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The Fiscal Architecture of Subnational Governments in Federal Nepal

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Abstract

The formation of the three tiers of government represents a novel experiment in Nepal's federal journey since the adoption of the new constitution in 2015. State power in the former unitary system, both rights and responsibilities, has been divided across federal, provincial and local tiers of government, with a mix of exclusive and concurrent powers for each. In matters within their jurisdiction, subnational governments can formulate laws on financial rights, set their own budgets, make decisions, devise plans and policies, implement those plans, levy taxes, and collect revenues. In the roughly three years since devolution went into effect, a few problems and uncertainties have cropped up, particularly in the exercise of power. Subnational governments complain that the center has not been very cooperative when it comes to the formulation of laws, allocation of resources, transfer of the institutional set-up, etc. However, there have been some achievements in the implementation of federalism. Institutional structures have formed at the subnational government levels, they have begun staffing, and their fiscal situations are gradually strengthening. Improvements have been made in almost all areas, including social, human development, economic, infrastructure and administrative sectors. A sense of positive competition has been created between different local and provincial governments. However, a continuing point of tension in Nepal's federal devolution is shape of the fiscal architecture supporting the new rights and responsibilities of subnational governments. The constitution provides many functional responsibilities to provinces but only limited revenue rights. This structure conflicts with the "finance follows function" principle of effective decentralization, suggesting that initiatives are needed to review the fiscal space of the provincial level. The purpose of this paper is to analyze existing institutional structures and details of subnational government finance ("fiscal architecture") in Nepal, primarily at the provincial level, and identify recommendations for improvement.

Keywords: Subnational governments, Fiscal architecture, Institutional set up, COVID-19

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1. Introduction

Nepal moved from a unitary system of governance to a federal system through a constitution enacted in September 2015. This comprehensive reform created three tiers of governments (also referred to as federal units): the federal government, seven provincial governments, and 753 local governments.¹

The constitution clearly lays out the exclusive and concurrent functions of each tier of governments in its Schedules 5, 6, 7, 8 and 9. There are 35 exclusive functions for the federal government, 21 exclusive functions for provincial governments, 22 exclusive functions for local governments, 25 concurrent functions for federal and provincial governments, and 15 concurrent functions for all three levels of governments. Table 1 summarizes some of the exclusive and concurrent rights assigned to different levels of governments (federal units).

Table 1. Exclusive and Concurrent Rights to Federal Units

	Exclusive rights	Concurrent rights	
		Federal & Provincial	Federal, Provincial & Local
Federal	Defense, central planning, currency, foreign affairs, citizenship, passport, etc. (Schedule 5)	Civil & criminal procedure, supply & distribution of essential goods, population management, social security, casino, etc. (Schedule 7)	Cooperatives, education, health, agriculture, irrigation, mines, minerals, disaster management, environment, forest, personal events, archaeology, motor vehicle permits, etc. (Schedule 9)
Provincial	Provincial police administration, provincial civil service, higher education, provincial level development activities such as electricity, irrigation, roads, land management, etc. (Schedule 6)		
Local	Town Police, management of local services, basic and secondary education, basic health, local roads, drinking water, etc. (Schedule 8)		

Source: Constitution of Nepal, as quoted by Devkota (2020).

Although many public functional responsibilities have been constitutionally devolved to

¹ The constitution defines the local level as a rural municipality, an urban municipality, or a district assembly (Art.56). In terms of exercising power, the role of district assembly is almost negligible. Its responsibility is just to coordinate with other level of governments. It has no financial powers. Similarly, it includes no 'consolidated fund.' Its administrative expenses are borne by the provincial and federal governments. In terms of numbers, there are 77 district assemblies. In the pre-federalization period, the role of district assembly was very influential. At that time, the district assembly was called the District Development Committees (DDC) and worked between the central government, the Village Development Committee (rural municipality), and the municipality.

subnational (provincial and local) governments, revenue-raising powers are still highly centralized, with the federal government continuing to collect more than 80 percent of all public revenues.² Analysis of revenue assignments reveals that the constitution assigns most revenue-raising powers to the federal government. However, this does not mean that the federal government uses all the revenue it raises. Part of this revenue goes to subnational governments through the revenue sharing and fiscal transfer channels. The constitution also provides for a National Natural Resources and Fiscal Commission (NNRFC), which guides the mechanisms of fiscal federalism, including fiscal transfers. See Table 3 for the assignment of revenue-raising powers to the three tiers of government in Nepal.

In terms of fiscal transfers, the provinces and local governments receive four types of grants: fiscal equalization, conditional, special, and matching grants. Parallel to the grants from the federal level, local governments also receive such grants from their provincial governments.³ Both the federal government and provincial governments distribute fiscal equalization transfers to lower-levels governments based on formulae and criteria recommended by the NNRFC. In addition, the provincial and local tiers receive 15 percent each of fiscal resources collected across the country from value-added taxes (VAT) and excise duties from domestic production under the heading of “revenue sharing.”⁴ As per the Intergovernmental Fiscal Arrangement Act 2017, the

² In overall tax revenue collection, VAT makes the primary contribution at 30.88 percent, followed by customs and other import duties (19.52 percent), income tax payable by enterprises and corporations (15.47 percent), excise taxes (15.14 percent), and the use of goods and permission to use goods (3.52 percent). The cumulative share of these five taxes is around 85 percent. Per the Constitution, these five tax headings were designated as exclusive revenue-raising powers of federal government. Further, the federal government also retains a greater share from the non-tax headings as well (Devkota, 2017).

³ Provinces started providing fiscal transfers to local governments from their first full budget in FY 2018-19 and transferred about 10 percent of their total budgets to the local level in FY 2020-21. In general, the provinces have established good practices in distributing grants to the local level from their own sources.

⁴ Out of total fiscal transfers to the subnational levels, this “revenue sharing” heading comprised 21.49 percent in FY 2018-19 (see Table 5). From this heading, the subnational levels can fund administrative expenses, including the salary and allowance of officials.

federal government keeps 70 percent and the remaining 30 percent is shared down to subnational governments based on criteria related to population, geography, human development index, etc. Similarly, the provincial and local governments get 25 percent each of royalties from natural resources⁵ collected from the respective subnational governments' jurisdiction areas. The NNRFC makes the criteria for the distribution of both "revenue sharing" and natural resources royalties.

The subnational governments can, in matters within their jurisdiction, formulate laws on financial rights, set their own annual budgets, make decisions, devise plans and policies and implement the above. They can also, likewise in matters within their jurisdiction, levy taxes and collect revenue.⁶ The resulting fiscal resources, institutional set-up, etc. are essential to carrying out the tasks constitutionally assigned to the subnational governments. The main goals of this paper are to briefly analyze existing institutional structures and details of the subnational government finance and make recommendations for improvement.

The second section of this paper describes the demographic, geographic, human development, and economic characteristics of the provincial governments (disaggregated data on local governments is unavailable and so not included). The third section covers constitutional and legal provisions regarding subnational governments including the pillars of revenue assignment, such as the taxing powers, revenue sharing (including that from natural resources), fiscal transfers, and borrowing. The fourth section briefly describes the fiscal situation of the federal government. The institutional aspects of fiscal architecture are described in section five. The sixth section

⁵ In the constitution, royalties from natural resources are included in the concurrent list of all three levels of government. As per the Inter-Governmental Fiscal Arrangement Act, 2017, provinces and local levels each receive 25 percent of the royalties from the federal level collected from the use of natural resources, such as mountaineering, forestry, electricity generation, mining, etc.

⁶ This is especially true for the exclusive functional areas. In Nepal, there is a kind of consensus among the three tiers of government that it is possible to make laws on issues within an exclusive right. This provision is also included in Article 59 of the Constitution. However, in practice, the federal government has not allowed it to work well, instead interfering in the jurisdictions of subnational governments.

analyzes the finances of the subnational levels, focusing on the provinces. Section seven elaborates the main issues and challenges, and the last section describes the way forward.

2. Brief Highlights of the Provincial Governments' Socioeconomic Indicators

The demographic, geographic, human development, and economic aspects of the provinces are presented in Table 2. The table shows that Bagmati Province has the largest population, 21 percent of the national total. On the other end, Karnali Province has the smallest population, only 6 percent of the national total, despite having the largest geographical area (22 percent). In terms of HDI and literacy rate, Bagmati Province has the highest ranks followed by Gandaki and Province One. Province Two has the lowest position in both the HDI and literacy.

Table 2. Socioeconomic Details of Nepalese Provinces

Province	Population in thousands (a)	Total area in sq. km (a)	Count of Local levels (a)	Per capita Income, USD (b)	Percent in Poverty (b)	HDI Index Score (c)	Literacy rate (5 years+), percent (c)	GDP in billions of RS (20-21) ⁷	Budget in billions of RS (20-21) ⁸
One	4,535 (17)	25,905 (18)	137	919	19.7	0.58	71.22	612 (15.6)	40.9
Two	5,404 (20)	9,661 (7)	136	645	47.9	0.51	49.54	519(13.3)	33.5
Bagmati	5,529 (21)	20,300 (14)	119	1917	12.2	0.661	74.85	1455(37.2)	51.4
Gandaki	2,404 (9)	22,585 (15)	85	1192	14.2	0.618	74.81	344(8.8)	34.8
Five	4,499 (17)	17,318 (12)	109	803	29.9	0.563	66.43	550(14.0)	36.3
Karnali	1,570 (6)	31,873 (22)	79	597	51.2	0.538	62.77	161(4.1)	33.7
Sudur-Paschim	2,553 (10)	19,874 (13)	88	683	33.6	0.547	63.48	274(7.0)	33.3
Nepal	26,495	1,47,516	753	1047	28.6	0.587	65.94	3914(100)	1475

⁷ As per the Economic Survey of FY 2020-21 published by the Ministry of Finance (MOF, 2021a), the GDP of Nepal has reached Rs. 3,914 billion.

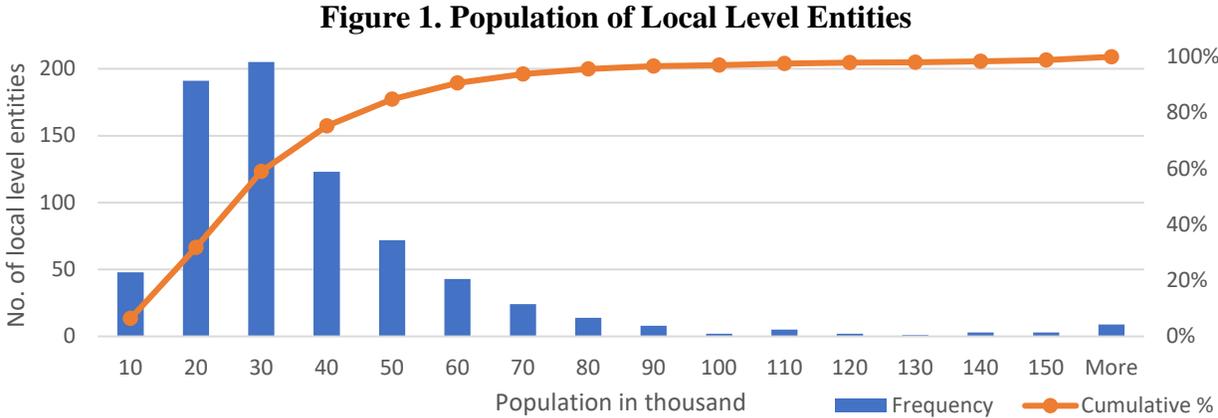
⁸ In aggregated provincial budgets, the proportions of grants and revenue sharing comprise 38% and 23%, respectively. Another 22% derived from the cash balance of previous fiscal year, i.e., unspent budget. Further, own-source revenues and loans contributed 14% and 3%, respectively (see Table 7). The figure Rs. 1,475 billion includes the total budget of the Government of Nepal for FY 2020-21. In Nepal, the fiscal year starts on Sawan 1 (July 15). The budget of the federal government is announced one and a half months before the start of the fiscal year and the budget of the provincial government is announced one month before. The federal government has released a budget of Rs. 1,647 billion for FY 2021-22. There is a constitutional provision that the budget should be presented in the parliament on Jestha 15 (May 29). However, with the House of Representatives dissolved and the budget brought about through an ordinance, constitutional and legal questions have arisen. Similarly, provincial budgets totaled about Rs. 232 billion for FY 2021-22 when released Asar 1, 2078 (June 15, 2021). The size of provincial budgets have been reduced due to the COVID-19 pandemic. Due to political uncertainty, some provinces have not been able to make public the details of their budgets, meaning some information, including the internal revenues of certain provinces, could not be obtained.

Source: a. Central Bureau of Statistics, 2014 b. National Planning Commission, 2020b c. Nepal Human Development Report, 2020. Note: Figures in parenthesis indicate percentage of the national total.

In terms of per capita income, Bagmati Province has the highest per capita income level at USD 1,917. Karnali Province has the lowest per capita income at only USD 597. Similarly, the Multidimensional Poverty Index (MPI) shows the highest poverty incidence in Karnali Province (51%) and Province Two (48%). Bagmati Province accounts one-third (37.2%) of the country's GDP. Karnali Province contributes the lowest share of GDP (4.1%). In terms of the literacy rate, Bagmati Province and Province Two rank in the highest and the lowest positions, respectively. In size of budget, Bagmati Province has the largest figure of Rs 51.43 billion; Sudurpaschim Province has the smallest, with only Rs. 33.48 billion. In terms of per person budget, Karnali Province includes the largest at Rs 22.5 thousand, followed by Gandaki and Sudurpaschim Provinces at Rs 14.5 thousand and Rs 13.1 thousand, respectively. On contrary, Province Two and Lumbini Province include the lowest per person budgets at of Rs 6.2 thousand and Rs 8.1 thousand, respectively. The federal budget size is Rs. 1,475 billion. In the subnational level government revenue, fiscal transfers account for the lion's share of monies coming from the federal government (see Table 6).

Out of total 753 local level entities, 460 are Rural Municipalities, 276 are Municipalities, 11 are Sub-Metropolitan Cities and 6 are Metropolitan Cities. Province One has the highest number of local governments (137), followed closely by Province Two (136). At the other extreme, Karnali Province, despite having the largest geographical area, has only 79 local level entities. Localities also vary in terms of population; the largest five municipalities account for around 10 percent of total population. The Kathmandu Metropolitan city (the capital) has the largest population at 975,453 (about 4% of the national population). By contrast, another local government in Nepal

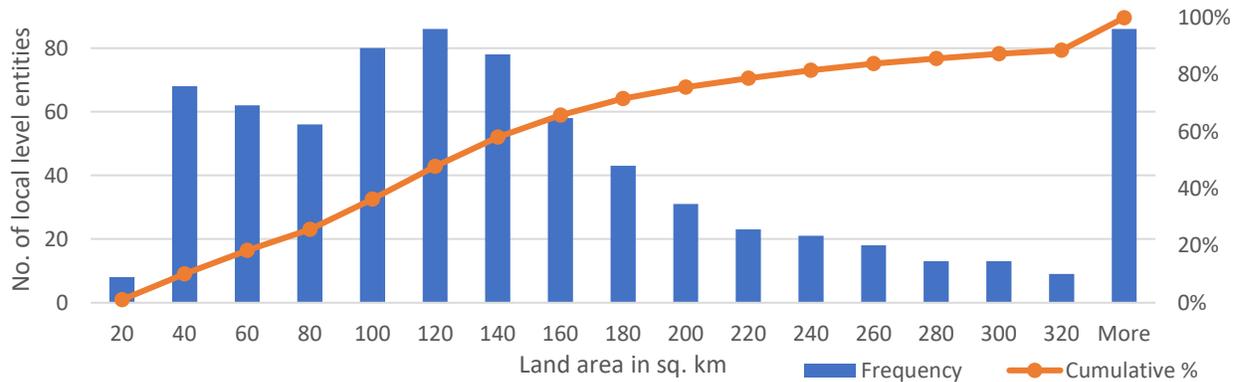
has only 538 residents (Narpabhumi Rural Municipality in Manang, a Himalayan district connected to Tibet). The population structure of local level entities is summarized in Figure 1, which shows that there are around 50 local levels with population of 10,000 or less. The most typical population size for a local level entity (205) is in the range of 20-30,000, while there are only 9 local level units with a population of more than 150,000.



Source: Author's derivation, 2021

In terms of land area, the five most populous local government units account for just around 7 percent of country’s land area. By contrast, the Namkha Rural Municipality alone has 1,420 square kilometers (around 2% of the national area), which makes it 50 times larger than Kathmandu Metropolitan City. With local level population varying from 538 to around one million and land area from seven square kilometers to 2,420, Nepal has many different levels of population density. The land area of local level entities is summarized in Figure 2. There are 8 local level entities having land areas of 20 square kilometer or less. At the other extreme, there are 86 local governments with land areas greater than 320 sq. km. However, the most typical land area of local level entities falls in the range of 110-120 sq. km., representing 86 LG units.

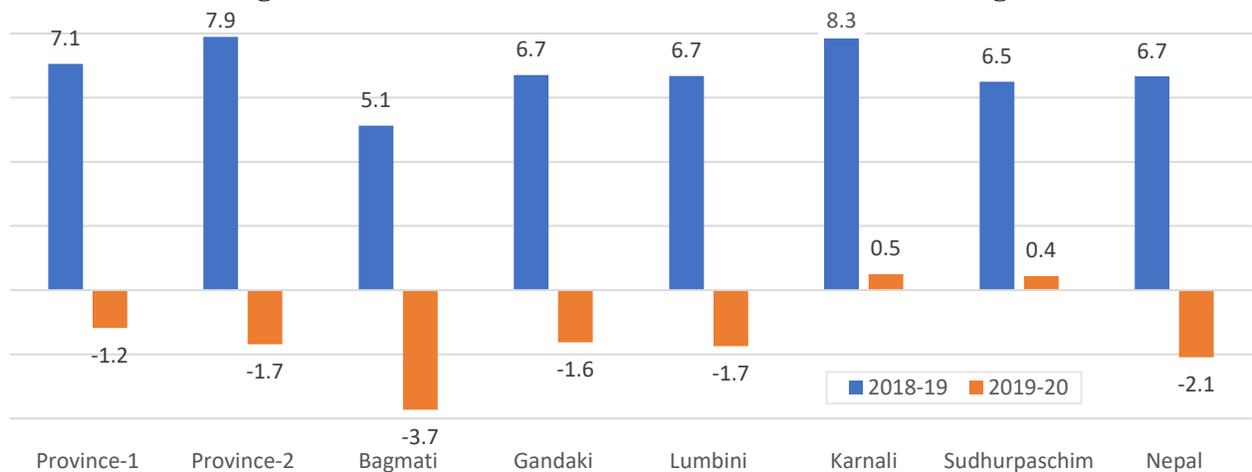
Figure 2. Land Area of Local Level Entities



Source: Author's derivation, 2021.

In terms of real GDP growth, it exceeded 6 percent in all provinces except Bagmati in FY 2018-19 (Figure 3). However, due to the unfolding COVID-19 pandemic crisis, which has induced lockdowns and suspension of most economic activities, the economies of all provinces were adversely affected and economic growth declined heavily in FY 2019-20. The country's GDP growth was around 7 percent in FY 2018-19 has declined to minus 2.1% in FY 2019-20.

Figure 3. Economic Growth Rate of Provinces (Percentage)



Source: MOF, 2021a

3. Constitutional and Legal Provisions for the Fiscal Architecture at Subnational Governments Level

In this paper, the review of the fiscal architecture of subnational levels includes five aspects: 1) expenditure responsibilities; 2) revenue-raising powers; 3) revenue sharing, including revenues from natural resources; 4) fiscal transfers; and 5) borrowing (also known as debt). This

follows the meaning of the “fiscal architecture” in Bahl (2012). Wallace (2001, p. 2) defines “fiscal architecture” more broadly to include the “potential impact of the important economic, demographic and institutional changes on the ability of a government to finance public goods.” Where relevant, this paper also discusses the impact of socioeconomic and demographic factors on the ability of Nepal’s subnational governments to discharge their functions.

The constitution assigns key revenue headings to the federal government (Table 3). These headings include customs duty, excise duty, value added tax, corporate income tax, individual income tax, tourism fee, passport fee, visa fee, etc. The provinces are provided with nominal revenue raising rights. These include land registration fee, motor vehicle tax, entertainment tax, advertisement tax, agricultural income tax, etc. The local level units have powers to raise revenue from local taxes such as property tax, house rent tax, house land registration fee, vehicle tax, service charge, tourism fee, advertisement tax, business tax, land tax, entertainment tax, etc.

Table 3. Revenue-Raising Powers of Different Levels of Government

	Federal	Provincial	Local
A. Tax Revenue	(1) Custom Duty (2) Excise Duty (3) Value Added Tax (4) Corporate Income Tax (5) Personal Income Tax (6) Remuneration Tax	(1) House and Land Registration Fee (2) Vehicle Tax (3) Entertainment Tax (4) Advertisement Tax (5) Tax on Agricultural Income	(1) Property Tax (2) House Rent Tax (3) House and Land Registration Fee (4) Vehicle Tax (5) Land Tax (Land Revenue) (6) Entertainment Tax (7) Advertisement Tax (8) Business Tax
B. Non-Tax Revenue	(1) Passport Fee (2) Visa Fee (3) Tourism Fee (4) Service Fee (5) Gambling/Lottery (6) Fines and Penalties	(1) Service Fee (2) Tourism Fee (3) Fines and Penalties	(1) Service Fee (2) Tourism Fee (3) Fines and Penalty
C. Other Revenue	(1) Other tax and nontax raised/levied according to federal and other prevailing laws.	(1) Other tax and nontax raised/levied according to the provincial law and other prevailing laws on the provincial jurisdiction.	(1) Other tax and nontax raised/levied according to the local law and other prevailing laws on the local government level jurisdiction.

Source: Constitution of Nepal, as quoted in the Intergovernmental Fiscal Arrangement Act, 2017.

Some revenue raising rights at the province and local levels overlap with each other and with the federal level. The land registration fee, vehicle tax, entertainment tax, and advertisement tax are on the exclusive taxing rights list of both the provincial and local levels.⁹ In fact, the provinces do not have substantial revenue raising rights reserved only to them, except for the agricultural income tax. Even this tax has generated only nominal revenue for the provinces. In FY 2018-19, all seven provinces collected only Rs 32 million total from this revenue heading. In FY 2020-21, they have projected Rs 145 million from this revenue right (see Figure 7). This demonstrates another difficulty of the current fiscal architecture: as the provinces have just recently been formed, they lack full information about their financial statuses and rights. There is no preparation to estimate the scope of revenue; instead, the provinces have had to start from scratch, with most of their work being done based on projections.

Nepal's federalism is heavily centralized on the revenue side. To decentralize this revenue, the Intergovernmental Fiscal Arrangement Act 2017 included a “revenue-sharing” provision. Per this act, provincial and local governments have a legal entitlement to receive 15 percent each of fiscal resources from value-added taxes (VAT)¹⁰ and excise duties from domestic production under the heading of “revenue sharing.” The federal government has created a divisible fund to deposit the amount collected from these headings. Out of total funds collected in the entire country, the federal government keeps 70 percent of this amount and distributes the

⁹ To solve this problem, a single tax administration system has been implemented, in which one level of government collects and distributes proceeds to the other(s). For example, provincial governments collect vehicle taxes and share 40% of that revenue to the local government. The provincial and local levels classify revenue collected from these headings as 'revenue sharing.' However, some local levels have been found to have not distributed the revenue of these headings to the provinces. Similarly, some provinces have blocked local level fiscal equalization grants and do not distribute the shared revenue. While the situation has improved somewhat over time, some provinces still complain that local level governments have not paid much attention to revenue collection due to this compulsory distribution sharing.

¹⁰ Out of total Government of Nepal revenue collections, tax revenues comprise the lion's share at 87%. The non-tax headings share a nominal impact, making up only 13% of revenues. Within the tax headings, the VAT contributes 31% and the excise duty 15% (Devkota, 2017).

remaining 30 percent (15 percent each) to the provincial and local levels by the formula recommended by the NNRFC. In the formula, 60 percent weight is given to population. The remaining 40 percent includes geographical area, socioeconomic development indicators, etc.

In the constitution, provisions related to royalties from natural resources are included in the concurrent revenue list for all three levels of governments. The Intergovernmental Fiscal Arrangement Act defines the sharing ratio for the divisible pool amount. Accordingly, the provincial and local governments get 25 percent each of royalties from natural resources including those from mountaineering, forestry, electricity generation, mining, etc. The NNRFC has developed a separate formula for the distribution of each of these natural resource headings. The government distributes them as per the formulae recommended by the NNRFC. Similar to “revenue sharing,”¹¹ the federal government has created a separate divisible fund account for these royalty headings. Revenue collected across the country in the revenue sharing headings (VAT and excise duty) are shared among all subnational governments. However, the royalties of natural resources are distributed only to those subnational government units that are located in the geographic area where these revenues are collected.

Fiscal transfers are an integral part of the fiscal architecture at the subnational levels. In terms of fiscal transfers, Article 60 of the constitution states that necessary arrangements will be made to distribute the revenue collected by the Government of Nepal to the federal, provincial, and local levels. This article also states that the amounts of fiscal transfers will be as per the recommendation of the NNRFC and the provincial and local levels will receive four types of grants: fiscal equalization, conditional, special, and matching grants. After the implementation of

¹¹ Out of total fiscal transfers to the subnational levels, this heading comprises 33.65 percent (see Table 3). From this heading, the subnational levels can fund administrative expenses including the salary and allowance of officials.

federalism, provincial and local governments have started receiving all four types of grants. The National Natural Resources and Fiscal Commission Act, 2017, and the Intergovernmental Fiscal Arrangement Act, 2017, have been promulgated to enable legal provisions for fiscal transfers. These Acts specify the definition and distribution criteria of grants and revenue sharing.

In addition to transfers from the federal to provincial and local levels, the constitution provides for mandatory fiscal transfers from the provincial to the local level as well. Accordingly, the provinces have started distributing grants to the local level units. Parallel to the four grant types from the federal level, the local level entities also receive such grants from the respective provincial governments.¹² Both the federal government and provincial governments distribute fiscal equalization transfers to their constituent subnational government units based on formulae and allocations methodology approved by NNRFC. In fiscal transfers, the fiscal equalization grant has an important place. The constitution states that this grant should be distributed on the basis of fiscal need and revenue capacity.¹³

The Constitution states that only the federal government has the right to take foreign aid and loans. Such assistance and loans should be taken for the overall economic stability of the country. Further, the Intergovernmental Fiscal Arrangement Act states that provincial and local level entities cannot take any kind of foreign grant or assistance without the prior approval of the federal government.

Article 251 of the Constitution empowers the NNRFC to determine the limits on internal

¹² Provinces started providing fiscal transfers to local governments from their first full budget in FY 2018-19 and transferred about 10 percent of their total budgets to the local level in FY 2020-21. In general, the provinces have established good practices in distributing grants to the local level from their own sources.

¹³ The NNRFC Act 2017 stipulates that transfers made to each provincial and local government from the federal government, and from provinces to local governments, be made based on several indicators including human development and multi-dimensional poverty indices, an infrastructure index, area revenue capacity, area expenditure needs, and so on.

borrowing that can be undertaken by the federal, provincial, and local levels by analyzing macroeconomic indicators. However, the law stipulates that provincial and local level entities must obtain the consent of the federal government before taking internal loans. With the approval of the federal government, the provincial and local levels can take loans from various agencies. Similarly, the federal government has a legal provision to give loans to the subnational governments. There is an old entity, the Town Development Fund,¹⁴ for local level borrowing. However, no similar type of institution(s) have been established for the provinces. Similarly, to date, no province has taken any loan from the federal government (also see section six).

4. The Federal Level's Revenues and Expenditures

The outbreak of COVID-19 has severely affected most of the economic sectors of the country including agriculture, industry, electricity, construction, trade, tourism, transportation, education, health, etc. As pointed out by the Central Bank of Nepal, 61 percent of industrial and business establishments were completely closed in the outbreak period (NRB, 2020). The National Planning Commission has estimated that Nepal has lost equivalent of Rs 200 billion (five percent of GDP) in various sectors of the economy in FY 2019-20 (Acharya, 2020). Due to the outbreak of COVID-19, the federal government tax revenue declined by 7 percent in FY 2019-20; in FY 2018-19, the revenue had increased by 3.4 percent. Similarly, exports declined by 6.6 percent in FY 2019-20, where in FY 2018-19 it had increased by 25.3 percent. The tourism sector was badly affected. The number of tourist arrivals had increased by 2.1 percent in 2019 but declined by 81 percent in 2020. Foreign currency earnings from the tourism sector likewise declined by 70 percent in 2020 (MOF, 2021a). The outbreak has created many problems, including in poverty alleviation. Many people have lost their employment. This has seriously affected overall public revenues and

¹⁴ It is the only autonomous financial intermediary institution in the country, established by the Government of Nepal in 1989. It provides debt financing to urban local governments. The federal government is developing this entity into an infrastructure financing entity for all local level units.

expenditures of the entire country, including those of the subnational governments. Steps have been taken to address the crisis. The federal government has paid special attention to supporting vaccination to prevent Coronavirus. Relief programs have also been introduced for the different sectors including industry, trade, tourism, etc. However, there are still general grievances that the government has not been able to do a good job in managing the COVID-19 pandemic.

Federal revenues and expenditures for four fiscal years are summarized in Table 4. FY 20-21 and 21-22 are estimated figures. The total revenue of Nepal stood at only Rs 986 billion in FY 2018-19. Due to outbreak of COVID-19, the total revenue in FY 2019-20 declined by around 9 percent. The share of foreign loans and grants in total revenue was 15 percent in FY 2018-19. The loans share is estimated to be 26 percent in FY 2021-22. Similar to revenues, expenditures are also lower i.e., only Rs 1,110 billion in FY 2018-19, which declined by 3.24 percent in FY 2019-20. Compared to recurrent expenditures, the share of capital expenditures is minor (22%) in both FY 2018-19 and 2019-20. Of total expenditures, the share supported with internal revenue was around 67 percent in FY 2018-19 and 68 percent in FY 2019-20.

Table 4. Federal Government Revenues and Expenditures (Rs, billion)

S.N.	Particulars	Actual	Revised estimate	Estimate		% change 18-19 to 19-20
		2018-19	2019-20	2020-21	2021-22	
A.	Revenue					
1	Internal revenue	742	727	890	1065	-2.02
2	Foreign grant	23	32	61	65	39.13
3	Foreign loan	124	121	299	315	-2.42
4	Internal loan	97	19	22	25	-80.41
	Total	986	899	1272	1470	-8.82
B.	Expenditure					
1	Recurrent	716	702	949	1004	-1.96
2	Capital	242	240	353	492	-0.83
3	Financing (Loan/interest payment)	152	132	173	201	-13.16
	Total	1110	1074	1475	1697	-3.24
	% of capital exp. in total expenditure	21.80	22.35	23.93	28.99	
	% of internal revenue to expenditure	66.85	67.69	60.34	62.76	

Source: National Planning Commission, 2020a

5. Institutional Set-Up of the Fiscal Architecture at the Subnational Government Levels

After the provincial elections held in November and December of 2017, seven provincial governments came into existence in February 2018. In each province, seven ministries¹⁵ were created including the Office of Chief Minister and Council of Ministers. Similarly, the office of the Chief of Province¹⁶ and the Provincial Assembly¹⁷ were established as the legislative organs in the province.

Province Treasury Controller Offices¹⁸ were created in all the provinces under the provincial Ministries of Economic Affairs and Planning¹⁹ to work in the field of financial management. The role of this entity in the provinces is similar to that of the Financial Comptroller General Office²⁰ in the federal government.

The Business Allocation Rules 2017²¹ for the provincial government has set out the roles and responsibilities of all the provincial ministries and other executive bodies under them. This was based on the “Unbundling Exercise,”²² which was an important policy document in detailing out the constitutional responsibilities for the operation of the provincial governments. Currently, there are 1,080 institutions at the provincial level, including the ministries, directorates, and

¹⁵ These include: Office of the Chief Minister and Council of Ministers, Ministry for Economic Affairs and Planning, Ministry for Internal Affairs and Law, Ministry for Physical Infrastructure and Development, Ministry for Land Management, Agriculture and Co-Operatives, Ministry for Social Development, and Ministry for Industry, Tourism, Forest, and Environment.

¹⁶ The Chief of Province is the highest institution in the hierarchy of provincial governance and is considered to be a representative of the federal government in the province.

¹⁷ There are 550 provincial legislature members in seven provinces. Bagmati and Karnali Provinces include the largest and the smallest number of provincial parliamentarians at 110 and 40, respectively.

¹⁸ It is responsible for operating the province consolidated fund, facilitating the implementation of the budget, and maintaining accounts of the income and expenditures of the provincial government.

¹⁹ Like the Ministry of Finance at the central government, it is the Ministry of Finance of the province.

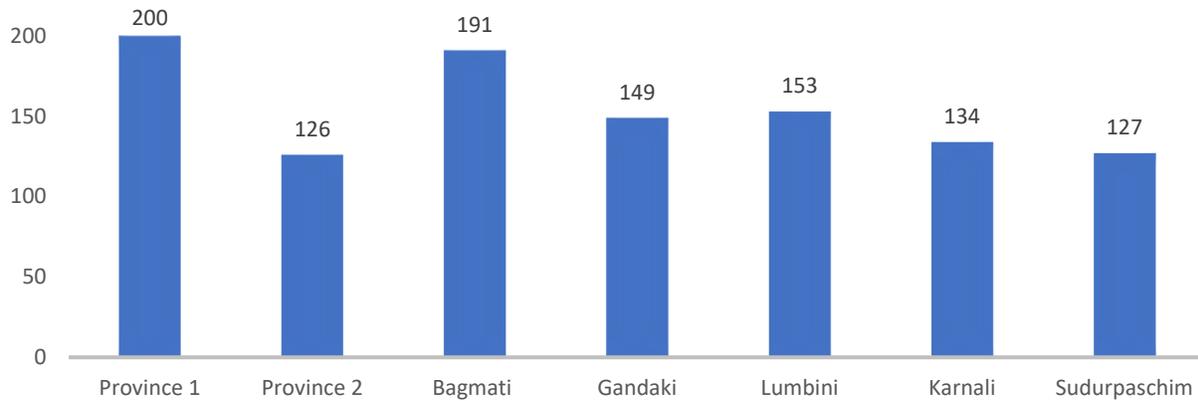
²⁰ <https://www.fcgo.gov.np/>

²¹ The document is concerned with what provincial ministries should do. It specifies the responsibilities of the ministries. It was prepared by the federal government and sent to the provinces. The foundation of Nepal's federalism is also based on this document.

²² It is an elaboration of the functional responsibilities in the schedule of the constitution for the three-tier government. In this exercise, the functional responsibilities were broken down into different sub-functions. Altogether, 1795 functions were identified, in which 870, 565, and 360 belong to the federal, provincial, and local governments respectively.

various district level offices (Figure 4).

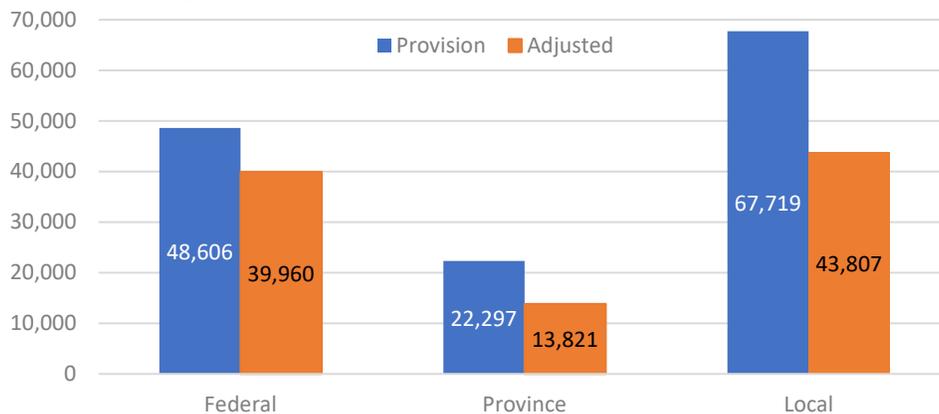
Figure 4. Numbers of Total Institutions at the Province Level



Source: Office of the Auditor General, 2020.

Article 302 (2) of the Constitution mandates that provincial and local governments adhere to the management and operations of government services as per federal law. After the adoption of the Civil Servant Adjustment Act 2017, the existing government employees were reassigned to the federal, provincial, and local levels. Out of 99,571 civil servants, 39,960 (40.12%) stayed at the federal level, 13,821 (13.87%) in the provinces, and the rest 43,807 (43.98%) were reassigned to the local levels (Figure 5). This population of employees has been judged insufficient: the federal government estimated the need for a total of 138,622 employees across all three tiers of governments (48,606 federal [35%], 22,297 provincial [16%], and 67,719 local [49%]).

Figure 5: Details of Civil Servants Adjustments

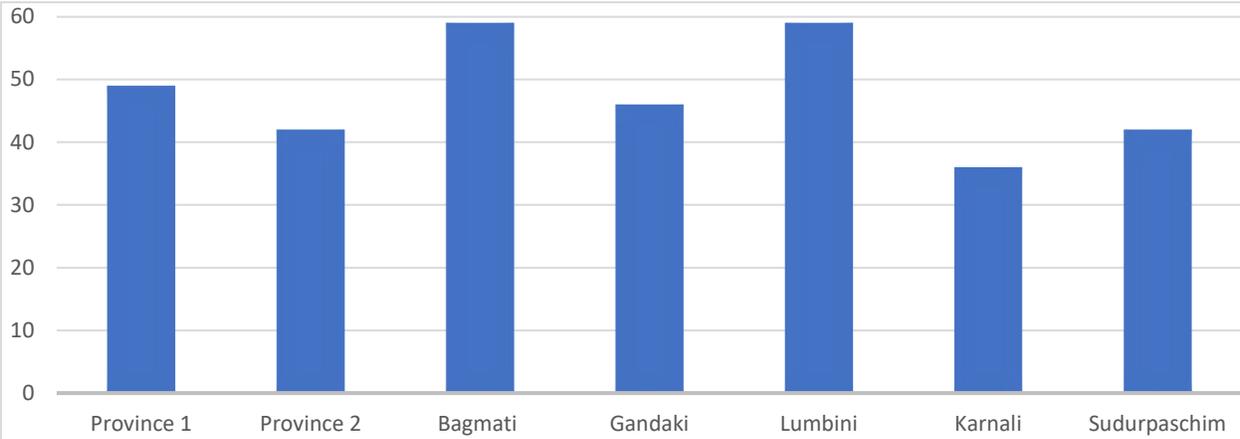


Source: MOF, 2019b.

The federal government made these adjustments in the allocation of civil servants, but the needs of staff at the provinces are different. There is a pressing need for provinces to conduct their own Organizational and Management surveys, create necessary institutions, and recruit required personnel on their own terms through the Provincial Public Service Commission.

As of December 2020, provincial governments had enacted 333 laws in total (Figure 6) including in the areas of security, governance, economic development, social development, and infrastructure development. Bagmati and Lumbini Provinces have introduced the highest number (59) of laws each, followed by Province 1 (49) and Gandaki (46). Province 2 and Sudurpaschim each have enacted 42 laws. Karnali has enacted the lowest number (36) of laws. Some important laws include: the Finance Procedure Act, Provincial Intergovernmental Fiscal Transfer Act, Revenue Sharing Act, Administrative Procedure Act, Industrial Investment Act, etc. Law is needed to run any government. Nepal's provinces have been in existence for less than five years. Along with the formation of the provinces, the law-making process is also gradually improving. In theory, laws may vary depending on provincial justification and needs; however, at the time of writing, the laws of almost all the provinces are the same.

Figure 6. Number of Laws Passed by Provincial Assemblies



Source: Devkota, Shrestha, and Ghimire (2021).

Key institutions and legal documents related to fiscal architecture at the subnational government levels are summarized in Box 1. The Office of Auditors General (OAG), National Natural Resources and Fiscal Commission (NNRFC), Ministry of Finance (MoF), and Financial Comptroller General Office (FCGO) comprise the central level financial institutions. The OAG and the NNRFC are constitutional bodies. A key role of the OAG is auditing the financial details of all tiers of governments. The NNRFC is known as the custodian of fiscal federalism. The MOF is the central authority of the Government of Nepal, charged with the responsibility for fiscal transfers, among others. The Ministries of Economic Affairs and Planning at the provincial level play similar roles for their governments. The FCGO's key role is to track the revenues and expenditures at each level of government. It also provides technical backstopping for the subnational levels. The Provincial Treasury Controller Offices play the same role at the provinces as FCGO does for the nation. The Provincial Policy and

Box 1. Key Entities and Legal Documents Related to Fiscal Architecture at the Subnational Levels

A. Institutions

- OAG, NNRFC, MOF and FCGO
- Ministry of Economic Affairs and Planning
- Provincial Policy and Planning Commission
- Provincial Treasury Controller Office
- Intergovernmental Fiscal Council

B. Legal documents

- Intergovernmental Fiscal Arrangement Act²⁴
- Provincial Financial Procedure Act²⁵
- Provincial Intergovernmental Fiscal Transfer Act²⁶
- Local Government Operation Act²⁷

Source: Author's compilation, 2021.

²³ This act elaborates provisions for revenue raising powers, revenue sharing, grants, external assistance, and loan arrangements for all three tiers of government. Additionally, it provides mandates for public financial management and planning of revenues and expenditures, including the development of a medium-term expenditures framework every year while preparing the annual budget.

²⁴ It makes the provincial financial management system accountable, transparent, and result-oriented by managing the operation and management of the Provincial Consolidated Fund and other funds, and contains important provisions related to budget formulation, disbursement and expenditure, accounting and reporting of financial transactions, internal controls, audits, and other economic activities.

²⁵ This act highlights details of fiscal transfers and management systems from the provincial governments to the local governments.

²⁶ This act provides overall provisions for local government administration and operation. This includes provisions on local government jurisdictions, roles and responsibilities, legal committees, etc. that are necessary for the effective operations of local governments.

Planning Commission is an advisory body for the provincial government responsible for planning. The Intergovernmental Fiscal Council²⁷ is a common forum for all the tiers for fiscal management issues.

6. Analysis of Subnational Revenues and Expenditures

Table 5 summarizes executed revenues and expenditures of subnational governments for FY 2018-19. The total revenues of provincial and local entities stood at Rs 229 billion and Rs 343 billion, respectively. Within these, the own-source revenues stood at Rs 24.88 billion and Rs 26.73 billion. Similarly, the contribution of fiscal transfers to the provincial and local level entities stood at Rs.115 billion and Rs. 226 billion. In the fiscal transfer figures of the local governments, transfers from provinces are also included. The status of expenditures is similar to that of revenues. Total expenditure stood at Rs 112 billion for provincial governments and Rs 269 billion for local governments, respectively.

Within the total revenues of the provinces and local governments, the share of own-source revenue was 10.86 percent and 7.80 percent, respectively. After including revenue sharing, the ratio rises to 30.31 percent for provinces and 22.03 percent for local governments.²⁸ Similarly, the ratio of local government expenditures to GDP (7.78%) is higher than the provincial ratio of 3.24 percent.

The subnational governments' ability to spend does not keep up with their revenues. The

²⁷ The Intergovernmental Fiscal Arrangement Act, 2017 has the provision for an Intergovernmental Fiscal Council in the chairmanship of the federal Finance Minister. The Council provides consultation and coordination in matters related to the management of intergovernmental finances between the federal, provincial and the local governments.

²⁸ Revenue sharing is the division of tax revenue collected from VAT and excise duties. The federal government collects and shares this revenue with the subnational governments. The Ministry of Finance and NNRF publications have categorized it as a fiscal transfer. However, in the report of the OAG, it has been included within the classification of subnational governments' revenue. The subnational governments have also taken it as their own revenue. Since the federal government shares this revenue with some conditions, there is definitely reason to argue for considering it as a grant, with more discussion needed to settle this matter.

most important part is that less than five years have passed since the formation of the local and provincial governments' level according to the new federal structure. There have been issues in staffing, law formulation, office set-ups, etc. In fact, the federal government has not sincerely cooperated in solving problems at the subnational governments' level (Devotka, 2021).

Table 5. Revenue and Expenditure of Subnational Levels (Rs, billion, FY 2018-19)

Revenue and Expenditure	Rs, Billion		Per Person (Rs, 000)	
	Province	Local	Province	Local
Revenue				
Own-source revenues	24.88	26.73	0.94	1.02
Revenue sharing ²⁹	44.54	48.78	1.68	1.86
Fiscal transfers ³⁰	115.00	225.94	4.34	8.61
Cash balance ³¹	44.58	41.25	1.68	1.57
Total	229.00	342.70	8.64	13.06
Expenditures	112.08	269.04	4.23	10.25
% of own-source revenue to total revenues	10.86	7.80		
% of own-source and shared revenues to total	30.31	22.03		
% of expenditures to general government expenditures	10.01	24.02		
% of expenditure to national GDP	3.24	7.78		

Source: Devkota (2020).

Table 5 summarizes the actual revenue and expenditure of the subnational level for the FY 2018-19. Table 6 summarizes budgeted fiscal transfers, including revenue sharing, in FY 2019-20 and 2020-21. The table shows that the subnational governments have around one-third of the federal budget received in transfers. In terms of GDP, the subnational governments received 12.31 percent in FY 2019-20 and 11.20 percent in FY 2020-21. (The budgeted revenues and expenditures for the provincial level in FY 2019-20 and 2020-21 are summarized in Table 7.)

²⁹ Out of the total local government revenue sharing figure of Rs 48.78 billion, around 10.5 percent includes vehicles tax revenue sharing from the province.

³⁰ In case of local transfers, transfers from the province to the locality is also included. Out of total local figure of Rs 225.94 billion, province shares include around 7 percent.

³¹ The budget/resources not spent last year is called "cash balance." This includes fiscal equalization grant, internal revenue, and revenue sharing movies. Other grant types return to the granting body.

Table 6. Fiscal Transfers (Budgeted): Vertical Shares (Rs, billion)

	Provincial		Local		Subnational Total ³²	
	2019-20	2020-21	2019-20	2020-21	2019-20	2020-21
Fiscal equalization grant	55.3	55.19	89.95	90.5	145.25	145.69
Conditional grant	44.55	36.35	124	161	168.55	197.35
Special grant	5	3.14	5	6.83	10	9.97
Matching grant	5	5.19	5	4.78	10	9.97
Revenue sharing	65	61.07	65	61.07	130	122.14
Total	175	161	289	324	464	485
Percent of federal budget	11.41	10.92	18.86	21.99	30.27	32.91
Percent of GDP	4.64	3.72	7.67	7.48	12.31	11.20

Source: Devkota (2020)

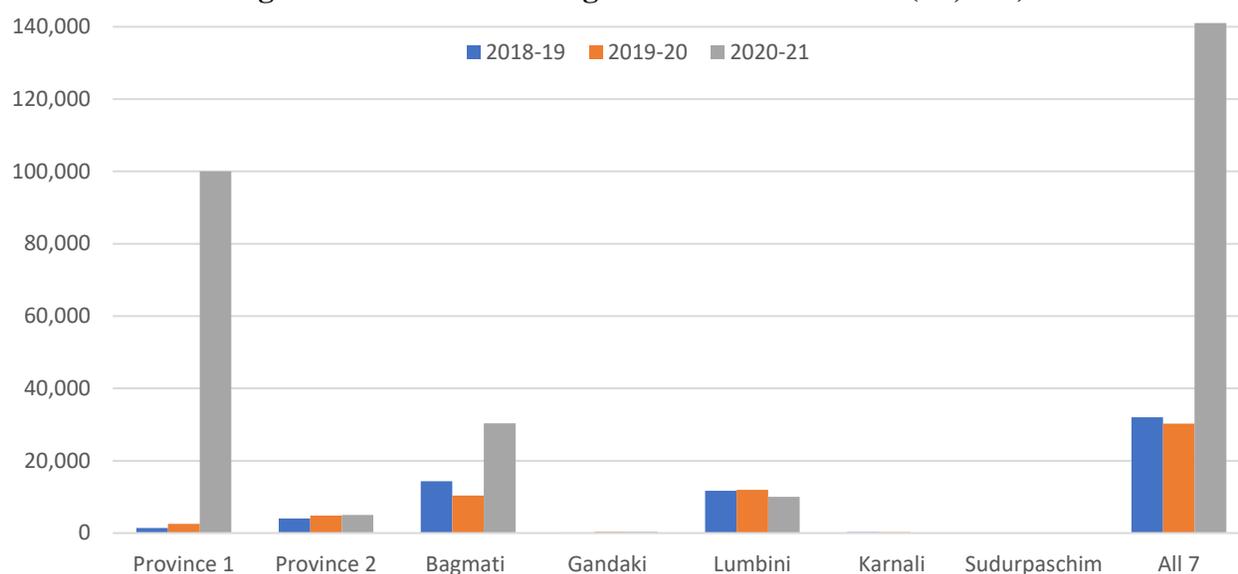
The provinces formulated their first full annual budgets in FY 2018-19. The actual revenue of the provinces for that year was Rs 229 billion. In FY 2019-20 and 2020-21, the provinces adopted annual budgets of Rs 260 billion and 264 billion, respectively (Table 7). In total, the share of own source revenue (OSR) in the provincial budgets was 11 percent in FY 2019-20 and 14 percent in FY 2020-21. This share of 11% to 14% from OSR and another 25% from guaranteed revenue sharing is not trivial by developing country standards, especially when the ability of the newly created subnational governments to design, enforce, and administrate taxes remains highly questionable.

However, whatever rights the provinces were given overlap with that of the local level units. The provinces' only truly *own* tax revenue source is the agricultural income tax, which is only a nominal source, as they have not been able to tap this heading. The provinces collected only Rs 32 *million* from this heading in FY 2018-19 (see Figure 7), compared to Rs 25 billion in total own-source revenues. Figure 7 also includes projected revenues for the FY 2019-20 and FY 2020-21. Neither Karnali nor Sudurpaschim Provinces collected or expect to collect any revenue from

³² The numerical figure of fiscal transfer including revenue sharing in the budget presented by the federal government from the ordinance for the fiscal year 2021-22 is Rs. 509 billion. Which is about 31 percent of the total federal budget. The percentage ratio has been decreased of about two percent compared to FY 2020-21. According to the constitution, the budget cannot be presented from the ordinance. It should be presented in the Parliament. As the validity of the budget is also being debated in Nepal now, other aspects of FY 2021-22 budget are not discussed here.

the agricultural income tax. In FY 2020-21, the total projected revenue from this heading is expected to be only Rs 145 million. While it is true that the provinces do not have sufficient revenue-raising powers in law, it is also a problem that they do not make good use of their existing own revenue sources. Until they can exercise the revenue-raising powers given to them with sincerity, it will be difficult to secure additional powers.

Figure 7. Revenue from Agricultural Income Tax (Rs, 000)



Source: Provincial governments budget speech documents, FY 2020-21

Fiscal transfers (excluding revenue sharing) contribute to 45 percent and 38 percent of the budgeted expenditures in FY 2019-20 and 2020-21 respectively. Out of seven provinces, three provinces have also budgeted loan figures. However, the share of their loans is nominal. It is unfortunate that the share of cash balance seems somewhat higher, at 17 percent in FY 2019-20 and 22 percent in FY 2020-21. There is a growing tendency to keep fiscal transfer figures as a cash balance for the next year without spending them. This is an accusation leveled by the federal government to the subnational governments' level.³³ It is important to increase the

³³ The annual and half-yearly review reports of the Ministry of Finance have information in this regard. There are news reports and articles in various daily newspapers as well.

spending capacity at the subnational governments' level.

Table 7. Revenue and Expenditure (Budgeted) of Provincial Level (Rs, billion)

	FY	One	Two	Bagmati	Gandaki	Lumbini	Karnali	Sudhur paschim	Total	% budget exp. ³⁴
OSR	19-20	4.12	3.13	12.2	3.69	4.9	0.3	0.84	29.18	11.24
	20-21	5.25	2.72	19.35	4.91	4.97	0.32	0.7	38.22	14.47
Revenue sharing	19-20	10.27	10.42	10.6	7.7	9.9	7.44	8.04	64.37	24.80
	20-21	9.54	9.52	9.7	7.57	9.47	7.4	7.87	61.07	23.12
Fiscal transfers	19-20	21.2	16.17	18.05	13.96	16.61	16.92	14.5	117.41	45.23
	20-21	15.11	13.41	14.87	13.36	14.07	14.83	14.21	99.86	37.80
Loan	19-20	0	1.3	0	1.98	0	0.75	0	4.03	1.55
	20-21	5	1	0	2	0	0	0	8	3.03
Cash balance	19-20	6.61	7.7	6.75	4.8	5	8.94	4.78	44.58	17.17
	20-21	6	6.91	7.5	7	7.85	11.19	10.59	57.04	21.59
Budgeted expenditure	19-20	42.2	38.72	47.6	32.13	36.41	34.35	28.16	259.57	100
	20-21	40.9	33.56	51.43	34.84	36.35	33.74	33.38	264.2	100

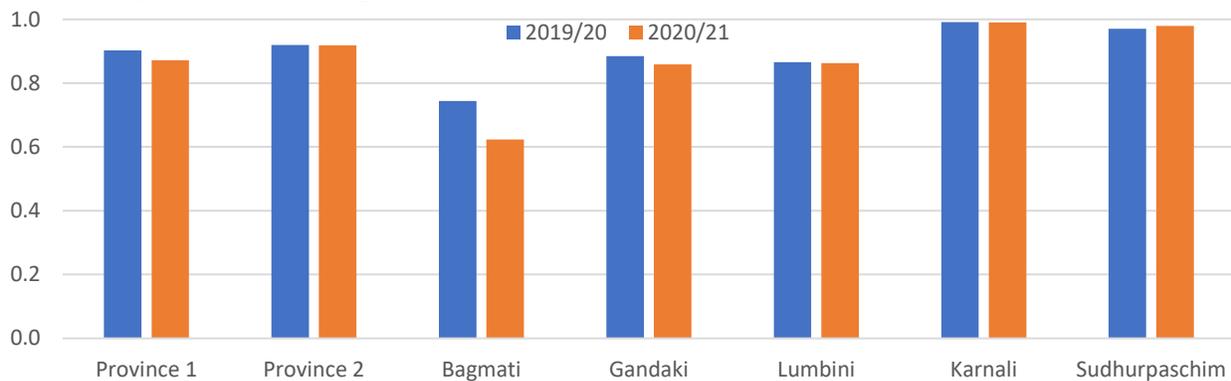
Source: Author's analysis based on provincial governments' budget speeches documents of FY 2019-20 and FY 2020-21.

The fiscal dependence ratios of the provinces in FY 2019-20 and FY 2020-21 are presented in Figure 8, which shows that the provinces are highly dependent on revenue sources that are beyond their control. The average provincial fiscal dependence ratio³⁵ is 0.78 for FY 2019-20. Among the provinces, Karnali Province, Sudurpaschim Province, and Province Two are most fiscally dependent on external revenue sources, while Bagmati Province has more fiscal means in its own hands. The fiscal dependence ratios are even higher for local governments (based on the data set summarized in Table 5), with an average of 0.92 in FY 2019-20. The ratios suggest that both the provincial and local level entities may wish to work harder on generating more internal revenue, particularly the local level.

³⁴ On June 15, 2021, the provinces presented their Rs 232 billion collective budget for the FY 2021-22. Some provinces have not released detailed figures yet. As per telephonic conversation with officials of all seven provinces, the total budget of Rs 232 billion is divided as follows: 39.71% for grants and fiscal transfers (fiscal equalization, conditional, special, and matching grants), 23.49% revenue sharing (division of VAT and excise duty), 17.87% internal revenue, 17.87% cash balance, and the remaining 1.15% internal loans. As this is based on preliminary figures, there may be slight revisions when final budget details are released.

³⁵ Here, the fiscal dependence ratio is defined as one minus the ratio of own source revenue to total expenditure.

Figure 8. Fiscal Dependence Ratios of Provinces (FY 2019-20 & FY 2020-21)



Source: Author's derivation based on data table 5.

7. Main Issues and Challenges

In the first five years of the federal system and the provincial governments it created, there have been both fiscal challenges and successes. This section describes the challenges still facing local and provincial governments as Nepal's new federal system continues to mature.

Institutional ambiguity, legislative delays, and inadequate cooperation of the federal government

Institutional ambiguity and legislative delays have been a major factor in the failure of Nepal's fiscal federalism system to function properly as expected at the subnational government levels. The creation and election of officials to subnational governments before federal elections were held confused and delayed many necessary legislative processes, as subnational governments' laws often had to be based on or informed by federal laws that had not yet been completed. Further post-election legislative delays at the federal level and inadequate cooperation by the federal government further aggravated this problem. For example, it took about two years to reassign civil servants to the newly created provincial and local governments. To date, the Federal Civil Service Act, which is necessary for legislating provincial and local level civil service laws, has not been enacted after being stalled in the federal parliament for more than two years. Although the Provincial Public Service Commissions have been formed, they have not been able to function properly without the enabling federal laws. Similarly, the Federal Education Act,

Health Act, etc. have not been enacted yet. These missing national laws create ambiguities in the devolution of public functions across the three tiers of government, despite the specification of powers by the constitution and the actual implementation of the fiscal federalism reforms.

Limited fiscal space at subnational levels

The own-source revenue rights of the subnational governments, especially for the provinces, are highly limited. Most of the revenue rights assigned to provincial governments overlap with those of local governments, such as the vehicle tax, land registration fees, entertainment tax, advertisement tax, etc. Due to the lack of revenue-raising authority, provinces are forced to depend on federal fiscal transfers and revenue sharing, which currently account for more than two-thirds of their total revenues. The provinces' only *truly* own-source tax revenue is from the agricultural income tax, which remains nominal to date (see Figure 7 above).

The condition of revenue collection

By the constitution, the revenue rights of local governments include the property tax, house rent tax, business tax, advertisement tax, service fees, etc. Despite possessing authority for most of the subnational revenue handles, local governments have not paid much attention to revenue mobilization. The share of own-source revenue in their total revenue pool is only about 8 percent (see Table 5 above). Even if revenue-sharing is also included, this ratio rises to just 22.03 percent. Compared to the taxing powers now controlled by local governments, their revenue efforts have been far from reaching their potential.

To the extent relevant, a similar problem is seen in the provinces as well. Though provinces have far fewer revenue-collecting rights, they have not maximized the activation of the rights they do hold. The largest components of the province's own-source revenues are the vehicle tax and house and registration fees. Provinces can also collect revenues from entertainment and

advertisement taxes, fines, tourism fee, and income from sale of services and goods, etc. Even with these rights, provincial own-source revenues remain small.

Issues with fiscal transfers

Although subnational governments receive the lion's share of their revenues from federal fiscal transfers, the related policies and management of these transfers are still plagued with problems. For example, conditional grants to subnational governments account for 41 percent of total federal to subnational fiscal transfers in FY 2020-21 (see Table 6 above). However, the programs and projects of this grant are very small, with dozens of programs and projects with a cost of less than Rs 100,000 each. In FY 2020-21, the provinces received conditional grant funds amounting to Rs 36.35 billion for a total of 13,256 programs and projects. The local governments received Rs 161 billion in conditional grants for 84,000 programs and projects. The small average size of these programs and projects indicate that the federal government is more likely to send numerous petty programs and projects to subnational governments, which are more burdensome to manage, rather than send a large pool of revenue the receiving government can use as it sees fit. Not only should the federal government increase the size of these fiscal transfers to resolve this issue, but it should also work to reduce the haphazard nature of conditional grant allocation.

Lack of laws and market mechanism for subnational public borrowing

Although provincial and local governments are allowed to borrow under the limit of up to 12 percent of their total revenues from own sources and revenue sharing, few have actually leveraged these means of resource mobilization. Province One, Gandaki, and Karnali Provinces presented deficit budgets to mobilize additional resource through internal loans from the federal government and internal market in FY 2019-20. However, these provinces have not been able to do so due to the lack of regulatory basis for the financial market mechanisms including mechanisms for the issuance of debentures. The federal government to date is yet to provide such

legal provisions.

Disappointing performances

Despite the challenges, a primary institutional framework necessary for fiscal federalism has been formed and the necessary laws governing the functioning of subnational governments have been enacted. In case of local governments, the Local Governments Operation Act was enacted in 2017. The act provides many opportunities for local initiatives on both the revenue mobilization and public expenditure fronts. Similarly, the required minimum staff is also present at the local level. There is no problem of fiscal resources, but some people have complained (in local publications) that they are not performing well and local level governments are not serious about providing effective and quality services to the local people.

There is also a high level of dissatisfaction with the provinces, to the point of some calls for provinces to be scrapped.³⁶ Some claim that provincial officials pay more attention to increasing administrative expenses such as salaries, allowances, and enjoyment of vehicle facilities than to their duties.³⁷ Additional claims hold that development work is not being done on a need-based basis and officials paying attention only to their constituency.³⁸ Due to these reasons, citizens are not satisfied with the subnational government levels, particularly the provinces. These

³⁶ Public complaints have included comments such as [paraphrased] 'The country was taken to federalism without serious discussion. It is not a good system of governance. It must be scrapped.' Civil society and journalists have expressed negative opinions about federalism and some political parties have begun lobbying against it, asserting that federalism is not necessary.

³⁷ This is the mostly commonly expressed grievance of the people towards the provinces. At present, the number of institutional structures, including offices, is increasing in the province. Of course, creating a new structure increases administrative costs in the beginning, but some provinces have *unnecessarily* increased the number of ministries, appointed more political appointments, and raised the number of district levels offices, changing the way people look at the province.

³⁸ There are widespread criticisms that almost all the provinces have budgeted funds in the name of a 'Constituency Development Fund,' meaning that planning is done by looking to the Members of Parliaments. Such programs and projects are taken out of their pocket rather than following a participatory planning process. Similarly, the budget was not allocated proportionately in all the local levels within the province. There are complaints that the Chief Ministers and Ministers of the provinces focused only on their constituencies and did not allocate budget on the basis of infrastructure development and poverty mapping.

subnational level entities should take the voice of the people seriously and put their act together to create a better performance to meet the rising expectation of the people.

Outbreak of COVID-19

The outbreak of COVID-19 has also emerged as a major problem for subnational governments. It has affected all economic sectors and the GDP growth rates of the provinces. The first and second years of the establishment of the subnational government levels were spent on institutional structures and law making. Just as they started to have enough experience to progress, COVID-19 appeared. The budget could not be spent as expected due to this pandemic, as it caused problems with internal revenue collection as well as mandating a shift in focus to pandemic management, disrupting development work. Due to this pandemic, significant problems have emerged in the social, economic, infrastructure, tourism, development, and other areas of subnational governments. In fact, the pandemic problem arose right at the time when the fiscal structure of the subnational levels was first being strengthened, creating problems in the overall fiscal architecture system of the subnational levels of government.

8. Conclusion and The Way Forward

After the promulgation of the constitution, the state structure of Nepal underwent transformative changes to comply with the new federal system of governance. The state power of the former unitary system was divided across three tiers of governments. Accordingly, the provincial and local governments have had new functions in this federal set-up, with the provincial level of government being entirely new. The constitution lists exclusive and concurrent rights for the three levels of government. These rights were elaborated through an unbundling exercise carried out to resolve possible disputes between the federal units. Based on this unbundling exercise, the division of work responsibilities among the council of ministers of the federal and

provincial governments (Allocation of Business Rules), the Intergovernmental Fiscal Arrangement Act 2017, and the Local Government Operation Act 2017 have been prepared. This exercise has laid the foundation for the implementation of federalism in Nepal.

The subnational governments (local and province levels) have begun setting up new structures, bringing with it a need for new offices to carry out their constitutional responsibilities. No matter how many nominal rights the subnational governments have, they need offices, staff, and the legal basis and fiscal resources to actually perform their work. Administrative expenses increase in proportion to institutional structure. According to the constitution, many functional responsibilities have been devolved to the subnational governments. As responsibilities shift to the subnational levels, so do institutional structures. In theory, as federal responsibilities are reduced, so too are its structures and staff count, while subnational government institutional structures and staffing need to be strengthened. However, structures at the federal level have not been reduced. Instead, additional institutional structures have been set up in the name of various projects in parallel with the jurisdiction of the subnational levels of government, undermining the effectiveness of the move to a decentralized system.

Nepal's federalism is based on the principle of cooperation and coexistence. By coordinating with the federal government, the subnational levels of government can also provide services from some of the federal government offices. For these duties, it is not necessary to open offices parallel to the offices of the federal government. For example, there are District Treasury Controller Offices of the federal government in each district and they can provide support to the provinces. Thus, it is not necessary for the provinces to open such offices in the districts again. Yet some provinces have opened such offices in the districts. It is important to work in a coordinated manner, including in building organizational structures.

In order to make the constitution more functional, necessary laws have to be formulated at the earliest opportunity. Some laws have to be adopted by the federal level. The subnational governments are supposed to adopt many of their laws based on the laws of the federal level. However, due to the absence of federal laws such as the Federal Civil Service Act, the Federal Education Act, and the Health Act, subnational governments have not been able to draft their own laws on the respective subjects. Similarly, the federal government has not enacted laws related to concurrent rights. Due to such policy ambiguity at the federal level, subnational governments have not been able to function smoothly. The federal government needs to make laws as soon as possible so that subnational governments' problems are resolved.

The constitution provides many functional responsibilities to the provinces. To fulfill these functional responsibilities, speed up service delivery, and build a government accountable to the people, they need sufficient fiscal resources. However, the constitution provides limited revenue-raising powers to the provinces. As per the finance follows the functions principle, initiatives are needed to review the revenue rights of the provinces. This requires paying special attention to their stakeholders.

Another problem is that subnational governments have not been serious in utilizing the revenue-raising powers assigned to them. The fiscal dependence ratios of subnational government are high. The provinces and local governments should work harder on own-source revenue mobilization. The federal government also needs to create the necessary environment for this. The subnational governments need support in areas such as managing staff, drafting legislation, developing institutional structures, etc.

The citizens have started to benefit from the local and provincial governments through the services they provide and programs they execute. With a few exceptions, there are signs of

improvement in almost all areas. A sense of positive competition has been created between different local and provincial governments. Thoughts have been developed on how to strengthen financial means and resources, how to achieve maximum development with limited means and resources, and how to provide services to the citizens in a comfortable and easy way. People have conveniently found the government at their doorsteps to a much greater extent than under the previous, unitary system. However, despite these achievements, there is dissatisfaction among the citizens. The performance of federal, provincial, and local governments has not been up to the expectations and aspirations of the people. Governments at all three tiers need to seriously review their work and attitudes to meet the rising expectations of the people towards fulfilling their constitutional rights and obligations in accordance with the nascent federal system.

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