FISCAL FEDERALISM IN NEPAL: CHALLENGES AND OPPORTUNITIES

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Abstract

The Constitution of Nepal was formally promulgated and it declared the country as a Federal Democratic Republic on September 20, 2015 by the Second CA. Fiscal powers were shared among the federal government, the state governments and the local governments. The Constitution further defined the framework of fiscal federalism within the pattern of income and resource distribution. The primary objectives of this study is to review the modality presented in the new Constitution on the natural resources, economic rights and revenue allocation. The study finds that the fiscal decentralization initiatives have not been successful in minimizing the political, social, economic, regional and ethnic inequalities inherent for nearly 240 years of a unitary system of governance in Nepal. The study recommends that VAT, excise duties and income taxes have to be allocated at the federal, states and local levels in the ratio of 70 percent, 15 percent and 15 percent respectively by the Constitution. Intergovernmental transfer modality has included in the Constitution. Revenue sharing from hydropower has been a controversial issue in Nepal. National Natural Resources and Fiscal Commission (NNRFC) has been constituted at the central level to make national level development plans and to make recommendations for additional grants and loans for the state and local governments. The Constitution has further defined the framework of fiscal federalism within the pattern of income and resource distribution. The theoretical study indicates that there is various controversial and overlapping issues required clarity in process of implementation in the years to come.

Keywords: Challenges and Opportunities, Fiscal Decentralization, Fiscal Federalism, Intergovernmental Transfer,

Background

Fiscal Decentralization**:** Fiscal decentralization is the transfer of expenditure responsibility and assignments in generating revenue to the lower levels of governments. It is the granting of independence or autonomy to the local governments. It is the mechanism of sharing fiscal resources among the different tiers of the government. Fiscal decentralization involves transferring expenditure and revenue responsibilities from the central government to sub-national

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governments.

Modern political system is predominantly based on people's participation, local self-governance and decentralization. Decentralization is therefore an integral part of the modern governance at the central, provincial, and at the local level. It promotes democratization, equity, people's participation and effective service delivery at local level through transfer of authority, power, responsibilities including fiscal authority and resources to lower level of the government. Both in the developed and developing countries, people are demanding more decentralization for participatory local democracy and local development, effective service delivery and addressing diversities. Globally, it has become the necessity for the better service delivery and compulsion for participatory governance.

On the other hand, fiscal decentralization, or the transfer of fiscal power from the Central Government to Local Governments (LGs), is seen as part of a reform package to all developed and developing countries to improve efficiency in the public sector, to increase competition among LGs in delivering public services, and to stimulate economic growth. It has caught much attention of the policy makers and economists around the globe. Indeed, it entails the assignment to LGs or resources to finance the functions for which they are responsible. In general, it is the assignment of expenditure functions and revenue sources to Local Governments. Over the past two decades most developing and transitional economies have embarked upon fiscal decentralization. It is, because, fiscal decentralization is considered as an effective policy instrument to foster economic growth and macro-economic stability (Martinez-Vazquet & McNab, 1997).

Fiscal Federalism**:** Nepal is a multi-ethnic, multi-lingual, multi-religious and multi-cultural country. The Constitution 2015 has established Nepal a Federal Democratic Republic State.

Fiscal federalism is financial relations between units of governments in a federal government system. It depends upon country specific geo-political and socio-economic circumstances with the aim of achieving the policy objectives of that particular country. The objectives include efficiency, equity, stabilization as well as regional balance, national integrity and political stability (Bird, 2002).

Fiscal federalism is one of the important areas in the public finance discipline. The term fiscal federalism was first introduced by the German-born American economist Richard Musgrave in 1959. Fiscal federalism deals with the division of governmental functions and financial relations among levels of government (Musgrave, 1959).

Fiscal Federalism is concerned with the division of revenue and expenditure responsibility among different tiers of government. Hence, allocation of tax and expenditure function to the various level of government is the foremost issue of fiscal federalism (NEA, 2009, p. 28). Fiscal federalism is concerned with understanding what functions and instruments are best centralized and what are best placed in the sphere of decentralized levels of government (Oates, 1999, p. 1120). Fiscal federalism explores the roles of the different level of the government and the ways in which they relate to one another (Oates, 1999, p. 1110).

"Fiscal federalism refers to the allocation of tax-raising powers and expenditure responsibilities between different levels of government" (Akindele & Olaopa, 2002).

Conceptual Framework of Fiscal Federation

Fiscal Federalism	Fiscal Resources Fiscal Autonomy Fiscal Decision Making	Resource Mobilization Resource Allocation Fiscal Capacity

(Study, 2019)

Objectives

The key objective of this study is to analyze fiscal federalism model in Nepal. But some specific objectives of this study are as follows:

- To clarify fiscal decentralization and fiscal federalism,
- To explore components of fiscal federalism,
- To understand about Inter-governmental fiscal transfers,
- To analyze local borrowing in fiscal federalism.

Methods and Materials

This study is an analytical study based on the application of macroeconomic theory of the public sector. The study is based on secondary data. Data published from various governmental and non-governmental organizations are used to analyze the government's fiscal situation. Economic surveys, budget speeches and plan documents published by the Ministry of Finance and the National Planning Commission and various reports published by the Local Body Fiscal Commission and Financial Comptroller General Office are the major sources of statistical information. Apart from this, reports published by the World Bank and UNDP are also taken under consideration.

Components of Fiscal Federalism

Regional inequality inherent in Nepal was one of the major causes for the need of federalism. The economic literature suggests that public expenditure should be directed more towards the less-developed regions. The issue of regional differences in public expenditure has been critical in Nepal. Per capita government expenditure across regions remains highly unequal which is undesirable for egalitarian and just Nepal.

Components of Fiscal Federalism

Fiscal Federalism			
A. Expenditure assignment	B. Revenue assignment	C. Inter-governmental fiscal transfer	D. Sub-national borrowing

(Study, 2019)

A. Expenditure Assignments

Expenditure assignment is the first step in designing an international fiscal system. Designing revenue and transfer components of a decentralized inter-governmental fiscal system without concert expenditure responsibilities would weaken decentralization process. The key success of a decentralized system is matching expenditure responsibilities with the objectives of service assignment.

A decentralized body is more accessible, more sympathetic and quicker to respond to local needs. It provides closeness between citizens and governments. It enhances the sense of ownership and responsibility. It encourages the local population to carefully plan, monitor and protect the results (Musgrave, 1985; Rao, 1997; Bird, 2002; Dafflon, 2006; Boadway & Shah, 2009).

Allocation, redistribution and stabilization are three functions of the government. Musgrave (1985) argued that the latter two are 3the primary responsibility of the central government. The federal government usually plays a major role in providing pure public good like national defense. Some functions like stabilization policy, monetary policy, income redistribution policy and justice, foreign affairs, international trade, cultural and communication policy, strategic investment and investment policy must be performed at the national level by the federal government. The central government should focus its role on nationally significant infrastructures like railways and airlines. Federal government can play a major role in shaping health and education programs.

B. Revenue Assignment

Once the assignment of expenditure responsibility has been determined the second key question as: who gets what resources? “The revenue assignment acquisition as tax policy is known in the context of inter-governmental fiscal relation is often considered the second main pillar or building block of fiscal decentralization policy” (Bird, 2011).

No universal model for local government and revenue assignment is applicable for all countries around the world and the best model depends on many other factors on (Stephenson & Holm, 2000): The type, the size, the type of functions they are going to perform, the cultural context of the country and historical experiences, and the administrative capacity at the local level or local government.

In assigning taxes to the government at federal, province and local level, the following considerations should be born in mind (Hicks, 1955, p. 115): a) Revenue from taxes should not be subject to inherent fluctuations. The jurisdiction of these governments is small. Their power of maneuver is limited. So, they need steady incomes. b) From administrative point of view, these taxes should be easy to assess and collect. It is an admitted fact that general level of state administration is lower than that of the national governments. And c) For the sake of convenience, it is necessary that, at lower levels of government, tax base be localized in order to avoid dispute over jurisdiction. Financing responsibilities require resources. Hence, revenue assignment is concerned with the question "who should levy what taxes?" Revenue resources for different levels of government are identified.

In most developing and transitional economies, local governments do not have significant tax collection powers. Richer and larger countries are usually more decentralized in terms of revenue assignments (Broadway & Shah, 2009). It is argued that the broad and mobile tax bases may be assigned to the central government for stabilization of the economy and redistribution income. The sub-national governments may raise revenues through users' charges, benefit taxes and taxes on relatively less mobile taxes (Musgrave, 1985 & Rao, 1997). In most federal system of government, taxes on international trade (custom duties) are levied at the central level. Taxes on the consumption of goods and services are levied at both the central and sub-national levels. At the manufacturing stage, VAT is levied by the central government and destination-based VAT up to the retail stage is levied by the states.

The supporters of decentralized system of revenue from natural resources believe that since the natural resource rent is the income in excess to cover the costs required to cover all inputs (roads, airports, ports, upgraded schools, health and social services, environmental protection, etc.), and all these input responsibilities are under the jurisdiction of sub-national governments, the revenue assignment should be assigned to the sub-national governments for both efficiency and equity considerations. Further, they consider that sharing of rents with all level of the government foster competition (Brosio, 2006).

C. Inter-Governmental Fiscal Transfers (IGFTs)

Inter-governmental fiscal transfers (IGFTs) are transfers of funds from one level of government to another. This may be to fund general government operations or for specific purposes. Since revenue assignment often does not provide regional and local governments with sufficient revenues to fund their expenditure functions, inter-governmental transfers are often necessary to assure revenue adequacy. Transfers are often necessary to assure revenue adequacy. Transfers are grants from one level of government to another (often from higher to lower) for the purpose of funding government activities. The term *transfer* is often used interchangeably with the term grants, subsidies**.**

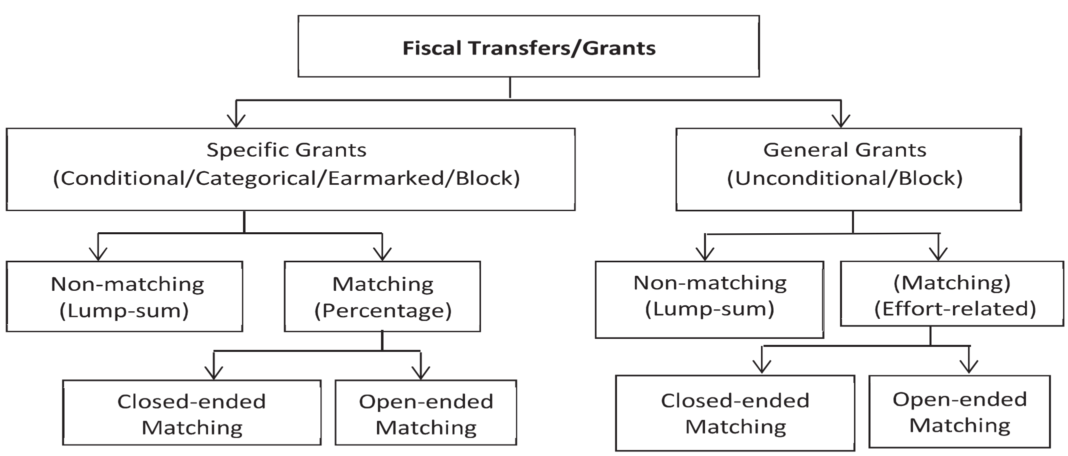
Inter-governmental fiscal transfers are the dominant sources of revenue for both sub-national governments in most developing countries. Central transfers finance 85 percent of local expenditures in South Africa, 72 percent of provincial and 85 percent of local expenditures in Indonesia, 67 to 95 percent of state-local expenditures in Nigeria and 70 to 90 percent of expenditures in less prosperous states in Mexico. The design of these transfers is of critical importance for efficiency and equity of local public services provision and the fiscal health of sub-national governments (Shah, 1994). Inter-governmental transfer is one of the major components of public sector responsibilities in federations. In most of the cases, inter-governmental transfer takes place from higher level to lower level of government

The logic of centralizing revenue collection is generally stronger than that of centralizing expenditure responsibilities all over the world. The share of social sector expenditures in total spending is very high in modern welfare states and these responsibilities are usually heavily borne by constituent unit governments with some federal assistance all over the world. In this background, virtually every country faces the problem of fundamental imbalance between expenditures and revenues. Therefore, the need for intergovernmental fiscal transfers arises to close the budgetary gap. No simple and uniform pattern of transfers will be suitable for all circumstances.

Fiscal transfers are particularly important in fiscal federalism that do not have extensive tax sharing. Fiscal transfers are, therefore, alternative to tax devolution. Fiscal transfers can be of legal entitlements, discretionary, conditional and unconditional. Large grants are legal entitlements in many federations. Conditional grants encourage sub-national governments to spend more on program which are prioritized by the federal government. Fiscal transfer based on discretionary or negotiations are undesirable. The formula based distribution is regarded as a sound transfer system. Formulas should not be too complex and desire degree of inter-jurisdictional equalization can be built into such a formula (Bird, 2002).

The current scenario of intergovernmental transfer in Nepal is guided by the political or electoral theory of public expenditure which explains that trend in public expenditure depends on electoral preferences of politicians. The transfer scheme has not been systematic and effective. The Ministry of Finance (MoF) directly provides fiscal transfer as a grant to state and local governments (753).

Classification of Fiscal Transfers (Grants)



Source: Dafflon, 2012.

Provisions of Grants

a. **Fiscal Equalization Grants**

The government of Nepal shall, on the recommendation of the Commission distribute fiscal equalization grants to the State and Local Level on the basis of their need for expenditures and revenue capacity.

b. **Conditional Grants**

Conditional Grant method is used to accomplish various inter-governmental objectives as well, besides being a balancing factor. The Government of Nepal shall provide conditional grants to the State and Local Level to implement any project of the state or Local Level.

A conditional transfer (grant) from a federal government to sub-national government or local government involves a certain set of conditions and rules. If the lower strata of the government are to receive this type of transfer, it is compulsory to agree to the spending instructions of the federal government. A matching grant is one, which matches the lower government's expenditure on some specific good or goods. When there is ceiling on the total amount of matching grant, it is a closed-ended matching grant. A grant that is earmarked for a particular use is called an earmarked or a specific or non-matching grant. Often a higher-level government gives earmarked grants to lower governments.

c. **Complementary Grants**

The Government of Nepal may provide complementary grants to the State and Local Level to implement any project related to infrastructure development.

d. **Special Grants**

The Government of Nepal may provide special grants for any specific project to be operated by the State or Local Level having any of the following objectives: -

a) to develop and deliver basic services like education, health and drinking water,

b) to achieve balanced development of inter-State or inter-Local Level,

c) to uplift or develop the class or community discriminated economically, socially or in any other form.

e. **Sub-National Borrowing**

Borrowing in sub-national level would be for capital expenditure only in federal structure. Sub-national level-especially the province and local governments would be given the right of borrowing but only from within the country. International lending, if necessary to sub-national level, would be allowed in condition of permission from the center in advance.

Discussions

Fiscal Imbalance

With the different roles of different tiers of the government on expenditure and revenue, it is possible that there will be monetary imbalance among different levels of the government. For example, federal government may generate more revenue but spend less while state level governments may generate less but spend more and vice-versa. Similarly, among the states, some states may be needier but generate less while others may require less but generate more revenue. These types of imbalances are known as fiscal imbalance (NEA, 2009). The lack of symmetry between the tax powers and the expenditure responsibilities of sub-national governments result in fiscal imbalances (Singh, 2014, p. 408). Lack of adequate funds at the local level creates a problem known as fiscal gap. Fiscal imbalance is also called sometimes fiscal gap. Lack of adequate funds at the local level creates a problem known as fiscal gap. Fiscal imbalance is also called sometimes fiscal gap.

In a federation, provision of revenue assignment has to be decentralized, but most of the tax powers have to be vested in the center. This will obviously lead to considerable fiscal imbalance between the center and the states. The levels of vertical and horizontal fiscal imbalances are key issues in the fiscal federalism. There are two types of fiscal imbalance: Vertical Fiscal Imbalance, and Horizontal Fiscal Imbalance

a) Vertical Fiscal Imbalance

Tax powers are concentrated in the center. But functions are more or less evenly distributed between the center and the states. This has created substantial vertical fiscal imbalance i.e., imbalance between the center and the states in respect of their incomes relative to needs.

Vertical fiscal imbalance is concerned with the question "How is any imbalance between expenditure and revenue at different levels of government resolved?" This deals with the provision of central grants to local governments. Vertical fiscal imbalance refers to surplus resources relative to responsibilities with one tier of government, usually the Federal Government and corresponding deficiencies of resources relative to responsibilities at the lower tiers government, i.e., states and local governments.

The center has much larger amount of tax collection than what it needs to provide the revenue resources that it has to provide, while the states or the lower bodies has in their command much less resources than what they need for providing the revenue resource that they should provide. This imbalance is referred to as vertical fiscal imbalance. This problem is removed through transfers of incomes from the center to the lower level governments. These transfers are called grants.

By Lane (1968): "In a multi-level government, vertical fiscal imbalance refers to a situation in which the division of revenue sources and expenditure functions between the federal government is insignificant".

b) Horizontal Fiscal Imbalance

Horizontal fiscal imbalance means fiscal imbalance among states and also among local bodies within a state.

Horizontal fiscal imbalance refers to the differences in the ability of provinces/territories to raise revenues to meet the needs (expenditures) of their citizens. This type of imbalance is referred to as the existence of economic inequalities between the states. Horizontal fiscal equity in a federation seeks to achieve inter-personal equality in tax payment among the different states.

Horizontal fiscal imbalance refers to imbalances in fiscal capacities at the same tier of government i.e., differences at the provincial level or differences at the level of local bodies.

Horizontal fiscal imbalance is concerned with reducing or removing differences in need and capacity is at the same level of government. The concepts of fiscal federalism are related to vertical and horizontal fiscal balance in federation. The nations related to horizontal fiscal system are related to regional imbalance and horizontal computational. Similarly, the vertical fiscal system is related to vertical fiscal imbalance between two senior levels of government that are the central and the states. The concept of horizontal fiscal imbalance is relatively non-controversial. The concept of vertical fiscal imbalance is quite controversial.

While vertical fiscal imbalance refers to imbalance between two tiers of government, horizontal imbalance refers to imbalances at the same level of government, i.e., with respect to provinces or with respect to local governments. Vertical imbalance and horizontal imbalance together are known as the issue of inter-governmental fiscal transfers.

Corrective Measures of Fiscal Imbalance

Some corrective measures of fiscal imbalance are as follows:

a) **Fiscal Commission (FC) Transfers**

The FCs practice of filling up the gap between projected revenue need and fiscal capacity of a state with tax devolution and grants- in – aid is referred as **gap filling.**

b) **National Planning Commission (NPC) Transfers**

Another source of central funds to the states is the National Planning Commission (NPC) which was set up by the central government to implement Five Year Plans and one-year development budget.

c) **Central Ministry (Ministry of Finance) Transfer**

The Central Ministry transfers constitute the third source of central funds to the states. The Central Ministry makes transfers to their counterparts in the states for specific projects, which may be wholly funded by the center or funded by both the center and the state.

d) **Inter-governmental Loans**

Another key source of central funds to the states is the inter-governmental loans. States get loans from the center at subsidized rates.

e) **Rural/Urban Local Bodies**

Given the functions and tax powers assigned to the local bodies, there also exists considerable vertical imbalance between the state and its local bodies.

Fiscal Institutions

Although there is guideline given by economic theory for assigning role for expenditure and revenue generation along with guidelines for grant design, there is no uniformity among different nations towards these responsibilities. It may be due to the difference is social, political, cultural, geographical, economical and other characteristics.

Fiscal institutions are those types of institutions which distribute or share the intergovernmental fiscal grant or transfer from Federal government to state and local level governments rationally either by vertical or horizontal way. Each level of government has its own fiscal institution. Fiscal institutions established or licensed or chartered from Central Government may be classified as central level fiscal institutions and those charted or licensed from state level Government may be classified as state level fiscal institutions.

Fiscal Transfers: Role of Fiscal Institutions

The Committee on Division of Natural Resources, Financial Rights and Revenue Sharing has recommended the setting up of a National Natural Resources and Fiscal Commission (NNRFC) to oversee the system of fiscal transfers in federal Nepal. It is important to consider the constitution, duties, responsibilities, technical support, and coordination with other institutions for the NNRFC. Suitable ideas can be derived taking into account the international experience in this regard.

There have not been any major controversies regarding the establishment of a National Natural Resources and Fiscal Commission (NNRFC) that were recommended by the Constituent Assembly Committee on Natural Resources, Financial Rights and Revenue Sharing.

Some of the comparable fiscal institutions across the federal countries in the world include:

a. Commonwealth Grants Commission, Australia
b. Finance Commission, India
c. Financial and Fiscal Commission, South Africa
d. National Fiscal/Finance Commission, Nepal
e. Fiscal Arrangements Committee, Canada
f. National Finance Commission, Pakistan

National Natural Resources and Fiscal Commission (NNRFC)

NNRFC manage and deal with issues of vertical and horizontal imbalances. The recommendation of the NNRFC regarding access to non-tax revenues may have significant implications for the determination of shares in central taxes and grants by the NNRFC for determining equalization transfers.

Managing Natural Resources Conflict

The demand for federation and autonomy arises at times from the real or perceived unequal distribution of resources, including natural resources. And there is no guarantee that the federal arrangement howsoever conceived will automatically militate against such conflict arising in the course of provincial and national governance.

In Nepal, where water and, to some extent, forests are the most prominent natural resources with significant economic and social value, the assignment of authority and responsibility for their uses and the distribution of accrued benefit is of critical importance. For this reason, also, the criteria defining the boundaries of constituent states should be as broad as possible with the resource endowments of various regions enhancing the possibility of fair distribution of potential benefits from their uses. Both resources are critical economically and from the standpoint of environment. In all probabilities, the latter subject will remain in the central government sphere. Apart from the issues of economy, including the royalties involved, and the trade-offs, social issues, such as the water rights of the local population, can emerge in the course of the development of one project or another.

Model of economic rights and revenue allocation in the new constitution

The Federal Democratic Republic Constitution of Nepal 2015 has provided the model of fiscal federalism based on the recommendation presented by the Committee on Natural Resources, Economic Rights and Revenue Allocation.

- **Sharing Tax Revenue: Corrective Measures**

The major sources of revenue are custom duty, value Added Tax (VAT), excise duty, corporate income tax, and personal income tax which comprise around 80 percent of total tax revenue are assigned to be collected by the central government.

The state and local level government are assigned to collect entertainment tax, advertisement tax and registration charge of land and house concurrently. Property tax, local revenue, vehicle tax, business tax and house rent tax is assigned to be collected by the local level. The service charges, punishment and fines and tourism charges will be collected concurrently by all three levels of governments (Table 1).

- **Sharing Non-Tax Revenue: Corrective Measures**

Non-tax revenues are the financing sources most consistent with the efficiency goals of a decentralized system. Therefore, users' charges, one of the major parts of non-tax revenues should be assigned to the local government.

Receipts from sale of public commodities and services like charges for drinking water, education, electricity, postal services, irrigation and transport should be also assigned to the local governments.

Therefore, non-tax revenues derived from the activities of the central government like corporate debt servicing will go to the central government whereas non-tax revenues collected from users' charges will have to be assigned to the local governments in federal Nepal.

- **Sharing Natural Resources Revenues**

Some natural resources are variable between federation and sub-national governments within federation. The revenue share from natural resources is allocated among federal, state and local governments as 50 percent, 25 percent and also 25 percent respectively.

Revenue sharing from hydropower will be a controversial issue in Nepal. The royalties of hydroelectricity could be shared by the sub-national governments and local level. Profits and taxes of hydropower will go to the Federal government. The National Natural Resource Commission (NNRFC) will be responsible for the distribution of revenues generated from natural resources.

- **Institutional Arrangements and Corrective Measures**

A three-tier institutional set-up may be useful, for which constitutional provisioning is needed. At state level, a State Planning Commission (SPC) can be established in each state to prepare state development plans. Similarly, State Fiscal Commission in each state may be established to deal with the transfers to be made to local bodies.

National Natural Resources and Fiscal Commission (NNRFC) has prepared vertical and horizontal distribution of economic and revenue right among federal, province and local government and fiscal management, formula preparation of conditional, non-conditional, equalization and size and theory of capital grant, study and research of financial sectors, frame of fiscal transfer and suggestions to solve the issue of fiscal resource distribution and so on.

- **Effective Federal System in West Parliamentary Style**

A West-minister style parliamentary system of government is chosen at least eight important factors need to be taken into account for an effective federal system. These include i) drawing of boundaries; ii) creating institutions of legislature, executive and independent judiciary at both Central and State/provincial levels; iii) assignment of legislative domains of the Central and States/provinces including tax powers and expenditure functions; iv) Asymmetric arrangements for some of the states/regions within the states; v) Protection of and ensuring access to services and opportunities to the minorities/ethnic, linguistic and other identities through a system of affirmative action; vi) transfer system which is stable, independent, equitable and sustainable; vii) an independent institutional mechanism to determine the systems of transfers; viii) independent institutions to ensure accountability, safeguard the autonomy, enable inter-governmental bargaining, monitor and regulate inter-governmental competition and conflict resolution.

Opportunities and Challenges of Fiscal Federalism in Nepal

Fiscal federalism is considered to be an optimal institutional framework for the provision of public services. As observed by Alexis de Toqueville more than a century ago, “The federal system was created with the intention of combining the different advantages which result from the magnitude and littleness of nations” (1980, Vol. 1, p.163). The gains from the magnitude and littleness can be realized only when the functions of different levels of governments and various units which each of the levels are clearly specified according to their comparative advantage. The system allows reaping gains from the common market and economies of scale in the provision of national public goods. This is achieved by providing public services according to the diversified preferences of people.

First, as stated by Breton (2000), most of the opportunities and challenges attributed to federalism are actually those of decentralization. Thus, provision of services according to diversified preferences of people, greater accountability in the provision of public services to the people, greater propensity to innovate from intergovernmental competition, greater participation of the people in public affairs - all these opportunities are attributable to decentralization. Similarly, problems arising from spillovers and overlapping jurisdictions, the challenge of coordination between and among different levels of government, costs of signaling the preferences for different services including inter-jurisdictional mobility are the costs attributable to decentralization and not federalism.

Second, in federal systems, the powers are owned by the level of government, to which powers are assigned. They cannot be extinguished or taken away. Although it is difficult to find the classical federalism conceptualized by Wheare (1964) in which, the participating governments are *coordinate* and *independent*, the federal system entails that the assignment system is determined independently. There should be an effective system of checks and balances to ensure autonomy and to prevent encroachment.

Third, closeness of the governments to the people ensures greater accountability. They model the inter-governmental behavior in terms of principal-agent relationship underline the importance of hard budget constraints and focus on the importance of competition – both vertically between different levels of government and horizontally among different units within the same level to enhance efficiency in the delivery of public services (Oates, 2008).

Fourth, both the first and second generation theories help us to identify the important pre-requisites for the efficient functioning multilevel fiscal systems. There should be clarity in the assignment system and assignments should be according to comparative advantage. When there is some overlapping in the assignment system, there should be systems and institutions to resolve them.

Fifth, it is important to assign revenue raising powers to the states to forge a link between decisions on revenue and expenditures at the sub-national level. This is necessary for reasons of both efficiency and accountability. Assignment of revenue powers is also necessary to ensure fiscal autonomy and hard budget constraint.

Sixth, while fiscal transfers are necessary to resolve vertical fiscal imbalances and to enable comparable levels of public services at comparable tax rates across the federalism, it is important to ensure that the transfer system does not provide the incentive to *raid and fiscal commons.*

Seventh, a major advantage of a federal system is the large common market, but the opportunity from this can accrue only when not only all impediments to trade in factors of production as well as commodities are removed, but also mobility of commodities, capital and goods is facilitated. Ensuring a common market is at the heart of creating dynamism in fiscal federalism. Impediments in maintaining the common market can be posed by the policies restricting the movement of labor, capital and commodities.

Eighth, the literature on market promoting federalism shows that it is important to avoid soft budget constraints in both national and sub-national levels. Efficient credit markets, a mature banking system and well-developed credit rating institutions are important preconditions for the centre to keep itself away from bailouts. These will promote inter-governmental competition and minimize incentives for bailouts.

Ninth, there can be benefits from inter-governmental competition. Competition can lead to efficiency benefits in public service provision; it can also motivate innovations and productivity increases in public service delivery. It is important to ensure that there is a measure of competitive equality and predatory competition does not take place. Unequal competition could be destabilizing and can, in the extreme, break of the federation.

This is particularly important in the context of globalization as the states with more developed markets and infrastructure can reap higher benefits from access to domestic and international markets and grow faster than those with less developed markets and infrastructures. It is also important to regulate the competition, provide a negotiating platform and resolve inter-state and center-state conflicts.

Conclusion and Recommendations

The Constitution 2015 has many positive aspects on the issues of Natural Resources, Economic Rights and Revenue Allocation. However, some provisions seem to be incompatible with the global fiscal federalism practices. Fiscal federalism focuses the financial relations between units of governments in a federal government system. As provided for the functional responsibilities by the Constitution to be performed multi-levels of government and the financial resources that can be raised for provision of collective goods and services. The Constitutional provisions defined the framework of fiscal federalism within the pattern of income and resource distribution, fiscal transfer, grants, borrowing and the institutional capacity of the federal system.

The major sources of revenue customs duty, value added tax (VAT), corporate income tax, excise duty and personal income tax which comprise around 80 percent of total tax revenue are assigned to be collected by the central government. The service charges, punishment and fines and tourism charge are assigned to be collected concurrently by all three levels of government. In this modality, around 90 percent of total tax revenue will be under the jurisdiction of the central government. The custom duties by nature have to be collected by the federal government. Therefore, VAT and income taxes will have to be collected concurrently at both the central and sub-national governments which will support the expenditure responsibilities of the sub-national governments adequately. Revenue sharing from hydropower will be a controversial issue in Nepal.

The Constitution has provisioned National Natural Resources and Fiscal Commission (NNRFC). However, a three-tier institutional set-up may be useful, for which constitutional provisioning is needed. A Federal Fiscal Commission (FFC) and the National Planning Commission will have to be constituted at the central level to make national level development plans and to make recommendations for additional grants and loans. There are various controversial and overlapping issues which require clarity in process of implementation in the years to come.

Creating a federal system entails considerable work besides drawing up the boundaries and naming the states. Federal system has to be created with adequate checks and balances even when all the preconditions are met, as the jurists say, the Constitution is a living entity and federalism, how well it is crafted, is a work in progress.

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