

Fiscal Federalism and Economic Growth: Evidence from Case Studies:

Fiscal federalism is a concept that deals with the financial relations between units of government in a federal government system. It is a part of the broader discipline of public finance and was introduced by the economist Richard Musgrave in 1959. The theory of fiscal federalism assumes that a federal system of government can be efficient and effective at solving problems that governments face, such as the just distribution of income, efficient allocation of resources, and economic stability.¹ It is not just about the distribution of spending, taxing and borrowing powers among different tiers of government but also about sharing the responsibility of producing equitable economic fruits across the country. The foundation of fiscal federalism is built on four pillars: Expenditure assignment, revenue assignment, inter-governmental fiscal transfers and public debt management.²

Nepal has made significant progress on fiscal federalism since the transition to a federal system in 2015. However, there are still challenges to overcome to strengthen the regulatory framework, institutional setup, human resource capacity, and public financial management (PFM) systems at the provincial and local levels.³ The World Bank has recommended developing a fiscal federalism roadmap that encompasses a clear set of actions, sequence, timeline, and responsible actors to improve fiscal federalism outcomes in Nepal. The report also recommends reinforcing the intergovernmental fiscal transfer system and establishing a consolidated PFM performance database at the subnational level.

In Nepal, fiscal federalism is a key component of the country's transition to a federal system, which began with the promulgation of the constitution in 2015. The constitution assigns expenditure responsibilities and revenue sources to the central, provincial, and local governments, giving all three levels of government the power to enact laws, prepare budgets, and mobilize their own resources. Specific fiscal federalism policies in Nepal include:

Revenue Potential of Provincial and Local Governments: A study conducted in June 2020 by the Internal Revenue Department (IRD) and the National Natural Resource and Fiscal Commission

¹ Naim Kapucu, FISCAL FEDERALISM ENCYCLOPÆDIA BRITANNICA (2016), <https://www.britannica.com/money/topic/fiscal-federalism> (last visited Nov 8, 2023).

² Gopi K Khanal, OPINION: PROMISES AND PERILS OF FISCAL FEDERALISM THE KATHMANDU POST (2023), <https://kathmandupost.com/columns/2023/08/02/promises-and-perils-of-fiscal-federalism>. (last visited Nov 8, 2023).

³ World Bank Group, NEW WORLD BANK REPORT RECOMMENDS REFORMS TO STRENGTHEN FISCAL FEDERALISM IN NEPAL WORLD BANK (2023), <https://www.worldbank.org/en/news/press-release/2023/06/15/new-world-bank-report-recommends-reforms-to-strengthen-fiscal-federalism-in-nepal> (last visited Nov 8, 2023).

(NNRFC) assessed the revenue potential of provincial and local governments and made recommendations to enhance their own-source revenue generation.⁴

Tax and Non-Tax Revenue Administration at Subnational Level: The administration of tax and non-tax revenue is a crucial aspect of fiscal federalism in Nepal. The responsibilities for revenue collection and administration are shared between the central, provincial, and local governments.

Revenue and Royalty Sharing: Fiscal federalism in Nepal involves the sharing of revenue and royalties between the central, provincial, and local governments. This includes the sharing of value-added tax (VAT), personal income tax (PIT), and royalties from natural resources.

Inter-Governmental Fiscal Transfer System: The World Bank has recommended reinforcing the intergovernmental fiscal transfer system in Nepal. This system includes fiscal equalization grants, conditional grants, and revenue sharing, which are essential for ensuring fiscal balance and equity among the different levels of government.

Consolidated Public Financial Management (PFM) Performance Database: The establishment of a consolidated PFM performance database at the subnational level is another recommendation by the World Bank. This database would help monitor and improve the efficiency and effectiveness of public financial management at the provincial and local levels.

Since the implementation of fiscal federalism policies in Nepal, there have been some improvements in service delivery in different regions. Here are some specific examples:

Improved health sector: Data shows that service delivery in the health sector has been improving compared to the pre-fiscal federalism period or the period before intergovernmental fiscal transfers were initiated⁵. This can be attributed to the increased availability of resources and the accountability of subnational governments in the delivery of healthcare services.

Increased local government autonomy: The new federal system in Nepal aims to empower subnational governments, giving them more discretion and autonomy in decision-making⁶. This can lead to more efficient and effective delivery of public services at the local level, as local governments are better positioned to understand and address the needs of their communities.

⁴ FISCAL FEDERALISM IN NEPAL - IIDS.ORG.NP (2020),

<https://www.iids.org.np/images/publications/7a06e163acf0126073dc168f1d73339b.pdf> (last visited Nov 8, 2023).

⁵ Yoshihiro Saito, Nayan Krishna Joshi & Marcela Roza, TOWARDS IMPROVED SERVICE DELIVERY: FOUR WAYS NEPAL CAN STRENGTHEN FISCAL FEDERALISM WORLD BANK BLOGS (2023),

<https://blogs.worldbank.org/endpovertyinsouthasia/towards-improved-service-delivery-four-ways-nepal-can-strengthen-fiscal> (last visited Nov 8, 2023).

⁶ Strengthening fiscal decentralization in Nepal's transition to federalism, ADB.ORG (2022),

<https://www.adb.org/sites/default/files/publication/806946/fiscal-decentralization-nepal-transition-federalism.pdf> (last visited Nov 8, 2023).

The impact of fiscal federalism on economic growth in developing countries like Nepal has been studied less extensively than in developed countries. However, some evidence suggests that fiscal federalism can have a positive impact on economic growth in developing countries. An empirical study conducted in 2020 found that fiscal decentralization can have a positive impact on economic growth in federal developing countries. The study found that fiscal decentralization can lead to increased public investment, which can in turn lead to higher economic growth⁷. A study on the United States found that there is a positive relationship between fiscal federalism and real GDP growth. The study used the ratio of local governments' revenue to GDP or local governments' spending to GDP as a measure of fiscal federalism.⁸ Fiscal federalism allows for the decentralization of the provision of public goods to subnational governments, which can lead to more efficient and effective delivery of services at the local level. A meta-analysis of fiscal federalism and economic growth found that - especially in more decentralized countries - human capital as a share of general government spending is significantly higher⁹.

The promise of fiscal federalism is to deliver services effectively and efficiently to all Nepalis while ensuring inclusion and equity. The World Bank has recommended several reforms to strengthen fiscal federalism in Nepal, including developing a fiscal federalism roadmap, reinforcing the intergovernmental fiscal transfer system, and establishing a consolidated PFM performance database at the subnational level. Fiscal federalism is the engine of good governance that helps ensure the availability of required resources and builds accountability of the subnational governments to generate revenue, opportune distribution of fiscal transfers, and, most importantly, the processes and capacities to spend those resources in an efficient manner.

However, there are still challenges to overcome to strengthen the regulatory framework, institutional setup, human resource capacity, and public financial management (PFM) systems at the provincial and local levels. The impact of fiscal federalism on economic growth can vary depending on the specific context and the design of the fiscal federalism system. It is important to consider factors such as the overall size of the public sector, the level of intergovernmental fiscal transfers, and the efficiency of resource allocation in order to fully understand the relationship between fiscal federalism and economic growth in developing countries.

⁷ Imran Hanif, Sally Wallace & Pilar Gago-de-Santos, *Economic growth by means of fiscal decentralization: An empirical study for federal developing countries*, 10 SAGE OPEN 215824402096808 (2020).

⁸ Yıldız Özkök & İbrahim Çütcü, DOES FISCAL FEDERALISM MATTER FOR ECONOMIC GROWTH? EVIDENCE FROM THE ... [HTTPS://WWW.TANDFONLINE.COM/DOI](https://www.tandfonline.com/doi) (2021), <https://www.tandfonline.com/doi/full/10.1080/00036846.2021.1998337> (last visited Nov 8, 2023).

⁹ FISCAL FEDERALISM, DECENTRALIZATION AND ECONOMIC GROWTH: A ... - ECONSTOR, <https://www.econstor.eu/bitstream/10419/127468/1/847215245.pdf> (last visited Nov 8, 2023).