

Fiscal Federalism of Nepal: A Perspective on its Practice

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A. Introduction

Nepal's federal constitution has completed eight years of its promulgation in September 2023. The Federal Constitution of Nepal 2015 has created a three-tier system of governance namely, the federal, the provincial (state) and the local. The provincial and local or municipal levels are also jointly called 'sub-national' units under the federal scheme of the state. The state restructuring under the new the constitution has carved out seven provinces and 753 local levels. The seven provinces replaced the erstwhile five development regions and the local governance structure saw a major change after nearly 4,000 local bodies were converted into 753 local levels, at present, with 293 municipalities (including 6 metropolitan cities, 11 sub-metropolitan cities, 276 municipalities) and 460 rural municipalities.

The implementation of federalism practically began in 2017; only after the completion of elections to all these three tiers of the legislatures/governments --federal, provincial, and local -- according to the constitutional mandate. Upon completion of their five-year term, a new set of representatives, elected in 2022, has taken office at their respective levels. The most attractive aspect of Nepal's federal design is the constitutionally devolved rights to make decisions at provincial and local levels regarding their economic governance. Since the responsibility for managing public finances and ensuring its effectiveness rests at the immediate level of the government, this devolvement poses the next challenge in the Public Finance Management (PFM) of federal Nepal.

In the federal state system, the management of public finances by different federal units and the economic responsibilities shared between different levels of government are based on the principle of fiscal federalism, the term first coined by German-American economist Richard Masgrave in 1959. Later other economists, notably Wallace Oates (1972) and Anwar Shah (1997), expanded the theoretical rigor of the discipline. The fiscal federalism serves not only as a mechanism to share financial resources and responsibilities of public goods provisions among different tiers of the federal units but also diversify the financial (and political) risks (Brooks, 2014).

Fiscal federalism defines and organizes the financial relationships, fiscal resource assignment across the political units, their jurisdiction of economic decisions, and the government spending system among the levels of government (three in Nepal's case) under the federal system of governance. In Nepal, the practice put in place by the National Natural Resource and Fiscal Commission (NNRFC), the constitutional body assigned with fiscal federalism or public financial management under the federal state structure, consists of the following components.

- i. Revenue Sharing,
- ii. Fiscal Equalization grants,
- iii. Conditional Grants,
- iv. Internal Loans, and
- v. Natural Resources (royalties thereof)

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This paper, against the backdrop of constitutional/legal, institutional, and economic governance aspects of Nepal's fiscal federalism, cursorily reviews fiscal performance, mainly at the subnational levels, based on experience of the first five-year tenure of the executives elected under the federal political dispensation.

B. Constitutional and legal framework

Article 60 of the constitution is the key to distribution of financial sources between the federation, province, and the local level. It has the following arrangement:

1. The Federation, province, and local level may impose taxes on matters falling within their respective jurisdictions and collect revenue from these sources. Provided that provisions relating to the imposition of taxes and the 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 province and local level shall be as recommended by the NNRFC.
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, Province 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 fulfilment of temporary needs.

Another important provision in the constitution to practically operationalize fiscal federalism is Article 251 that defines functions, duties and powers of NNRFC.

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, Province and Local Governments (LGs) 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 Province 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 Province 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 Province and Local Governments out of the State Consolidated Fund,
- (e) to recommend measures to meet expenditures of the Federal, Province and Local Governments, and to reform revenue collection,
- (f) to analyze macro-economic indicators and recommend ceiling of internal loans that the Federal, Province 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 Province and a Local level, and between Local levels, and make suggestions to act in a coordinated manner for the prevention of such disputes.

2. NNRFC 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.

3. Other functions, duties and powers and rules of procedure of the National Natural Resources and Fiscal Commission, detailed bases required to be followed in the mobilization of natural resources or distribution of revenues, and other matters including conditions of service of the officials of the Commission shall be as provided for in the Federal law.

Articles 116, 204 and 229 have made provisions for Federal, Provincial and Local Level Consolidated Funds respectively, broadly defining the kind of revenues to be credited to these Funds. The most important federal law pertaining to implementation of fiscal federalism is the Intergovernmental Fiscal Arrangement Act 2017. Other laws that have bearing in fiscal federal operations are NNRFC Act 2017 and Local Government Operations Act, 2017. Two relatively new laws have also come into force. The Federation, Province and Local Level (Coordination and Inter-relation) Act, 2020 defines the project design and execution framework for all three levels and Public Debt Management Act that repealed The Loan and Guarantee Act, 1968 and The Public Debt Act, 2002. The government has created new entity called Public Debt Management Office (PDMO) under this new law.

B.1 Revenue Sharing

Section 6 of the Intergovernmental Fiscal Arrangement Act 2017 makes the following arrangements to share the revenue collected from value added tax (VAT) and excise duty:

- 1. In order to share among the Government of Nepal, State and Local Level, the amount of value added tax and excise duty collected from domestic products, the Government of Nepal shall create a Federal Divisible Fund and deposit such amount in the Fund.

2. Out of the amount credited to the Federal Divisible Fund pursuant to Sub-Section (1), seventy percent shall be distributed to the Government of Nepal, fifteen percent to the province and fifteen percent to the local level.

To implement these arrangements, Section 15 of the NNRFC Act 2017 has set the bases for the distribution of revenues. Under sub-section (1), the Commission has detailed bases and framework for the distribution of revenues between the Government of Nepal, province and local level and recommended the government by assigning the following weightage for computation:

(a) population and demographic details,	60 %
(b) territory/area,	15%
(c) Human Development Index,	5%
(d) requirement of expenditure,	5%
(e) attempts made for revenue collection,	3%
(f) infrastructure development,	10%
(g) special condition.	2%

The detailed bases and framework determined by the Commission shall be acceptable for five years. It cannot be changed more than once during the period. The current recommendation was made by the Commission in fiscal year 2021/22 and, unless reviewed, will remain effective till fiscal year 2025/26.

B.2 Fiscal Equalization Grants

In addition to constitutional provisions, Section 8(1) of the Intergovernmental Fiscal Arrangement Act, 2017, authorizes the Government of Nepal to distribute fiscal equalization grants to the provincial and local levels on the recommendation of the Commission. Similarly, under Section 8(2), the provincial government shall distribute fiscal equalization grants to the local level within its jurisdiction.

According to the Section 16 (1) of the NNRFC Act 2017, the Commission, while making recommendations to the Government of Nepal and province, in relation to the Fiscal Equalization Grant to be provided by the Government of Nepal to province and local level and by the province to local level.

The formula adopted by the NNRFC in determining the amount of the equalization grant is based on the following weightage.

a) Human Development Index	10 %
b) Socio-economic inequality	5%
c) Infrastructure development	10%
d) Scope of revenue collection,	5%
e) Necessity of expenditure and capacity to collect revenue	70%

In addition to this, the NNRFC also sets a benchmark so as to ensure that each subnational level, both province and local, received a moderate level of minimum grant from the federal government.

	FY19	FY20	FY21	FY22	FY23
Recommended by NNRFC					
Federal to provincial	50.3	55.3	57.6	58.0	61.4
Federal to local	85.2	89.9	93.7	94.6	100.2
Provincial to local	4.4	6.2	6.3	7.0	7.6
Budgeted					
Federal to provincial	50.3	55.3	55.2	58.0	61.4
Federal to local	85.2	89.9	90.1	94.6	100.2
Provincial to local	4.0	6.2	6.3	7.0	7.6
Disbursed					
Federal to provincial	50.3	55.2	55.2	57.9	N/A
Federal to local	85.3	89.9	90.0	84.6	N/A
Provincial to local	4.0	6.3	6.3	N/A	N/A

Source: NNRFC and Ministry of Finance

B.3 Conditional Grants

The Intergovernmental Fiscal Arrangement Act, 2017 has a dedicated Section (9) on conditional grants to the province and local level from federal and to local from the provincial governments to implement any project of the province or local level or the Government of Nepal on the basis as prescribed by the Commission. The grantee government may specify necessary terms and conditions to the recipient government in relation to the implementation of the project.

There are other two types of grants -- the complementary grants and special grants -- from federal to provincial or provincial to local level have been stipulated by the law. Complementary grants may be provided to implement any priority infrastructure development project with ready feasibility of the project, estimated project cost, benefit mapping and financial and human resource mobilization capacity to implement it. The Special Grants will be provided to develop and deliver basic services like education, health and drinking water, to achieve balanced development of inter-province or inter-local level and to uplift or develop economically, socially discriminated class or community.

It is interesting to note that, in terms of transfers to local levels observed over the last five years, the fiscal equalization grant and conditional grant constitute approximately 55 and 35 percent, with only the remaining 10 percent allocated as complementary and special grants.

Table 2 (q) : Intergovernmental Fiscal Transfer (Rs in 10 million)

Details	2019/20		2020/21		2021/22 *	
	Province	Local level	Province	Local level	Province	Local level
Grants	10740.91	25058.12	10830.32	30802.82	5661.33	17725.18
Fiscal Equalization Grant	5529.86	8996.52	5519.50	9622.46	3710.81	6164.68
Conditional Grants	4393.19	15100.55	4480.95	19105.78	1649.93	10987.92
Complementary Grants	422.84	484.34	440.58	1208.16	214.71	267.88
Special Grants	395.02	476.71	389.29	866.43	85.88	304.70
Revenue Sharing	4455.21	4455.21	5575.57	5575.57	3989.52	3989.52
Value Added Tax	3358.55	3358.55	4228.72	4228.72	3052.56	3052.56
Excise Duty (Domestic)	975.00	975.00	1223.78	1223.78	936.96	936.96
Royalty Distribution	121.66	121.66	123.07	123.07	-	-
Total	15196.12	29513.33	16405.89	36378.39	9650.85	21714.70

Source: Financial Comptroller General Office, 2022

*Till mid-March

Note : Amount Released is considered as fiscal transfer

B.4 Internal Loans

Nepal, as a young federal state, is still in the process of establishing all the necessary frameworks to enable subnational governments to access debt instruments and create appropriate institutional structures for monitoring debt sustainability. This effort aims to enhance their fiscal efficacy. Both the constitution and related laws take very conservative approach of control than facilitate the subnational governments in raising loans.

Articles 115 and 228 of the constitution provide for raising the loans by both provincial and local governments, respectively, by formulating required laws and with prior consent from the federal government. Other two Articles of the constitution, 203 and 228, essentially delimit the provincial and local governments, respectively, to raise loan and provide guarantee 'except as provided for in the law'.

Article 251 has, among others, also assigned the NNRFC the following roles:

1(e) to recommend measures to meet expenditures of the federal, provincial and local governments, and to reform revenue collection,

1(f) to analyze macro-economic indicators and recommend ceiling of internal loans that the federal, province and local governments can borrow,

The sub-clause (f) above is the most critical constitutional provision to enable the SNGs to borrow or raise loans on their own.

Section 14 of the Intergovernmental Fiscal Arrangement Act, 2017 on internal loans has stated:

1. The Government of Nepal, the province and local level may obtain internal loans within the limits as recommended by the Commission.

Provided that the province and local level shall, before obtaining internal loans, take consent of the Government of Nepal.

2. The Government of Nepal and the province may raise internal loans by issuing bonds subject to the prevailing law.

3. The province and local level shall, while seeking consent from the Government of Nepal to obtain loans, submit a proposal to the Ministry along with particulars of the plan for

which loans have been sought, outputs and outcomes likely to be achieved from the plan, loans payment plan and institution extending the loans.

4. The Government of Nepal may, if the proposal submitted pursuant to Sub-Section (3) is found to be eligible for implementation, grant consent to the concerned province or local level to obtain internal loans.

The government has created a new entity called the Public Debt Management Office (PDMO). According to the new Public Debt Management Act of 2022, the Government of Nepal, or a provincial government with the consent of the Government of Nepal, can raise internal loans from time to time by issuing one or more types of bonds within the ceiling prescribed by the NNRFC. There was no such provision in the previous public debt laws.

The NNRFC has recommended the ceiling for the federal government to raise the loan not exceeding 5.5 percent of the total gross domestic product (GDP) in current prices of the country for the year. For the provincial and local governments, the ceiling is 12 percent of the total of the own source revenue and the amount to be received as the revenue sharing from the higher tier of the government. Despite these provisions, mobilization of internal loans has not actually been brought into practice by the subnational governments.

Deficit financing proposed by the provincial governments while presenting their annual budget.

Rs in millions

Province	FY 2018/19	FY2019/20	FY2020/21	FY 2021/22	FY 2022/23
Koshi			5,000		
Madhesh	1,000	1,300	1,000	1,000	
Bagmati					
Gandaki	800	988	2,000	2,000	
Lumbini				2,070	
Karnali	1,000	750			
Sudurpashchim					

Source: NNRFC (2022)

According to a NNRFC (2022) report, although, some provincial governments presented the income and expenditure estimates with the goal to mobilize internal debt, no such loan has been raised and utilized so far. Some of the local levels have mentioned about debt financing for some of the projects in their budget statements, but none of them have been able to raise the loans, mainly due to the lack of laws and regulations to facilitate it.

B.5 Sharing of royalty from natural resources

Article 59(4) of the constitution provides the federation, province and local level for the equitable distribution of benefits derived from the use of natural resources or development. Article 59 (5) also states, if, in utilizing natural resources, the local community desires to make investment therein, they shall be accorded priority to invest.

Section 7 of the Intergovernmental Fiscal Arrangement Act, 2017 has set rules on distribution of royalty to be obtained from natural resources.

1. In order to distribute the royalty obtained from the natural resources among the Government of Nepal, province and local level, the Government of Nepal shall create

the federal divisible fund to deposit such amount obtained from the royalty in accordance with Federal law.

2. The Government of Nepal shall distribute the royalty pursuant to Sub-Section (1) as specified in Schedule-4 (given below).

Schedule-4

(Relating to Sub-Section (2) of Section 7)

Distribution of Royalty of Natural Resources (In percentage)

S.N.	Topic of the Royalty	Government of Nepal	Concerned State	Concerned Local Level
1	Mountaineering	50	25	25
2	Electricity	50	25	25
3	Forest	50	25	25
4	Mines and Minerals	50	25	25
5	Water and other Natural Resources	50	25	25

In additional note to Schedule 4, the Act has stated, 'the Government of Nepal, on the recommendation of the Commission, shall allocate and distribute the royalties of natural resources in the proportionate ratio to the province and local level as affected by the use of natural resources (Concerned Local Level, District Coordination Committee).'

Such recommendation once made by the Commission may be valid for next five years.

C. Institutional frameworks for fiscal federalism

C.1 Federal units: Federal, provincial, and local legislatures and governments are undoubtedly the most important institutions of federalism. The main objective of the creation of the provinces was to envision them not only as separate political-administrative units but also as active independent economies. The main justification for the creation of the provinces was to enhance their economic prosperity. Several alternative scenarios in the proposed provincial economy should have been considered as to how the division between the provinces of available resources, especially attractive tax points, could lead to the mobilization and utilization of resources in the best way. Similarly, when determining the number of local levels, it was important to pay attention to the possibility of each unit, though small, becoming an active economy. While demarcating, statistical analysis of population, geography, size, availability of natural resources, and access to infrastructure such as transportation were not given due consideration. Without any study, analysis or evidence, the boundaries of the province and local levels were fixed. Provinces were not formed on the basis of principle of economic viability and sustainability. The demarcation should have been based on existing poverty rates, human development indices, literacy rates, per capita income, average life expectancy and access to public amenities. That was a terribly missed opportunity. As the result, the political federal units are in dire need of institutionalization and unable to deliver on economic expectations.

It is also the reason, even after eight years of the implementation of the federal constitution, all the laws required to be made by the federal and provincial governments could not be made. For the local level to exercise, the constitution has put a barrier in countless places that many important issues will only be dealt as determined by the federal or provincial law. But in absence of these

laws, provincial and local economies are unable to function at the expected pace and direction. The management of public finance, mainly the annual budget formulation and implementation processes at every subnational level need to be institutionalized, procedure-based for effective and timely public expenditure.

C.2 The National Natural Resources and Fiscal Commission is undoubtedly the most pivotal constitutional body to properly implement the fiscal federalism in Nepal. In several successful federal countries, such fiscal commissions operating under different names are effective and impartial with adequate constitutional authority and decision autonomy to set their own procedures and rules. They enjoy extensive constitutional powers, often as a quasi-judicial entity.

NNRFC has been victim of a faulty constitutional design, anti-federal predatory political sentiment coupled with centralism-oriented conservative bureaucratic set up. As the result, the appointment of the office-bearers was never a political priority. Due to heavy political influence, even in recent and still incomplete appointments, the Commission fails to assert its constitutional authority and functions more as an extended branch of bureaucracy rather than as a quintessential constitutional body. The authority of the Commission has been further encroached by enactment of several preemptive laws; before the Commission came into functional existence where its involvement and inputs were inevitable. In successful federal nations, comparable commissions have been explicitly awarded far superior constitutional authority than in our case.

The Finance Commission of India pursuant to Article 280 (3) of the Indian constitution directly reports to the President of India, not to the government. Section 8 (1) of the Finance Commission (Miscellaneous Provisions India) Act, 1951 states, “The Commission shall determine their procedure and in the performance of their functions shall have all the powers of a civil court under the Code of Civil Procedure...”

But the NNRFC in that sense has been made a lameduck right from the beginning of drafting the federal constitution. It has effectively been made a subservient to the government. Except in a couple of instances to be able to ‘determine’ the modalities and formulas for fiscal assignments, it can only ‘recommend’ or ‘suggest’ fiscal measures to the government(s).

C.3 Public Debt Management Office (PDMO) was created under the Ministry of Finance (MoFin) December 26, 2018. A dedicated single public debt management office was a long-felt need. Nepal's key development partners were recommending the government to create such an institution to do all back office, middle office and front office functions related to public debt. ADB had first produced a report in 2013 recommending for such a unit. The Act enables the PDMO and is assigned with a. Public debt forecasting b. Policy formulation c. Domestic debt management d. Foreign debt management, and e. Research responsibilities; but yet to operationalize these functions. Since a new law has now been enforced, the institutional approach of public debt in a fashion to consolidate the fiscal federalism operations can be expected to begin sooner than later.

C.4 Financial Comptroller General Office

Financial Comptroller General Office (FCGO) is responsible for the treasury operation of the Government of Nepal and is under the Ministry of Finance. It oversees all government expenditures against budget, tracks revenue collection and other receipts and prepares consolidated financial statements of the government. It conducts the internal audit of revenue and expenditure of the government. Other important responsibility of it includes ensuring timely repayment of

internal and external debts, investing in the loan and equity of public enterprises and maintaining the records related to these financial transactions.

FCGO has field offices in 77 districts of the country. In each district there is a District Treasury Controller Office (DTCO) which is involved in releasing budgets to government offices, budgetary controls and reporting that of. One Pension Office under the FCGO manages the distribution of pension of retired civil servants. Government Dues Recovery Office under the FCGO is responsible for the recovery of government dues.

In line with the implementation of fiscal federalism at subnational level, FCGO launched a Sub-national Treasury Regulatory Application (SUTRA), a planning, budgeting and accounting software to facilitate and implement a structured financial management procedure of the SNGs. Initiated in November 2017, SUTRA has been acknowledged widely by the local governments and additional features with offline mode is being developed to cover the remote municipalities as well. The functions of the FCGO are critical in fiscal federalism operations as it provides the status and quality of public financial management at the subnational level. It helps to evaluate the fiscal gap and possible demand for public debt. It may also be useful to create a basis to measure creditworthiness of the SNG units.

C.5 Intergovernmental Fiscal Council

Section 33 of the Intergovernmental Fiscal Arrangement Act, 2017 has made the provision of Intergovernmental Fiscal Council with a 3-year tenure of office-bearers 'to hold and maintain necessary consultation and coordination among the Government of Nepal, the province and local level on intergovernmental fiscal arrangements.' It has the following structure:

- (a) Minister for Finance, Government of Nepal -Coordinator
- (b) Minister for Finance, State -Member
- (c) Fourteen persons with each two persons, including one woman from each State, representing from among Mayors and Deputy Mayors of Village Bodies and Municipalities recommended by each State -Member.
- (d) Three persons, including one woman, from among financial experts nominated by the Ministry -Member
- (e) Secretary of the Ministry -Member-Secretary

C.6 Inter-State Council

Article 234 of the constitution has instituted an Inter-State Council to settle political disputes arising between the Federation and a province and between provinces. It has Prime Minister as chairperson, and Minister for Home Affairs, Minister for Finance and Chief Ministers of the provinces as members. The Council may meet as required.

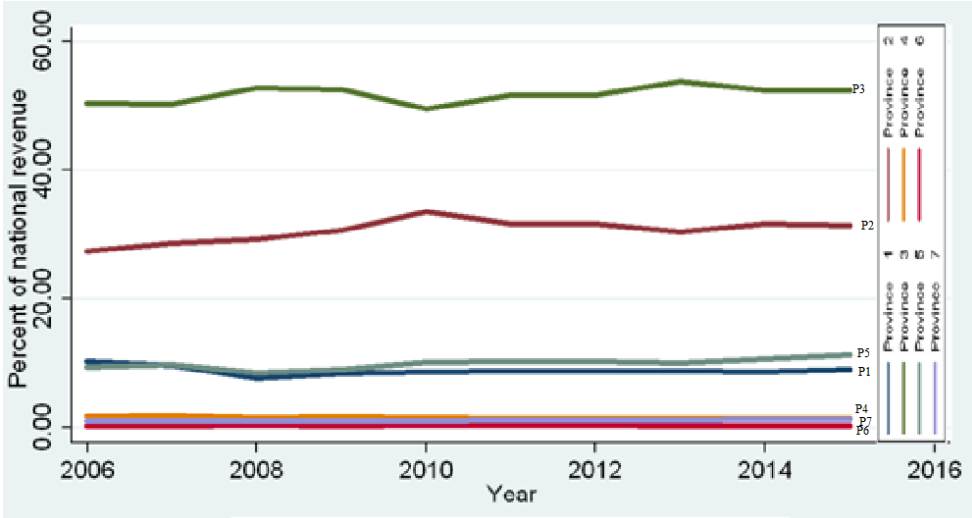
The role and effectiveness of these institutional arrangements are under questions, therefore, need a thorough review. For example, The Intergovernmental Fiscal Council and Inter-State Council are not even able to hold timely meetings when the economy faces crisis and provincial governments are knocking the door of the Supreme Court to be able to exercise their constitutional rights.

D. Economic governance

D.1 Fiscal gap

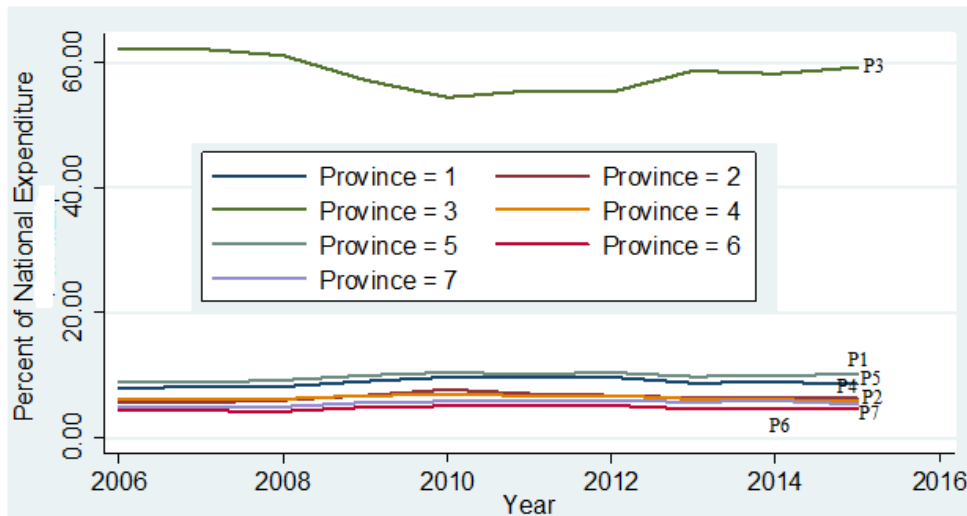
The assignment of fiscal responsibilities in Nepal’s federal scheme has blatant skewness with inherent challenges towards ensuring economic fairness across the federal units. Nepal’s fiscal federal design is largely overwhelmed by expenditure decentralization without due consideration of at least some degree of fairness in equitable distribution of tax and revenue points while creating, mainly, the provinces. While envisioning a welfare state through federalism, the political class seemed to have preoccupied by an assumption that federal government as if has endless means, or reserves, of (financial) resources enough to meet all current and future demands for financial resources of the SNGs. But that is not certainly the case.

The fiscal gap in the provincial levels, represented by the difference between their capacity to collect revenue and actual expenditure, is extremely skewed across the provinces. A study covering a decade from 2006 to 2015 (Wagle, 2018) on decentralization ratio of the provinces has shown precariously unsustainable expenditure trends.



Revenue Generated by Provinces (Percent of Total National Revenue)²

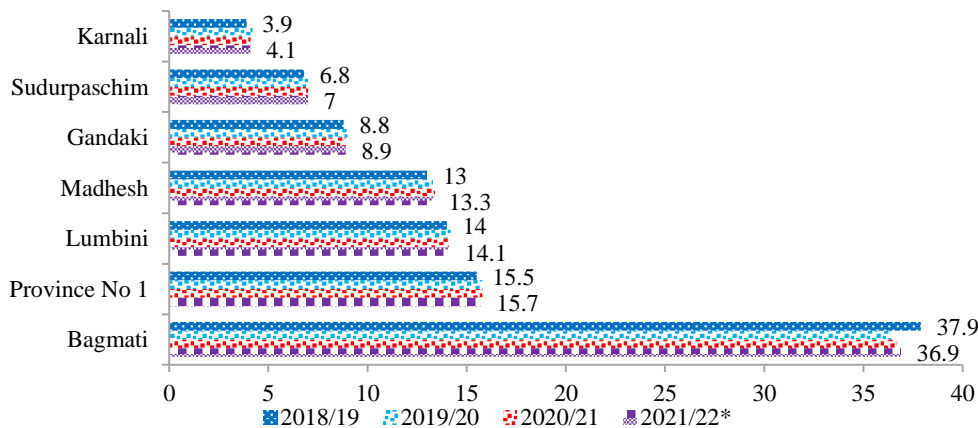
² These calculations by the author are based on the district level revenue and expenditure data from the Office of the Auditor General.



Percent of Total Expenditure of National Budget by Provinces

The scenario has barely changed, with political federalization occurring without due economic considerations.

Chart 15(a): Province-wise Contribution to National GDP (In percent)



Source: Central Bureau of Statistics, 2022

Even before Nepal embarked into federal system of governance; efficient budget formulation and public financial management remained as key areas of impending rapid reform. The central planners seated in the capital blindly decided about the projects and allocation even for the ones located in the great distance. The importance of locally evolved, demand-driven and evidenced-based allocation system was never respected. An ad hoc approach in earmarking, under the direct influence of powerful politicians and members of parliament, still rules the roost. The central planning commission not only continues to exist at the centre but the provinces have also copied the centralized planning practices against the norms, practices and spirit of federalism.

Nepal's PFM in general suffers from both 'supply side' and 'demand side' aberrations. On the supply side, institutional capacity, mainly of the line ministries, to ensure systems and processes is very weak. On demand side, absorption capacity of the resources, transparency in public procurement, accountability of the decision-makers and financial reporting system need substantial improvement at all levels of governments; federal, provincial and local. Under the

federal structure, planning, budget formulation, allocation and implementation by the SNGs are, at least in theory, expected to be more efficient compared to unitary system of governance.

During last five fiscal years, the annual plans and budget formulation appeared to have barely managed by provincial and few large municipalities. Ministry of Finance developed and issued Local Level Plan and Budget Formulation Guideline 2017 to enable, mainly, the LGs to formulate a functional budget. Ministry of Federal Affairs and General Administration (MOFAGA) circulated a template with six key components to be included in the annual budget. The items included in the template were: estimates of income, estimates of revenues and grant receipts, expenditure estimates, area wise (sectoral) expenditure estimates and list of annual programmers. The format of the approval sheet of the annual programmes was also included. But, this has hardly substantially improved the budget making skills and expenditure efficiency.

At the local level, and to a lesser extent at the provincial level, the annual budget writing method and appropriation has not been in line with economic good governance. Due to the lack of general knowledge about the nature and system of the budget among the elected representatives and the absence of employees with knowledge about it, many municipalities are still not able to prepare and implement the budget on time. The budget prepared by the majority of the municipalities, which have completed the rituals of presenting the budget, has not been in its expected form or according to the 'template' provided by the Ministry of Federal Affairs. Both the practice and tradition of spending the budget in discipline are not appreciated and put in practice.

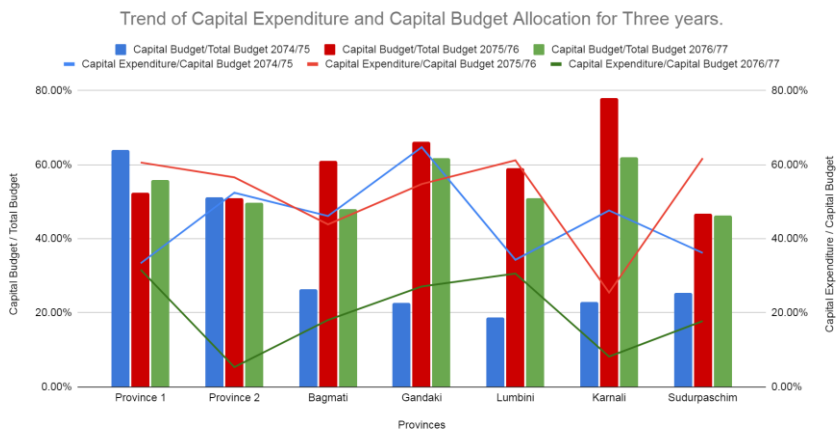
Table 15 (a): Province-Wise economic and social indicators

Indicators	Nepal	Province No 1	Madhesh	Bagmati	Gandaki	Lumbini	Karnali	Suderspaschim
Administrative and Demographic Staats¹								
Number of Local Level	753	137	136	119	85	109	79	88
Population (In percent)	100	17.03	20.99	20.84	8.49	17.55	5.81	9.29
Area (In Percent)	100	17.6	6.6	13.8	15.3	11.8	21.6	13.3
Economic and social sector								
Economic Growth Rate(Producers Price) In Percent ¹	5.84	5.41	4.82	6.74	6.17	5.36	5.47	4.93
Province-wise contribution to GDP (Producers' price) ²	100	15.7	13.3	36.9	8.9	14.1	4.1	7
Per Capita GDP (In Us \$) ¹	1372	1267	868	2430	1437	1103	964	1031
Registered Number of Industry ²	8656	807	572	5614	798	656	79	130
Number of micro, cottage and small industry ²	555776	76059	78204	176689	59980	94138	29248	41458
Investment in Industry (Rs. In Billion) ²	2512.1	555.6	141.7	912.7	548.7	171.1	135.2	47.2
Company Register Number ³	283358	20837	17562	200262	15724	18713	3526	5677
Hydropower Production (Meghawatt) ⁴	2023	327	21	1016	565	31	11	52
Forest Area (In Percent) ⁵	100	17.16	3.99	16.5	12.36	14.74	17.9	17.34
Local Road Network (KM) ⁶	64617	13129	6002	16001	11570	9139	3301	5475
School Number ⁷	34368	6759	4258	6569	3987	5622	3112	4061
Financial Sector⁸								
Branch number of Bank and Financial Institution	11349	1828	1725	2926	1405	2186	451	828
Per Branch Population	2572	2720	3551	2079	1765	2344	3758	3274
Branch number of insurer ⁹	2905	506	384	807	321	421	187	279
Province-wise Expenditure (Rs in ten million) ¹⁰	18883	2795	2255	3559	2562	3210	2204	2297
Province-wise Revenue (Rs. In ten million) ¹⁰	8794	1241	1226	2563	973	1212	767	812

Source: 1. Central Bureau of Statistics, 2022. 2. Ministry of Industry, Commerce and Supply, 2022. 3. Office of the Company Registrar, 2022 (Non-source company 1057 are included in total number but not included in the province-wise company 4. Ministry of Energy, Water resource and irrigation, 2022. 5. Ministry of Forest and Environment, 2022. 6. Ministry of Federal Affairs and general administration, 2022. 7. Ministry of Education, Science and Technology, 2022. 8. Nepal Rastra Bank, 2022. 9. Beema Samittee, 2022. 10. Financial Comptroller Office, 2022 (Expenditure and revenue data are based of the annual data of FY 2020/21)

D.2 The absorption capacity

The financial resource absorption or expending capacity even at the federal government level has remained as a persistent irritant in Nepal's PFM. Between FY 2010/11-2019/20 only 62.8 percent of the allocated capital budget was spent. This is despite the very ineffective trend of very large chunk of such allocation is being spent towards the end of the fiscal year often without due process and comprising on the quality of the public works that are carried out in the haste of blowing away the allocated budget within a month or so. With the adoption of the federal polity, some definitional discrepancies have also cropped up. 'Grants transferred from the federal government to the province and Local Levels are accounted in the current expenditure of the federal government. Large part of the grants transferred to the province and local levels can be used for the capital expenditure of the province and local governments, the combined capital expenditure of the province and local government is estimated to be higher than the capital expenditure of the federal government in the current fiscal year' (Economic Survey, 2019/20, para 3.26).



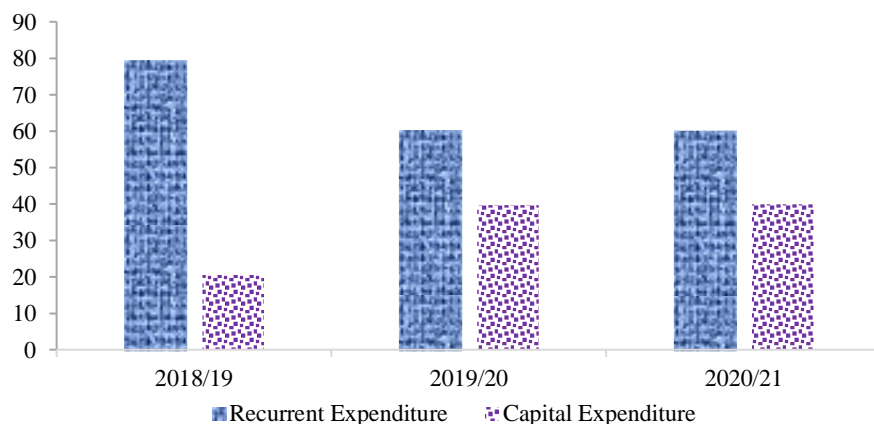
तालिका १४(ड): आर्थिक वर्ष २०७८/७९ मा प्रदेश सञ्चित कोषको प्राप्ति र भुक्तानीको आर्थिक विवरण (रु. करोडमा)

विवरण	कोशी	मधेश	बागमती	गण्डकी	लुम्बिनी	कर्णाली	सुदूरपश्चिम	जम्मा
१. राजस्व, अनुदान र अन्य प्राप्ति	३२३५.५	३०३५.१	४९१४.२	२५१७.२	३१२३.६	२५१२.७	२५०८.४	२१८४६.९
१.१. राजस्व	१३४४.१	१४९७.५	३२०३.२	१११०.९	१४३०.०	८४७.६	९१९.२	१०३५२.५
क. कर	१२२५.४	१३८४.७	२५७०.९	९६९.०	१२७३.१	८२१.४	८८२.५	९१२६.९
ख. अन्य राजस्व	११८.७	११२.८	६३२.३	१४१.९	१५६.९	२६.२	३६.८	१२२५.६
१.२. अनुदान (नेपाल सरकार)	१८४६.६	१५१०.१	१५६७.६	१३८७.४	१५७४.६	१६४९.२	१५६३.५	११०९८.९
१.३. बेरुजु तथा अन्य प्राप्ति	४४.९	२७.५	१४३.४	१८.९	११९.१	१६.०	२५.७	३९५.५
२. वित्तीय व्यवस्थाबाट प्राप्ति	०.०	०.०	४.४	०.०	०.०	०.०	०.०	४.४
३. यस वर्षको खुद प्राप्ति (१+२)	३२३५.५	३०३५.१	४९१८.६	२५१७.२	३१२३.६	२५१२.७	२५०८.४	२१८५१.३
४. भुक्तानी	२९९६.६	२२२६.६	३७९९.५	२२०४.४	३००५.५	२३९४.९	२०८८.०	१८७१५.४
५। समायोजन	०.०	४४४.४	२५९.६	१६५.७	६२.१	०.०	०.०	९३१.७
६. (यस वर्षको भुक्तानी (४+५))	२९९६.६	२६७०.९	४०५९.१	२३७०.०	३०६७.६	२३९४.९	२०८८.०	१९६४७.२
७. यस अवधिको कोषमा भएको थप घट (+/-) (३-६)	२३८.९	३६४.२	८५९.५	१४७.२	५६.१	११७.९	४२०.४	२२०४.२
८. आर्थिक वर्षको सुरुवातको मौज्जात	०.०	१०५९.०	२३३४.७	२८५.९	४७०.४	९५४.५	०.०	५१०४.४
९. आर्थिक वर्षको अन्त्यको मौज्जात (७+८)	२३८.९	१४२३.२	३१९४.१	४३३.१	५२६.५	१०७२.४	४२०.४	७३०८.६

स्रोत: महालेखा नियन्त्रक कार्यालय, २०७९

By the end of March 2023, the expenditure trend in the local levels was not improved. The share of current and capital expenditure remained 71 and 29 percent respectively. The data on their ability to spend according to the approved budget allocation is not systematically available. The story of capital expenditure at the local level is also not fundamentally different.

Chart 15 (g): Expenditure structure of local level (As percentage of Expenditure of local level)



Source: Financial Comptroller General Office, 2022
 Note: Due to the extreme low of Financing expenditure it is included in the recurrent expenditure.

Year	2018/19		2019/20		2020/21		Total	Private	Local level	International
	Expenditure (N)	Capital Expenditure (N)	Expenditure (N)	Capital Expenditure (N)	Expenditure (N)	Capital Expenditure (N)				
2018/19	28253	20129	28253	20129	28253	20129	28253	20129	0	0
2019/20	28253	20129	28253	20129	28253	20129	28253	20129	0	0
2020/21	28253	20129	28253	20129	28253	20129	28253	20129	0	0
Total	84759	60387	84759	60387	84759	60387	84759	60387	0	0

D.3 Public procurement

Nepal's public procurement is still highly centralized. The Public Procurement Act 2007 have been amended tenth time so far but still has failed to incorporate effective public procurement rules and procedure for provincial and specifically local governments. The annual report of Public Procurement and Monitoring Office for FY 2018/19 stated that implementing a transparent public procurement mechanism according to federal structure of the country has remained a major challenge. One of the biggest challenges apparently is the lack of political will to decentralize the public procurement legislation process. Automation in the bidding process certainly remains a bottleneck.

At the operational level, the conflict of interest among political leaders at the subnational level in the bidding process has largely gone unmonitored. The term 'Dozer of mayor' is now commonly bantered about at the local levels. Even after the elected representatives assumed office in LGs, complaints about irregularities at local level have not come down. Elected representatives, especially those who have the background of contractors have been buying their own dozers and working on projects of local governments, in a clear case of conflict of interest. They are using

their power and authority to bag contracts for their own firm (The Kathmandu Post, 31 January, 2019).

D.4 Fiscal discipline and transparency

There is a notorious term '*beruju*' in Nepali accounting and audit system. The Financial Procedures Act 1999 has tentatively translated it into English as "irregular amount" and has defined as 'such a transaction indicated or found on audit as a transaction carried on without fulfilling such requirements as to be fulfilled in accordance with the prevailing law or a transaction of which such accounting as to be maintained has not been maintained or a transaction which has been carried on in an irregular or unreasonable manner.'

Just as a glimpse of gravity of aberration in fiscal governance, The Auditor General's Fifty-Seventh Annual Report 2020 states that in FY 2019/20, the total outstanding 'irregular amount' reached to Rs. 418.32 billion after deducting the settlement and adding this year's irregularity amount of Rs. 40.84 billion. In the last fiscal year, accumulated outstanding irregularity was Rs. 377.48 and only Rs. 7.48 billion was recovered in course of audits and follow up audits. The total amount under 'action to be taken' category to recover or settle, which stood Rs. 683.66 billion up to previous fiscal year, slightly decreased to Rs. 664.44 billion in the last fiscal year.

Irregularity at the subnational level is also significant. In provinces, according to the report, total amount of Rs. 189.25 billion of 998 entities was audited, resulting in the total irregularity of Rs. 8.20 billion or 4.33 percent of the expenditure, out of Rs. 740.65 billion of 747 local levels audited, resulted in total irregularity of Rs. 38.13 billion or 5.15 percent of the expenditure. The irregularity figures in the both level of subnational units are higher than 4.05 percent in federal agencies, which in fact is a cause of concern from the point of view of implementing the fiscal federalism and devolution of fiscal powers.

Whichever level of government is to implement the budget/plan, the legislature of the same level should enact the laws of economic accountability as well. The 'accountability mechanism', process and practice should be adopted at the level of their respective governments. It is necessary because even though the laws formulated by the association are applicable, it is not possible and practical to monitor all the local levels and regulate them from the center.

E. Conclusion

Despite these important constitutional, legal and structural provisions for managing the public finances of the federal system, challenges exist in the formulation and implementation of plans and implementation by the sub-national levels covering all aspects of economic development in their jurisdiction in accordance with the federal spirit and global good practices. Capacity building of both elected executives and civil service personnel to empower them to effectively manage finances in their own independent capacity is inevitable.

As the subnational units, mainly the local levels, apparently exhibit highly varied levels of resource gaps, public goods needs and fiscal capabilities, a comprehensive and holistic stratification/classification of the local levels would be the most logical first imperative to achieve the aforesaid three key objectives of the subnational debt financing. Such stratification should be uniformly recognized in all aspects of intergovernmental relations, vertical and horizontal, among federal, provincial and local governments. In absence of any form of credit rating and fiscal capacity-based stratification of the LGs, the outcome of this classification, apart from debt financing purpose, may also be applied in several other aspects of planning and policy making.

There must far more liberal debt financing regime in place to enable subnational governments to mobilize extra resources. Introduction of performance and overall rating systems is important for them to make efficient and accountable.

In Nepal's particular context, the local levels enjoy constitutionally vested fiscal power. But, one particular challenge the NNRFC now faces is not only putting an uniform viable formula for stratification of sub-national units in place but also to correct so called stratification or classification forced into the system without proper homework. Such classification/stratification exercises carried out by different agencies and several laws is very fragmented and does not follow the same universal benchmarks. For example, the Local Government Operations Act 2017 has classified the local levels as metropolis, sub-metropolis, municipality and rural municipality. It has set different population and budget benchmarks for different geographical area like mountains, hills, plains and the Kathmandu valley; without even assigning the weight for particular component. Similarly, the stratification charted out by the MOFAGA for its purpose to fix the remoteness allowance to the government employees simply cannot be practically applicable to ascertain the financial needs and to address fiscal capability-related issues of the concerned local level.

In view of strikingly exogenously given different economic, geographical and social conditions of local governments, judicious treatment towards them not only in allocating financial and other resources but in every possible aspect of implementing federalism is critical. Despite being in the same bracket by legal definition, each local level's institutional strengths, resource needs, mobilization capacities, social indicators and access to resources is drastically different.

Finally, adoption of the federal system was a turning point in Nepal's history. Now the development of the country is largely dependent on the success of this system. The debate over whether this system was necessary or suitable for Nepal is now history. Of course, many aspects of its proper implementation have been neglected and aspects of apparent economic potentials are ignored, which require continuous improvement. It is possible for the country to catch the pace of development only if the economic and political aspects of federalism such as the almost unlimited authority of local governments, devolved of power on economic decision-making are put into maximum practice in the true spirit of fiscal federalism.

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