
Economic Viability and Legal Aspect of Fiscal Federalism in Nepal

Chandra Prasad Dhakal, Ph.D.

Assistant Professor of Economics at Saraswati Multiple Campus, Tribhuvan University, Nepal,

email – cpddhakal@gmail.com

Article History: Received 20 July 2023; Reviewed 17 Aug. 2023; Revised 2nd Sep. 2023; Accepted 15 Sept. 2023

Abstract

Fiscal federalism is one of the important tools for economic viability in the nation. Nepal follows federal system of government with allocation of certain economic rights to federal units. Constitution of Nepal (2015) makes the provision of three levels of government and all the governments have certain financial rights such as preparing and implementing the budget in its' territory. The study analyzes economic viability and legal aspect of fiscal federalism in Nepal. Objectives of the study are to highlight the legal aspects of financial federalism and analyze budget practice of fiscal federalism of Nepal. Qualitative research design was used to fulfill the objectives of the study. Only secondary source of data was used for this study. Data were collected through library research and interpretive paradigm was used to complete the research. Finding and conclusion of the study has been based on interpretation of data. The implementation fiscal federalism is not effective in Nepal as well as implementation mechanism of the governments is found also weak that makes fiscal federalism as controversial issue in economic development.

Keywords: *Fiscal, federalism, Nepal, economic aspect, budget*

Introduction

Nepal is one of the developing nations of South Asia and struggling for economic growth and social development. Constitution of Nepal (2015) tries to sketch the guidelines of economic growth on the basis of socio and economic transformation. According to the constitutional provision there are three levels of governments (federal, province and local) are formed and have been activating in its' territory for seven years. All governments have lunched budget on the basis of constitutional and legal provision. Constitution of Nepal article 59 mentioned the financial power of Exercise of financial powers Article 59 (1) of the Constitution states, "The Federation, Province and Local levels shall make laws, make annual budget, decisions, formulate and implement policies and plans on any matters related to financial powers within their respective jurisdictions". The Inter Government Fiscal Agreement Act (IGFA) make the provision of using financial rights to federal, provincial, and local levels as, "federal, provincial, and local levels shall prepare an estimated statement of public expenditures on subjects under their domain each fiscal year, including those for

recurrent and capital expenditures and fiscal arrangements". Local and province governments have equal rights to make and implementation budget in its' territory. Local Government Operation Act (2017), National Natural Resources and Fiscal Commission Act (2017) also provided background for allocating and implementing budget in according to federal structure. In this regard National Natural Resources and Fiscal Commission Report (2020) notes, "Budget formulation and implementation process not only related to constitutional and legal provision but also related to the behavior of the local leaders and nature of bureaucracy" (p.5). Administrative culture plays great role on budget formulation and its' implementation. Nepal adopted a federal system of governance after promulgating the constitution of Nepal in 2015. The Constitution prescribes a three-tier governance system with federal, provincial, and local levels. Constitution makes clear provision about rights of federal, province and local level in annexes (from annex 5 to 9). In annexes there mention certain fiscal rights related to collect revenue, fee, tax and other charges. Each of the governments prepare annual budget in according to the constitution and legal provision and implements the fiscal federalism in Nepal.

Since long time, Nepal had exercised centralized fiscal policy and budget also prepared on the basis of centralized notion of resource mobilization. In the history of annual budget, sixty-two budgets were made on centralized concept (NNRFC, 2022). However, after promulgation of the Constitution of Nepal (2015), budget has prepared in federal form. Since 2017 local and province level governments began to make budget on the basis of constitution and local government operation act 2017. On the basis of constitutional guidelines fiscal federalism, each of the government made budget and approved from legislature before the end of June. In this legal context fiscal federalism is playing role to enhance the economic viability in nation by activating budget and programs.

Methodology

To analyze the issue raised in the paper, qualitative research design was followed because qualitative research design helps to analyze the issue in natural setting with sufficient information. In this regards Moser highlights, "Qualitative research supports to bring out the reality as natural phenomena with natural setting" (p.5). Like Morse's idea in this study information were gathered legal document and analyzed how legal system played role to establish fiscal federalism in Nepal. Due to nature of the study only secondary sources of data were used for this study. Secondary data supports to analyzed issue on the basis of the evidence of written document. Basically, legal documents like Constitution of Nepal, Report of national Commission of finance and Natural Resource, Local Government Operation Act National of and other government reports, books are the main source of secondary information. Library research method was used to collect secondary information.

Policy and Practice of Fiscal I federalism in Nepal

Constitution of Nepal (2015) makes different provision for fiscal federalism in Nepal. Article 56 highlights the federal structure of the nation (federal, province and

local) with certain rights. Article 57 divides state power between the three levels, which are further mentioned in the constitutional Schedules. Schedule-5 details the 35 exclusive powers of the federation. Schedule-6 lists the 21 powers of the provinces and Schedule-8 lists the 22 exclusive powers of the local units. Each level has to exercise its exclusive powers in accordance with the Constitution and laws. Schedule-7 of the Constitution included 25 powers shared between the federation and the provinces. The federal and the provincial government can exercise these powers in accordance with the Constitution and federal and provincial laws. Similarly, Schedule-9 includes 15 concurrent powers shared between the federal, provincial, and local levels, which can be exercised in accordance with the Constitution, and federal, provincial, and local laws. Article 57 (6) requires that any law made by a Provincial or Local Assembly by exercising their concurrent powers has to be consistent with federal law, and laws made at the local level are to be consistent with provincial laws. Article 59 (1) of the Constitution notes that all three levels can formulate laws, prepare an annual budget, take decisions, formulate plans and policies, and implement them in matters related to their financial powers within their respective jurisdiction. Article 59 (2) of the Constitution highlights the financial matters under the concurrent list, federal policies, standards, and laws can be made to be applicable to the provinces as well.

The Constitution makes provision to share power with all governments and provides for fiscal transfers, including grants and revenue-sharing. Provinces can have also righted to collect levy, taxes and collect revenue in accordance with Article 60 (1) of the Constitution. Article 60 (2) states that the Government of Nepal (GoN) shall make the necessary arrangements to equitably distribute the revenue it generates between the federal, provincial, and local levels. According to Article 60 (3), the amount of fiscal transfer that a province or local unit receives is recommended by the National Natural Resources and Fiscal Commission (NNRFC). In the same way, article 60 (4) of the Constitution states that the GoN shall distribute fiscal equalization grants to provincial and local units on the basis of their expenditure needs and capacity to generate revenue. Article 60 (5) mandates provinces distribute fiscal equalization grants and revenue collected from its sources to local units based on the latter's expenditure needs and revenue capacity. In Article 60 (6), the Constitution mentions that the GoN will make arrangements for conditional, complementary, and special grants for provinces and local units from the Federal Consolidated Fund in accordance with federal law. Article 60 (7), highlights that the distribution of revenue between the federal, provincial, and local levels shall be transparent. Article 60 (8) requires that federal laws regarding revenue distribution should take into account national policy and national needs; reduction of regional imbalance; ending poverty, inequality, and exclusion; and the autonomy, fiscal powers, service delivery, revenue generation, potential use of revenues, and the execution of emergency needs of the provinces and local units. (Acharya, et.al, 2020).

Similarly, article 116 of the constitution imagines the establishment of a federal consolidated fund as, "All funds received by the government of Nepal, including those from revenues, loans, and other incomes will be credited to the Federal Consolidated Fund".

Similarly, article 204 imagines the establishment of a province consolidated fund in which the provinces are required to deposit all revenues received, all loans raised, and all amounts received in the repayment of any loans from the federal government. Likewise, each local unit is also required to set up their own Local Consolidated Funds in accordance with Article 229 of the Constitution (MoF, 2017).

Articles, 231-237 of the Constitution has provisions related to intergovernmental relations between the federal, provincial, and local governments. Article 232 of the Constitution mentions that "the relation between the federal, provincial and local governments shall be based on the principles of cooperation, co-existence, and coordination, which is among the defining features of Nepal's federal system". Article 59 (1) of the Constitution allows the three levels of government to formulate and implement plans, policies, and programs, and make their own annual budgets within their respective jurisdictions. Article 59 (3) requires sub-federal governments to adhere to federal laws regarding their budgetary processes. Article 59 (7) states, "Federal laws will guide the provincial system in relation to budgets, public financial management, and fiscal discipline". The Constitution allows the Office of the Auditor General (OAG) to audit expenditure details of all federal, provincial, and local entities Article 285 (3) of the Constitution allows for provincial and local levels to create and operate their own services for their employees in accordance with the law. Under the transitional provisions in the Constitution provided in Article 302 (2), the GoN is mandated to adjust civil servants from the erstwhile government service to federal, provincial, and local governments in accordance with the law (NPC, 2020).

To enhance the fiscal federalism in Nepal federal parliament can be enacted laws. The law focuses on intergovernmental fiscal transfers, the role and responsibility of the fiscal commission, the operations of local governments, financial procedures, fiscal responsibility, etc. The Intergovernmental Fiscal Arrangement Act, (2017) was enacted to implement intergovernmental fiscal transfers among the three levels of government. The Act defines the process related to the transfer of grants, revenue-sharing, borrowing, budget management, public expenditure, and financial discipline for all three levels of government. The National Natural Resources and Fiscal Commission Act, 2017 defines the institutional arrangement, and roles and responsibilities of the commission along with the principles of fiscal federalism in accordance with constitutional provisions. The Finance Procedure and Fiscal Responsibility Act, 2019 was enacted to make the financial management system accountable, transparent, and result-oriented. It provides standards and guidelines for the management and operation of the *federal consolidated fund* and other government funds. It contains provisions related to budget formulation, disbursement, expenditure, accounting and reporting of financial transactions, internal controls, and audits. The act requires the *Financial Comptroller General's Office* (FCGO) to consolidate financial statements across all levels and submit the same to the OAG. Provinces should keep their accounting and financial statements as approved by the GoN in accordance with the Act. (MoF 2020).

The Local Government Operations Act (2017) incorporates the unbundled

constitutional functions of local governments and provides a mechanism for operations. It also defines the financial procedures of local governments, including the establishment of their consolidated funds, maintenance of their accounts in prescribed formats, the process of preparing their budgets, and the mechanism for spending and public procurement. The Federal, Provincial and Local Level (Coordination and Interrelations) Act, 2020, popularly known as the Intergovernmental Relations and Coordination (IGRC) Law, 2020, enacted by the federal parliament in accordance with Article 235 of the Constitution contains provisions on intergovernmental relations and coordination. This law standardizes for intergovernmental relations and coordination, including that for introducing laws and policies at the provincial and local levels. It is expected to foster cooperation and coordination in matters of common interests and resolve disputes between and among the federal units.

All the provinces and local bodies have enacted their financial procedures act which provides the legal basis for public spending, financial reporting, and accountability. Intergovernmental Fiscal Transfer Act and Revenue Sharing Act enacted in 2020, have altogether enacted 333 laws law (Shah et al., 2021), including in the areas of security, governance, economic development, social development, and infrastructure development. Bagmati and Lumbini have introduced the highest number (59) of laws each, followed by Province 1 (49), Gandaki (46). Madhes province and Sudurpaschim each have enacted 42 laws. Karnali has enacted the least number (36) of laws (MoF, 2019).

The national natural resources and fiscal commission (NNRFC) play vital role to estimate fiscal resources particularly for fiscal transfers and determining. The NNRFC is entrusted with the responsibility of ensuring fiscal equity through the fair distribution of resources to the three levels. It plays a crucial role in designing a balanced and transparent intergovernmental fiscal transfer mechanism that is expected to reduce vertical and horizontal fiscal imbalances and resolve potential disputes that may arise between the levels of government, especially in areas of fiscal transfers and natural resource mobilization (MoF, 2017).

The Ministry of Finance (MoF) of the federal government is handed over with several responsibilities with regard to fiscal federalism. MoF is responsible for executing fiscal transfers through the federal budget as per the recommendations of the NNRFC. The MoF is the key institution responsible for preparing and implementing the federal budget. Like that at the provincial level, the Ministry of Economic Affairs and Planning (MoE) is the main institution with regards to planning and budgeting. The responsibility of the MoE includes economic analysis, formulation and implementation of economic policies, revenue-sharing, and fiscal management at the provincial level. It coordinates with other ministries in formulating and implementing periodic and annual development plans for the provinces (NPC, 2015).

In the constitution of Nepal expenditure assignment schedules 5 to 9 of the Constitution list concurrent powers, functional responsibilities of the federal, provincial, and local governments. Government has the power to make expenditures in matters under

its exclusive jurisdiction. Provinces are assigned with exclusive functions including the administration of provincial police, banking and financial institutions, operation of radio, FM, and television, provincial statistics, trade and industry, provincial highways, vehicle management, and transportation. Like that local government also share concurrent powers with federal and local levels which include cooperatives, education, health, agriculture, hydropower, drinking water, irrigation, forest, environment, mines and minerals, social security, vital registration, etc. (NNRFC, 2020).

In the context of revenue collection Provinces are allocated with revenue powers which include tax and nontax sources and royalties from natural resources. The revenue powers assigned to provinces include agricultural income tax, house and land registration fees, motor vehicle tax, entertainment tax, vehicle tax, tourism fees, service fees, fines, penalties, and other taxes that may be levied in accordance with provincial laws in matters under their jurisdiction. Only agricultural income tax is under the exclusive domain of the provinces. Other revenue sources assigned to the provinces can also be levied by federal or local governments. In order to resolve this dilemma, a *Single Tax Administration (STA)* system has been introduced. In accordance with the IGFA Act, provinces collect motor vehicle tax for themselves as well as for the local levels and local levels collect building and land registration fees, advertisement tax, and entertainment tax levied etc. The following table shows it in detail.

Table: 1 Revenue Powers of the Federal, Provincial, and Local Levels

Source of Revenue	Federal Level	Provinces	Local Level
Customs	√		
Excise Duty	√		
Value Added Tax (VAT)	√		
Individual Income Tax	√		
Corporate Income Tax	√		
Remuneration Tax	√		
Agriculture Income Tax		√	
Entertainment Tax		√	√
Motor Vehicle Tax		√	√
Advertising Tax		√	√
Building and Land Registration Fee		√	√
Wealth/Property Tax			√
Land Tax			√
House Rent Tax			√
Business Tax			√

Non tax			
Source of Revenue	Federal Level	Provinces	Local Level
Passport and Visa Fees	√		
Lottery, Casino	√		
Charges Service Fees	√	√	√
Tourism Fees	√	√	√
Penalties	√	√	√
Other			
Other tax and non-tax revenue Levied according to federal, Provincial, and local laws	√	√	√

Source: Adapted from the Constitution of Nepal, 2015 and the IGFA Act

Above table highlights the fiscal federalism of Nepal including rights of collecting tax, and nontax revenue by federal, province and local government. In some taxes are collected by two or more than two governments e.g., tourism tax collected by federal, province and local governance. Likewise, entertainment tax is collated by local and federal governance. It shows duality in fiscal federalism.

In revenue sharing, certain parameter has followed by the NNRFC, however, some of the local governments that have enough natural resources have not shared the tax with province. The constitution and local government operation act as well as the NNRFC also made the following guideline to allocate the revenue. The following table highlights in detail.

Table: 2 Revenue-Sharing Criteria to the Federal province and Local Levels

Criteria	Weightage (%)
Population	50
Geographical Area	15
Human Development Index	15
Efforts for Revenue Collection	5
Infrastructure Development	5
Special Criteria	5
Expenditure Needs	5
Total	100

Source: NNRFC (2020)

Above table highlights the revenue-sharing criteria among federal, Province and local levels. NNRFC made certain criteria to allocate revenue to the local and province level. Basically, revenue collected from Vat and income tax are allocated to the local and province according to above mentioned criteria. Population, geographical area and human development index are the main criteria for allocating the revenue to the province and local level. Like that the following table shows weight age of indicators for determining the share of royalties collected from mine, mountaineering and hydroelectricity.

Table: 3 Criteria and Weight age of Indicators for Determining the Share of Royalties

S. N	Indicators	Mountaineering	Electricity	Mines
1	Geographical situation	40	50	50
2	Local Level with Base camp	10		
3	Affected area	25	25	30
4	Affected population	25	25	20

Source: NNRFC (2019)

Table 3 shows the guideline of royalties sharing collected from mine, hydro-electricity and mountaineering. Geographical situation, local level with base camp, affected population is the main indicators to allocate royalties collected from mountaineering, hydro-electricity and mines.

Constitution of Nepal article 252 (1) notes the allocating the budget to province and local level on the guidelines of NNRFC as, Article 251 (1) F, states that the "NNRFC can recommend fixing the limit of internal borrowing for the federal, provincial, and local levels taking into account the overall economic indicators of the country. Provincial governments have executed three full budgets and are currently implementing their fourth budget". This analysis of provincial budgets is focused on the budget's objectives and priorities, sources of the budget, resource outlay, expenditures, and programs. Provinces have the authority to formulate and implement their own budgets and programs. Each province's minister for economic affairs and planning is required to present the provincial budget to their respective provincial assembly. Among other things, the budget should include revenue estimates, expenditures to be borne by the Provincial Consolidated Fund, and expenditures to be made in the upcoming fiscal year (Shah, et. al. 2021).

The Ministry of finance provides guidelines and frameworks to prepare the midterm expenditure format and budget for provincial ministries. These constitute the basis for preparing the budget, prioritization, expenditure. The guidelines of budget ceilings are sent to the respective ministries and agencies by the second week of Falgun (mid-March). The MoE must enter ministry-wise budget ceilings in the provincial line ministry budget information system (P-LMBIS) before sending them to the concerned ministries and agencies. The ministries should then enter their programmes into the P-LMBIS for themselves as well as for offices under them and stay within the budget ceilings and guidelines before sending it back to the MoE by Baisakh 5 (third week of April) (MoF,2019).

Development plan has started in Nepal since 2013 B.S. with long-term vision, mission, and strategies for socioeconomic development of nation. Now the fifteenth national development plan is going on with the slogan of "Prosperous Nepal; Happy Nepali". Milestones of the national plan's long-term vision for Nepal are to graduate from the group of least developed countries by 2022, become a middle-income country. Like that it is hoped that Nepal will have upgraded and a high-income country by 2043 (2100 B.S.). Three levels

of government are guided by this vision and made plans and the implementation of the Sustainable Development Goals (SDGs). Role of fiscal federalism is high to achieve the sustainable development goal.

Conclusion

Fiscal federalism is not effectively practiced in Nepal; however, some hopeful experience of a federal system of governance can be seen in few years practice. Local and province government release budget in time use its' own resources, and exercise planning, programming. In some cases, lack of clear Policy of government, fiscal federalism became problematic in Nepal, however, constitution and laws imagine fiscal federalism is the main tools for economic and social development of the nation. After adopting federalism some negative aspect of economic development also appears in the system such as increase the corruption, tension of sharing more budgets, increasing undeclared (*beruju*) amount. There is tension of capturing resources by local and province level, duplication in development work, domination of federal government, and anarchy in financial discipline. Due to double tire in service delivery system local, federal and provinces government are confused on responsibility. Local government has low capacity of tax collection and mobilization of resource so that fiscal federalism is being as main cause corruption in Nepal that creates new problems in Nepal for economic development.

Running cost of the government is high and it also creates duplication in expenditure assignment, however, federal government tries to control by legal provision. The attempt could not bring positive result in practice because unclear due is increasing year by year. As finance should follow functions in a federal system, the revenue powers of the provinces need to be revisited, including in the drafting of laws related to their concurrent powers. Provinces should refrain from the practice of withholding or threatening to withhold grants to local levels though this is not a systemic issue, it was reported in a few provinces that they have threatened to withhold grants to local levels that have not transferred the revenue they have collected on behalf of the province

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