transfers each of which is based on either efficiency or equity, and each of which may apply to varying degrees in actual federal economies:

- i. Fiscal Gap: An imbalance between the revenue-raising ability of subnational governments and their expenditure responsibilities (the “vertical imbalance”) might arise for two reasons. First, there may be (often inappropriate) assignment of taxing and spending responsibilities such that expenditure needs of sub-national governments exceed their revenue means. Second, many taxes are more efficiently collected at the central level responsibilities to avoid tax competition and inter-state tax distortions, so transfers are necessary to enable local levels to carry out their expenditure responsibilities.
- ii. Fiscal Inequity: A country which values horizontal equity (i.e., the equal treatment of all citizens nationwide) will need to correct the fiscal inequity which naturally arises in a decentralised country. Sub-national governments with their own expenditure and taxation responsibilities will be able to provide their residents different levels of services for the same fiscal effort owing to their differing fiscal capacities. If desired, these differences may be reduced or eliminated if the transfers to each jurisdiction depend upon its tax capacity relative to others, and upon the relative need for and cost of providing public services.
- iii. Fiscal Inefficiency: The argument for such transfers is reinforced by the fact that the same differentials which give rise to fiscal inequity also cause fiscal inefficiency.

- iv. Interstate Spillovers: This is the traditional argument for matching conditional grants. Normally, subnational governments will not have the proper incentive to provide the correct levels of services which yield spill over across jurisdictions. In theory, a system of matching grants based on the expenditures giving rise to the spillovers will provide the incentive to increase expenditures. In practice, the extent of the spillover will be difficult to measure so the correct matching rate to use will be somewhat arbitrary.
- v. Fiscal Harmonisation: To the extent that the central government is interested in redistribution as a goal, there is a national interest in redistribution that occurs via the provision of public services by the subnational governments. Expenditure harmonisation can be accomplished by the use of (non-matching) conditional grants, provided the conditions reflect national efficiency and equity concerns, and where there is a financial penalty associated with failure to comply with any of the conditions. In choosing such policies there will always be a trade-off between uniformity, which may encourage the free flow of goods and factors, and decentralisation which may encourage innovation, efficiency and accountability.

They are categorised in two distinct categories:

- i. **General Purpose Transfers (unconditional)**: General Purpose transfers are provided as general budget support, with no strings attached. These transfers are typically mandated by law, but occasionally they may be ad hoc or discretionary. Such transfers are intended to preserve local autonomy and to enhance inter-jurisdictional equity (Anwar, 2007). As per the Intergovernmental Fiscal Arrangements Act, 2017, Clause 8 specifies only general purpose transfer in the name of the Fiscal Equalisation Grant. As per Budget 2018/19, Fiscal Equalisation Grants are as follows:

Table 5: Fiscal Equalisation Grant for the fiscal year 2018/19

States	Grant amount (NPR)
State 1	6610300000
State 2	7016100000
State 3	5969700000
State 4	6776700000
State 5	6869700000
State 6 (Karnali)	9131400000
State 7	7924700000
TOTAL (STATE)	50298600000
TOTAL (LOCAL)	85207500000
No. (LOCAL)	753
AVERAGE (LOCAL)	113157370.5

The above numbers are total amounts set aside for distribution amongst seven states and seven hundred fifty-three local governments. The parameters and weightage for further disbursement of funds to each state and each local government is as follows:

Parameters for disbursement of fiscal- equalisation grant to the states

- 60% Cost of Development and Public-service Delivery
- 15% Multi- dimensional Poverty Index
- 10% Infrastructure Index
- 15% Indicators of social and economic discrimination

Parameters for disbursement of fiscal- equalisation grant to the local government

- 70% Gap between Expenditure Requirement and Revenue Generation Capacity
- 10% Human Poverty Index
- 5% Indicators of Social and Economic Discrimination
- 15% Infrastructure Index

ii. Specific Purpose Transfers: Specific Purpose transfers are intended to provide incentives for governments to undertake specific programs or activities. These grants may be regular or mandatory in nature or they may be discretionary or ad hoc.

Conditional transfers typically specify the type of expenditures that can be financed (input-based conditionality). These may be capital expenditures, operating expenditures, or both. Conditional transfers may also require attainment of certain results in service delivery (output-based conditionality). Input-based conditionality is often intrusive and unproductive, whereas output-based conditionality can advance grantors' objectives while preserving local autonomy (Shah, 2007).

There are three types of grants within the specific transfer grants as mandated by the Intergovernmental Fiscal Arrangements Act 2017: Conditional, Complementary and Special.

a. Conditional Grants: The budget disbursement for conditional grants for the 2018/19 is as follows:

Table 6: Conditional Grants for the fiscal year 2018/19

States	Conditional Grants
State 1	13276700000
State 2	9181100000
State 3	10615600000
State 4	6501900000
State 5	9670300000
State 6 (Karnali)	7562100000
State 7	6327800000
TOTAL (STATE)	63135500000
TOTAL (LOCAL)	109845600000.00
No. (LOCAL)	753
AVERAGE (LOCAL)	145877290.8

- b. Complementary Grants: The Federal Government has set aside 5,00,00,00,000 each for both States (7) and Local Governments (753).
- c. Special Grants: The Federal Government has set aside 5,00,00,00,000 each for both States (7) and Local Governments (753).

The table below details out all Intergovernmental Transfers by the Federal Government to both State and Local governments:

Table 7: Various fiscal transfers from the Federal Government for the fiscal year 2018/19

GRANT TYPE	STATE (7)	LOCAL (753)
Fiscal Equalisation Grant	50298600000	85207500000
Conditional Grant	63135500000	109845600000
Complementary Grant	50000000000	50000000000
Special Grant	50000000000	50000000000

8

COMPARATIVE CONCLUSIONS

The practise of fiscal federalism is also varied given the vast variation in federal countries. Federal systems are seen to provide safeguards against the threat of centralised exploitation as well as decentralised opportunistic behaviour while bringing decision makers closer to the people (Shah, 2007). While 25 countries subscribe to the federal system of governance, for this study we chose to select only six, given the time and resources at our disposal. The countries have been selected given multiple factors of developed and developing nations (with more number of developing countries) spanning across the world. Additionally, factors such as population, type of federal structure, orders of government etc. have also been considered. Similarly, the nature of transfers used to correct regional inequities is also vast given the type and nature of transfers provided to sub-national governments. The countries selected for our study are:

- i. Australia
- ii. Brazil
- iii. Canada
- iv. India
- v. South Africa
- vi. Nigeria

There are two distinct categories under which fiscal countries can be shelved given the features they exhibit, they are, dual federalism and cooperative federalism. Dual federalism distinctly separates the responsibilities of the

federal (or central) with the sub-national governments (state and local). According to W. Riker (1964), under such a system, “two levels of government rule the same land and the people, (2) each level has at least one area of action in which it is autonomous, and (3) there is some guarantee of the autonomy of each government in its own sphere.” In our sample, Canada, India and, Australia belong to the dual federalism category. Cooperative federalism, as the name suggests, is a model with interlinked federal and sub-national governments’ functions. Brazil, Nigeria, and South Africa belong to the cooperative federalism category.

Within the dual federalism model, federations usually subscribe to either the layer-cake model or coordinate authority model. There is a hierarchical (unitary) type of relationship among the various orders of government in the layer-cake model. The national government is at the apex, and it has the option to deal with local governments either through state governments or more directly. Local governments do not have any constitutional status: they are simply extensions of state governments and derive their authority from state governments. In the coordinate-authority model of dual federalism, states enjoy significant autonomy from the federal government, and local governments are simply handmaidens of the states and have little or no direct relationship with the federal government. Canada and India are examples of the coordinate authority model while Australia is an example of the layer-cake model.

The cooperative federalism model exhibits three variations: independent, interdependent and marble cake. The federal government determines policy and the state and local governments act as implementation agents for federally determined policies in the interdependent model. Examples of the same from our sample are Nigeria and South Africa. In view of federal domination of policy making, in this model, state/provincial governments have a voice in federal policy making through a second chamber (the upper house of the Parliament), for example, the Council of Provinces in South Africa. In the marble cake model of cooperative federalism, various orders of government have overlapping and shared responsibilities, and all constituent governments are treated as equal partners in the federation.

Example of the same is Belgium (though we have not studied it in detail), with its three territorial and four linguistic jurisdictions, has a strong affinity with this approach. Finally, in a model of cooperative federalism with independent spheres of government, all orders of government enjoy autonomous and equal status and coordinate their policies horizontally and vertically. Brazil is an example of a federation practising this form of federalism.

Nepal comes very close to the independent model of a cooperative federal structure. All three orders of government (federal, state and local) enjoy autonomous powers and also coordinate their policies both horizontally and vertically. This can be clearly seen in Part 5- Structure of the State and Distribution of State Power and Part 20- Interrelations between Federation, State and Local levels via Article 57 where the states and local level policies have to adhere to the Constitution and Federal law and can be struck down if found to be inconsistent. Article 232 clearly mentions the principles of cooperation, coordination and, coexistence to manage relations between the three levels. Article 233 also specifies relations between states to be coordinated among them. Finally, the Intergovernmental Fiscal Arrangement Act 2017, Clause 36 also emphasises on coordination and cooperation with respect to fiscal policies and coordinate policies among them. Thus, it can be deduced that Nepal would fall under the category of a cooperative federalism of an independent sphere like Brazil. A chapter devoted to the comparison of Brazil with Nepal is included separately since Brazil is the only type of independent cooperative federation existing in the world today.

In our sample, all developing countries: India, Nigeria, South Africa and Brazil have constitutionally recognised third tiers (or local levels) of government whereas Australia and Canada have two tiers of government. Although not all enjoy an equal status in comparison, for example Brazil has a more autonomous tiers of government, whereas in India, the federal government is all powerful than the state and the local governments so much so that the federal government also has powers to change state boundaries and has paramountcy on residual and concurrent subjects. South Africa has a distinct focus on separation of law-making and law-executing powers where the

central government is engaged solely in law and policy formulation and the sub-national governments implement those laws. India, Nigeria, Australia have strong central governments whereas the influence of central governments on sub-national governments in Brazil and Canada is weak in comparison. Here, the state governments have considerable authority to determine their own taxation rates. Australia's constitution mandates the policy of following regionally differentiated policies by the central government.

Canada, Australia, Nigeria and, Brazil conform to the subsidiarity principle on allocation of spending and regulatory responsibilities while India and South Africa have a constitutional strong federal domination due to their respective historic legacies. The second tier of government (provinces/states) have a strong role in regulatory and spending responsibilities in Canada, fairly strong in Brazil, Australia, India, with a less strong hold in South Africa (social and infrastructure services are centralised in South Africa). Local governments are very strong in Brazil, Canada while Australia and India have a very weak local government structures. In Australia, local governments have no or insignificant role in public service delivery and are primarily responsible for property-oriented services such as garbage collection, street cleaning etc.

Federal fiscal systems are also wary of macro-economic stability of the country for which fiscal discipline and prudence are important considerations to maintain a stable national accounting. Different federations employ a combination of different tools to main the macroeconomic stability of the country. Fiscal Discipline refers to a state of an ideal balance between revenues and expenditure of government, in an economy. If the fiscal discipline is not maintained, then the government expenditure exceeds government receipts. Under this condition, the government would have to borrow funds or incurred with deficit financing from the central bank. This may depreciate the currency and create inflation in an economy. Unsustainable fiscal policy can jeopardise service delivery, safety of financial system, creditworthiness and overall macroeconomic stability.

8.1 Brazil and Nepal: A Fiscal Comparison

Brazilian federation comprises of three tiers of government; a federal government, 27 state governments and 5570 municipal government. Brazil's constitution of 1988 provides framework for assignments of revenue and expenditure functions among the Union, states and municipalities. The constitution provides exclusive power to the federal government in some matters, some functions are shared between union and state, municipal government has power to look into certain other aspects, and residual power lies within the states.

Defence, Currency, Postal service, Telecommunication, Energy, Railway, National Highways/ Transport, Police, National Statistics, International and Interstate Trade and Commerce, Immigration, Urban Development, Use of water resources, Regulation of credit, foreign exchange, insurance and securities, Directives, National Education, and Regulation of Labour are prerogative of the federal government/ Union.

The responsibilities regarding Pre-school and Elementary Education, Urban Land use, Preservation of local culture, Preventive health care and local transport are exclusive of local government. Health and Sanitation, Environmental preservation, Agriculture, Culture and Education are shared between Federation and States.

Table 8: Expenditure responsibilities assignment among different levels of governments in Brazil and Nepal

Expenditure Categories	Brazil	Nepal
Defence	F	F
Currency	F	F
Railway	F	F
National Highways	F	F
Energy	F	F,S,L

Police	F,S	F,S,L
National Statistics	F	F
International/Interstate trade and commerce	F	F
Immigration	F	F
Regulation of credit, exchange, insurance and securities	F	F
Social Security	F	F
Health	F,S	F,S
Agriculture	F,S	S,L
Culture	F,S	S
Urban Land Use	L	L
Protection of local culture	L	L
Preventive health care	L	L
Local transport	L	L
Basic/Elementary Education	L	L
Higher Education	F,S	F,S

Note: F= federal government, S= state or provincial government, and L= local government

The above table compares the expenditure assignments on some of the major headings among federal, state and local level in Nepal and Brazil. Expenditure assignment in both the countries look quite similar except for some minor differences. For instance, energy is assigned to federal government in Brazil, whereas, it is jointly assigned to all three levels of government in Nepal. Even though, qualitative differences are of low severity, quantitative differences may be of significant degree. The percentage of expenditure that goes into each of these headings might differ significantly. Similarly, in the case of shared responsibilities, the ratio of expenditure (federal: state: local) can be different in Brazil and in Nepal. But, as expenditure statistics of state and local level are not available yet, such comparison cannot be done.

Taxation is the major source to finance these expenditures. Brazil's federal government has power to levy taxes in import and exports, income and other earnings, industrialised products, credit transactions, foreign exchange operations, insurance and transactions relating to negotiable instruments/securities, rural property, and large fortune (wealth). States can raise General Value-added Tax (ICMS), taxes in inheritance, gifts and donations of property and automobile tax. Likewise, local government can raise revenue through urban property tax, service tax and tax on property transfers.

In the case of Nepal, federal government can levy custom duty, excise-duty, Value Added Tax, corporate and personal income tax, and remuneration tax. Agro-income tax is raised by state government, whereas, house and land registration fee, motor vehicle tax, entertainment tax, and advertisement tax are looked after by state and local governments. Local governments have exclusive power to raise wealth tax, land tax, house rent tax, and business tax.

Table 9: Tax headings assignment to federal government in Brazil and Nepal

Revenue source (Nepal)	Revenue source (Brazil)
Customs Duty	Taxes on Imports/ exports
Excise-Duty	Large fortune tax
Value Added Tax	Tax on Industrial Product (IPI)
Corporate Income Tax	Corporate Income Tax
Individual income Tax	Personal Income Tax
Remuneration Tax	Rural Property Tax
	Taxes on financial operations and insurance

Table 10: Tax headings assignment to state governments in Brazil and Nepal

Revenue source (Nepal)	Revenue source (Brazil)
House and land registration fee	General value added tax (ICMS)
Motor vehicle tax	Taxes in inheritance, gifts and donation of property
Entertainment tax	Automobile tax
Advertisement tax	
Agro- income tax	

Table 11: Tax headings assignment to local governments in Brazil and Nepal

Revenue source (Nepal)	Revenue source (Brazil)
Wealth tax	Urban property tax
House rent tax	Service tax
House and land registration fee	Tax in property transfers
Motor vehicle tax	
Land tax	
Entertainment tax	
Advertisement tax	
Business tax	

According to Shah (1990), tax assignment in Brazil is coherent with the economic principle. However, the major problem sales tax on industrial products, General value added tax and service tax which are of similar nature are handled by different levels of government. Hence, tax base for federal tax on industrial products and the state general value added tax partly overlap. Similarly, ICMS (Brazilian acronym for General value added tax) and local service tax also have overlapping tax bases. Hence, it is recommended that all these taxes be clubbed into a single value-added tax and power to levy the tax be given to federal government. The revenue deficit arising from this policy should be addressed by revenue sharing mechanism among the three tiers of government, which Nepal has rightly done according to the principles of fiscal federalism.

The above table clearly indicates that the heading under which federal government can raise revenue is very similar in Nepal and Brazil. On the contrary, the sources of tax revenues of the state and local governments differ if we compare Brazil and Nepal, with state and local governments in Nepal having additional sources of tax revenue. However, till now data pertaining to the revenues of the state and local governments of Nepal are not yet available, hence, comparative analysis of the share of revenue that goes to different orders of government is not possible.

9

ANALYSIS OF THE CURRENT FRAMEWORK OF FISCAL FEDERALISM

1. Distortionary transfers of resources

As mentioned in the 'Principles of Fiscal Federalism' chapter, a sound fiscal structure should be such that it prevents distortionary transfer of capital and labour from one sub-national jurisdiction to the other. In order to prevent the distortionary transfer of such resources, the principle suggests that fiscal residuum³ of the people of equal economic status should be equal. However, the current federal structure and plans seem to have given no priority to this particular factor. Till date, government's plan does not include equalization of fiscal residuum of the equals, which could lead to the distortionary movement of resources from the jurisdiction where the difference between benefits received and total tax payments is lower than the jurisdiction where it is higher. This might lead to unequal growth which is one of the major objectives of federalism.

2. Disregard to vertical fiscal imbalance

The current framework of fiscal federalism seems to have disregarded vertical fiscal imbalance and has primarily focused on horizontal fiscal imbalances. Horizontal fiscal imbalance addresses the difference in needs and revenue generating capacity of sub-national governments of equal status, whereas vertical fiscal imbalance addresses such difference among the different orders of government. Mismatch between the expenditure responsibilities and the total revenue generation (including the funds received from revenue sharing and equalization grants) could affect ability of the sub-national government in efficient and effective public service delivery.

³ Fiscal residuum is the difference between total tax payments and total benefits received out of the public services. This concept has been thoroughly explained in the 'Principles of Fiscal Federalism' chapter.

3. Unavailability of the data for efficient fiscal transfers

Maintaining horizontal and vertical fiscal balance is one of the major concerns which determines the success of federalism. Similarly, another important factor to be considered as mentioned above is prevention of distortionary transfer of resources from one sub-national jurisdiction to another sub-national jurisdiction by equalising the fiscal residuum of the citizens. However, we lack sufficient data to calculate vertical and horizontal fiscal imbalances. In order to calculate these, we need data related to revenue base of various sub-national jurisdiction and also the needs of the public goods and service of those jurisdictions. Similarly, the major challenge is to calculate fiscal residuum of citizens. In order to calculate fiscal residuum of the citizens data related to productivity of the citizens measured in terms of their income and the amount of benefits received in terms of public goods and services by them. Unavailability of these statistics could lead to unscientific fiscal transfers and failure to solve the problem of fiscal imbalance and inequity.

4. Capacity of sub-national government

The sub-national governments lack institutional capacity to prioritise expenditure and raise revenue accordingly. Moreover, they also lack skilled human resource and capacity to make laws related to the powers and responsibilities assigned to them by the constitution. This could directly affect efficient public service delivery by the sub-national governments. Hence, we cannot expect smooth functioning of the government in terms of providing public services. Therefore, one of the priorities of sub-national governments should be invest on development of their human resource and institutional capacity. The federal government should also assist them in doing so.

5. Unwillingness of Federal government to give up power/ authority

Even after federalization and formation of all three levels of government whose responsibilities and rights have been mandated by the constitution, the federal government still seems unwilling to give up the

power which have now been assigned to the lower level of governments. This view has been supported by the fact that the federal government still has not dissolved many of its department and agencies whose works have now been delegated to sub-national governments. For instance, it has clearly been mentioned in the Schedule-7 of the constitution that local infrastructure and agricultural roads is the exclusive responsibility of the local government. However, Department of Local Infrastructure Development and Agricultural Roads, which is the federal government agency is still functional. Even though the responsibility of development of local infrastructure and agricultural roads has been assigned solely to the local government, federal government intervention still exist. This may result into conflict between the federal government and local government, and adversely affect the development and maintenance of local infrastructure.

6. Local government lack clear understanding about their rights and responsibilities

Currently, local governments are not aware about their rights and responsibilities. There have been instances where they levied taxes under the headings which fall under the purview of federal government such as VAT, putting extra tax burden on the people. Similarly, lack of understanding of their roles under federal structure could also adversely affect production and delivery of public goods and services.

7. Income tax administration by the federal government could exclude Micro enterprises

Most of the microenterprises in Nepal are either informal or semi- formal in nature. Many of them are operating their business without formal registration with all the concerned authorities. They are only registered with municipal government and are not registered with the federal tax authority. Since they are not registered with the federal tax authority (the one who is responsible for collection of income tax), the state has not been receiving the income tax revenue from them. Even in the federal structure, the authorities relating to income tax administration

has been given to the federal government, and therefore, the problem of these enterprises falling outside the income tax bracket could still prevail in the new system as well.

10 AREAS FOR REFORM

A summary of principles that Nepal's Fiscal Commission and concerned governments could consider in their revised considerations on the fiscal architecture of the country are summarised as follows:

1. Output based transfers

A recent innovation in the field of new public management, output based transfers reward jurisdictions which improve their services in a given set of parameters and strengthening demand for good governance by lowering the transaction costs for citizens in obtaining public services under the new institutional economics approach. It seeks to create a competitive service delivery environment by making financing available on similar conditions to all providers, government and non-government. Output-based transfers link grant finance with service delivery performance. These transfers place conditions on the results to be achieved while providing full flexibility in the design of programs and associated spending levels to achieve those objectives. The incentive and accountability regime created by output-based transfers is expected to create responsive, responsible, and accountable governance without undermining local autonomy. In contrast, traditional conditional grants with input conditionality undermine local autonomy and budgetary flexibility while reinforcing a culture of opportunism and rent seeking. A comparison of the traditional and output based transfers is given in the table below:

S.N.	FEATURE	TRADITIONAL GRANT	OUTOUT BASED GRANT
1	Grant objectives	Spending levels	Quality and access to public services
2	Grant design and administration	Complex	Simple and transparent
3	Eligibility	Recipient government departments/agencies	Recipient government provides funds to all government and nongovernment providers
4	Conditions	Expenditures on authorized functions and objects	Outputs-service delivery results
5	Allocation criteria	Program or project proposal approvals with expenditure details	Demographic data on potential clients
6	Compliance verification	Higher level inspections and audits	Client feedback and redress, comparison of baseline and post grant data on quality and access
7	Penalties	Audit observations on financial compliance	Public censure, competitive pressures, voice and exit options for clients
8	Managerial flexibility	Little or none. No tolerance for risk and no accountability for failure	Absolute. Rewards for risks but penalties for persistent failure

9	Local government autonomy and budgetary flexibility	Little	Absolute
10	Transparency Focus	Little, Internal measures only	Absolute, External, competition, and, benchmarking
11	Accountability	Hierarchical to higher-level government, controls on inputs and process with little or no concern for results	Results based, bottom-up, client driven

2. Legislation for fiscal responsibility and budget management

Although the constitution and intergovernmental fiscal arrangements act mentions fiscal responsibility, it does not, however, comment on how and what level of ceilings should be maintained. An absence of such regulation may induce over budgeting of government money and increase pressure on the macroeconomic stability of the country. A fiscal rule imposes a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates. Fiscal rules typically aim at correcting distorted incentives and containing pressures to overspend, particularly in good times, so as to ensure fiscal responsibility and debt sustainability (IMF). As quoted before, Brazil and India have successfully adopted fiscal rules which have greatly helped the countries manage their macroeconomic stability. These can be further categorised on four types:

- Debt Rules: Set an explicit limit on the stock of public debt
- Budget Balance Rules: Constrain the size of the deficit and thereby control the evolution of the debt ratio
- Expenditure Rules: Limit total/ primary/ current spending, either by putting a ceiling on its growth, or on the relevant ratio to GDP.
- Revenue Rules: Set ceilings or floors on revenues, or determine use of windfall revenues

3. Prevention of distortionary transfer of resource

In order to prevent the distortionary transfer of resources which could lead to unequal growth and development, the federal government should also give focus in maintaining horizontal fiscal equity among the citizens of various jurisdiction. By equalising fiscal residuum of the people residing in various precinct, government can maintain horizontal fiscal equity and prevent the distortionary transfer of resources among various jurisdictions.

4. Focus on vertical fiscal balance for effective public service delivery

As mentioned in the previous section, the fiscal federal framework in Nepal seems to have given less priority to vertical fiscal imbalance and has only focused on horizontal fiscal imbalance. As existence of vertical fiscal imbalance hampers efficient public service delivery, it should also be considered while distribution of grants.

5. Collect and create database for scientific and efficient fiscal transfers

As mentioned above, currently we lack data for scientific fiscal transfers so that both vertical and horizontal fiscal transfers could be corrected and distortionary transfers of resources could be prevented. Hence, all three levels of governments should collect the data necessary for efficient fiscal transfers in a coordinated manner. So, that we can continuously improve the efficiency of the fiscal transfers.

6. Delegate responsibility to the lower orders of government in practice

The federal government should completely leave the responsibility assigned to the sub-national governments. As mentioned earlier, it is still holding many of the powers assigned to the lower orders of government. The federal government still holds centralised mentality and perceives that lower level of government is incapable of performing the responsibilities provided by the constitution. This may result into

the inter-governmental conflict and effect the development process. Hence, the federal government should dissolve all the agencies and departments who are performing the works which have been constitutionally assigned to sun-national governments.

7. Income tax administration for the micro enterprises is to be done by local government

The matters related to income tax of micro enterprises whose area of operation usually do not exceed a local jurisdiction should be handled by local government. Most of the micro enterprises do not possess all the information regarding business registration. They are registered only with the local government and hence they do not lie within the income tax base of the federal government. Because of this, on the one hand the government is losing tax revenue which it could have collected from them, while on the other hand, due to the semi-formal status, these enterprises are deprived of various benefits, for instance, they cannot benefit from various plans and programs of the federal government which could enhance their growth. It also reduces their access to credit. Therefore, if the income tax administration for the micro enterprises could be done by local government, it could benefit both the government and these enterprises.

8. Prioritise fiscal aspects of federalism

Fiscal federalism, despite being one of the most important issues is least discussed in the process of implementation of federalism in Nepal. Moreover, it has not been in the priority of the government. It has been more than a year since National Natural Resource and Fiscal Commission, a constitutional body responsible for looking into fiscal matters under federal structure has been formed, but the commission has not got its full shape. The government is yet to appoint all the members. As much priority has not been given to the fiscal aspects, various problems have already started to arise. Due to the lack of institutional capacity of the local government and their knowledge regarding their rights and responsibilities, they have not been able to prioritise their

expenditure responsibilities. Moreover, there are instances where some of the local governments have raised revenue under the headings assigned to federal government. Some of the local governments lack capacity even to maintain the basic books of accounts. In order to solve these issues and other issues mentioned above, the government should put fiscal federalism in priority. The federal Ministry of Finance (MoF) and NNRFC must co-ordinate to bring in the representatives of the sub-national governments, sectorial experts and representatives of the finance committee to discuss the various problems that currently exists and also the problems that the country might encounter in the future to come up with solutions to these problems.

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Samriddhi Foundation is an independent policy institute based in Kathmandu that focuses on economic policy reform. Established in 2007, Samriddhi aims at facilitating a discourse on pragmatic market based solutions for a free and prosperous Nepal.

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