

Policy of Fiscal Federalism in Nepal with References of the Practices of Local Government

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Abstract

With promulgation of the constitution of Nepal in 2015, Nepal officially adopted a federal form of government as per as legal and constitutional framework. Constitutionally, Nepal follows the three levels of governance, federal, province and local. All levels of governments have certain economic rights to handle the policy and program in their catchment area. This study it analyzes the constitutional provision of fiscal federalism and the special rights of local government interim of financial rights like tax collection, budgeting making and other revenue sharing activities. Qualitative research design has been followed for this study and analyzed the data on the basis of qualitative paradigm, specially, interpretative mode of analysis. Only secondary source of data collected from library and internet study were used in this study. Findings and conclusion of this study have been based on discussions analysis of the legal provision and practice of fiscal federalism. On the basis of discussion, it is found that practice of fiscal federalism did not effectively practice in Nepal. Without proper fiscal federalism, federal government cannot deliver service to local people. The study will help to formulate plan and policy for proper use of financial federalism.

Keywords: Federalism, Local government, Fiscal finance, Practice

1. Introduction

Before the promulgation of the constitution of Nepal 2015 political system of Nepal was based on unitary form, however, interim constitution of Nepal 2006 sketched the federal system and abolished the monarchy as a symbol of unitary system of government. In this regards, interim constitution of Nepal 2007 part 17 "structure of state and local self-Governance" noted, "To bring an end to discrimination based on class, caste, language, gender, culture, religion and region by eliminating the centralized and unitary form of the State, the State shall be made inclusive and restructured into a progressive, Democratic Federal System. The final decision relating to the structure of the State and federal system shall be made by the Constituent Assembly. By taking the references of the condition of interim constitution political parties discussed the structure of federalism the constitution of Nepal 2015. Constitution of Nepal 2015 article 56 as "article 56. *Structure of State*: (1) The main structure of the Federal Democratic Republic of Nepal shall be of three levels, namely the Federation, the State and the Local level. (2) The Federation, State and Local levels shall exercise the power of State of Nepal pursuant to this Constitution and law" (p.44). The constitution not only poetically based division but also financially allocated the economic rights in these three administrative units (CBS, 2018). This study analyzes the fiscal federalism and its situation in Nepal by taking the references of local government. Main

objectives of this study are to analyze the constitutional legal provision related to local governance to exercise financial rights such as revenue collection, budget allocation and establishing relationship with state and province governance in an economic issue.

Fiscal federalism focuses on the distribution of resources to the lower units of government. In this regards Oates, (1972) highlights, fiscal federalism not only focuses on the rights but also forces to allocate resources to the local units" (24). Without fiscal decentralization local units cannot deliver the service to the local people. In the context of Nepal Adhikari (2019) notes that fiscal federalism could not work properly because federal government has hold most of the economic resources and only distributes few sources to the local government. MoF (2021) provides some suggestions for effective implementation of fiscal federalism in Nepal. Lack of confusion on policy, long run legacy of centralized government, culture of the high level government staffs fiscal federalism cannot work properly in Nepal.

2. Research Methodology

The study was based on a qualitative research design and provisions made on constitution and laws were the main subjects of discussion on the issue so that only secondary sources were used as data and these data were collected through library research and internet study. Collected information was systematically analyzed by taking the references of legal document and properly analyzed in according to context and situation. Constitution of Nepal (2015), local government operation act (2016), budget document 2022, and plans were the main sources of the secondary data. Interpretive paradigm was used to analyze the issue raised in this paper.

3. Study Area

Nepal is a new developing federal republic nation located in south Asia. The nation has adopted the federal system of governance before few years ago. Federal, provincial and local are three levels of governments are activated in Nepal that special administrative as well as financial rights. There are seven provinces, 753 local bodies (local Governments) and one federal government are in Nepal with certain special rights.

Figure 1: New Map of Republic Nepal



Source: <https://www.google.com/> adopted Feb, 20 2023

Fiscal federalism highlights the economic rights of local level that only worked an administrative unit of central government in the past. After the promulgation of new constitution, a local government has got certain constitutional and legal rights to do economic work like budget preparation, local tax and revenue collection. (MoF, 2019). The practice has been started since 2016 after restricted the local bodies in Nepal. The election of local bodies was held in 2017. Since the time local bodies of Nepal have been using certain constitutional and legal economic rights in its' catchment area. Various scholars and writers also studied about the issue of fiscal federal in Nepal by taking the references of fiscal democratization. In this regards Oates (1972) notes, "In principle, the most important benefit from fiscal decentralization is the increased efficiency and increase in welfare gain resulting from moving governance closer to the people as local government has best interest of its constituents" (p.6). Without proper budget a local government cannot work properly so, certain economic rights is necessary for the lower unit of the government in the line democratic system. He further noted, "Sub-national governments being closer to the people they are governing can respond to the preferences of the people in their area with tailored policies and budgets to achieve locale specific goals. It can also help foster political and administrative accountability of by empowering local governments" (p.5). Fiscal decentralization or financial federalization both help to increase the accountability, efficiency and effectiveness in resource mobilization that Sewell, (1996) states, "Fiscal decentralization can also help in efficient allocation of resources whereby sub-national governments can play pivotal role as they have better information regarding local level demand, needs, and expectations" (p.6). Fiscal federalism effectively works for resource mobilization and resource collection from the local level. Shah (2007) highlights that "Without fiscal federalism federal system of the government cannot work properly" (p.5). Soul of federalism remains on the economic issue without economic rights federal units cannot work properly in practice. Adhikari, (2019) notes, "In the context of Nepal fiscal federalism cannot properly practice due to various reasons like lack of practice, lack of skill and capacity of the management, political tussle and unclear policy also play a role on it" (p.56). Above reviews and comments show that fiscal federalism is not an easy task for the government. Nepal government prepared various laws for the constitutional provision as, Local Governance Operation Act (2017), National Natural Recourse and Fiscal Commission (NNRFC) Act (2017). These acts and policy tried to facilitate the fiscal federalism in Nepal, however there is still confusion of laws that goes on "seven provisions relating to the management of budget deficits and other fiscal discipline of the Federation, State and Local level shall be as provided for in the Federal law" (Local Governance Operation Act (2017)). The act also creates confusion because act cannot simplify the constitutional provision of tax collection. Constitution provision goes on:

Articles 60. Distribution of sources of revenue: (1) The Federation, State and Local level may impose taxes on matters falling within their respective jurisdiction and collect revenue from these sources. Provided that provisions relating to the imposition of taxes and collection of revenue on matters that fall within the Concurrent List and on matters that are not included in the List of any level shall be as determined by the Government of Nepal. (2) The Government of Nepal shall make provisions for the equitable distribution of the collected revenue to the Federation, State and Local level. (3) The amount of fiscal transfer receivable by the State and Local level shall be as recommended by the National Natural Resources and Fiscal Commission. (4) The Government of Nepal shall, on the basis of the need of expenditure and

revenue capacity, distribute fiscal equalization grants to the State and Local level. (5) Each State shall, in accordance with the State law, distribute fiscal equalization grants out of the grants received from the Government of Nepal and revenues collected from its sources, on the basis of the need of expenditure and revenue capacity of its subordinate Local level. (6) Provisions relating to distribution of conditional grants, complementary grants or special grants for other purposes to be provided by the Government of Nepal from the Federal Consolidated Fund shall be as provided for in the Federal law. (7) Distribution of revenues between the Federal, State and Local level shall be made in a balanced and transparent manner. (8) A Federal Act on the distribution of revenues shall be made having regard to the 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 fulfillment of temporary needs. (Constitution of Nepal, 2015)

Above constitution provision is confusing of tax collection because the role of local and state government role is only seen as supportive to the federal government. These bodies have certain rights but these rights are determined by the behavior of the federal government. On the other hand, local bodies have no capacity to use these rights because the institutional development and management skill is very weak in local bodies. In constitution there is a provision of separate independent constitutional body in Part- 26 National Natural Resources and Fiscal Commission article 250. "National Natural Resources and Fiscal Commission: (1) There shall be a National Natural Resources and Fiscal Commission of Nepal, consisting of a maximum of five members including a Chairperson" (Constitution of Nepal 2015). National resource and fiscal commission could not work properly in Nepal because the commission has no capacity to manage the system. The commission uses the data of national planning commission so that the function of the independent commission is duplication of national planning commission as if constitution has given the following rights to the National Natural Resources and Fiscal Commission as:

Article 251. Functions, duties and powers of National Natural Resources and Fiscal Commission: (1) The functions, duties and powers of the National Natural Resources and Fiscal Commission shall be as follows: (a) to determine detailed basis and modality for the distribution of revenues between the Federal, State and Local Governments out of the Federal Consolidated Fund in accordance with the Constitution and law, (b) to make recommendation about equalization grants to be provided to the State and Local Governments out of the Federal Consolidated Fund, (c) to conduct study and research work and prepare parameters as to conditional grants to be provided to the State and Local Governments in accordance with national policies and programs, norms/standards and situation of infrastructures, (d) to determine detailed basis and modality for the distribution of revenues between the State and Local Governments out of the State Consolidated Fund, (e) to recommend measures to meet expenditures of the Federal, State and Local Governments, and to reform revenue collection, to analyze macro-economic indicators and recommend ceiling of internal loans that the Federal, State and Local

Governments can borrow, (g) to review the bases for the distribution between the Federal and State Governments of revenues and recommend for revision, (h) to set bases for the determination of shares of the Government of Nepal, State Government and Local level in investments and returns, in the mobilization of natural resources, (i) to do study and research work on possible disputes that may arise between the Federation and the States, between States, between a State and a Local level, and between Local levels, and make suggestions to act in a coordinated manner for the prevention of such disputes. (2) The National Natural Resources and Fiscal Commission shall carry out necessary study and research work about environmental impact assessment required in the course of distribution of natural resources, and make recommendations to the Government of Nepal. (Constitution of Nepal 2015)

National Natural Resources and Fiscal Commission annually make the guidelines to allocate budget and distribute the revenue collected from VAT and other national resources, however, it hardly implements in practice. National Natural Resources and Fiscal Commission have no rights to check either the government allocates budget on the basis of guidelines or not. The commission uses various sources of data and evaluation report to make guidelines of budget distribution because it has not capacity to make guidelines on its ' data so that the role of National Natural Resources and Fiscal Commission are not effective on implementation of federalism in Nepal.

To implement the constitution in practical action Nepal government introduced the local governance operation act in 2016 through amendment of local self-government act 1999. In chapter nine of the law article 54 notes, "54. Not to impose tax, raise or acquire loan except as per the law: the rural municipality and municipality shall not impose, collect any tax and raise loan in its jurisdiction, except as per the law" (local governance operation act 2016). The act clearly notes local government collect tax from its' catchment area but only few local bodies collect the tax and revenue on the basis of act other local bodies only collect some titles. The confusion falls on annex- 7 (List of concurrent federal and provincial), Powers/Jurisdiction (RELATED TO ARTICLE 57(3), 109, 162 (4), AND 197). Like this there is confusion of SCHEDULE 9. List of concurrent Powers/Jurisdiction for Federation, Province and Local Level (RELATED TO 57 (5), 109, 162 (4), 197, 214 (2), 221 (2) AND 226 (1). In common rights to collect tax and revenue the federal government has been collecting the tax and local government cannot oppose the federal government because in part 20 it is mentioned domination of federal government on two government by making the provision" article 231 Federal law shall be formulated to be enforced across Nepal or to any region of Nepal according to the need". (Constitution of Nepal, 2015). It shows that federal government has rights to control both provincial and local governments because it has special legal rights to make law. However, Local Governance Operation Act 2016 makes provision to collect revenue from following;

Chapter- 10; Financial working procedures of the rural municipality and municipality 69. Local consolidated fund: (1) there shall remain a separate consolidated fund of every rural municipality and municipality. (2) The following amount shall be credited to the fund as per Sub-clause (1): (a) Funds received from Inland revenue and income, (b) Funds received from revenue sharing, (c) Grants and other amount received from the Government of Nepal, (d) Grants and other amount received from the provincial government, (e) Funds received from any individual, organization as donation, grant etc. (f) Funds provided from the foreign assistance received by the government for the

rural municipality and municipality based on national priority from foreign governments, agencies, association or individuals, (g) Grants and other funds received from another rural municipality and municipality (h) Funds received through domestic loan, (i) Funds to be received from any other source. (3) All the amount to be deposited into the fund of the rural municipality or municipality shall be deposited in the designated bank account. (Local Governance Operation Act 2016).

The Local government has above mentioned economic rights to collect economic resources from the local level. However, it is not possible to collect tax, revenue, fee from all titles because in some title federal government creates confusion and duplication or double in tax collection. The act has also provision for expenditure as:

(4) The provision related to expenditure of the amount deposited in the fund as per Subclause (1) shall be as per the local law, (5) While drafting law as per Sub-clause (5), it should be made as such that no amount shall be debited from the fund except the amount as follows: (a) The amount as per the annual budget approved to be spent from the consolidated fund by the Assembly. (b) In case of the annual budget being under consideration, the amount not exceeding one third of the expenditures allocated in the budget under consideration in the form of advance for daily operations, (c) The amount to be paid or submitted by the rural municipality or municipality as per the court's verdict, (d) The amount designated by the assembly for the emergency fund as per Clause (56). (e) The principal and interest of the loan taken by the rural municipality and municipality. 70. Emergency Fund: The rural municipality and municipality may establish and operate an emergency fund as per the local law. (Local Governance Operation Act (2016)).

The above-mentioned provision noted that the local government has enough rights to collect and spend the source by exercising local governance operation act 2016, however, except few local bodies most of the local bodies are depended on the budget allocates from the centre. Own resource is very nominal because there is a lack of source of local revenue and tax. During the time of restructure, it is not thought to properly divide the natural resources. In some local bodies source of natural resources is high and rest of the local bodies there is not enough natural resources to handle economic resources. In this context it is possible of economic discrimination and fiscal federalism to fall into the crisis.

4. Conclusion

Fiscal federalism is one of the challenging issues in Nepal in the federal system of government. Local bodies have no capacity to mobilize local resources so that the federal government manages the cost of local government through foreign loan therefore foreign loan is increasing in Nepal after implementation of federal system of government. Government has not effective mechanism to control local government therefore expenditure of local government is increasing day by day. Local government could not work as per the provision of constitution and law because federal and province government hold some rights of the local bodies without any legal guidelines. To get the popularity from development related work the political party leaders hold the development program that is legally run by the local level. In this context there are various challenges to properly implement the fiscal federalism in Nepal.

5. Recommendations

There is confusion of policy level therefore it should be clarified the confusion policy by law. Federal, province and local government should think about the constitutional and legal provision and implementing tax policy. It should be developed mutual understanding among three level of government to use natural resources and other resources mobilization



like construction of road in various local level. It should be developed cooperative culture among three level of government. Civil society should be conscious about the rights and responsibility of local government and play a role to support for the implementation of fiscal federalism in Nepal. Government timely identifies the policy level problems and prepares law in time.

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