



# Fiscal Federalism in Nepal: Journey so far

**Prepared for seminar on**

**NEPAL'S POLICY REGIME AND PRIORITIES IN THE CONTEXT OF  
FEDERALISM**

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# What is inside?

- Evolution of Federalism in Nepal
- Financial resources
- Constitutional and legal provisions
- Fiscal transfers
- Internal borrowing
- Natural resources distribution



# What is Fiscal Federalism?

- An optimal institutional framework for public service provisioning  
The federal system was created with the intention of combining the different advantages which result from the magnitude and littleness of nations (Alexis e Toqueville)
- Not only a political issue, rather for the economists – almost all governmental systems are federal, even in the countries with unitary governance system
- **Confusion** – clear demarcation between fiscal federalism and fiscal decentralization



# Evolution of Federalism

- Highest form of decentralization ????????
  - Deconcentration
  - Decentralization
  - Devolution
  - Federalization
- Initiation – Decentralization Act, 1983; Local Self Governance Act, 1999; Constitution of Nepal, 2015



# Attributes for a successful implementation

- 3F + C
  - F = Finance
  - F = Functionaries
  - F = Finance
  - C = Capacity
- Strengthened and reliable database



# Financial Resources

## Federal

- Revenue
- Foreign Aid
- Internal Borrowing

## Province

- Fiscal transfers from Federal consolidated fund
- Own source revenue
- Foreign grants (with approval from GON)
- Internal Borrowing
- Loans from GON

## Local

- Fiscal transfers from Federal and provincial consolidated funds
- Own source revenue
- Internal Borrowing
- Loans from GON



# Constitutional Provisions

## Article 60

- Amount of fiscal transfers to be recommended by National Natural Resources and Fiscal Commission (NNRFC)

## Article 251

- Roles and Responsibilities of NNRFC on fiscal transfers, internal borrowing and natural resources utilization



# Legal Provisions

## Inter-Governmental Fiscal Transfers (IGFT) Act

- VAT and Internal excise be shared among federal, provincial and local governments (70% to federal, 15% each to provincial and local)
- Royalties be shared (50% to federal, 25% to provincial and 25% to local)
- Fiscal transfers from federal to provincial and local as well as from provincial to local on recommendation of NNRFCC
- Internal borrowing – limit to be recommended by NNRFCC
- Provisions for loans from GON





# Forms of Fiscal Transfers

## Grants

- **Fiscal equalization** – narrowing the gap between expenditure needs and revenue potential
- **Conditional** – implementing the national policies, standards
- **Complementary** – matching the resources
- **Special** – focusing on special needs

## Revenue Sharing

- VAT, Internal Excise and Royalties to be shared



# Legal Provisions

## National Natural Resources and Fiscal Commission (NNRFC) Act

### Criteria for revenue sharing

- Population and demographic structure
- Area
- Human Development Index
- Expenditure Needs
- Efforts on revenue collection
- Infrastructure development
- Special conditions

### Criteria for Fiscal Equalization Grants

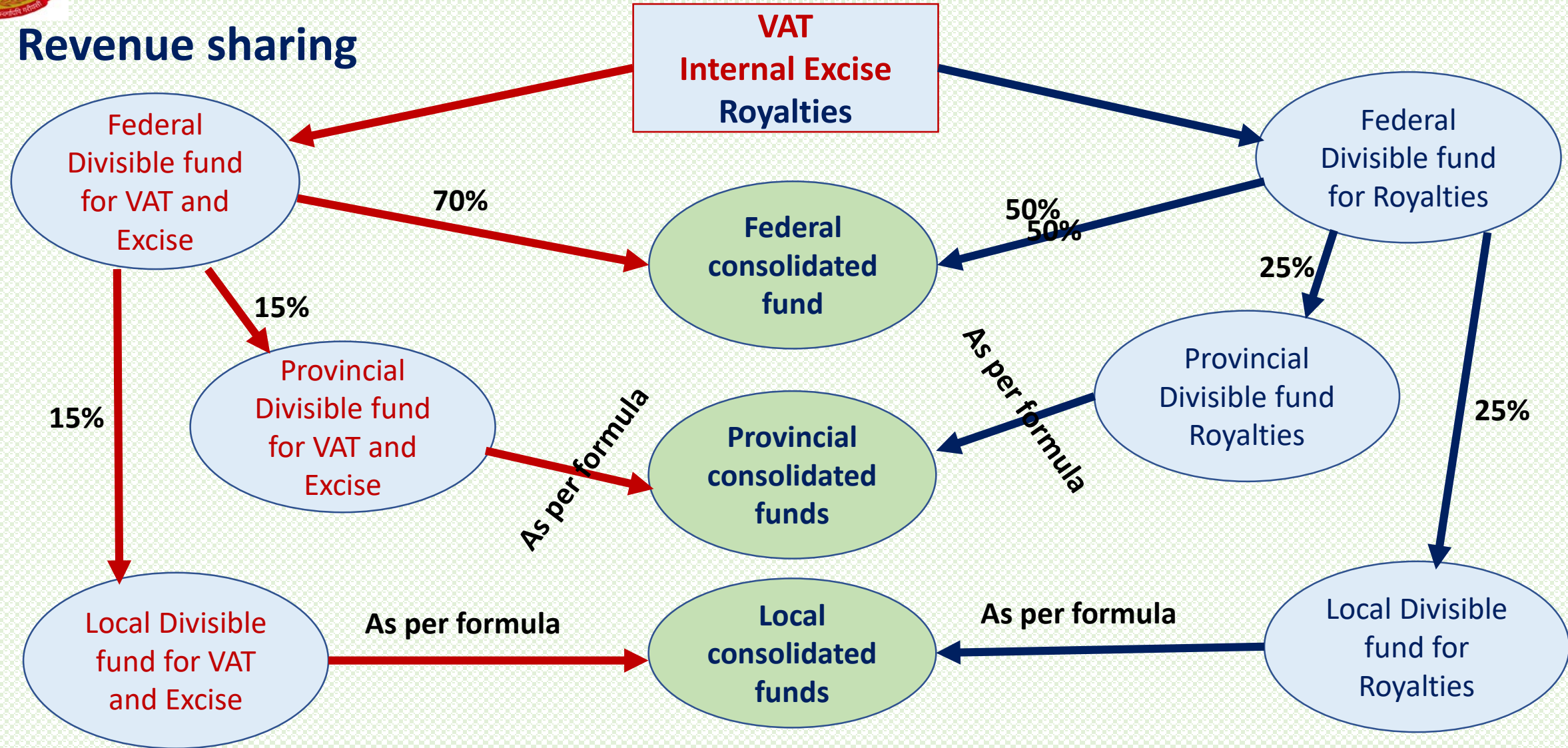
- HDI incorporating Education, health, drinking water
- Comparative development of other province and local level
- Socio-economic and other discrimination
- Infrastructure status and needs
- Service to be delivered
- Status of revenue and its potential
- Expenditure needs



# Modality of fiscal transfers

National Natural Resources and Fiscal Commission

## Revenue sharing



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# Modality of Fiscal Transfers

## Fiscal Equalization Grants

- To be transferred in four installments (on 10<sup>th</sup> August, 19<sup>th</sup> October, 16<sup>th</sup> January and 15<sup>th</sup> April)

## Conditional Grants

- A quarter of total to be transferred on 17<sup>th</sup> July
- Rest to be transferred on the first day of each trimester as the progress goes



# Methodology adopted

- **Indices derived to address the criteria set in NNRFC Act**
  - **Infrastructure Index** – Connectivity related infrastructures
  - **Discrimination (disparity) Index** – Economic, Gender, Environmental and Social discrimination
  - **Under Development Index** – Infrastructure and discrimination (disparity) based
  - **Human Development Index** – Disaggregated up to provincial and local on the basis of NHDR, 2014
  - **Human Poverty Index** - Disaggregated up to provincial and local on the basis of NHDR, 2014
  - **Multi Dimensional Poverty Index** of NPC
  - **Cost of service delivery index**
- **Studies conducted for expenditure needs, revenue potential and discrimination**



# Use of Indices

## Revenue Sharing

Criteria	Province	Local
Population	70	70
Total	80	
Dependency Ratio	20	
Area	15	15
Human Development Index	5	5
Under Development Index	10	10
Infrastructure	70	
Cost of Service Delivery	20	
Discrimination Index	10	
Minimum amount	-	Rs. 30 million



# Use of Indices

## Vehicle tax sharing from province to local

- Vehicle tax being the shared rights of both province and local level
- Set of criteria used for this purpose
  - Length of the roads      50% (maintenance of the roads)
  - Population                      45% (pollution, environmental and traffic risks)
  - Forest and Greeneries      5% (to encourage greeneries, carbon sequestration, minimize environmental risks)



# Use of Indices

## Fiscal Equalization Grants

Criteria	Province	Local
Gap between revenue potential and expenditure needs	-	70
Cost of expenditure	60	-
Human Poverty Index	-	10
Multi Dimensional Poverty Index	15	-
Discrimination Index Economic 50%, Social 45%, Climate change vulnerability 5%	15	5
Infrastructure Index Road density, electricity availability, access to ICT	10	15
Minimum amount	Rs. 1.02 bn	Rs. 60 mn





# Validation of formulas derived

- An international expert thoroughly reviewed
  - Recognized the appropriateness on the basis of available data
- Workshop held to share the experiences of South Africa, Australia, India and Nepal
  - Methodologies recognized



# Conditional Grants

- Bases for conditional grants recommended
- Largely projects/programs decomposed as per the jurisdiction of tiers of governments
- Projects and/or activities with resources handed over to respective governments
- From next year onwards – policy based conditions to be applied



# Internal Borrowing

- Upper limit for
  - Federal 5% of projected GDP for this FY
  - Provincial 10% of sum of revenue shared amount and own source revenue
  - Local 10% of sum of revenue shared amount and own source revenue
- However, legal and monetary instruments not yet ready in provinces and locals
- Internal borrowing to be made to finance capital formation activities



# Budget FY 2018/19

National Natural Resources and Fiscal Commission

Source	Rs. In billion	Expenditure	Rs. In billion	Transfers (Rs. In billion)		
				Categories	Province	Local
Revenue	831	Recurrent	845	Revenue Sharing	57	57
Foreign Aid Grants Loans	312 58.8 253.2	Capital	314	Fiscal Equalization Grants	50	85
Internal Borrowing	172	Financing	156	Conditional Grants	63	110
Total	1315		1315	Complementary and Special Grants	20	
				Foregone Revenue	51	
				Total Transfers	493	

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# Natural Resources Distribution

## Constitutional Provision

- Article 251: NNRFC to
  - recommend the natural resources distribution, identify the share of investment and benefits for natural resource utilization
  - develop the dispute resolution mechanism

## Legal Provision

- Clause 14 of NNRFC Act provides the criteria for investment and benefits sharing
- Clause 7 of IGFT Act and subsequent schedule 4 identifies the percentage of royalties



# Natural Resources Distribution

## Clause 14 of NNRFC Act

### Criteria for investment sharing

- Status and potential of revenue collection
- Investment capacity
- Share of outcomes
- Share of outcomes utilization
- Infrastructure status and needs
- Economic status and

### Criteria for benefits sharing

- Location of natural resources
- Affected areas from natural resources mobilization
- Dependency on natural resources
- Population to be benefitted
- Dependent population
- Participation in protection and sustainable management of



# Natural Resources Distribution

- Inventories being prepared
- Location, direct and indirectly affected locals and provinces being studied
- Information being mapped in GIS
- Data being updated
- List being prepared on possible disputes



# Challenges ahead

- Gap between aspirations and resource
- Capacity constraints at all level
- Centralized mindset – not only at the center but also at the subnational levels
- Dispute resolution among the tiers of government – both horizontally and vertically





# Some Limitations

- Commission yet to be formed
- Lack of disaggregated data up to local level
- Capacity constraints at NNRFC



# What next ?

- Data strengthening
- Capacity needs assessment and capacity development (at provincial and local levels)
- Capacity development of NNRFC
- Studies on expenditure needs, natural resources distribution, revenue potentiality, internal borrowing capacity and macroeconomic fundamentals at provincial and local level, performance measurement, tax provisions in provinces and locals



# Thank You !

**Feedback and suggestions are welcome**