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Economics of Fiscal Federalism in Nepal

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Outline

Executive summary
1. Introduction
2. Focus of the Study
3. Fiscal Federalism at International Level
   4.1 Revenue assignments in Nepal
   4.2 Inter-governmental fiscal transfer
   4.3 Expenditure assignments
   4.4 Existing budgetary practice in Nepal
5. Policy Recommendation
6. References
Economics of Fiscal Federalism in Nepal

Executive Summary

Nepal is in irreversible path of the federalism. There is huge debate among the political parties on different issues such as numbers of states, names of the states, carving the boundaries of the states, classification and management of natural resources, revenue sharing and resources allocation, reliable fiscal policy with regard to the proposed federal structures.

There is wide disparity in terms of resources including revenue collection among the districts. Those states having such resource and revenue earning will obviously be economically viable as compared to others without sources of income. This would further lead to disparities among the states. Hence, possible solution would be to carve boundaries based on the economic viability.

Finding sustainable, efficient, equity based redistribution of resources that ensure and enhance welfare and prosperity among the sub national in units should be at the center in deciding numbers of states and delineating their boundaries. This paper focuses on the revenue and expenditure sharing and intergovernmental transfer to the different tiers of government. It also makes some policy recommendations based on the international experiences.

1. Introduction

Nepal has a centralized governance system for a long time. In the past, regional structure was purely a conception of the elite and development experts and, not a grass root demand from people. This structure was designed neither for devolution of political power to the people nor for addressing any grievances of the marginalized socio-cultural groups of people. There were some attempts of decentralization and policy of cultural diversity but it could neither devolve power nor satisfy the people’s aspiration for their identity and cultural as well as ethnic rights (Khanal, 2009). This ultimately led the demand of proportional representation and reservations in job, education etc and federation in the end.

If we examine the other aspects of the economy, we find serious unequal distribution of the resources and facilities in different areas. There is a wide disparity in the level of education and health indicators across regions and districts. Syangja district has the highest primary enrolment rate of 97% compared with 70% in Sarlahi district, which has the lowest enrollment rate. Six districts headquarters are still not linked with roads and one third of the districts does not have access to road during rainy seasons. Sixty percent of the households of Nepal do not have access to electricity yet, while households without having any access to electricity in the mid and far western mountain regions are about 80 percent. Health care facilities, hospitals, health posts etc are concentrated only on the urban areas; people from the rural areas are deprived of the basic health facilities (Cyan at el 2009).

Above all, persistent widespread poverty and underdevelopment in some of the regions of the country for a longtime is the leading motivator of the demand of federalism in Nepal. The amended Interim Constitution 2007 declares Nepal as Federal Democratic Republic. However the design of the federal structure is not yet finalized. It is one of the major tasks of constitutional assembly. A "State Restructuring Commission" was set-up by the Constitutional Assembly with a view to design an appropriate federal structure in Nepal. Recently, major political parties have reached consensus on Maoists combatant integration, which was one of the major hurdles in the peace process. Hopefully, state restructuring will take place soon. However, the allocation of resources among federal states is a matter of serious concern. This is a contentious issue and needs to be addressed rationally to avoid future intra state conflict on resources sharing and revenue allocation. This policy brief examines some of these issues and recommend fiscal policies which can be useful in carving federal states in Nepal.
2. Focus of the Study

The political parties and groups have proposed the different models of federal states in Nepal according to their diversified interests. However, the major thrusts of any such fiscal federalism should be the regional equality or horizontally balanced states. Unbalanced horizontal provinces may produce the larger development gaps. Large regional disparities create the serious threats for disunity and in extreme case, for disintegration (Shah, 2007). According to a recent study, that hill and mountain districts are poor in terms of revenue generation but rich in natural resources and there may be the conflict in resource sharing. The possibility of future interstate conflicts can be reduced by focusing on equity and efficiency on resource sharing (Pyakuryal, et al., 2009).

To preserve national integrity, vertical fiscal balance is also equally important. In general, it is desirable that centre should be stronger than provinces. But there is a possibility that a strong fiscal power at the centre may exploit the state governments and hinder the local development. On the other hand, a weak central government may give birth to the separation of state. Thus some sorts of balances are necessary.

Some questions can nevertheless be raised - what is the economic viability of these proposed provinces? What is the distributive justice of economic resources? Are these proposed provinces horizontally balanced? What are the list of taxes and items of expenditure entertained by central government, provinces and local bodies or the combination of these governments? How the revenue is shared at different layer of governments? How the natural resources will be managed? What will be the better fiscal mechanism that will minimize the vertical and horizontal gaps in different provinces and layers of governments? Without understanding the existing situation of revenue collection, expenditure practices of the local governments in Nepal and resource allocation and revenue sharing practices at international level, it may not be possible to answer these given questions.

3. Fiscal Federalism at International level

“Federalism” is the system of the Government in which sovereignty is constitutionally divided between a central governing authority and constituent political units (like states or provinces). It is a system based on democratic rules and institutions in which the power to govern is shared between national and provincial governments. In a unitary system, regional governments are legal creation of central institution. In federal system each layer of government has autonomous constitutional exercise. There are approximately 28 federal countries out of 192 countries around the world, ranging from the very rich to the very poor countries and very large to very small. Federation has emerged and adopted in those countries under different circumstances. Some of the countries such as United States of America, Switzerland, Australia, and Canada have adopted federalism to bring together the formerly separate and independent units. Their common interest is to make strong federal states by preserving their own identities. On the other hand, some Latin American countries such as Argentina, Brazil and Mexico are being increasingly federal after initiation of democratic process with the collapse of dictatorial regimes. The countries like Pakistan, India, Malaysia and Nigeria, which were the former European colonies, became federal countries after the post war break up of European Empires (Anderson, 2008). While some countries such as Sudan, Iraq, Bosnia-Herzegovina and Sri Lanka etc adopted federalism after post conflict situation, others such as Spain, Belgium emerged as federal countries from unitary states. A study conducted by Professor George Anderson shows that central government of Switzerland and Canada collect 45% of the total revenue, United States collect 54%, Belgium, India, Austria, Australia, Germany and Spain collect 60 to 75% of the total revenue, whereas central governments of other federal countries such as Argentina, Malaysia, Mexico, Nigeria, South Africa etc collect 80% of the revenue. Central government expenditure is lowest in Belgium, Switzerland, Canada and Germany, which is about 30-40% of the total spending. Central spending in Austria, Australia, Argentina, Brazil, India, Mexico, Nigeria, Spain, Russia, and United States ranges from 45 to 60%. Similarly, the central government’s transfer to the local government in Switzerland, United States and Canada lies between 13 to 26%, whereas, it is about 23 % and 30 % respectively in the case of Russia and Malaysia. The central government of Germany transfers about 44%; India and Australia both transfer 46% to the constituent units. The Central governments of Nigeria, Mexico and South Africa contribute largest intergovernmental transfer, which is about 87% to the local bodies. Thus it can be seen that large share of local government expenditures of those countries are funded by the central transfer.

1 ([http://en.wikipedia.org/wiki/Federalism](http://en.wikipedia.org/wiki/Federalism)).

Nepal has been exercising decentralization in various forms over a long time. During Rana Period (1846 - 1949), Rana Prime Ministers virtually monopolized all the posts and political powers and even neutralized the power of the King. In the absence of constitution, a system of patrimony dominated the entire governance process (Dahal et al., 2001, p.39). The democratic movement of 1950 overthrew the Rana regime and introduced multi-party democracy which opened the door for decentralization. The interim constitution 1951, introduced, for the first time, a brief provision for Local Goveriances (Shrestha, 2002). During the Panchayat regime (1962-1990) various conceptual innovations were made to decentralize resources and authority in the country. The decentralized attempts in this period could be envisaged from the Decentralization Plan 1965, District Administration Plan 1975, Integrated Panchayat Development Plan 1978, Decentralization Act 1982, and Decentralization Working Procedure Rules 1984 (Dahal et al., 2001). There were four tiers system of governance: National, Zonal, District and Village. Yet, the power sharing between the central institutions of state and lower units was difficult, because decentralization meant central control of local units, top down development and upward accountability. In that sense, decentralization under Panchayat System appears to be the hybridization of de-concentration and delegation of administrative power and authorities rather than a true devolution (Dahal et al., 2001, p.40).

Even though process of decentralization started since 1960, significant change was witnessed only after the restoration of multiparty democracy in 1990s. The promulgation of new Local Self Government Acts (LSGA) 1999 and Regulation 2000, make provisions for decentralization to local bodies for the following assignments: expenditure assignment, revenue assignment, revenue sharing and the authority of local level borrowing. These are widely accepted as four fundamental pillars of fiscal decentralization (Cyan et al, 2009).

Nepal's local governance structure at present is two tiered with District Developments Committees (DDC) at the top tier and Municipalities and Village Development Committees (VDCs) at the bottom tier. As per the LSGA 1999, local bodies are managed by the elected bodies with the support of the administrative staffs of the government (Gyanwaly, 2004).

There exists big gap in revenue collection in different districts of the country. One study shows that 12 districts of Nepal contributed 94% of the total revenue collection, while remaining 63 districts contributed only 6% of the total revenue. Kathmandu districts alone contributed 42% of the total revenue (Aalen, L. and M. Hatlebakk.2008). At the moment, there is higher dependency of local governments on central government. The data for 2005/2006 reveals that only 8% of the total expenditures are with the authorities at local level with the remaining 92% in the hands of central government. Similarly central government collects 95% of all national revenue with only 5% collection by local bodies (Cyan et al, 2009). Such inequality of revenue collection might ultimately lead conflicts on revenue sharing and resources allocation within the federal states. On the other hand, redistribution of wealth from the wealthy state to poor state might also raise serious concern in the proposed federal states. There is often found disputes on natural resources allocation in the federal countries such as oil revenue allocation in Niger Delta in Nigeria, water conflict in some of the states in India etc.

With regard to the fiscal situation, the budget deficit has started declining gradually after 1990’s economic liberalization. Likewise, debt / GDP ratio is below 60% during two decades after 1990. Budget deficit is also under control, which was 3.5% of total GDP in 2009/10. It met the EU fiscal regulation of debt deficit not exceeding 60% of GDP and 3% of GDP respectively. During that period, nontax revenue as the percentage of GDP was stagnated around 2 to 3%, while tax revenue to the total GDP gradually increased. The following provisions have been made on revenue, expenditure assignments and intergovernmental transfer on LSGA 1999 and LSGR 2000.

4.1 Revenue assignments in Nepal: As per LSGA 1999, VDC and municipalities are allowed to impose different types of taxes such as: house and land tax, land revenue and tax or malpot, haat bazaar tax or local market tax/shop tax, vehicle tax registration, etc. Internal revenue sales and grants are the main sources of income of the VDCs, which also receive grants from GON, DDCs and donor partners (DPs). As per the revenue sharing principle, 25% of the tax collected from the land tax should be distributed to the DDCs, which are entitled to levy tax on roads, paths, bridges, irrigation, ditches, ponds constructed or maintained by them. Similarly, they can also
levy taxes on account of natural resource utilization. In addition, the DDCs may levy non-taxes as fee and charges. They are entitled to levy different types of service charges and fees for providing various public services to the people and can earn from the sale of their property (Cyan et al, 2009). Of the total tax collected from export and sales incomes from natural resources, 35-50% would have to transfer to the concerned VDCs and municipalities as stated in LSGR 2000. DDCs also generate revenues from other sources such as revenue sharing from the center. Such revenue sharing is guided by the principle of establishing territorial or jurisdictional rights to the local government wherever natural resources existed².

4.2 Intergovernmental fiscal transfer: Each VDC receives a minimum of 1.5 million rupees on an annual basis. On the other hand, additional grants are assigned to the local bodies on the various formulas. For VDCs, different variables and indicators are considered such as population, cost index and area; for municipality: population, area, ratios of administrative expenses and internal revenue are considered and for DDC: human development index, population, area and cost index are considered (table below). For VDC level unconditional block grants, 60% weight is given to the population; similarly 60% weight is covered by the population in municipal level unconditional block grant. However 20% weight is given to the population in the case of DDC’s level block grants, interestingly 50% weight is assigned to HDI.

4.3 Expenditure assignments: LSGA devolved the various roles and responsibilities to the local governments. In addition, central government also assigns the various roles to the LBs through the annual budget each year. The major areas devolved to the municipalities and VDCs as per the act are: drinking water, education, agriculture, sports, irrigation, tourism and cottage industries, infrastructure and transport, public health services, language and culture, Human resources development, forest and environment protection, implement the cooperative movement, public health services, language culture etc. Likewise, following responsibilities such as rural drinking water, hydro power, agriculture, agriculture road and transportation, land reform and land management, cottage industry, health services, tourism, information and communication, river control etc are assigned to DDCs. Despite sound decentralization policies, it could not be effectively implemented due to unclear delineation of the expenditure and revenue responsibilities to the local bodies, creating ambiguity in undertaking fiscal responsibility.

4.4 Existing budgetary practice in Nepal: Budget formulation in Nepal started since 1956 and presented to the parliament annually. Before 1990, under the absolute monarchy, the budgets were centrally planned with unclear development objectives. People’s participation on budget formulation and implementation was almost none. The budgets did not reflect the actual grassroot level problems, planning, needs etc, completely based on top down approach. After the restoration of multiparty democracy, people’s participation on budget development, formulation and implementation are highly encouraged. Both top down and bottom up approaches are taken into account for effective budget implementation. Despite positive move on budgetary formulation and implementation, there are still a lot of weaknesses. Because of poor coordination between central and local levels, the decentralization and power devolution remain only in words and not in practices. Lack of trained manpower and budget in local level etc are the main hindrances in budget making. In order to enter into federal system of governance, there is a need to address those weaknesses found in existing budgetary practices. Vertical and horizontal coordination and information sharing system between LBs and central government and devolution and decentralization of power sharing in practices will help to formulate effective budget.

<table>
<thead>
<tr>
<th>Design of formula on the following basis</th>
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<tbody>
<tr>
<td>Indicators/LBs</td>
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</tr>
<tr>
<td>Population</td>
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<td>Cost index</td>
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<td>Area</td>
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<td>Administrative index</td>
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<td>HDI</td>
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<td>Internal revenue</td>
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Source: Adapted from (Cyan et al, 2009).

² Center shares 50% of the hydroelectricity royalties, 50% of mining royalty, 30% tourism entrance fee and 10% royalty collected from forest product with the concerned DDCs. As per the rule, 12% royalty from the hydropower plant should be allotted to this district where the plant is located and remaining 38% should be shared with those districts, which are directly or indirectly affected by the operation of hydropower plants in this area.
5. Policy Recommendation

Establishment of an appropriate federal structure is the major challenge for political parties in Nepal. As stated above, there is wide disparity in revenue collection among the districts. Those states having revenue earning capacity will obviously be economically viable as compared to others not having sources of income such as natural resources, custom points and industries. Such differences are more likely to lead disparities among the states. So possible solution would be carving boundaries based on the economic viability of these states. Carving the states boundaries based on ethnicity and identity will not be economically sustainable and viable.

Issues such as number of states and their names, carving boundaries of the states, classification and management of natural resources, revenue sharing and resources allocation, reliable fiscal policy with regard to the proposed federal structures are highly debatable. But finding sustainable, efficient, equity based redistribution of resources that ensures and enhances welfare and prosperity among the sub national units should be at the center. Forming too many states, will further add financial burden to the states rather than make them economically strong. Only those states having sound financial and revenue base will highly benefit. In view of this, maximum 5 to 8 states based on north south vertical integration seems to be the most appropriate solution.

Regarding the fiscal federalism, how the expenditure assignments including the tax, intergovernmental transfer, and natural resources contributions are made between the different tiers of governments or constitutions units are important. Based on international experience, expenditures responsibilities are normally assigned to the state or local governments because they are closer to the local people and they understand better the taste and needs of the people. Tax responsibilities should be allocated to the states and central government in such a way that imposing tax by the authorities should not have distortionary impacts on the economy. Allocating tax to different layers of governments should ensure equity, efficiency and stability. Taxes and resources which have a base extending over the whole country, and which affects the economic life of the whole nation should be included in the federal list, and other taxes on the individual states and the impacts of which seldom go beyond the boundaries of a state should be allotted to the states governments. For instance, custom duties, corporate income tax, natural resource tax, excise duties etc normally should be imposed by the central government, while land tax, user charges, poll tax etc should remain with the local or state governments. Sometime some of these taxes can be jointly imposed by federal and state governments.

We have observed that in all federal countries of the world, the centre is financially stronger than the states. Generally revenue is assigned to the central government because of the administrative efficiency; on the other hand, expenditures are assigned to the states. Due to such allocation of task between central and state government, it has been found that revenue increment in federal level is far higher than the state level, and thus expenditures on the state level grow quickly than the other federal level. This trend creates fiscal imbalances in the economy. Such imbalances in the economy can be corrected by intergovernmental transfer from the central government to the state government. For instances, in India, the financial Commission is a constitutional body, which designs the formula and allocates. There is a need to develop simple devolution formulae to effectively address the nuances of imbalances. The more difficult a formula is to understand, the more likely it can be twisted or manipulated in implementation without anybody being able to tell the differences. Such types of autonomous constitutional body need to be formed, which works fairly for the betterment of the country.

Transfers of resource to the states are of usually three types: division of proceeds of certain tax, grants by the centers to the states and loans given by the center. Some percentages of proceeds of certain taxes should be shared between the center and states. There are certain taxes, which are levied and collected by the central government wholly and partially distributed to the states. Such distributions of tax proceed to the sub national government should be clearly mentioned in the constitutions, based on states contributions of taxes in the total revenue, needs of the states, populations, social backwardness, etc. When taxation devices are insufficient to correct the imbalance between the federal and state governments, grants are allotted on the basis of needs measured in terms of population, plans for welfare and development, and backwardness of the states.

Natural resources revenue normally comes from royalties, licenses fee, export tax and corporate tax. In Nigeria and Argentina, central governments collect the natural resource revenues, and are shared with the provincial
governments on the basis of population, equality of the states and principles of derivation (more revenue to
the resources owned states). Likewise, in Canada, provincial governments have complete control over the
natural resources. That is why, one of the province Alberta, has twice capacity of revenue raising than others
province in Canada. In most of the federal countries, central governments control the natural resources and
share them with the states or local governments. Similar mechanism need to be adopted in Nepal as well.
Central Government should collect revenue from major revenue sources such as hydropower, income tax,
corporate tax etc and share rationally with the states governments, so that it can contribute to promote
economic growth at the initial stage.

Election manifesto of three major political parties show that there exists much commonality in division of
powers and distribution of jurisdictions. There is already consensus among them that the foreign policy,
currency, national security, international trade, monetary policy and central bank, large hydropower, mega
projects, railways, airways, national highways, custom duty and others issues of national interest should be
controlled by the central government, whereas other issues like water, land, forest resources, education, health
etc should come under the jurisdiction of provincial government.

In the conclusion, while carving the boundaries, economical viability should be taken into account to lessen
the possible disputes in the future. Regarding the resources allocation and revenue sharing, we have to take
inferences from other federal countries and apply best practices that are suitable in our context. In most of
the cases, we have found that center takes control of all the revenues and royalties from natural resources and
distribute to all provinces or states on equality basis to reduce the existing gaps. In Nepal also, Center should
have full control of all revenues and royalties from natural resources and distribute them to the states
governments efficiently to reduce the inequality among states.

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There is wide disparity in revenue collection among the districts. Those states having greater revenue earning capacities will obviously be economically viable as compared to others not having sources of income such as natural resources, custom point and industries. This would lead to further disparities among the states. In view of this, carving boundaries based on the economic viability would seem to be the best possible options for deciding the numbers of federal states and in delineating their boundaries.

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