Economic Policy under Federalism

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Nepal's Policy Regime and Priorities in the Context of Federalism

2-7 September 2018, KU/IIDS

Kathmandu

Economic and Developmental Impact

- Opportunities for enhanced Economic Development provided by the Constitution
- Possible Impact to
  - Economic Growth,
  - Equity and
  - National Development
- Challenges
- Conclusion

Opportunities for growth and development-(1)

- The ‘Principle of Subsidiarity’ that governs the three-tier approach is expected to result in higher efficiency and effectiveness in promoting economic opportunities from and within subnational governments (Federal government will perform only those tasks which cannot be performed at a subnational levels).
- Local governments have legislative, judicial, and executive powers
- Elected governments first time in 20 years – if don’t do good work will be voted out
- People can complain about the local services – right in their doorstep; they don’t have to go to Singh Durbar

Opportunities for growth and development - (2)

- Local government –are accountable and tend to work hard
- Local governments can have their own development plan for their constituencies (to limited extent, though)
- Provinces have the power to develop-– medium size infrastructures like roads, irrigation, electricity, drinking water; tourism products, industrial corridors and parks. They can also provide mainly non-fiscal incentives to industries and tourism products.
- Similarly Municipalities can develop small size infrastructures like roads, irrigation, drinking water, electricity; tourism products, SMEs. They can also provide mainly non-fiscal incentives to industries and tourism and other private sector development.

Opportunities for growth and development-(3)

- Less problem of coordination (now the works of previously DDC/VDC/Central government departments are all done by municipalities)
- Can prioritize projects/policy to exploit the local comparative advantages
- Modality of intergovernmental transfer provides opportunity to exploit regional comparative advantage
- Provinces/subnational governments could also mobilize local resources (e.g. water/hydro resources and minerals etc.) for growth
- Competition between provinces may grow
- PPP is also an opportunity—it also can be carried out by Provinces and Municipalities by themselves

Opportunities for growth and development-(4)

- Country’s Development is the aggregation of regional development (provincial and municipal)

- But, Federal Policy has a great role to play in development

Fiscal Policies

- Expenditure may go up because of higher number of bureaucrats, higher coordination cost, lower economies of scale and higher demand for budget
- Federations are expected to spend more on social and welfare spending (“race to the top”)
- Provinces if allowed, may choose to have budget with higher deficit to give more to their respective constituents and also will be derived by the concept that their deficit will be financed or bailed out by the Central government (Moral hazard problem)
- There is a possibility of lower degree of tax evasion (federal states should enjoy higher levels of legitimacy than unitary states)
- **Solution**: Hard budget Constraint, Consultation and Consensus with provinces on intergovernmental governmental transfer

Corruption (Lower)

- Leaders and bureaucrats are closer to the people and would difficult to have rent-seeking behavior
- Easy to get local information
- System is more transparent in a smaller jurisdiction
- since the constituent units of federal states are closer to the people, it is likely that their rules could be more effective than those of unitary states.

Corruption (higher)

- governments will be closer to the people, and will thus be subject to local capture (anything that has to be done has to be done by local officials or should be initiated by locals; people don’t and can’t antagonize local bureaucrats and politicians– so local capture and thus more corruption)
- Since the existence of the constituent states is constitutionally guaranteed under federal constitutions, rent seeking investments under federations (specially on policy) might pay off over a higher number of periods and appear, hence, more attractive. (therefore more corruption)

Government Effectiveness (promises are credible, quality bureaucrats)

- Government effectiveness may be lower in Federal System
    - Talented people would like to stay in Capital city or cities for the expected opportunities available to go abroad, take job in private sector, and other alternative income generating and job opportunities and other quality facilities like health and education
    - greater number of players must consent if the government wants to follow on its promises (compared to unitary states) (therefore policies may be credible, but reforms may be difficult)

    - **Solution**: Stable Policy, quality bureaucrats, rule of law, emphasis on reform and growth

Productivity (+ve)

- Policy swings will be less in Federal (because it is difficult to have consensus to change policies with sub-national governments)
- Competition among provinces could improve productivity
- If central bank is strong, inflation can be controlled and helps in productivity positively
- Possibility of focusing on local comparative advantage. Implication is higher productivity
- public goods provided in federations are more closely aligned with citizen preferences than they are in a unitary state, this can be interpreted to imply that the goods are better tailored to the needs of the regional population, which should, in turn, be reflected in higher levels of total factor productivity.

Productivity (-ve)

- More than one power centers=> instability=> lower productivity
- in a situation where exogenous shocks necessitate swift action, it is likely that federally structured states will find it more difficult to take such action than will unitary governments

Economic Growth

- Possibility of competition among different jurisdictions (+ve)
- Decentralized priority and decisions may enhance growth (+ve)
- According to one estimates a 10% stronger decentralization of <u>expenditures</u> increases the growth of real GDP per capita by 0.12-0.15%-points in high-income countries (+ve)
- In developing and transition countries with a weaker party system a 10 per- cent higher decentralization <u>expenditure</u> decreases the growth of real GDP per capita in developing countries by 0.14 percentage points (–ve)
- Administrative costs will shoot up (even now the share of internal revenue is only 40% of admin cost) (-ve)
- Preamble, Guiding Principles, Fundamental Rights, and Policies (-ve)

Economic Growth

- The reasons for a positive relation between federalism and economic growth might mainly be valid in democratic countries with sufficient experience with the rule of the law. In developing and transition countries, the rule of the law and democratic traditions still have to emerge so that the advantages of decentralization can develop. In these countries the situation is often worsened by ethnic conflicts and disruption, possible efforts to secede, and mismanagement of expenditure
- In more culturally divided states, decentralized political structures lead either to more central redistribution in favor of the more culturally remote regions, worsening central fiscal balance, or to more regional revolt. At a certain point, a weakening central government may be prompted by its weakness to switch, quite rationally from appeasement to the use of force.

Economic Growth

- The size of the central budget will tend to grow as states become more efficient and devoted to providing public goods: whether centralized or decentralized, small, public-good-providing states will be rare.

- Reducing subsidies or transfers in the federal countries can create more political problems than in unitary states.

Inequality

- **Reduction of Inequality is mainly the responsibility of Federal Government** and therefore its reduction depends on the Federal Policy and the implementation capacity of subnational governments.

- **Subnational governments can have influence in reducing inequality** (early childhood opportunities, targeted programmes in deprived ethnic groups and poor; enhancing agricultural productivity, job-creation and skill development; selective positive discrimination attempt; tax system of course is largely Federal)

Inequality

- **Example: Non-majoritarian political system:** In the Brazilian political institutional context, ***mayors have an incentive to support nationally driven social program.*** They participate in implementing it regardless of their partisan affinity to the federal center and were able to claim some political credit for themselves, while also stimulating their local economy with small cash inflows.

Economic Policy and Federalism

- Fiscal Policy
- Monetary Policy
- Sectoral Policy/ Structural improvement

Fiscal Policy – largely a Domain of Federal Government

- The objective of fiscal policy is to maintain economic stability, enhance sustainable growth and employment opportunity. For countries like Nepal, the main purpose of fiscal policy is to accelerate the rate of capital formation and investment.
- Tax – Basically Federal (VAT, Customs, Income Tax, and Excise)
- Borrowing (Prerogative of Federal; Provinces/ Municipalities can borrow but within the framework provided by Federal Government)
- Foreign Assistance is the responsibility of Fed. Government
- Spending (budget deficit- expansionary or neutral or contractionary through the permission of the Fed. Govt.)
- But Provinces and Municipalities can supplement (real sector growth is the sum of regional and national growth)

Monetary Policy (responsibility of Federal)

- Related to money supply, liquidity, credit and interest rate

- Mandate according to NRB Act 2002 includes
  - Price stability (normally done by expansionary vs contractionary monetary policy)
  - External stability (e.g. as the ability of a country to meet its financial obligations arising out of international transactions.)
  - Financial stability (resilience to economic shocks and is fit to smoothly fulfil its basic functions)
  - Facilitating economic growth (through monetary policy)

Sectoral Policy (capital formation, sources of growth etc.)

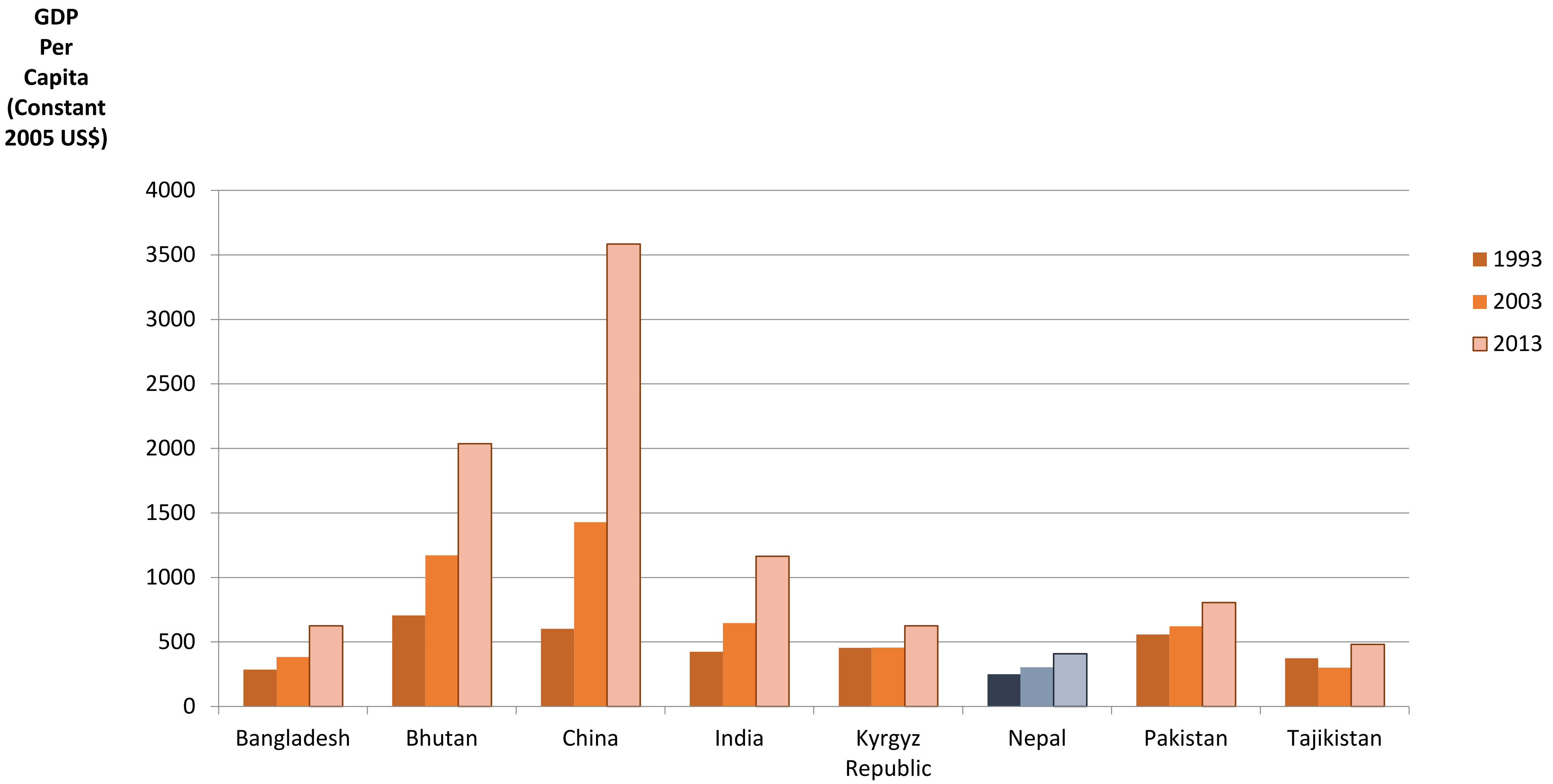
- Government Actions that are intended to influence the economy of the country (examples:)
  - Trade Policy (tariff and non-tariff barriers; incentives)
  - Investment Policy (FDI etc.)
  - Regulations (price controls etc.)
  - Functional Allocation (Agriculture vs industry etc.)

- Most of them are within the prerogative of Federal Government (except to some extent the functional allocation)

Challenges: Low growth, low investment, low productivity and inadequate employment

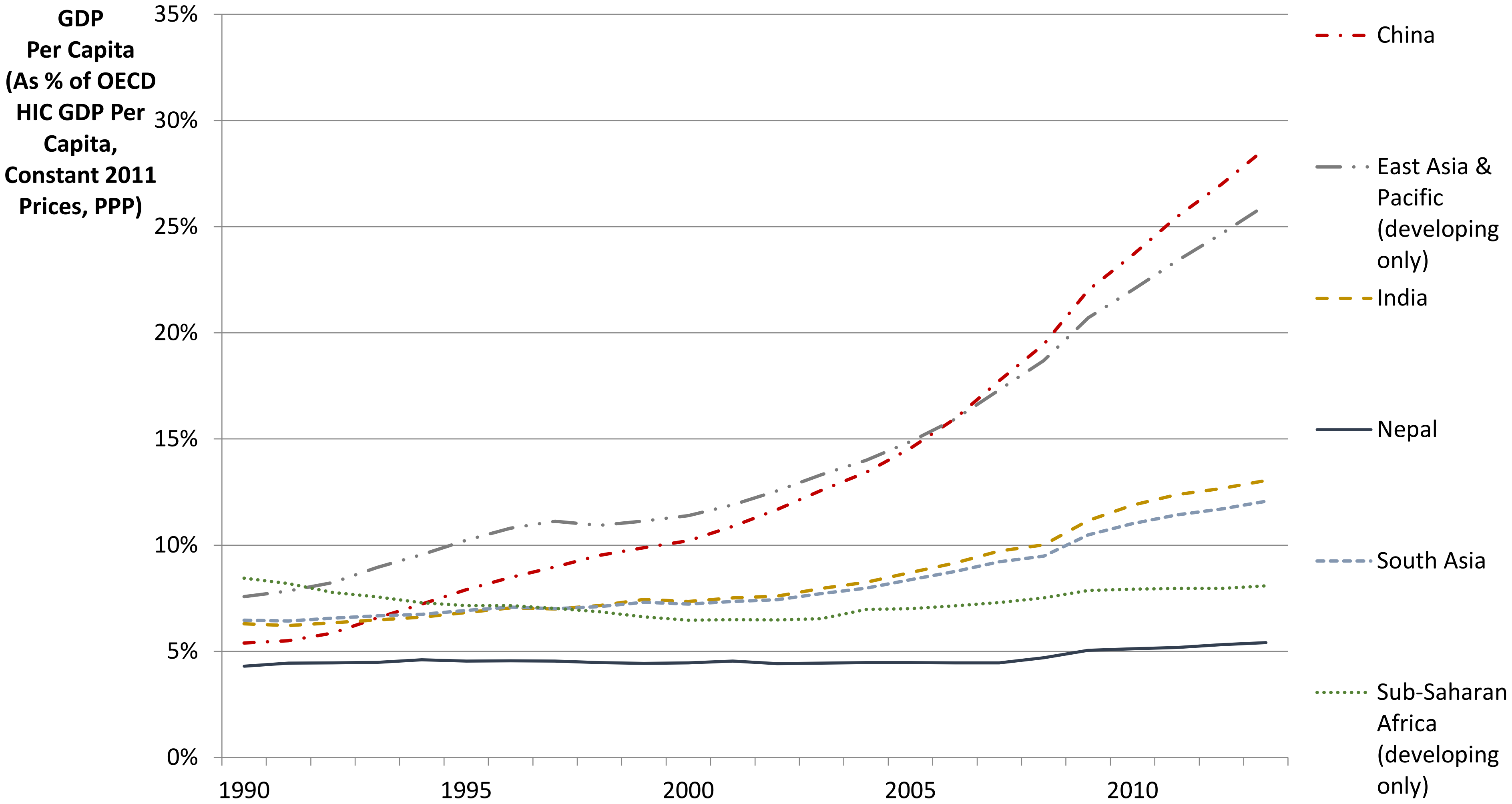
	1996/97	2017/18
Gross fixed Capital formation (% of GDP)	21.7	34.1^
GDP Growth	4.8^	4.1***
Export-GDP Ratio	8.1*	2.7
Import-GDP	33.4	39.7
Trade deficit-GDP	-25.3	-37.0
Manufacturing share in GDP	8.4*	5.4
FDI (million $)	-	161
Productivity growth (2000-2010)		0**
Laborers leaving the Country	3,259	383,493
Remittances income (% of GDP)	0.98	28.31
*2002/03 ^ (1990/91-1995/96)	** Agriculture and manufacturing (APO 2013)	*** (2002/03-2017/18) ^largely driven by reconstruction

Nepal has grown more slowly than neighbouring countries…



Source – World Bank

…meaning it has not been part of the great Asian convergence



Source – World Bank

Investment and Growth Low in Nepal

- Investment level (GFCF) is very low (% of GDP) (India 30%, China 45%, Bangladesh 30%, Nepal 23% in 2014) (It has increased sharply in 2017 in Nepal mainly because of reconstruction investment)

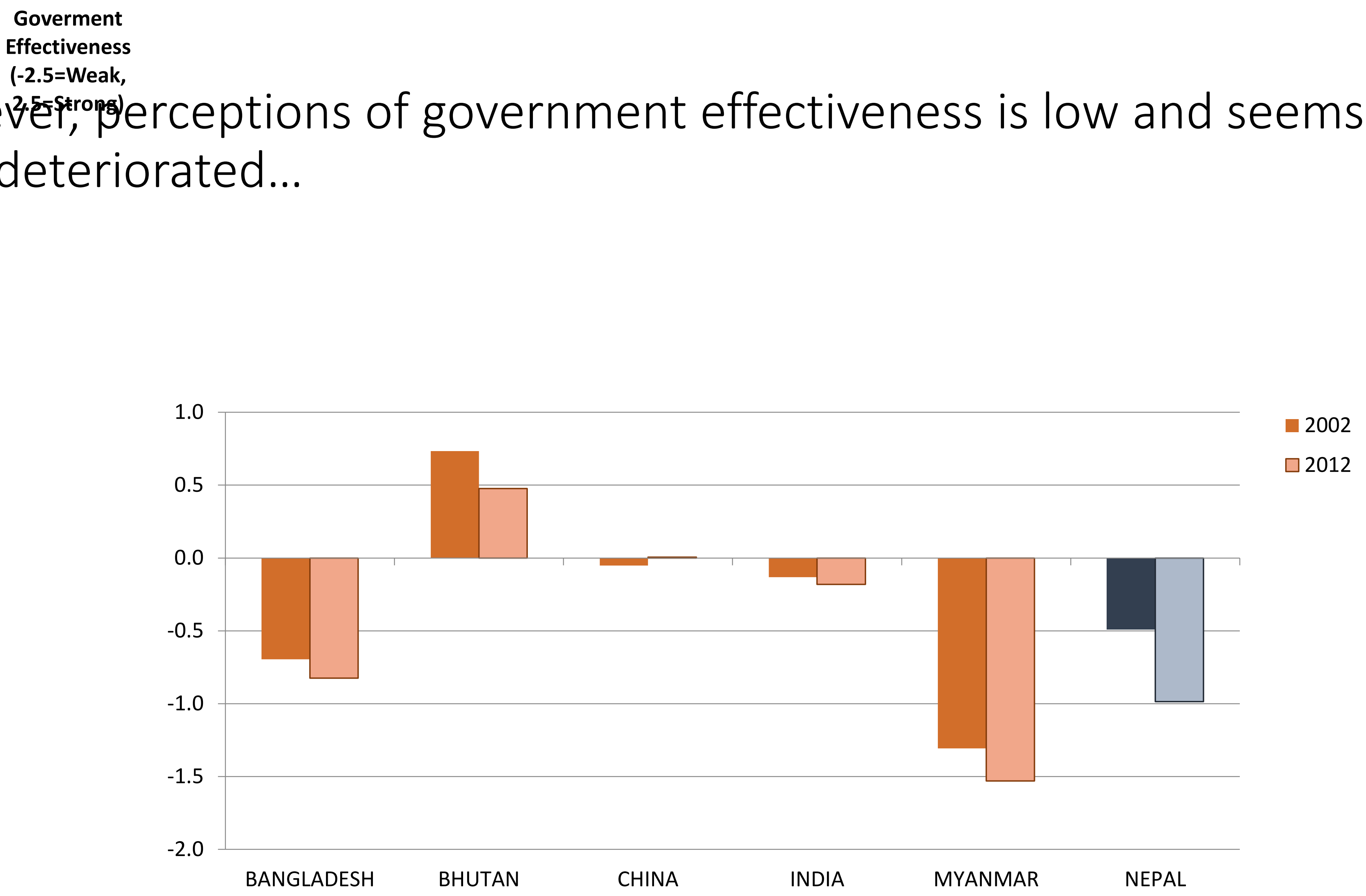
- FDI (per capita in 2017) in Nepal is small (India US$ 33, China 105, Bangladesh 13, Nepal 7)

- Growth is low (%) (India 7.2%, China 8.8%, Bangladesh 6.1%, Nepal 4.1%)

Main Reasons for Low Growth and weak Investment

- Private Investment low and not growing
- Government unable to spend on capital formation (budget surplus in some years in the past)
- Agriculture infrastructure weak (only about 25% arable land has year round irrigation)
- Political instability (frequent change of government in the past)
- Perception about government effectiveness is deteriorating
- Confusion about the role of state

However, perceptions of government effectiveness is low and seems to have deteriorated…



Government Effectiveness reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. *Source – World Governance Indicators*

What will Nepal invest in for growth?

- Ask yourself: what would you do with Rs. 10 million?
- Would you invest in Nepal? In what?

In practice: most investment in trade and services…

  - Trade (imports): low long-term capital commitment but if done well good to make $
  - services: not competing with Indian imports (non-tradable like ghar-jagga).
  - Why not in other areas?

Won't be enough for long-term growth!

Investment procedures Inadequate

- High transportation cost (US$ 2300 for shipping a container from Kathmandu, which is 28% higher than the average of South Asian countries)
- Poor labor relations and inadequate electricity supply (partially addressed)
- Land Acquisition is difficult
- Procedural problems (bureaucratic red tape including in the area of entry, exit, IEA/EIA, permits, Visas, reinvestment etc.)

Export-- Issues

- Transportation cost high; infrastructural issue
- Absence of value chain activities with India and elsewhere (no policy; very few investment from regional/ global multinationals)
- Tariff and non-tariff barriers (non-tariff mainly in India; tariff in Bangladesh etc.)
- Opportunities for electricity exports still to be opened
- Coordination problem in government is high
- Tourism (service export) -– product development and infrastructure improvement including airports inadequate.

Prioritization and other issues

- Prioritization of government programs weak (93% under P1), and
- Infrastructure weak
- Government’s capacity to spend weak

Additional Strategies for Growth

- Agriculture commercialization and productivity (irrigation), High value crops (only 20% agricultural land used for HVCs), and agro and food processing industries

- Skill Development (only 1% going to overseas employment are skilled and 25% semi-skilled)

- Education (Secondary school completed labor earns about 5 times that of labor with no education)

Industry (manufacturing)

- Special Economic Zones (14 declared by GoN); 7 provincial industrial estates and other existing/developing Industrial estates
- Developing Industrial corridors and attracting investment
- Attracting FDI – including providing automatic route
- Policy and incentives for value chain activities
- Simplifying government procedures
- Unbundling Industrial work for Provinces, Municipalities and Federal

Services

- May be there are many sectors for reform but should focus on Tourism and IT

- Product development in tourism is important (e.g. nothing other than Maya Devi Mandir in Lumbini; Similar situation in Pokhara (ACAP) and Sagarmatha national park). Plenty of other places for development

- IT– should be focused; has a great potential

Investment and so on

- Private investment is the fundamental driver of growth; Public investment should work as the enabler
- Investors (small or large) need confidence that it is worth investing for the long-run and bottlenecks for investment should be addressed.
- Government spending and infrastructure development should help improve environment for private investment and exports
- Roles of provinces/ municipalities for industrial development including SMEs should be clearer

Where will the capital for investment come from? And Market?

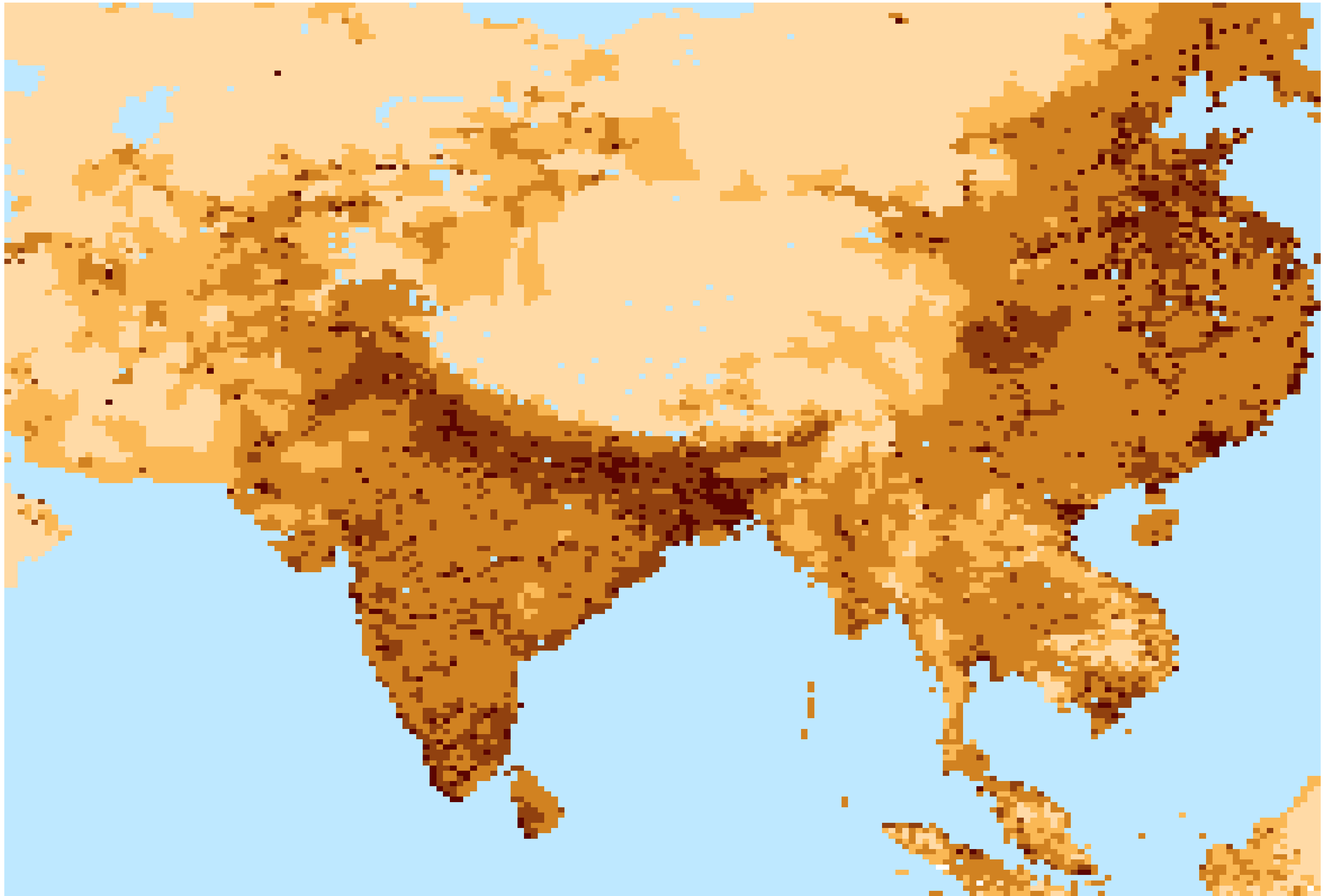
- Nepal has some financial resources!
  - Plenty of Forex: Balance of Payments Surplus thanks to remittances
  - Fiscal Budget Surplus (in some years) and prioritization of expenditure
  - Monetary Space (relatively low credit to GDP ratio)
  - Plenty of Aid
- **Problem is NOT financial resources but opportunity to invest them!**
  - **A state failing to invest**
  - **A private sector including foreign capital waiting to invest until it is sensible to do so for the long-run**

It needs to take on the challenges!

- Nepal will never grow fast unless it takes on the challenge of India and the region
  - A massive market at its doorstep
  - It won’t be able to compete with everything but the creativity and productivity of Nepalese workers can surely have plenty of niches!
  - However protectionism does not work!

- Both India and China will also be the mass market for tourists, and the main source of FDI

…on the doorstep of one of the continent's most densely populated regions



The three challenges of Revitalizing Growth

- Where will the growth come from?
  - There is capital (country, region, and the world)
  - 450m people on the doorstep
  - Unlocking private and public investment
- How Nepal’s economy be competitive?
  - Try to link up with value chain with India
  - Tap the opportunity of migration- remittances, returnee migrants and investors

National Development

- Aggregate of regional development is the national development and depends on
  - Level and growth of Provincial/ Municipal development
  - Coordination between Local, provincial and central government
  - Effective implementation of projects/ programs
  - Federal Policy for private sector investment including FDI
  - Adequate staff and skills of administrative staff
  - Federal policy and management of social and poverty alleviation programs

Challenges- 1

- Unbundling still not clear: Functional responsibilities of federal, state and local governments still unclear (only cabinet decision; but not reflected in Acts/ regulations)(e.g. project costing one hundred thousand is the responsibility of Fed gov. and also has been transferred to Provinces as conditional grant project; cottage industries are under provinces)
- Inadequate Acts and regulations, and the possibility of lack of harmonization of Acts/regulations among different spheres of governments
- Inadequate Staff and Capacity of the government is weak. Physical facilities and working environment in many cases are- not conducive

Challenges-2

- **Capacity shortfall.** Inappropriate recruitment practices, political interference, and inadequate support from senior governments all contribute to a capacity shortfall which is experienced in South African local government.
- As of now, no implementation unit has been established in most of the subnational governments
- Not enough laws/regulations etc.
- Administrative cost (operation expenses including wards, additional staff, council expenditures; infrastructure costs etc.)
- Higher demand for New projects/plans– No prioritization attempt so far

Challenges-3

- Orientations to local and state level elected and administrative officials: (confused situation; ward chair don’t know what to do; Municipality/provinces not clear about their scope of work and limitations)

- Financing is a big issue, if not planned properly (may not have enough resources for anything)

- Fiscal discipline has to be maintained (which is week now– both at expenditure side and revenue side; misappropriation may increase)

Lessons for Nepal (Anwar Shah)

- Fiscal rules accompanied by "gate keeper" intergovernmental councils/committees provide a useful framework for fiscal discipline and fiscal policy coordination. In this context, one can draw upon industrial countries' experiences with 'golden rules' (Lander parliaments no longer have tax legislation authority and Bund and Lander borrowing is restricted by the German constitution to projected outlays for capital projects (the so-called "golden rule")), and 'common budget (Swiss principles: These embody the following general principles: (a) the growth rates of public expenditures should not exceed the expected growth of nominal GNP; (b) the budget deficit should not be higher than that of the previous year; (3) the number of civil servants should stay the same or increase only very slightly; (4) the volume of public sector building should remain constant and an inflation indexation clause should be avoided) could be useful for developing specific guidelines are useful.

Lessons for Nepal (Anwar Shah)

- To ensure fiscal discipline, governments at all levels must be made to face financial consequences of their decisions. This is possible if the central government does not backstop state and local debt and the central bank does not act as a lender of last resort to the central government.

- An internal common market is best preserved by constitutional guarantees. National governments in developing countries have typically failed in this role.

Lessons for Nepal (Anwar Shah)

- Intergovernmental transfers in developing countries undermine fiscal discipline and accountability while building transfer dependencies that cause a slow economic strangulation of fiscally disadvantaged regions. Properly designed intergovernmental transfers on the other hand can enhance competition for the supply of public goods, fiscal harmonization, subnational government accountability and regional equity. Substantial theoretical and empirical guidance on the design of these transfers is readily available.

- Periodic review of jurisdictional assignments is essential to realign responsibilities with changing economic and political realities. With globalization and localization, national government's direct role in stabilization and macroeconomic control is likely to diminish over time but its role in coordination and oversight is expected to increase as regimes and subnational governments assume enhanced roles in these areas. Legal systems (or constitutional) and institutions must be amenable to timely adjustments to adapt to changing circumstances.

Lessons for Nepal (Anwar Shah)

- Contrary to a common misconception, decentralized fiscal systems offer a greater potential for improved macroeconomic governance than centralized fiscal systems. This is to be expected as decentralized fiscal systems require greater clarity in the roles of various players (centers of decision making) and transparency in rules that govern their interactions to ensure a fair play.

Other Recommendations

- No compromise in macroeconomic stability
- Strong, convincing, transparent formula/mechanism for revenue distribution
- Strong fiscal management system and discipline including hard budget constraints
- Accelerated National level reform policy (e.g. For. Investment Act, infrastructure e.g. electricity, national highways to reduce the cost of doing business etc.)

Other Recommendations (2)

- Robust mechanism for closer collaboration between the levels of government in drawing up plans to minimize conflicts

- Stronger mechanism to monitor national level targets which are implemented by subnational governments

- Development of regional comparative advantage should be emphasized

Thank you