Challenges of Fiscal Federalism in Nepal

Introduction

Fiscal federalism is the distribution of fiscal decision-making power across different levels of government. Nepal practiced centralized fiscal policy, until the promulgation of the Constitution of Nepal (2015). This Constitution decentralized its fiscal decision-making power providing financial rights to all three levels of government (federal, province, and local).[1] The financial rights include the power to make laws, make annual budgets, and decisions, and formulate and implement policies and plans on any matters relating to financial powers within their respective jurisdictions. Against this backdrop, there are few fiscal management complications arising while enforcing these financial rights of revenue-raising power, revenue sharing, fiscal transfer, and budget formulation.

Revenue Raising Power

The Constitution of Nepal enables all three levels of government to impose taxes on matters falling within their respective competence and collect revenue from those sources. Revenue collection under the headings of land registration fee, vehicle tax, entertainment tax, and advertisement tax overlap with the provincial and local levels. Although a single tax administration[2] was introduced for the aforementioned headings, there are still overlaps in the assignment of functional powers of the three levels, including education, health, roads, irrigation, agriculture, etc.[3]

Levying agricultural income tax on the basis of land characteristics falls under the ambit of the provincial government, and conflicts with the jurisdiction of local government as land tax falls under the jurisdiction of the local government.[4] Similarly, the unclear division of tax responsibilities has encouraged few municipalities to collect pollution tax, which has not been stipulated in any laws and rules. Additionally, vehicles en route to their destination through the Birgunj-Pathlaiya corridor pass through Birgunj Metropolitan City, Parwanipur Rural Municipality, and Jitpur Simra Sub-Metropolitan City where each of the local governments were alleged to have imposed scrap taxes unlawfully.

A number of reasons such as confusion in the collection of taxes, contradictions in constitutional and legal provisions, and lack of knowledge on the part of elected representatives and the general public hinder the subnational government from raising sufficient revenue to finance their expenditure. Further, capacity constraints at all levels for the collection, management, and mobilization of revenue have impaired the efficiency of subnational governments.

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[1] Constitution of Nepal 2015. Article 60.

[2] National Natural Resources and Fiscal Commission Act 2074 (2017), Section 5. Retrieved from https://www.lawcommission.gov.np/en/wp-content/uploads/2021/01/National-Natural-Resources-and-Fiscal-Commission-Act-2074-2017.pdf

[3] The Asia Foundation. (2021). Planning and Budgeting in the Provinces of Federal Nepal (p. 51). Retrieved from https://asiafoundation.org/wp-content/uploads/2021/06/Planning-and-Budgeting-in-the-Provinces-of-Federal-Nepal.pdf

[4] Samriddhi Foundation. (2020). Study of Agricultural Income Tax in Federal Nepal (p. 44). Retrieved from https://samriddhi.org/publications/study-of-agricultural-income-tax-in-federal-nepal/

Revenue Sharing

As per the provision for revenue sharing in The Intergovernmental Fiscal Management Act, the subnational units (Provincial and local levels) receive 15 percent respectively of the revenue collected from VAT and excise duty and 25 percent from the royalty collected from the use of natural resources such as water, forest, electricity, mining, and mountaineering.

The Auditor General's Annual Report, Summary, 2022[5] identified that amongst the NRs. 5 billion 430.9 million collected in aforementioned under the five royalty headings of the Federal Divisible Fund in 2019/20, 55.20 percent is provided to the Government of Nepal and 44.80 is distributed equally to both the provincial governments and local levels. The report shows that the amount collected has been divided at a different ratio contradicting Schedule 4 of the Intergovernmental Fiscal Arrangement Act, 2017.

Further, the lack of timely deposit of revenue collected to the provincial government by the local government, and threats to withhold grants to local level government by the provincial government has affected effective revenue-sharing mechanisms.

Fiscal Transfer

Fiscal transfer is crucial for an equitable distribution of the allocation of financial resources to every level of government. In the present context, provincial and local governments rely heavily on fiscal transfers from the federal program. Fiscal transfers to the subnational government without objectively verifiable criteria and data might encourage them to push their budgetary activities beyond their means without any sharing of taxation burden. This poses the challenge of overfishing the fiscal pond. Thus, it is cardinal for subnational governments to strengthen their financial autonomy by increasing the revenue base and enlarging their own earnings.

The federal government has promised a fiscal transfer of Rs. 105.06 billion for seven provincial governments and Rs. 295.02 billion for local governments for the current fiscal year (2080/81) under the headings—equalization grants, conditional grants, complementary grants, and special grants. Fiscal equalization grants are provided based on the need for expenditure and revenue capacity at the province/local level. However, the Fiscal equalization grant has not addressed the issue of equity among provinces with a larger population and lower indicators of socioeconomic development. For example: despite having a large population, low revenue, and weak social and humanitarian infrastructure, Province 2 has not received a commensurate share of the fiscal equalization grants.[6]

It has been reported that sub-national governments have been receiving more conditional grants than fiscal equalization grants. In the budget for the fiscal year 2022-23, conditional grants make up 61 percent of the Rs. 299 billion in grants allocated by the federal government. The increase of conditional grants rather than fiscal equalization grants results in the involvement of two (or more) levels of government which was

[5] Office of the Auditor General. (2022). AG Summary Report, 2022 (p. 33). Retrieved from https://oag.gov.np/uploads/files/ttf-AG%20Summary%20Report,%202022.pdf

[6] The Asia Foundation. (2021). Planning and Budgeting in the Provinces of Federal Nepal (p. 53). Retrieved from https://asiafoundation.org/wp-content/uploads/2021/06/Planning-and-Budgeting-in-the-Provinces-of-Federal-Nepal.pdf

previously done by only one, without any improvements to citizens' lives and livelihoods. This challenge may act as a catalyst to jeopardize public support for the federal system of government. The Government of Nepal should follow the recommendations of the Commission while dividing and distributing royalties received from natural resources.

Budget Formulation

The local government under its exercise of financial rights has the power to make an annual budget and present it by Asar 10. Local governments are entrusted with this power with the rationale that they can better decide the areas that align with the preferences of the people of their local constituency.

Despite this power, budget delay at the local level is still a challenge. As many as 30 local governments have yet to present their budgets for the fiscal year 2023-24. Local representatives' lack of cooperation on budget endorsement, political interest above people's interest, and political differences stand as possible reasons behind the delay in budget presentation. This delay in budget directly affects the local government's service delivery and development works are crippled. Development activities are often pushed back. For example, Tirupati Rural Municipality presented its budget late in the fiscal 2021-22. As a result, half of the capital spending occurred in the year's final month. The practice of spending capital budget in the last months severely affects the work quality, causing chances of irregularities and increased undeclared *(Beruju)* amount. The Government of Nepal should follow the recommendations of the Commission while dividing and distributing royalties received from natural resources.

Conclusion

Fiscal decentralization has definitely assisted in the utilization of public resources and shared economic growth. Key legislations have been enacted and institutions responsible for determining the principles of fiscal decentralization are assigned. However, these arrangements contributing to fiscal federalism are new and their effects have not been evaluated yet. Thus, it possesses a few complications during its implementation. Further, inefficient audit systems, capacity constraints, corruption, duplication in expenditure, lack of financial record, poor public financial management, and centralized mindset even at the subnational levels further tighten the complication knots of fiscal federalism.

Way Forward

Nepal has definitely put its best effort into fiscal decentralization but it is equally crucial to ensure appropriate means for all levels of government to implement it. Timely fiscal gap assessments for the distribution of equalization grants and systematic monitoring and evaluation of the effectiveness of fiscal transfer will ensure financial equity among provinces. The use of data collection instruments to record financial data will aid in navigating the areas for the distribution of grants. Additionally, the Provincial and Local Governance Support Programme (PLGSP) might further aid in modernizing local governments with strong administrative systems and accountable public financial management.