

Equalization Payments and Fiscal Fairness in the Federal System of Nepal:

Analyzing the role of equalization payments in reducing fiscal disparities and ensuring fairness.

The Constitution of Nepal 2015, aims for a cooperative federalism with substantial fiscal decentralization. The four key component of fiscal decentralization are (i) assignment of expenditure functions and the budgeting process; (ii) revenue mobilization; (iii) intergovernmental transfers; and (iv) subnational borrowing. Stressing fiscal decentralization makes it clear that Nepal wishes to empower subnational governments (SNGs) by giving them more discretion and autonomy, while at the same time ensuring greater accountability in the operation of these newly empowered governments.

(i)

Nepal's constitutional and legislative framework, led by the National Natural Resources and Fiscal Commission (NNRFC), aims for fiscal equalization, reduced disparities, and fairness. The NNRFC guides federal transfers and natural resource royalties, enabling each government level to plan and budget based on assigned functions. The Subnational Treasury Regulatory Application (SuTRA) tracks spending, but ongoing implementation challenges may hinder federal monitoring of combined functions. Since 2018, expenditure patterns lack clarity in achieving desired equalization effects, hindered by data system construction challenges. The allocation of larger funds to certain provinces raises questions about overall equity and revenue capacity.

(ii)

Nepal's intergovernmental system creates a significant fiscal gap, with 85% of revenue going to the federal government, straining subnational governments (SNGs). Despite revenue sharing, SNGs struggle to cover service costs due to lower taxes. Government revenue, reaching 22% of GDP from 2010 to 2020, is insufficient for well-functioning SNGs, worsened by the COVID-19 impact on tourism. Disputes persist despite attempts to clarify revenue assignments. Local governments aim to boost revenue, with varying success, relying on equalizing grants for 78% of budgets. The government adjusts taxes to enhance provincial and local revenue, emphasizing political reforms for effective mobilization.

(iii)

Nepal addresses its vertical fiscal gap through intergovernmental grants outlined in key acts formulated in 2017, including the Local Level Operation Act, Intergovernmental Fiscal Management Act, and National Natural Resources and Fiscal Commission Act. These grants, such as fiscal equalization and conditional, alongside revenue sharing, aim to bridge fiscal disparities. However, concerns arise over the equitable distribution of fiscal equalization grants, and a shift towards conditional grants suggests federal control over local spending, potentially impacting equity. Disparities persist in provincial transfers to local governments compared to federal transfers, raising questions about fairness. Over the next two decades, the emergence of performance-based subsidies may pose challenges to equity considerations in the evolving system.

(iv)

The 2015 Nepalese Constitution permits borrowing at all levels of government, although obtaining domestic loans for provincial and local governments requires federal approval. Legislation also allows provincial governments to issue bonds (debentures) but excludes local governments from these powers. Subnational government borrowing is still low because of lax regulations, even with permissive policies. Annual borrowing caps are enforced by the National Natural Resources and Fiscal Commission, and SNGs struggle to close the borrowing gap between actual and potential. At the moment, SNG borrowing accounts for just 0.85% of total municipal income and receives little assistance from the local capital market.