Nepal's Fiscal Federalism Model in the New Constitution: Agenda for Amendments

Uma Shankar Prasad, Ph.D.*

Abstract

The first Constituent Assembly (CA) was dissolved without producing the constitution. The Constitution of Nepal as Federal Democratic Republic was promulgated on September 20, 2015 by the second CA. The primary objective of this study is to review the modality presented in the new constitution on the natural resources, economic rights and revenue allocation and recommend some amendments. The study finds that the fiscal decentralization initiatives have not been successful in minimizing the political, social, economic, regional and ethnic inequalities inherent for nearly 240 years of a unitary system of governance in Nepal. The study recommends: VAT and income taxes will have to be collected concurrently at both the central and sub-national levels. Other taxes including excise duties will have to be collected by the sub-national governments which will support the expenditure responsibilities of the sub-national governments adequately in federal Nepal. Intergovernmental transfer modality has to be included in the constitution. A Federal Finance Commission (FFC) and the National Planning Commission will have to be constituted at the central level to make national level development plans and to make recommendations for additional grants and loans. A State Planning Commission (SPC) and a State Finance Commission can be established in each state to prepare state development plans and to deal with the transfers to be made to local bodies.

Key Words: Fiscal federalism, Constituent assembly, Constitution, Decentralization, Revenue assignment, Expenditure assignment, Public sector, Local government

JEL Classification: E62, H71, H72, H76, H77

* Associate Professor, Central Department of Economics (CEDECON), Tribhuvan University, Nepal. Mobile: 9803575453, Residence Phone: 00977-1-4282363, umashankarceda@gmail.com

I. INTRODUCTION

The fundamental limitation of a unitary form of government is its informational and political constraints to meet diverse preferences among the residents of all communities in the country. A federal structure of governance promotes decentralized decision-making through a system of voluntary self-rule and shared rule (Watts, 1999). The federal system is conducive to greater freedom of choice, diversity of preferences in public services, political participation, innovation and accountability (Oates, 1972; Musgrave, 1985; Rao, 1997; Bird, 2002; Dafflon, 2006; Boadway and Shah, 2009). Various units will try different approaches to problems and the successful technique will be adopted by other units (Due and Friedlaender, 1994).

There is no globally accepted specific model for fiscal federalism. It depends on country specific geo-political and socio-economic circumstances with the aim of achieving the policy objectives of that particular country. The objectives include efficiency, equity, stabilization as well as regional balance, national integrity and political stability (Bird, 2002). One is the resolution of conflict between local and national preferences (Due and Friedlaender, 1994).

Nepal is a multi-ethnic, multi-lingual, multi-religious and multi-cultural country. After stagnant fiscal decentralization policies practiced over six decades dating back to 1950s, the Constitution 2015 has established Nepal a Federal Democratic Republic state. The first CA was dissolved after four years on May 28, 2012 without producing the constitution. The full-fledged constitution is promulgated on September 20, 2015 by the second CA as the commitment made by all political parties. The production of the new constitution is supposed to end all kinds of discriminations based on ethnicity, class, caste, language, gender, culture, religion and region. The new constitution has formally eliminated the centralized and unitary form of the state.

Being an unevenly distributed revenue base and natural resources, the demarcation of functions and finances (taxes and expenditures) between the centre, the states, and the local level has to be discussed by the leaders, policy makers, intellectuals and the people. The well-design fiscal arrangements for federal Nepal have become necessary.

The Federal Democratic Republic Constitution of Nepal 2015 has provided the model of fiscal federalism based on the recommendation presented by the Committee on Natural Resources, Economic Rights and Revenue Allocation. The strengths and weaknesses of the model by the independent researchers and intellectuals have not been studied adequately. However, some studies are conducted to sketch the fiscal model for the federal Nepal. In this context, this paper tries to critically analyse the pros and cons of the fiscal federalism model of Nepal presented in the new constitution 2015 and attempts to recommend the amendments required in the model by analysing the lessons learned from the federal states. The recommendations are expected to be supportive for the government in establishing the proper fiscal federalism model for federal Nepal.

II. METHODOLOGY

This study is an analytical study based on the application of macroeconomic theory of the public sector. The study is based on secondary data. Data published from various government and non-government organizations are used to analyze the situation. Economic surveys, budget speeches and plan documents published by the Ministry of Finance and the National Planning Commission and various reports published by the Local Body Fiscal Commission and Financial Comptroller General Office are the major sources of statistical information. Apart from this, reports published by the World Bank and UNDP are also taken under consideration.

III. FISCAL FEDERALISM: THEORETICAL PERSPECTIVES

Decentralization has become a global model of strengthening local governments. The proponents of decentralization policies believe that decentralization brings public services closer to the people. People have more opportunities to participate actively in decision-making process of local policies and activities than in centrally decided. This is sometimes known as preference-matching argument. It increases the greater efficiency and accountability of local governments. It enhances the democracy and protection of liberty. The decentralized system of governance has the greater ability to protect the rights and values of minority populations (Oates, 1972; Kalin, 2010). It increases the legitimacy of the local governments. It enhances economic efficiency of intergovernmental competition which often starts with the well-known Tiebout model. In this approach, different local governments offer different public tax-expenditure bundles and mobile individuals are supposed to allocate themselves according to their preferences (Bardhan, 2006).

The critics of decentralization policies argue that there are many problems with decentralized governance. However, the critics' arguments seem to be weak in comparison to supporters' arguments. The critics believe that the problems related to the local governance are: lack of resources, lack of democratically elected local authorities, lack of transparency and accountability, excessive control etc. (Kalin, 2010). The local governments have some power to levy local taxes and fees but these are difficult to collect. Local authorities often lack qualified and well-trained staff and therefore are unable to perform properly even if money is available. The information and accounting system and monitoring public bureaucrats are much weaker in developing countries.

The sceptics claim that decentralization may foster local and regional identities than the national identity. It puts national integrity in risk. Local autonomy may be manipulated by local elites for seeking their narrow personal benefits at the cost of general population who and the need of enhanced livelihood. Decentralization may increase corruption at local level. The increased efficiency and effectiveness of public resources may not be realized.

Components of fiscal federalism

The literature on fiscal federalism has been strongly influenced by the geo-political context in which it originated. The traditional normative approach of fiscal federalism was based on the assumption of a benevolent government. Much of the recent literature drops this assumption and takes government and politicians and officials as self-interested players. Thus, the normative approach has largely given way to a political economy approach (Ahmad and Brosio, 2006).

Revenue assignments

Decentralizing revenue-raising responsibilities is one of the most controversial issues in fiscal federalism. The proponents of decentralizing revenue-raising powers advocate that each government unit should be able to raise the revenues to finance its expenditures as an important precondition for stable intergovernmental competition in federations. Meaningful fiscal decentralization requires significant subnational taxing powers. It increases fiscal autonomy, efficiency and accountability (Oates, 1972; Rao, 1997; Bird, 2002; Dafflon, 2006; Bardhan, 2006; Ambrosanio and Bordignon, 2006; Boadway and Shah, 2009).

Critics argue that decentralized tax system can interfere with the efficiency of the economic union. The uncoordinated of setting of taxes is likely to result in state tax systems that differ either in their rate structures or in the definition of their bases. The situation ultimately leads to distortions in markets for resources and commodities that are mobile across states. Differences in tax structures can also increase the administrative and compliance costs. Decentralized taxes can also interfere with the achievement of redistributive equity. The possibilities for evasion and avoidance also increase (Boadway and Shah, 2009). In most developing and transitional economies, local governments do not have significant tax collection powers. Richer and larger countries are usually more decentralized in terms of revenue assignments.

Traditional normative approach advanced by Musgrave and Oates and public choice approach developed by Brennam and Buchanan argue that local governments should levy taxes on relative immobile bases or assets, in order to prevent tax competition and revenue losses. It is argued that the broad and mobile tax bases may be assigned to the central government for stabilization and redistribution reasons. The sub-national governments may raise revenues through user charges, benefit taxes, and taxes on relatively less mobile taxes (Musgrave, 1985; Rao, 1997).

The traditional theory of tax assignment is now being extended to political economy setting 'A Second-Generation Theory of Fiscal Federalism' (Oates, 2005). Under political economy model, the observed tax assignment in a federation is the outcome of a bargaining between different levels of government to raise their respective share of taxing powers. In this particular context, no universally accepted theory of tax assignment exists in economic literature.

In most federal system of government, taxes on international trade (custom duties) are levied at the central level. Taxes on the consumption of goods and services are levied at both the central and sub-national levels. In Canada, the federal government levies value added tax and provinces levy retail sales taxes. Brazil levies VAT at both the central and state levels. In India, the central government levies excise duties on manufactured products while the states levy taxes on the sale and purchase of goods.

At the manufacturing stage VAT is levied by the central government and destination-based VAT up to the retail stage is levied by the states. In Switzerland, the greater taxing powers are with the Cantons i.e. the revenue of the Cantons is nearly 80 per cent of the total tax revenue of the country.

The supporters of decentralized system of revenue from natural resources believe that since the natural resource rent is the income in excess to cover the costs required to cover all inputs (roads; airports; ports; upgraded schools, health and social services; environmental protection etc.), and all these input responsibilities are under the jurisdiction of subnational governments, the revenue assignment should be assigned to the subnational governments for both efficiency and equity considerations. Further, they consider that sharing of rents with all level of governments foster competition (Brosio, 2006).

The sceptics argue regarding the inefficiency in the geographical allocation of factors of production which derives from the concentration of rent. The geographical concentration of rent makes its amount disproportionate to the absorption capacity of subnational government units. It may derive misspending and corruption. Ultimately, the subnational governments may spend it in distortionary ways (Brosio, 2006).

Expenditure assignments

Under the federal system, a significant legislative authority is provided to the lower levels of government. There has been wide range of consensus among the fiscal federalist around the globe in respect to decentralizing the expenditure responsibilities. The proponents of decentralized expenditure responsibilities advocate that a decentralized body is more accessible, more sympathetic and quicker to respond to local needs. It provides close between citizens and governments. Government resources can be allocated more efficiently and reduce costs. Decentralization removes institutional and legal obstacles. It enhances the sense of ownership and responsibility. It encourages the local population to carefully plan, monitor and protect the results (Musgrave, 1985; Rao, 1997; Bird, 2002; Dafflon, 2006; Boadway and Shah, 2009).

Charles Tiebout (1956) argued that the preferred amount and type of local public goods provided to a given locality depends on the tastes and needs of local residents. Local governments are likely to be in a better position to match their provision with local preferences (Boadway and Shah, 2009). Citizens and consumers move their residence to those jurisdictions that offer them with the quantity and quality of services that they are looking for at the lowest cost which is known as ‘voting with their feet’ in fiscal federalism literature (Ahmad and Brosio, 2006).

Allocation, redistribution and stabilization are three functions of the government. Musgrave (1985) argued that the latter two are the primary responsibility of the central government. Therefore, the central government usually plays a major role in providing pure public good like national defence. Clearly, some functions like stabilization policy, monetary policy, income redistribution policy and justice, foreign affairs, international trade, cultural and communications policy, strategic investments and investment policy must be performed at the national level by the federal government.

Federal government can also play a key planning and financing role in major infrastructure but implementation may be by sub-national governments. However, the central government should focus its role on nationally significant infrastructure like railways and airlines. Federal government can play a major role in shaping health and education programmes.

It is believed that sub-national governments have a comparative advantage in implementing expenditure programmes. The expenditure responsibilities of providing quasi-public good like internal security, maintaining law and order, providing social services like education, health care, family welfare, housing and social security and development of economic services like agriculture, infrastructure, irrigation, power, public works, forestry, fisheries etc. should be assigned to the sub-national governments.

Major components of education and health care are decentralized to the states. In most of the federal countries, state governments provide primary and secondary education. However, university education may be provided by the central government, especially in countries where student mobility tends to be high. In the similar way, certain components of health care like research and doctor training may be delivered by the central government.

Intergovernmental fiscal transfer

The logic of centralizing revenue collection is generally stronger than that of centralizing expenditure responsibilities all over the world. The share of social sector expenditures in total spending is very high in modern welfare states and these responsibilities are usually heavily borne by constituent unit governments with some federal assistance. In this background, virtually every country faces the problem of fundamental imbalance between expenditures and revenues. Therefore, the need for intergovernmental fiscal transfers arises to close the budgetary gap. No simple and uniform pattern of transfers will be suitable for all circumstances.

Specific-purpose (conditional) transfers are intended to provide incentives for governments to undertake specific programmes. These transfers may be regular or mandatory or discretionary or ad hoc. Conditional transfers are particularly based on both input-based as well as output-based conditionality.

Fiscal transfers are particularly important in federations that do not have extensive tax sharing. Fiscal transfers are, therefore, alternative to tax devolution. Fiscal transfers can be of legal entitlements, discretionary, conditional and unconditional. Large grants are legal entitlements in many federations. Conditional grants encourage sub-national governments to spend more on programmes which are prioritized by the federal government.

Fiscal transfer based on discretionary or negotiations are undesirable. The formula-based distribution is regarded as a sound transfer system. Formulas should not be too complex and desired degree of inter-jurisdictional equalization can be built into such a formula (Bird, 2002).

IV. NEPAL'S STAGNANT FISCAL DECENTRALIZATION PRACTICES

Political and administrative decentralization practices: significant achievements

Historically, the political foundation of modern Nepal was laid only in 1768 with Prithvi Narayan Sah's conquest of Kathmandu valley known as unification of Nepalese state in the history of Nepal. In 1846, the autocratic Rana rule emerged with the advent of Jung Bahadur Rana, the first Rana prime minister of Nepal. The Rana rulers ruled over the country for more than one century. The administration was highly centralized. They hardly spared any thought for systematic socio-economic development of the country, except a few cases of sporadic attempts like the founding of first undergraduate college in Kathmandu valley in 1918 and the setting up of the first commercial bank in 1937. After abolition of the Rana regime in 1951, Nepal initiated towards planned development. The economic development on a planned basis in Nepal started with the launching of First Five Year Plan covering the period from 1956/57 to 1960/61.

The first attempt of decentralization initiative in Nepal started in 1954 through the creation of local governments called Panchayat. The Panchayat governments were created at the district, municipal and village levels. The country was divided into 75 districts. In 1974, further step was initiated by dividing the country into 14 zones and 4 development regions. The Decentralization Act 1982 and Regulation 1984 was another attempt.

The far-reaching initiative towards decentralization evolved after the restoration of democracy through the peoples' movement in 1990. The movement replaced the absolute monarchy by the constitutional monarchy. The District Development Committee (DDC) Act, VDC Act and Municipality Act were amended in 1991 and 1992. The government promulgated the Local Self Governance Act (LSGA) 1999 and Local Self Governance Legislation 2000 based on constitutional provisions. The LSGA has provided the foundation of policies and principles of devolving the rights, responsibilities, accountability and resources to make the local bodies efficient and effective at least in paper. The first Local Bodies Fiscal Commission was created in 2000 under the Ministry of Local Development. The Local Self Government Financial Regulation was adopted in 2007 to look after the local government financial system. The LSGA has also created three national level associations-Associations of District Development Committees in Nepal (ADDCN), National Association of Villages in Nepal (NAVIN) and Municipal Association of Nepal (MUAN) of local bodies.

The LSGA 1999 has provided the various types of expenditure and revenue collection responsibilities to the local levels. The LSGA 1999, LSGR 2000 and LSGFR 2007 have defined the local revenue assignment and its operational details. The VDCs are assigned to collect house and land tax, land revenue (*Malpot*), local market tax/shop tax (*Haat*

Bazzar tax), vehicle tax (registration, renewal and lump sum), entertainment tax, Bahal Bitauri tax (the taxes on small infrastructures built and maintained by VDCs or municipalities and used by small business holders) based on rent tenancy, advertisement tax, business means tax, commercial video tax, natural resource utilization tax and other taxes like collection and savings tax. The bases of these taxes are defined and fixed by LSGA 1999. The rates are defined by LSGR 2000 except *Haat Bazzar* and shop tax that can be defined by Village Development Council (ADB, 2009).

The municipalities are entitled to levy and collect house and land tax or integrated property tax, land revenue (*Malpot*), local market tax/shop tax (*Haat Bazzar tax*), vehicle tax (registration, renewal and lump sum), entertainment tax (collected from cinemas, video halls, cultural show halls, magic shows and circus), Bahal Bitauri tax (the taxes on small infrastructures built and maintained by VDCs or municipalities and used by small business holders) based on rent tenancy, advertisement tax, business means tax (on industry, trade, profession or occupation), commercial video tax, and other taxes like collection and savings tax and enterprise tax. The definitions of the base and rate with a few exceptions are given in the law. In most cases, rate caps are prescribed by the central government (ADB, 2009).

DDCs are allowed to collect tax on use of infrastructures (roads, paths, bridges, irrigation, ditches, ponds) constructed or maintained by them, tax on business use of natural resources (wool, turpentine, herbs, worn and torn goods, stones, slates, sand and bone, horn, wing, and leather of animals except those are prohibited), tax on export from district, tax on re-usable products and tax on re-cycling and re-usable goods. DDCs can also levy non-taxes as charges and fees for services. The DDC at the first tier has been given the power to define tax bases and rate caps (ADB, 2009).

The local bodies are not entitled to define tax bases in Nepal. Regarding the tax rates, caps are defined by the law. The local bodies have no power to make changes in LSGA and LSGR. In this particular context, a small number of local bodies are able to collect sufficient taxes. They have very narrow tax base. The situation has compelled them to depend on central transfers.

The LSGA 1999 has provided the various types of expenditure responsibilities to the local levels. The act has assigned 16 categories of expenditure responsibilities to District Development Committees (DDCs) and 11 categories of responsibilities each to Village Development Committees (VDCs) and municipalities. The expenditure assignment to DDCs, VDCs and Municipalities by LSGA include 1) agriculture, 2) drinking water, sanitation, habitat development, 3) hydropower, 4) work and transport, 5) land reform and land management (except VDC), 6) development of women and helpless people, 7) forest and environment, 8) education and sport, 9) wages for labour (except municipality), 10) irrigation and soil erosion and river control, 11) information and communication, 12) language and culture, 13) cottage industry, 15) health service, 16) tourism, 17) physical development (except district), 18) finance, 19) legal and 20) public safety. From 2001/02, the government has started the piloting of full devolution of some components like-basic health up to sub-health posts, primary education, agriculture extension including livestock services, small rural infrastructure and postal service. However, the expenditure responsibilities handed over to the local bodies has become a lip service. Only a few of them are implemented due to the lack of political will and resources.

The responsibilities assigned to DDCs include district level health services, protection and promotion of natural beauties, settlement and market development in rural areas, social welfare activities related to women, child, disabled, preparing district database, working against natural calamities etc. The village bodies according to the act have the duty of managing village health services; development and protection of tourist areas; pollution control; criteria development for housing, rest house, public toilet, garden, park, roads, sewage and drainage; land utilization development of village; human resource development; promotion of employment; vital registration etc. However, some responsibilities assigned to the central government are transferred to local bodies and some are assigned to local bodies but are transferred to the central government (ADB, 2009). However, the allocation of public expenditure between regions and districts is highly influenced by political forces. Political forces influence the provision of LSGA and the control of central authority has been continuing.

Stagnant fiscal decentralization practices

Existing expenditure and revenue structure of the local government

The central government collects the major part of taxes and the collected taxes are distributed in a prescribed manner in Nepal. Some taxes are assigned to collect by local bodies which constitute a small proportion of total taxes. There is high disparity in tax collection. The Central Development Region collects around 80 per cent of total revenue which includes the contribution of custom duties. Even if custom is taken out, the share of the Central Development Region will be high. The concentration of tax collection will have to be neutralized in federal Nepal. The local governments in Nepal have a weak revenue base relative to their expenditure responsibilities.

The expenditure of local level at VDCs, DDCs and municipalities is very small in comparison to total government expenditure. In the fiscal year 2013/14, expenditure of the local level was only 8 per cent of total government expenditure (LBFC, 2015). The revenue generated by the local levels is not sufficient to meet their expenditure responsibilities. In the fiscal year 2013/14, the share of local body's revenue was only 12.1 per cent of total revenue collection of the government (LBFC, 2015).

Local governments in most federations have a weak revenue base relative to their expenditure responsibilities. Therefore, the local governments highly depend on transfers. However, in Switzerland the communes raise about one third of total taxes raised in the country. In many federations like Brazil, India, South Africa-municipalities, i.e., the third tier of the government has various rights and responsibilities defined by the constitution.

The current scenario of intergovernmental transfer in Nepal is guided by the political or electoral theory of public expenditure which explains that trend in public expenditure depends on electoral preferences of politicians. The transfer scheme has not been systematic and effective. The Ministry of Finance directly provides fiscal transfer as a grant to DDCs, municipalities and VDCs. The current grant allocation methodology to the local bodies is:

Y=a+bX (Total grant = Minimum grant + Additional grant)

Where,

a = Minimum grant (VDC 1.5 million, Municipalities 3.0 million and DDC 4.0 million)

X = Explanatory/ expenditure need variables used in grant distribution such as population, area, poverty, etc. (X applies only in additional grant)

B = Coefficient of expenditure need variables

Table 1: Expenditure needs variables and their weight (%)

	VDCs	Municipalities	DDCs
Population	60	50	40
Weighted poverty	-	25	25
Area	10	10	10
Weighted cost	30	-	25
Weighted tax effort	-	15	-
Total	**100**	**100**	**100**

Source: Local Bodies Fiscal Commission, 2015

Need of federalism felt in connection to fiscal issues

For nearly 240 years of a unitary system of governance, Dalit, Janjati, Madhesi, Muslim, persons with disability, people of Karnali zone and women have been identified as socially and politically excluded groups in Nepal.

All these excluded groups have very low participation in governance from the very beginning. The proportion of Brahman, Chhetri, and Newar in all the bodies of governance: main political parties, cabinet, parliament, legislature, judiciary, civil service has been dominant and has increased over time. Their dominance in civil service increased from 70 to 90 per cent between 1985 and 2002 (DFID and the World Bank, 2006).

There are wide variations in poverty level based on rural-urban divide, geography, gender, ethnic groups and occupational castes. The Terai/Madheshi Dalits[1] are the poorest of the poor among ethnic groups in Nepal. About 80 per cent of the Madheshi Dalits live below the poverty line. The vulnerability of Dalits is not simply due to their poverty,

1 Chamar/Harijan, Musahar, Dushadh/Paswan, Tatma, Khatwe, Dhobi, Baantar, Chidimar, Dom, Halkhor.

economical status, or lack of education, but is a result of the severe exploitation and suppression by the upper classes.

Nepal has made significant progress over the past two decades in terms of human development indicators. Despite significant progress, human development indicators are still low with significant urban-rural, caste-ethnicity, gender and geographical variations. Nepal's Human Development varies more widely by caste and ethnicity. For every Human Development Indicators, Dalits Janjatis and Muslims fall below the national average. The Madhesi Dalits who constitute about 5 per cent of Nepal’s total population has lowest HDI value followed by hill Dalits.

Human Development Indicators clearly show existing gender disparities in Nepal. For example, despite significant progress, the adult literacy rate of women in 2011 was just half of men (UNDP, 2014). This was also visible in the indicator for average years of schooling. Representation of Nepalese women in civil and all three levels of elected government lag far behind that of men. Women representation in civil service and officer level is very low compared to men.

The culture of sharing wealth among ecological as well as development regions has not been encouraging to reduce regional disparities. The sense of national solidarity has not been influential. The emphasis on self-reliance has been prevailing in development process and allocation of resources.

Regional inequality inherent in Nepal was one of the major causes for the need of federalism. The economic literature suggests that public expenditure should be directed more towards the less developed regions. The issue of regional differences in public expenditure has been critical in Nepal. Per capita government expenditure across regions remains highly unequal which is undesirable for egalitarian and just Nepal.

Table 2: Share of public expenditures by development regions

Region	% share of population in 2011	% share of public expenditures			Growth rate of public expenditures	
		2001/02	2006/07	2011/12	2001/02-2006/07	2006/07-2011/12
• Eastern	21.9	11.2	9.8	11.8	47.0	132.3
• Central	36.5	66.3	67.4	61.5	70.6	77.4
• Western	18.6	9.8	9.7	11.0	65.2	121.0
• Mid-western	13.5	7.6	8.0	9.7	77.4	135.6
• Far-western	9.6	5.0	5.0	5.9	66.8	131.0
Nepal	**100.0**	**100**	**100.0**	**100.0**	**67.7**	**94.4**

Source: Consolidated Financial Statements, Various Issues, Financial Comptroller General Office, GoN

National Population and Housing Census (NPHC): National Report, Central Bureau of Statistics, Government of Nepal, 2014

Table 2 refers that there is wide variation in the public expenditures in Nepal. The share of public expenditures for the Central Development Region is higher than that of population. In federal Nepal, these disparities in public expenditures will need to be addressed.

Table 3: Per capita public expenditure and HDI by development regions

Region	Per capita public expenditure			Growth rate		Human development index (HDI)		
	2001/02	2006/07	2011/12	2001/02-2006/07	2006/07-2011/12	2000	2011	% Change
• Eastern	1,673	2,205	4,706	31.8	113.4	0.484	0.542	12.0
• Central	6,576	9,611	15,882	46.2	65.2	0.493	0.558	13.2
• Western	1,714	2,526	5,136	47.4	103.3	0.479	0.553	15.4
• Mid-western	2,010	3,117	6,810	55.1	118.5	0.402	0.503	25.1
• Far-western	1,819	2,667	5,612	46.6	110.4	0.385	0.493	28.1
Nepal	**3,441**	**5,050**	**9085**	**46.8**	**79.9**	**0.466**	**0.541**	**16.1**

Source: *Consolidated Financial Statements, Various Issues, Financial Comptroller General Office, GoN*

Nepal Human Development Report (NHDR), National Planning Commission Government of Nepal and United Nations Development Programme, 2014

The data presented in Table 3 reveals that the percentage growth in per capita government expenditure has not been consistent with percentage change in human development index across the development regions.

V. MODEL OF ECONOMIC RIGHTS AND REVENUE ALLOCATION IN THE NEW CONSTITUTION: CRITICAL EVALUATION

The Constitution of Nepal 2015 has provided the following responsibilities of the allocation of revenue among the different level of governments.

Table 4: Allocation of revenue among the different level of governments

Source of Revenue	**Federal**	**Province**	**Local**
Custom duty	□		
Value Added Tax	□		
Excise Duty	□		
Corporate Income Tax	□		
Personal Income Tax	□		
Payroll Tax	□		
Passport Fee	□		
Visa Fee	□		
Entertainment Tax		□	□
Advertisement Tax		□	□
Registration Charge of Land and House		□	□
Land Tax (Land Revenue)			□
Property Tax			□
Business Tax			□
Vehicle Tax			□
House Rent Tax			□
Service Charge	□	□	□
Punishment and Fine	□	□	□
Tourism Charge	□	□	□

Source: The Constitution of Nepal, 2015

Sharing tax revenue: corrective measures

The Constitution has clearly assigned the revenue sharing mechanism between three layers of government in Nepal. The major sources of revenue custom duty, value added tax (VAT), excise duty, corporate income tax, and personal income tax which comprise around 80 per cent of total tax revenue are assigned to be collected by the central government.

The state and local level governments are assigned to collect entertainment tax, advertisement tax and registration charge of land and house concurrently. Property tax, land revenue, vehicle tax, business tax and house rent tax is assigned to be collected by the local level. The service charges, punishment and fine and tourism charge will be collected concurrently by all three levels of governments (Table 4).

The above modality reflects that around 90 per cent of total tax revenue would be under the jurisdiction of the central government. Since custom duties (export and import duties) are collected by the central government by nature, VAT and income taxes will have to be collected concurrently by both the central and the sub-national governments. The other taxes including excise duties will have to be collected by the sub-national governments which will support the expenditure responsibilities of the sub-national governments adequately.

Sharing non-tax Revenue: corrective measures

Non-tax revenues are the financing sources most consistent with the efficiency goals of a decentralized system. Therefore, user charges, one of the major parts of non-tax revenues should be assigned to the local governments.

Receipts from sale of public commodities and services have been more or less the largest source of non-tax revenue in Nepal for last thirty years. This source includes charges for drinking water, education, electricity, postal services, irrigation and transport. Further, it consists of receipts from the sale of forest products, food and agricultural products etc.

Supply of public utilities can be a powerful instrument to achieve equity in society by supplying these goods to the poor at cheaper rate. But the service of public utilities in Nepal is biased in favour of non-poor. These services are limited to the urban and better-off population. The price of these services is identical for all. The majority of rural population are deprived from the services of electricity, drinking water and transport which has been a major political issue in Nepal.

Dividend and principal and interest payments include the receipts obtained from PEs. The government has invested a massive amount in PEs in form of share capital, loan capital, operating/transport subsidy and capital subsidy. But the share in non-tax revenue from principal and interest payments has been decreasing significantly in recent years because of privatization policy adopted by the government.

Therefore, non-tax revenues derived from the activities of the central government like corporate debt servicing will go to the central government whereas non-tax revenues collected from user charges will have to be assigned to the local governments in federal Nepal.

Sharing natural resources revenues

Natural resource revenues are very different from other sources. Some natural resources are variable between federation and sub-national governments within federation. But most are immobile. Since most of the natural resources are immobile, revenues from these resources can be assigned to the local levels. However, resources are almost concentrated in only some parts of the country, tensions could arise in sharing process.

Australia, Canada and the United States give control of natural resources and revenues predominantly to the sub-national governments. Some federations have made some sharing arrangements with sub-national governments and even the local governments.

Revenue sharing from hydropower will be a controversial issue in Nepal. Hydropower resources are highly concentrated in a small number of hill and mountain areas. It will create conflict if the revenues generated from hydropower will not be shared by wide discussion and after national consensus. The royalties of hydroelectricity could be shared by the sub-national governments and local level. Profits and taxes of hydropower will go to the central government. The National Natural Resource Commission will be responsible for the distribution of revenues generated from natural resources.

Proposed institutional arrangements and corrective measures required

The Constitution has the provision of two independent constitutional bodies (National Natural Resource Commission and National Finance Commission) to look after the fiscal matters and the management of natural resources. Both of the commissions will have maximum three members including the chairperson. The model of intergovernmental transfer has not been presented in the constitution.

However, a three-tier institutional set-up may be useful, for which constitutional provisioning is needed. First, a Federal Finance Commission (FFC) will have to be established. Second, the National Planning Commission (NPC) will have to be constituted to make national level development plans and to make recommendations for additional grants and loans. Third, at state level, a State Planning Commission (SPC) can be established in each state to prepare state development plans. Fourth, a State Finance Commission in each state may be established to deal with the transfers to be made to local bodies.

VI. CONCLUSION AND RECOMMENDATION

The whole analysis reflects that Nepal has made substantial achievements towards the political as well as administrative decentralization practices during the last six decades dating back to 1950s. However, the fiscal decentralization practices have been stagnant. The progress has not been encouraging in strengthening the role of local governments in development process. The fiscal decentralization initiatives have almost-failed in minimizing the political, social, economic, regional and ethnic inequalities inherent for nearly 240 years of a unitary system of governance.

The Constitution 2015 has many positive aspects on the issues of Natural Resources, Economic Rights and Revenue Allocation. However, some provisions seem to be incompatible with the global fiscal federalism practices.

The major sources of revenue custom duty, value added tax (VAT), corporate income tax, excise duty and personal income tax which comprise around 80 per cent of total tax revenue are assigned to be collected by the central government. The service charges, punishment and fines and tourism charge are assigned to be collected concurrently by all three levels of governments. In this modality, around 90 per cent of total tax revenue will be under the jurisdiction of the central government. The custom duties by nature have to be collected by the federal government. Therefore, VAT and income taxes will have to be collected concurrently at both the central and sub-national levels. Other taxes including excise duties will have to be collected by the sub-national governments which will support the expenditure responsibilities of the sub-national governments adequately.

Non-tax revenues derived from the activities of the central government like corporate debt servicing will go to the central government whereas non-tax revenues collected from user charges will have to be assigned to the local governments.

Revenue sharing from hydropower will be a controversial issue in Nepal. Hydropower resources are highly concentrated in a small number of hill and mountain areas. It will create conflict if the revenues generated from hydropower will not be shared by wide discussion and after national consensus. The royalties of hydroelectricity could be shared by the sub-national governments and local level. Profits and taxes of hydropower will go to the central government.

Intergovernmental transfer in Nepal has not been systematic and effective. It is highly influenced by the political domination theory. The Ministry of Finance directly provides fiscal transfer as a grant to DDCs, municipalities and VDCs. irrespective of their human development situation, development status and expenditure need. Therefore, clear modality needs to be explored.

The Constitution has the provision of two commissions: National Natural Resources Commission and National Finance Commission. However, a three-tier institutional set-up may be useful, for which constitutional provisioning is needed. A Federal Finance Commission (FFC) and the National Planning Commission will have to be constituted at the central level to make national level development plans and to make recommendations for additional grants and loans. A State Planning Commission (SPC) and a State Finance Commission can be established in each state to prepare state development plans and to deal with the transfers to be made to local bodies.

REFERENCES

ADB. 2009. *Nepal's Choices in Fiscal Federalism*, Kathmandu: Asian Development Bank

Ahmad, Ehtisham and Giorgio Brosio (eds.). 2006. *Handbook of Fiscal Federalism*, Edward Elgar Publishing Limited

Ambrosanio, Maria Flavia and Massimo Bordignon. 2006. "Normative Versus Positive Theories of Revenue Assignments in Federations" in Ehtisham Ahmad and Giorgio Brosio (eds.) *Handbook of Fiscal Federalism*, Edward Elgar Publishing Limited

Bardhan, Pranab. 2006. "Decentralization and Development" in Ehtisham Ahmad and Giorgio Brosio (eds.) *Handbook of Fiscal Federalism*, Edward Elgar Publishing Limited

Bhagwati, Jagdish. 2004. *In Defence of Globalization*, New Delhi: Oxford University Press

Bieri, Stephan. 1979."Fiscal Federalism in Switzerland", Research Monograph No. 26, Centre for Research on Federal Financial Relations, The Australian National University, Canberra

Bird, Richard M. 2002. "Intergovernmental Fiscal Relations: Universal Principles, Local Applications" in M. Govind Rao (ed.) *Development, Poverty, and Fiscal Policy: Decentralization of Institutions*, New Delhi: Oxford University Press

Boadway, Robin and Shah Anwar. 2009. *Fiscal Federalism: Principles and Practice of Multiorder Governance*: Cambridge, Cambridge University Press

Brosio, Giorgio. 2006. "The Assignment of Revenue from Natural Resources" in Ehtisham Ahmad and Giorgio Brosio (eds.) *Handbook of Fiscal Federalism*, Edward Elgar Publishing Limited

CA Secretariat GoN. 2009. *CA Committee on Natural Resources, Economic Rights and Revenue Allocation: Report of the Preliminary Draft of the Constitution with Concept Paper 2066*, Kathmandu: Constituent Assembly Secretariat, Government of Nepal

CBS. 2003. *Population Monograph of Nepal: Volume I and II*, Kathmandu: Central Bureau of Statistics, National Planning Commission, Government of Nepal

Dafflon, Bernard. 2006. 'The Assignment of Functions to Decentralized Government: from Theory to Practice' in Ehtisham Ahmad and Giorgio Brosio (eds.) *Handbook of Fiscal Federalism*, Edward Elgar Publishing Limited

DFID and WB. 2006. *Unequal Citizens: Gender, Caste, and Ethnic Exclusion in Nepal*, Kathmandu: Department for International Development (DFID) and The World Bank

Due, J. F. and A. F. Friedlaender. 1994. *Government Finance: Economics of the Public Sector*, Delhi: AITBS Publishers & Distributors

FCGO. 2008. *Consolidated Financial Statements: Fiscal Year 2006/07*, Kathmandu: Financial Comptroller General Office, Government of Nepal

Furgler, Dominik. 2000. "The Swiss Economy: Facing the Future" in Butler, Michael; Malcolm Pender and Joy Charnley (eds.). *The Making of Modern Switzerland, 1848-1998*, Macmillan Press Ltd. and St. Martin's Press LlC

GoN. 2008. *The Interim Constitution of Nepal 2063 (2007)*, Kathmandu: Government of Nepal

GoN. 2015. *The Constitution of Nepal 2072 (2015)*, Kathmandu: Government of Nepal

Kalecki, Michal. 1971. *Selected Essays on the Dynamics of the Capitalist Economy*, Cambridge: Cambridge University Press

Kalin, Walter. 2010. "Decentralization: Why and How?" http://www.ciesin.org/decentralization/English/General/SDC_why_how.pdf

Kletzer, Kenneth and Nirvikar Singh. 1997. "The Political Economy of Indian Fiscal Federalism" in Studipto Mundle (ed.) *Public Finance: Policy issues for India*, New Delhi: Oxford University Press

Krueger, Anne O. 1984. "Problems of Liberalization", in A. C. Harberger (ed.), *World Economic Growth*, California: Institute for Contemporary Studies

Kumar, Arun. 2002. *The Black Economy in India*, New Delhi: Penguin Books

LBFC. 2015. *Fiscal Situation Analysis of Local Levels 2014/15* (in Nepali), Kathmandu: Local Bodyl Fiscal commission Secretariat, Government of Nepal

Luck, Murray J.; Lukas F. Burckhardt and Hans Haug (eds.). 1987. *Modern Switzerland*, California: The Society for the Promotion of Science and Scholarship Inc.

Manandhar, M, S. Shrestha and P. Sharma. 2008. *Federal States in Nepal* (in Nepali), Kathmandu: Pairavi Book House

MoF. Various Issues. *Economic Survey*, Kathmandu: Ministry of Finance, Government of Nepal

Musgrave, Richard A. 1959. *The Theory of Public Finance*: New York, McGraw-Hill

Musgrave, Richard A. 1985. "A Brief History of Fiscal Doctrine" in R. A. Musgrave (ed.) *Handbook of Public Economics*, New York: Elsevier

Musgrave, Richard A. and Piggy B. Musgrave. 1989. *Public Finance in Theory and Practice*, Columbus: McGraw-Hill International Edition

NPC. 2003. *The Tenth Plan: 2002-2007*, Kathmandu: National Planning Commission, Government of Nepal

NPC. 2007. *The Three-year Interim Plan (2007/08 – 2009/10)*, Kathmandu: National Planning Commission, Government of Nepal

Oates, Wallace. 1972. *Fiscal Federalism*, New York: Harcourt Brace Jovanovich

Oates, Wallace. 2005. "Towards A Second-Generation Theory of Fiscal Federalism", *International Tax and Public Finance*, 12, 349-373, Springer Science, Business Media

Prasad, Uma Shankar. 2008. "Impact of New Economic Policies on the Fiscal Sector and Its Implications on Poverty Reduction in Nepal", New Delhi: Unpublished Ph. D. Thesis, Centre for Economic Studies & Planning, School of Social Sciences, Jawaharlal Nehru University

Prasad, Uma Shankar. 2009. "Federal Budget", *The Kathmandu Post*, (www.kantipuronline.com/kolnews.php?&nid=201675), 30 June

Prasad, Uma Shankar. 2009. "Nepal: Nature and Extent of Exclusion", *Telegraphnepal.com* (www.telegraphnepal.com/news_det.php?news_id=6425), 10 October

Prasad, Uma Shankar. 2009. "The Haves and Have Nots", *The Kathmandu Post*, (www.kantipuronline.com/news/news-detail.php? news_id=303069), 18 November

Prasad, Uma Shankar. 2015. "Nepal's Excise Systems and the Legal Frameworks: Agendas for Reform", *World Customs Journal*, Volume 9, Number 2, pp. 51-69.

Rao, Govinda. 1997. "Indian Fiscal Federalism: Major Issues" in S. Mundle (ed.) *Public Finance: Policy issues for India*, New Delhi: Oxford University Press

Rao, Govinda. 2006. "Fiscal Federalism in Planned Economies" in Ehtisham Ahmad and Giorgio Brosio (eds.) *Handbook of Fiscal Federalism*, Edward Elgar Publishing Limited

SCOPE. 2008. *Nepal in Federal Context* (in Nepali), Kathmandu: Society for Constitutional and Parliamentary Exercises

Sen, Amartya. 2000. *Development as Freedom*, New York: Alfred A. Knopf

Sen, Amartya. 2006. *Identity and Violence: The Illusion of Destiny*, New Delhi: Penguin Books

Shah, Anwar (ed.). 2007. *The Practice of Fiscal Federalism: Comparative Perspectives*, McGill-Queen's University Press

Siegenthaler, Hansjorg. 1978. "Switzerland in the Twentieth Century: The Economy" in Luck J. Murray; Lukas F. Burckhardt and Hans Haug (eds.) *Modern Switzerland*, California: The Society for the Promotion of Science and Scholarship Inc.

Stiglitz, Joseph E. 2000. *Economics of the Public Sector*, New York: W. W. Norton and Company Inc.

Stiglitz, Joseph E. 2002. *Globalization and Its Discontents*, New Delhi: Oxford University Press

Tanzi, Vito (ed.). 1990. *Fiscal Policy in Open Developing Economies*, Washington D.C.: International Monetary Fund

Tresch, R.W. 1981. *Public Finance: A Normative Theory*, Texas: Business Publication

UNDP. 2002. *Nepal Human Development Report 2001*, Kathmandu: United Nations Development Programme

UNDP. 2008. *Federalism and State Restructuring in Nepal: The Challenges for the Constituent Assembly*, Kathmandu: United Nations Development Programme

UNDP. 2009. *Nepal Human Development Report 2009*, Kathmandu: United Nations Development Programme

Watts, Ronald L. 1999. *Comparing Fiscal Systems*, 2nd ed., Montreal and Kingston: McGill-Queen's University Press

WB/Bird, Richard M. 2010. "Subnational Taxation in Developing Countries: A Review of the Literature", Policy Research Working Paper 5450, The World Bank, Poverty Reduction and Economic Management Network, Economic Policy and Debt Department

World Bank. 1999. *Nepal: Poverty at the Turn of the Twenty-first Century*, Kathmandu: the World Bank

World Bank. 2015. *World Development Report 2015*, Washington DC: the World Bank