

Fiscal Decentralization in Nepalese experience



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1. Background

Proper distribution of taxing authority and expenditure responsibility itself is an extremely complex task. Economists normally focus on growth, equity and efficiency, while politicians keep their attention on the distribution of power, responsiveness and accountability. It is commonly agreed that there is a positive relationship between economic growth and fiscal decentralization. The responsive and accountable governments always believe for equity and efficiency however this phenomenon demands a clear delineation of role and responsibilities between the levels of government. Generally, the defence, macro economic function, mega policy and huge infrastructures are assigned to the national government and considering the efficiency of the local and regional governments, other functions including small infrastructures, local economic activities and basic service deliveries are assigned to the subnational level.

The concept of decentralization has been changed continuously in the development arena. Previously, it was considered only to be delegation of power, but now decentralization also denotes the devolution of roles and responsibilities. The division of power based on certain principles can be deciphered from it. Thus, decentralization is also understood as a process of transferring authority, responsibility, power and accountability from the central government to subnational levels. It is an umbrella concept. Delegation, deconcentration and devolution are different forms of decentralization. Devolution is the advanced approach of decentralization, where law assures authority and accountability for local elected institutions.

2. Meaning of Fiscal decentralization

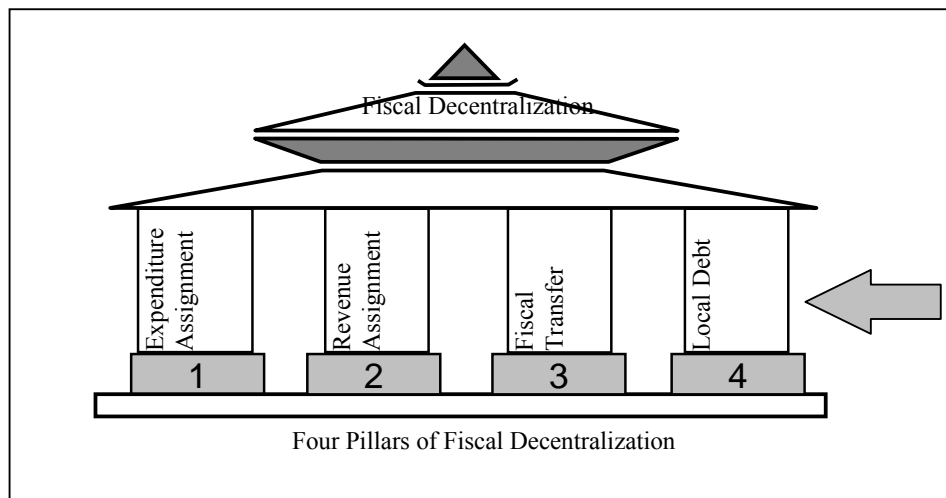
Fiscal Decentralization is one of the major components for a decentralized governance system, which is also known as a prerequisite functionary. James Edwin Key defines Fiscal decentralization as "the devolution by the central government to local governments (states, regions, municipalities) of specific functions with the administrative authority and fiscal

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revenue to perform those functions". It means fiscal decentralization required devolution of taxation authority to carry out the assigned responsibilities for the respective government. Today not only the local politicians; but central government itself is looking for effective fiscal decentralization. It is because that central government intends to meet all local needs through local governments in an efficient manner and that can only be fulfilled through devolution of fiscal power. Similarly central government is looking towards the local government's role on their national economic development addressing the demand of local politicians for more autonomy in the taxation power along with their expenditure responsibilities.

3. Dimensions of Fiscal Decentralization

Fiscal Decentralization is the composition of expenditure and revenue assignment, intergovernmental fiscal transfer and local government borrowings. All these four dimensions are interdependent on each other. An efficient fiscal decentralization always depends upon these factors.



Expenditure assignment is the delineation of role and responsibilities with entail funds. It makes institutions more accountable, minimizing duplication and overlapping the responsibilities. Subsidiary Principle has been strongly accredited while delineating the expenditure responsibility.

Revenue assignment is the next component of fiscal decentralization. This assures the sources generating funds required as per expenditure responsibilities. We know that the local revenue should be based on ability, economy and principal of benefit. Consistency between local tax and services is another imperative element to be kept in mind, while making revenue assignment between the levels of government.

Intergovernmental fiscal transfer is a gap-filling tool between local expenditure need and revenue assignment. The central government is sole responsible to develop and execute a

scientific and justified transfer mechanism. Population, geographic area, human development index, cost factor, categorization of local government, absorption capacity and financial fairness etc. may be some handy parameters to make the fiscal transfer equitable and logical. Regional governments are mostly used to carry out the delegated functions working as the development agency of central government. Unbalanced development and variation in development need among the regional governments is a realized fact. So equalization between local governments (horizontally vertically) is a grave topic to be addressed. Conditional and unconditional grant for local and regional governments have been practiced internationally. Conditional grant is generally allocated for delegated functions. Local government borrowing is also a gap-filling model, but experts speak to limit the borrowing up to certain point. In case of insufficiency of funds generated from revenue and fiscal transfer, local governments intend to borrow loan from bank and other finance companies.

4. Arguments for and against the fiscal decentralization

Some arguments have been raised against the fiscal decentralization at a continuous rate from its early initiation. It has been argued that local people do not have political power so that they can pressure local politicians to make resource efficient decision. Corruption is another concern, yet this cannot be generalized. The view is that the local authorities at least find themselves in more corrupting situations. It also has been assumed that the national bureaucrats are likely to be better than local bureaucrats having good knowledge of public expenditure management in tax and budget choices. Some times fiscal decentralization may exacerbate a central government's ability to deal with imbalances. It is because the devolution of fiscal authority tends to transfer the major volume of tax administration of the country to the local and regional government.

Some issues have occurred in the application of fiscal decentralization varying from country to country. In some cases central governments have felt their structural fiscal deficits and revenues collected at the regional and local levels exceed the central government's revenues. It has been observed for several times that discretionary power for the local government, degree of central control and dealings with vertical imbalances and horizontal inequalities as technical issues are not defined clearly before enactment of the fiscal devolution.

The arguments rose for and against the fiscal decentralization depend upon the level of development and political situation of the country. Wolman articulated the modern case for decentralized government and he had divided the proponent's arguments into efficiency and governance values. Efficiency is an economic value and it is expected that public sector emphasis to reflect public service assurance in the taxation policy as much as possible. Governance values include responsiveness, accountability, and political participation. Decentralization makes decision maker closer to the people and makes local politicians more responsive and accountable with them. It is because local politicians know more about the need and priority of local people than the central government and they remain alert for the election to come. Since local policy makers are closer to people, they can diversify during the formulation of public policy and offer citizens a greater choice in public service and tax options. Again the technical issues can be defined based on the expenditure responsibilities.

5. Fiscal decentralization in Nepalese practice

The Local-Self Governance Act (LSGA) 1999, for the first time has defined the principles and policies for a decentralized governance system in Nepal. According to these principles and policies, fiscal authority would devolve along with responsibilities, decision-making power and accountability to the local elected institutions. LSGA and respective regulations have been perceived as the milestone of decentralization; however in practice, the fiscal devolution has always been a least priority or neglecting sector.

5.1 Legal provisions focusing the dimensions of Fiscal decentralization:

After the promulgation of LSGA, the country has taken a step ahead on fiscal decentralization. The need of expenditure assignment has been accepted and role and responsibilities are assigned for different tiers of local government; but there is a huge overlapping and duplication. This overlapping scenario is not limited only between the tiers of local government but also with the central government too. Similarly the allocated responsibilities for local governments either are un-funded and/or under funded. In most of the cases it is being practiced, what local governments have been assigned for, the central agencies are doing same thing.

LSGA has made various provisions focusing the revenue responsibilities. As per the terms made by the Act, District Development Committees (DDC) can impose taxes on (i) different natural resources and worn torn goods that are exporting from the district, (ii) infrastructure (road, irrigation, ponds etc) taxes for those which are constructed by them or handed over to them. They are entitled to collect service charge and recommendation fee as approved by their respective councils. Similarly DDC are authorized to collect the revenue from the sale of natural resources like river bed materials and wooden swept by rivers from their jurisdiction. Likewise various provisions for revenue mobilization have been made in LSGA for Village Development Committees (VDC) and Municipality. They can collect revenue as rent tax, business tax, service charge, recommendation fee, house and land tax, property tax, parking fee, advertisement fee etc. Concerning the rate of these charges and taxes, the respective council of the local government is required to approved the rate based on the minimum and maximum range prescribed in Local Self Governance Regulation, 1999 (LSGR).

LSGA has made specific arrangements for central grants. As per the conditions defined, the Government of Nepal should allocate minimum grants for local bodies in yearly basis. Population size, level of development, revenue mobilization, need of financial resources and financial discipline maintained in local bodies are some indicators based on which government can allocate further additional grants as well. This has been perceived as the performance based grant system. Revenue sharing is another shape of central grant. According to law government should share the revenue collected as registration fee and royalties from electricity, mine, petroleum, forest and other natural resources and entrance fee from tourist and mountaineering etc. between DDCs and again DDC also should share this revenue among municipality and affected VDCs.

Local borrowing is one of the best possible choices for local bodies to fulfill the resource gap shortage from revenue authority and fiscal transfer. As per the settings in law, local bodies can borrow loan on the approval by their own council. But this has not been broadly practiced yet.

5.2 Institutional Arrangement and preliminary initiatives

After the enactment of LSGA some institutional arrangements have been set to enhance fiscal decentralization. A Local Body Fiscal Commission (LBFC), as a recommendatory body, is provisioned in the Act to make required research and studies related to local fiscal issues such as local taxation, revenue sharing, local financial management and accounting system.

A fiscal Commission was formed in 2001 and that commission completed a comprehensive study objectively to enhance the financial capability of different tiers of local bodies. It was the first report pledging fiscal decentralization that made different recommendations related to local revenue sources and administration, revenue sharing arrangement, central grants system, strengthening local accounting and auditing system, and accountability mechanism. A tentative expenditure assignment was also indicated by the study report. Commission recommended forming LBFC as a permanent institution.

As recommended by the study, LBFC as a permanent institution has been created with its full fledged secretariat. This commission took various initiations based on its road map in the way of strengthening fiscal devolution. Some comprehensive studies related to expenditure assignment, revenue assignment, intergovernmental transfer, expenditure needs and effectiveness, local financial management and others were successfully completed very shortly. These study reports give a clear roadmap of the fiscal decentralization improvement plan to the country, it required to own these reports and initiate implementation.

5.3 Major issues on fiscal decentralization

LBFC is an advisory body under the liaison of Ministry of Local Development (MLD). MLD provides premises and secretariat's staff with temporary position creation to the LBFC, but some behavioral problems have been observed due to comparatively lesser ownership of the staff by the Ministry regarding information and other benefit sharing. On the other hand, behaviorally there is hesitation to take ownership of the institution and its products by the MLD as it was envisioned during initiation. It seems the statement would become true that someone told at the beginning that LBFC would be in 'Birth Trap' on the behavioral ground. Notwithstanding, it is a behavioral concern and that can be managed if we intend. There are some other issues to be addressed in the time to come.

- 1 LSGA has defined the roles and responsibilities to all local government units. The defined roles and responsibilities are so broad that there is no responsibility which does not fall under the local government's jurisdiction if gone through the legal provision made. But there is a huge duplication and overlapping limited not only between the central and local but also between the different tiers of local government. Role and responsibilities are unclear rather than perfectly demarcated. Most of the responsibilities are either unfunded or under funded.
- 2 Principally we should agree that LSGA and its regulations intend to assign the revenue authority to the local government. Various revenue sources are identified and recommended for respective governments. But the sources assigned for them are looking unsustainable. It can be assumed that the assignment was made without sufficient study especially on service standard, expenditure need and potentiality of the resources. Revenue sources outlined for LBs are multifarious and heavy from the management point of view.

- 3 Revenue sharing between the central and local government has been practiced largely. Local and regional government used to carry out delegated functions on behalf of central government as development agents. As a consequence of which the central government has to compensate through sharing of revenue collected from their respective territory. Based on this universal practice same type of provision has been introduced in our context too. Local governments are entitled to get certain percentage of revenue collected as land registration fee and royalties from different sources. Some indicators have been developed and practiced for the sharing purpose between central and DDCs; however further exercise requires making these indicators doable and acceptable. For sharing between the different tiers of local government units neither any indicator has been developed nor practiced.
- 4 Central transfer is one of the apparatus that make local institutions accountable towards the central government. Sometimes central governments choose the transfer system rather than directly devolving the tax bases and revenue sharing; expecting that it helps to maintain the central control upon the local expenditure. Mainly there should be some features for a good transfer system; such as autonomy, adequacy and equity, certainty, predictability, simple and transparent. This is the indication that transfer system should be based on well-defined parameters. Central transfer is even critical for the horizontal and vertical equalization, which is based on need of development and expenditure responsibilities respectively. This equalization mechanism should also be based on pre-defined formula. But in our case central grant has been practicing on ad hoc. Some of the preliminary exercises have been made for an indicator based transfer system and an interim formula has been developed and executed, but further exercises call for making this system more applicable in all tiers of local government. The grant for municipality and VDC is entirely on ad hoc.
- 5 'Tax for quality service' is a universal phenomenon. Taxpayer seeks the service in return for paying tax to the government. This is even higher sounding to the local government that 'first gives us the desired service then only imposes tax'. It clearly shows that there must be a positive coherence between the tax and services from the local government. In our case the second part is missing. We should accept that most of the local government doesn't care the time frame, cost and quality of the services they are providing.
- 6 Maintaining financial discipline is being a very crucial concern in the local government. LSGA and local bodies financial administration regulation have characterized the process and procedures for accounting and auditing mechanism. Various formats in this regard has been developed and recommended. Adequate Institutional arrangements along with terms and conditions have been made to maintain financial discipline. Different tools also have been advised to make financial transactions transparent but desired discipline has remained a significant problem lying in front of them.
- 7 According to law a higher-level committee had to be formed as Decentralization Implementation and monitoring committee under the chairmanship of the Prime minister. Other adequate arrangements also have been shaped within the local institutions for monitoring and evaluation purposes. But in practice this is always disregarded. Even the meeting of the DIMC is not being organized as set down by law.
- 8 Coordination itself is a multifaceted function and a behavioral part. Degree of coordination depends on insight of others on a particular concern. If somebody perceives

for positive, there would not be the question of coordination and vice versa. In the Nepalese context speaking sincerely, most of the central line agencies hesitate to devolve the task as we are advocating since long back. They feel that local bodies do not have adequate capacity, every thing becomes worse due to the over burden on local institutions, local level should be capacitated before the departure etc. They believe on incremental approach of reform with the reservation that only the central level is competent to do every thing. Due to these reasons the question of coordination between the central and local comes in to existence frequently.

- 9 Local borrowing is vital as a gap-filling tool on local finance. LSGA has made policy for local borrowing but a detail guideline has not been prepared yet. Due to this reason local borrowing has not come in to practice since local units are feeling needed.

6 way forward

This is not an appropriate time to verbalize any more on existing mechanism of decentralization. Different ideologies are impending in political field regarding the future scenario of the state, especially on Unitary and Federal structure. But what ever may be the structural adjustment; decentralized governance system is always significant. It is more critical even in the federal type of structure. So recommendations are being made for acting out an effective and efficient fiscal decentralization keeping in mind a fragile scenario of structural set up of the state.

- 1 Broadly speaking there are two approaches of reform; Paradigm shift and incremental move. The first one is a political function and it needs authentic commitment and politically opening. Singapore, Korea, Philippines and some others have followed the same dimensions of reform after their political revolution. Theoretically, reform is a proactive function and that should be moved forward by the politicians. Bureaucrats are reactive and they intend to respond the demands only until the end of time. Similarly Administrator seeks to survive reforming the worst one and some time he believes on formalism -advocating more doing nothing. Reform initiatives in Nepal usually are based on coercion, pressure and hierarchy. We always believe in incremental approach. Past efforts were not successful due to the same reason. So that we should move making decentralization a political function.
- 2 Devolution is the best choice as an advanced approach of decentralization. Various efforts have been undertaken since last one decade in this scheme; though this is lying as a fruitless agenda. Despite various institutional and legal arrangements after the proliferation of LSGA, devolution could not step as expected. A piloting had enacted in primary health, primary education, rural infrastructure and agriculture extension, but DDC has been transformed only as an additional post office. Two years back government approved a policy to devolve most of the development activities up to district named as full-fledged devolution. A variety of interactions were undertaken between planning commission, MoLD and concerned line ministries. Process and procedures were also defined and forwarded for the endorsement, but nothing has happened so far.

There are two major causes behind the failure of the course of devolution. The first is political situation of the country and second one is erroneous approach for devolution. The political situation needs not to explain more, it is because everybody is aware of the political situation of Nepal since last thirteen years. But the second one is fundamental

and guided by our knowledge, intention and attitude. Devolution forever demands the perfect ness on the dimensions of fiscal decentralization. Expenditure assignments to some extent tends to role delineation and that should follow the principle of subsidiary. But we overlook this distinguished principle while commissioning the devolution process. We hunted the devolution process up to district rather than lowest tier of local government as per the competency of the level of government. Like wise we scrutinized the activities to be devolved sitting in the centre without bearing in mind for organizational competency and effective service delivery.

- 3 Adequate efforts were undertaken during the last ten years to brace fiscal decentralization in Nepal. It was equipped legally and structurally. A series of decisive studies had ended with valuable recommendations to make fiscal devolution stronger, but reports are lying as worthless materials. LBFC secretariat is not grooming as expected and unofficially it is used to verbalize as dumping site. If we are honestly committed towards the decentralized process we should review our past initiatives, and to correct our mistakes.
- 4 Our attitude, perception and behavior are the serious obstacle in governance process. We have been misguided from 'decentralization up to me' looking others dreadfully worst. We do not want to pass on authority to others. This is our behavioral fault and we should get rid from this power and ism phobia.

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