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### Implementing Federalism: The Case of Nepal

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## **Implementing Federalism: The Case of Nepal**

**Keywords:** Nepal, Federalization, Intergovernmental Relations, Public Sector Capacity

## **ABSTRACT**

The new Constitution of Nepal established a federal system of governance in 2015. Implementation began in 2018 following the 2017 subnational elections. The new system is comprised of seven provinces and 753 local governments. The Constitution assigns important functional responsibilities to provincial and local governments and mandates that they have significant autonomy in deciding how services will be delivered. Subnational governments accounted for over one-third of total government expenditures planned for FY2021, financed primarily by intergovernmental transfers. This paper describes the new federal system, discusses the early implementation successes and challenges, and draws some lessons from Nepal's experience.

## INTRODUCTION

In 2015, the new Constitution of Nepal (Government of Nepal 2016) established a federal system of governance, with seven newly created provinces and a radically restructured local level of government.<sup>1</sup> It is, by any stretch of the imagination, a "big bang" reform.

In March 2017, about 3,157 Village Development Committees and 58 municipalities—spread across 77 districts—were consolidated into 753 local government units.<sup>2</sup> This was followed by the first local-level elections in twenty years, conducted in three phases between May-September 2017. This new system of local government was created at the sub-district level, which had had very little capacity outside the old 58 municipalities in the past. While the 2015 Constitution still features District Development Committees (DDC)—indirectly elected from representatives of constituent local assemblies—so far this tier has not played a significant role. Furthermore, the district-level capacity that existed in the old, deconcentrated line offices has been disbanded and the staff absorbed by the 58 larger municipalities. While the Constitution and subsequent legislation mention different types of local governments—urban municipalities (metropolitan and sub-metropolitan cities, other urban municipalities) and rural municipalities—there is no distinction when it comes to the assignment of functions and revenue-raising powers. Notwithstanding the consolidation of VDCs into local government units in the new system, the reform represented fragmentation of local service delivery while moving decision-making closer to the constituency. In the old system, the subnational administrative structure was based at the

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<sup>1</sup> Out of 753 local governments, 460 are rural municipalities, 276 are municipalities, 11 are sub-metropolitan cities and 6 are metropolitan cities.

<sup>2</sup> While the seven provinces were established by the 2015 Constitution, the establishment of local governments was left to the Local Level Restructuring Commission (LLRC), which was subsequently formed on March 15, 2016, with a mandate to propose new local units within a year. On January 6, 2017, the LLRC initially proposed 719 local units, which was increased to 753 units in response to protests from Madhesh-based parties and intervention of the Supreme Court (Democracy Resource Center Nepal 2018).

district level. While there were central government employees assigned to serve as secretaries at each of the 3,157 VDCs, they often operated from a district center. Outside the old 58 municipalities, wards did not exist in their present form before 2015.

The current wards can be seen as an equivalent of the previous VDCs. Indeed, in 2017, wards were created by splitting former VDCs into two-three new wards with former VDC secretaries becoming ward secretaries. To the extent that the current 6,743 wards took over administrative functions (like collecting revenues and issuing certificates) from the previous 3,157 VDCs and 58 municipalities, this means doubling of administrative costs while making these services accessible for local residents. At the same time, given that each of the current 6,743 wards has the same representative structure with a five-member committee as the previous 36,000 wards had, it achieves consolidation of the representative and planning bodies. The ward committees participate in drafting and implementing projects in addition to maintaining and updating vital statistics, monitoring development projects, providing some municipal services, and more.

This paper describes the new federal system, now in its fourth year of operation, discusses the early implementation successes and challenges, analyzes certain impacts, and offers lessons (good and bad). The next section briefly reviews the history that brought Nepal to this dramatic change in governance. Then we turn to a description and analysis of the features of Nepal's new federalism, to the capacity of subnational governments to absorb this new system in such a short period of time, and to some of the main barriers to the implementation of the new federalism. The paper concludes with a discussion of the changing political dynamics and with a view of some lessons that other countries might draw from Nepal's experience with putting a federal system in place.

Analysis of the impacts of federalism in Nepal is limited by the availability of data. There is no census of local government finances that can be used to do a detailed analysis of the finances of individual subnational governments. Most of the fiscal information that we draw on is from the annual national budget and audit documents. The data problem exists because the statistical tracking system in Nepal is still in transition from one that has long served a fiscally centralized system with little need to monitor the activities of provincial and local governments (Irwin et al. 2020).

On the other hand, some indicators of progress with implementing federalism are available, e.g., the status of the legal framework, the degree to which local government training programs are in place, and the functioning of institutions and commissions that help govern the federalism. While tracking of these indicators is more descriptive than analytical, it captures important institutional design characteristics that underpins the workings of a successful federal system. We also make use of a survey of the newly formed subnational governments that was carried out to identify their readiness to accept their new responsibilities.

## **BACKGROUND**

Nepal has long attempted to establish some form of local self-government (Pokharel 2009 and Kelly 2016).<sup>3</sup> The previous Constitution allowed for local democratic elections to take place in

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<sup>3</sup> The restoration of multiparty democracy with the 1991 Constitution gave impetus to strengthening local self-governments. Implementation of the constitutional promise of popular participation through decentralization allowed for local democratic elections to take place in 1992. Subsequently, the adoption of the Local Self Governance Act (LGSA) of 1999 increased hopes for consolidation of local governance system and implementation of decentralization policies. However, the Maoist insurgency and ensuing conflict disrupted local elections and led to the absence of elected local authorities after 2002. After the adoption of the 2015 Constitution, the first phase of the local elections was held on May 14, 2017, in 34 districts of Nepal. Following this, local elections were carried out in most of the remaining local and provincial government jurisdictions on June 28, 2017, while the elections in

1992. The Local Self Governance Act (LSGA) of 1999 established 3,915 Village Development Committees (VDC), 58 Municipalities, and 75 District Development Committee (DDC). The chief officers of these local bodies were central government employees, and the staff was seconded from the central government. The gradual implementation of the LSGA provisions for more local autonomy was never completed due to the Maoist insurgency that started in 1996.

The Constitution of 2015, stemming from the Comprehensive Peace Agreement of 2006, introduced a new federal structure with the primary goal of nation-building. It moved forward with subnational elections, established provincial and local governments with significant fiscal autonomy, and put in place a new decentralized system that would transfer responsibility for spending an amount equivalent to about one-third of total government expenditures to subnational governments. Many of the necessary framework laws are now in place, an intergovernmental transfer system is functioning, expenditure assignments have been made, and provincial and local governments are now empowered to hire staff. Local government elections were successfully completed, officers are in place, and provincial and local governments are functioning. Assemblies are meeting regularly, laws and regulations are being developed, budgets were passed, most financials have been audited, and in 2021 about 38 percent of the total federal budget, inclusive of transfers, was classified in the budget speech as "directly gender responsive".<sup>4</sup> Survey research suggests that there is a feeling in the general population that things are moving in the right direction (Giri, Payakurel, and Pandey 2020). But while there has been progress in getting new systems in place, it is too soon to know their effects on service delivery

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province no. 2 were postponed to September 18, 2017. With the parliament dissolved on October 13, 2017, the general and provincial elections were held on November 26, 2017 (32 districts) and December 7, 2017 (45 districts).

<sup>4</sup> The total budget request from each ministry includes detail on programs classified into "directly responsive," "indirectly responsive," and "neutral" on the basis of the potential benefits to women under each program. The classification into these groups is subjective, but it is done each year and included in the annual budget speech of the Minister of Finance. For the 2017/2018 budget speech, about 36 percent of the total budget was classified as directly gender responsive and about 30 percent was classified as gender neutral.

and on citizen satisfaction. This is an important matter and underlines the importance of monitoring and evaluating the impacts of the system.

## **THE COSTS AND BENEFITS OF DECENTRALIZATION**

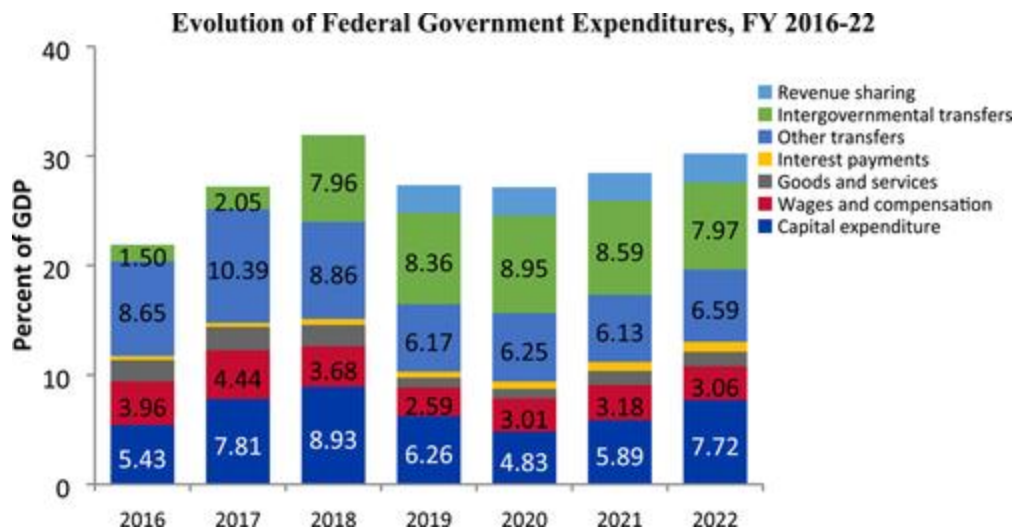
In April 2018, the World Bank estimated that the cost of transition to the federal system would be 3-4 percent of the GDP over the following four years (World Bank Group 2018). This estimate was based on three critical assumptions, which seem mostly to be holding fairly well. First, the overall wage bill of the government would not change significantly, i.e., increasing wages in the subnational government sector would be offset by declining wages in the federal government sector.

As is shown in Figure 1, the relative size of the wage bill of the federal government has declined over the 2016-2022 period. Furthermore, until the COVID-affected budget of 2021, the overall size of federal government expenditures (excluding intergovernmental transfers) had been steadily declining. The second assumption was that fiscal transfers for financing subnational expenditures would grow to 6.6 percent of the GDP by FY2021 from less than 2 percent in the pre-federalism period of FY 2013-16. In fact, intergovernmental fiscal transfers, even excluding revenue sharing, exceeded 8 percent of GDP in FY 2019-21 and are expected to be just under 8 percent of GDP in FY 2022, a level higher than the World Bank assumption.<sup>5</sup> As revealed in Figure 2, the growth in intergovernmental grants has been primarily driven by conditional grants, which include wages in the service facilities formally handed over by line ministries to subnational levels.

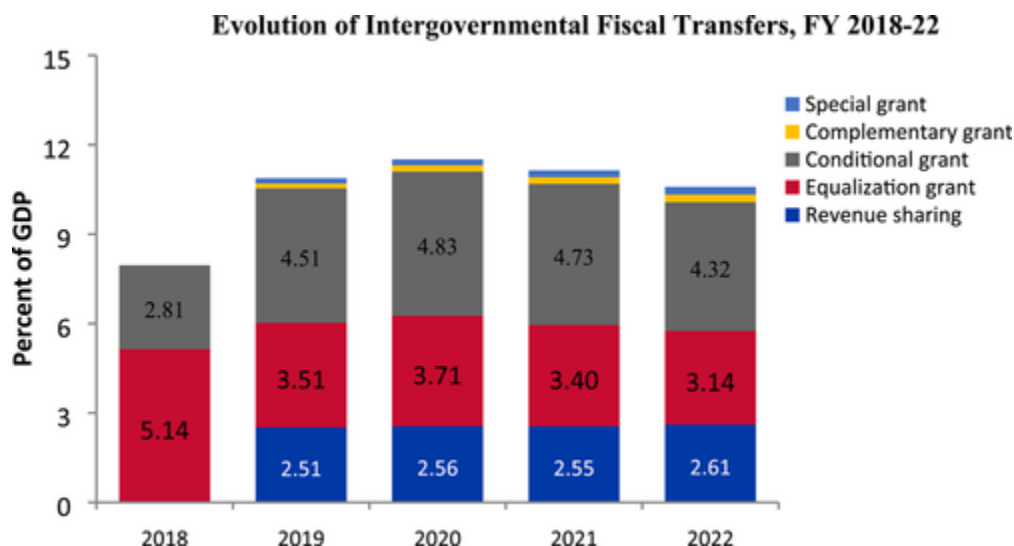
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<sup>5</sup> If revenue sharing were included in this measure of intergovernmental transfers, transfers would be above 10 percent of the GDP in FY2019 and above 11 percent in FY 2020 and 2021.





**Figure 1 :** Evolution of federal government expenditures, FY 2016-22. *Note:* Actual execution in 2018–2020, revised budget in 2021, and initial budget in 2022. *Source:* Annual budget speeches for FY 2018-22



**Figure 2:** Evolution of Intergovernmental Fiscal Transfers, FY 2018-22. *Note:* Actual execution in 2018–2020, revised budget in 2021, and initial budget in 2022. *Source:* Annual budget speeches for FY 2018-22

The third assumption was that the one-off establishment cost of subnational governments would be around 3 percent of GDP between FY 2017-2018. Available evidence suggests that these costs, including the cost of temporary and permanent structures, are not higher than the value used in the World Bank study.

There also are benefits to transitioning to a federal system. The three primary objectives of the federalism reform were the avoidance of conflict, better services and more opportunity for

disadvantaged populations, and the devolution of budget determination to subnational governments. While the benefits of achieving these three objectives are not directly measurable, there is reason to believe that their order of magnitude might be great. For example, one study reported that the civil war in Nepal was responsible for a cost equivalent to about 3 percent of GDP (Ra and Singh 2005). A World Bank study estimates that gender equality alone would be consistent with a 14 percent increase in the worldwide wealth of nations (Wodon et al. 2018).<sup>6</sup> Finally, more voice in government budget decisions could result in the local population getting more of the services they want from the government and could lead to more accountability of public officials and a greater willingness to pay taxes by local population.

### **NEPAL'S NEW GOVERNANCE SYSTEM AND FISCAL FEDERALISM**

The new Constitution calls on federal, provincial, and local governments to enjoy relations "...based on principles of cooperative, coexistence and coordination" (Art. 232).<sup>7</sup> This suggests the objective of strong local (third tier) government autonomy with little direct control by the federal or provincial governments.

According to the Consolidated Financial Statements issued by the Financial Comptroller General Office (FCGO), sub-national governments accounted for 31 percent of total government

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<sup>6</sup> The potential economic gains from gender equality in Nepal are substantial. The adult literacy rate is 71 percent for males and 45 percent for females. For every 100 males in the working-age population, there are 125 females. Yet, for every 100 employed males, there are only 59 employed females. Gender disparities also exist among the unemployed, and women earn, on average, 70 percent of what men earn (World Bank Group 2019, p. 43).

<sup>7</sup> In countries with cooperative federalism practice, all levels of government share the responsibility in the governance. Like many other federations, such as Germany and the US, in Nepal all levels of government work together on a variety of issues and delivery of programs. In contrast, competitive federalism refers to a concept in which center and constituent parts of the federation compete with each other. The competitive federalism idea has gained significance in India after the economic reforms of 1990s for liberalization.

expenditures in FY 2020. This is well above the international average of about 20 percent for low- and middle-income countries (Bahl and Bird 2018, 46). On the revenue side, the system is highly centralized, with sub-national government tax and non-tax collections, mostly centered in urban areas, contributing around 6 percent of all government revenues raised in the country in FY 2020.

### *Expenditure Assignment*

The distribution of expenditure responsibilities among the three levels of government in Nepal generally conforms to broad theoretical principles, i.e., functions with national benefits are assigned to the federal level, those with regional benefit zones to the provincial level, and those where benefits accrue roughly to local government boundaries to third-tier local governments. Consistent with the goal of local self-government, the third-tier local governments received responsibility for most basic functions, including primary and secondary education, health and sanitation services, local roads, irrigation, and the management of local markets. These local services were identified with an unbundling exercise to identify candidate subfunctions. A total of 800 sub-functions were included in the exclusive and concurrent lists<sup>8</sup>, which were synthesized in the integrated report approved by Cabinet.<sup>9</sup> The Constitution mandates that decentralization comes with autonomy to decide how services will be delivered and how they will be paid for.

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<sup>8</sup> The exclusive sub functions are those assigned to a particular level of government, while the concurrent subfunctions are those shared by more than one level of government.

<sup>9</sup> “Unbundling/Detailing of List of Exclusive and Concurrent Powers of the Federation, the State and the Local Level Provisioned in the Schedule 5, 6, 7, 8, 9 of the Constitution of Nepal,” Report prepared by the Federalism Implementation and Administration Restructuring Coordination Committee (February 2017).

In practice, the real autonomy of subnational governments in shaping their budgets is more limited than the 30 percent share of total government expenditures that passes through their budgets would suggest. Among the reasons for this are (a) almost 45 percent of their intergovernmental transfers comes in the form of tied grants, (b) more than half of their local officers are transferred federal officials whose ties to central ministries remain strong, and (c) a large number of Nepal's voters are not well versed on their rights to hold decision-makers accountable (Democracy Resource Center 2017; NASC 2018).

### *Revenue Assignments*

The value-added tax, excises and customs duties, and income taxes are reserved by the Constitution (schedule 5) for the federal government. Provincial governments can impose land and building registration fees, vehicle, advertisement, tourism and entertainment taxes, agricultural income taxes, and various fees and service charges. Local governments are assigned various forms of property and rent taxes, registration fees for land and houses, vehicle registration fees, and some other minor taxes and charges. Overall, the revenue assignment conforms to normative principles, such as the benefit principle (correspondence between the jurisdiction in which a tax is levied and the area in which the benefits are received), revenue stability, a fair distribution of burdens with respect to taxpayers' ability to pay, and a high visibility for taxpayers that can offer improved opportunities for subnational government accountability.<sup>10</sup> However, some of these revenue sources lack buoyancy with respect to changes in the local economy.

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<sup>10</sup> For more discussion of the normative principles see Martinez-Vazquez (2015).

Many tax bases (land registration fee, vehicle tax, entertainment tax, and advertisement tax) were assigned to both the local and provincial levels. In order to address this issue, a single tax administration system has been implemented so that only one subnational level collects the tax and shares the revenue with the other.<sup>11</sup> For example, provincial governments collect vehicle taxes and share 40 percent of that revenue with their constituent local government. Subnational governments could do a better job with revenue mobilization. They have revenue sources with some degree of potential, some rate-setting discretion and tax-collection authority. However, local and provincial governments are not exploiting the revenue bases assigned to them. The share of own-source revenues in total revenues is only about 12 percent for provinces and 8 percent for local governments as of FY 2020 (see Table 1). Some analyses place own source-revenue collection rates are only about 70 percent, even in more advanced municipalities like Kathmandu City (World Bank 2019).

**Table 1.** Evolution of own-source revenues

	Percent of total revenues			Percent of GDP		
	FY18	FY19	FY20	FY18	FY19	FY20
Provinces	N/A	7.22	12.48	N/A	0.32	0.57
Local governments	5.68	10.00	7.75	0.47	0.79	0.71
All subnational governments	5.52	9.30	9.99	0.47	1.11	1.28

*Source:* Authors' calculation from available budget execution data.

### *Intergovernmental Transfers*

<sup>11</sup> According to the Auditor General annual reports and Devkota (2021), some local governments do not keep proper records for these collections and as a result do not share the proceeds fully with provinces.

The Constitution provides four transfer channels: 1) equalization grants; 2) conditional grants; 3) complementary (matching) grants; and 4) special grants. In addition, the Intergovernmental Finance Management Act (IFMA) of 2074 (2017) mandates placing the revenues collected from excise taxes and VAT on domestic goods in a federal divisible pool to be allocated as follows: 70 percent to the Federal Consolidated Fund, 15 percent to the provincial divisible pool, and 15 percent to the local divisible pool.<sup>12</sup> The provincial and local divisible pools are to be distributed among recipient governments by two different formulae. The IFMA introduced a similar arrangement for sharing half of the royalties and natural resource revenues, with the exception that the horizontal allocation formulae only apply to those provinces and local governments where these revenues are generated.

In the first year of federalism implementation, the total vertical shares in Nepal (including revenue sharing and four other grant channels) were 7.96 percent of GDP in 2018, then peaked at 11.51 percent in 2020 before starting to decline with the 2022 level budgeted at 10.59 percent of GDP (Figure 2). Since 2019, about two-thirds of the total amount has been designated for local-level governments.

The composition of the intergovernmental transfer system is reasonably balanced in terms of grant types and objectives. The 2022 budget includes about 30 percent for equalization grants and about 25 percent for revenue sharing grants, both of which are distributed without conditions attached as to how the money must be spent. Conditional grants take up about 40 percent of total grant funding (Figure 2). There is a provision in the Constitution for provincial government grants to local governments, which accounted for about 7 percent of all transfers

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<sup>12</sup> This tax sharing entitlement was allocated for the first time in FY 2018/2019. It is a direct claim against national tax collections rather than a transfer from the consolidated fund. Because of this feature, the national budget does not classify the tax sharing grant as an intergovernmental transfer to subnational governments.

received by the local level in FY 2020. Less important in the present system are special and matching grants, which are used to target disadvantaged areas, and to incentivize local co-financing of infrastructure projects.

The horizontal sharing of an intergovernmental transfer is the distribution of the respective divisible pool among the individual local and provincial governments. In Nepal, these distribution arrangements vary by grant program. Revenue sharing and equalization grants are distributed by two different formulae, but both are based on some undisclosed indicators of expenditure needs as well as revenue capacity and effort. The formulae, first developed by the National Natural Resource and Fiscal Commission (NNRFC) secretariat, were revised annually both before and after the Commission was appointed (for more details, see Devkota 2020).

Conditional grants are payments to sub-national governments to implement (newly devolved) federal programs according to national standards and to comply with national and international commitments. Some of these conditional grants are more in the nature of cost-reimbursement grants because they are used to guarantee the cost of salaries of transferred central government employees (mostly education and health) and to cover the costs of legacy projects inherited from the former centralized regime. Conditional grants have been steadily increasing both in absolute and relative terms and have become the largest of the five categories of intergovernmental transfers from the federal budget (Table 2). These grants support almost 100 thousand specific projects prescribed by the federal governments, with some being as small as Rs. 50,000 ( $\approx$  USD 432). The increasing role of conditional grants, especially when structured in such a tightly prescribed manner, takes away from the ability of local government to shape their policies in response to local needs and preferences.

**Table 2.** Intergovernmental transfers from the federal budget, 2018–2021, by percent distribution

	Grant type	FY 2018			FY 2019			FY 2020			FY 2021 (budget)		
		LG	PG	All	LG	PG	All	LG	PG	All	LG	PG	All
Untied	Revenue sharing <sup>a</sup>				18.7	30.2	23.1	17.09	31.81	22.24	18.8	37.9	25.2
	Equalization	63.4	100	64.5	32.9	31.3	32.3	30.67	35.07	32.21	27.9	34.3	30.0
Tied	Conditional	36.6		35.5	46.6	33.2	41.5	49.52	27.96	41.99	49.7	22.6	40.7
	Complementary				1.1	2.5	1.6	1.33	2.68	1.80	2.1	2.0	2.1
	Special				0.7	2.7	1.5	1.38	2.48	1.76	1.5	3.2	2.1
	<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

*Note:* Revenue sharing grants first introduced in FY 2019, split in equal amounts between provincial and local levels. *Source:* Annual budget speeches for FYs 2018-21, Consolidated Financial Statements from the Financial Comptroller General Office (FCGO).

The IFMA (art. 8-9) empowers the (independent) NNRFC to make recommendations to the Government of Nepal and provincial governments regarding the operationalization of the "expenditure needs" and "revenue capacity" criteria required in the Constitution. Furthermore, the NNRFC is to recommend "... fiscal equalization grants to be obtained by each state and local level [unit] in accordance to the criteria...and the minimum grants to be obtained by each State and Local Level [unit]." The implication is that, for equalization grants allocated from the national budget, NNRFC suggests two amounts for each subnational government unit: one is lump sum irrespective of the formula criteria, and the other is determined by the formula criteria.

The NNRFC recommends criteria to be used by both the national and provincial governments in the allocation of conditional grants to their constituent units. The granting



government units determine the actual conditions to be attached to these grants. The allocation of matching and special grants is left entirely to the Government of Nepal.

### *The Incidence of Equalization Grants*

The Constitution (art. 60(4)) specifically makes provision for equalization grants and defines equalization in terms of expenditure needs, revenue capacity and effort.<sup>13</sup> But the Constitution stops short of defining the exact equalization objective. In making its recommendations on the formula, the NNRFC took into consideration a list of specific criteria added in the NNRFC Act (art. 16(1)) to make the formula operational. It published relative weights to use for each criterion (Table 3) but not the actual formula or data used for the calculation of indices of expenditure needs and revenue capacity. Reportedly, other than demographic data from the population census, no socio-economic data are available for individual local government units (Devkota 2020). Besides actual revenues and expenditures and demographic data available for each local government unit, these indices could only use data aggregated at the district and province levels.

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<sup>13</sup> This is consistent with the general view that an equalization grant reduces the gap between a jurisdiction's expenditure needs and its capacity to finance those needs, both measured at "normal" levels of effort. (Bahl and Bird, 2018, Chapter 7, Yilmaz and Zahir, 2020).

**Table 3.** Fiscal equalization grant allocation criteria and weights (percent) recommended by NNRFC

<b>Criteria</b>	<b>FY 2018/19 &amp; 019/20</b>		<b>FY 2020/21</b>
	<b>Province</b>	<b>Local</b>	<b>Province &amp; Local</b>
Multidimensional Poverty Index	15	-	-
Human Development Index	-	15	10
Economic and social inequality	15	5	5
Status of infrastructure development	10	10	10
Status of revenue	0	0	5
Expenditure need	60	70	70
Total	100	100	100

*Source:* Devkota (2020).

In practice, NNRFC also considered population size and land area when recommending minimum lump-sum amounts to cover fixed costs in addition to the amounts varying with the aforementioned criteria.<sup>14</sup>

It might be argued that the resulting allocation of formula-based equalization transfers is biased in favor of smaller (population) local governments and against more urbanized local governments. This bias could come about because of the fixed cost component of equalization grants. However, the NNRFC does not provide information about the actual formula or data used in making these allocations. In this analysis, fiscal data from the Ministry of Finance and NNRFC are used to study this question for equalization grants allocated to local government

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<sup>14</sup> Population size and land area are explicitly included in the formula for allocation of the shared revenues as required by the NNRFC Act (art. 15).

units. In addition to the fiscal data, we use 2015 data on the local population, land area, and poverty estimates produced by the World Bank country office using its own indirect estimation technique for micro-level geographic profiling (World Bank 2013).

In Table 4, we show that the average per capita allocations for metropolitan and sub-metropolitan cities are lower than those of other local governments in the system. In fact, there appears to be a monotonic inverse relationship with the gradation of the four types of local governments from the smallest rural ones (rural municipalities) to the largest urban ones (metropolitan cities).

**Table 4.** Equalization grants recommended and budgeted in FY 2019-21, by type of local government (Rs per capita, unweighted average)

	2019 budget	2020 budget	2021 budget	2021 NNRFC
Metropolitan city	1481	1535	1484	1545
Sub-metropolitan city	2075	2248	2181	2270
Municipality	3331	3492	3448	3589
Rural municipality	5593	6060	6173	6425
All local governments	4680	5027	5078	5286

We test this relationship further with a (log-linear) regression analysis on 753 local governments, which shows (Table 5) that local governments with smaller populations, larger land areas, and more wards receive significantly larger per capita equalization transfers. We can conclude from the regression analysis that per capita equalization grants are biased in favor of smaller-sized local governments, i.e., a ten percent smaller population, all else being the same, is associated with an about seven percent larger per capita equalization grant in the last three years.

**Table 5.** Implicit determinants of equalization grants to local government units

	<b>Dependent variable</b>			
	<b>2019 budget</b>	<b>2020 budget</b>	<b>2021 budget</b>	<b>2021 NNRF</b>
Poverty rate	-0.055 (0.047)	-0.154*** (0.039)	-0.137*** (0.036)	-0.137*** (0.036)
Population	-0.642*** (0.030)	-0.682*** (0.028)	-0.692*** (0.027)	-0.692*** (0.027)
Land area	0.033*** (0.009)	0.023*** (0.008)	0.019** (0.008)	0.019** (0.008)
Number of wards	0.028*** (0.004)	0.029*** (0.004)	0.026*** (0.004)	0.026*** (0.004)
Constant	14.496*** (0.305)	15.037*** (0.283)	15.181*** (0.271)	15.220*** (0.271)
Observations	753	753	753	753
$R^2$	0.833	0.884	0.899	0.899
Adjusted $R^2$	0.832	0.884	0.899	0.899

*Note:* Except for the number of wards and poverty rate, all variables are expressed in logarithms. Therefore, coefficients at such variables reflect percentage difference in grants per capita associated with percentage differences in the independent variables. The coefficient of the number of wards reflects the percentage difference in grants per capita associated with having one additional ward in a local jurisdiction. The coefficient at the poverty rate reflects a percentage difference in grants per capita associated with a one percentage point difference in the poverty rate. Estimation is by ordinary least squares. Heteroscedasticity robust standard errors are in parentheses; asterisks indicate significance at the 1% (\*\*\*) and 5% (\*\*) levels.

However, this is not inconsistent with the goals of equalization implied by the Constitution, given that the poorest local governments are located in remote Himalayan areas, which also have low population density. However, local governments in the lowland (terai) belt in the South, which tend to have higher population density, account for a larger share of the poor in the country, in particular the bulk of urban poor. Our regression results suggest that the poverty rate, all else being the same, is associated with a smaller per capita equalization grant. This is not surprising given that the criteria of human development and socio-economic inequalities are given a combined weight of only 15 percent in the equalization grant allocation

(Table 3). The bulk of the weight is given to the expenditure needs index, which, while not publicized, might take into account the need to maintain existing facilities in more developed localities.

One might question the efficiency implication of allocating resources to rural municipalities regardless of their ability to absorb these funds. One representative survey of different types of local governments found that, in FY 2018/19, they were only able to execute, on average, 80 percent of their recurrent budgets and 75 percent of their capital budgets (World Bank 2019). Surprisingly, absorption rates were lower in cities: 76 percent and 61 percent for recurrent and capital budgets respectively. When those local governments with disbursement rates below 60 percent for capital spending were asked the reasons for underspending, over one half responded that it was due to absence of technical staff and delays by user committees.

## **BARRIERS TO IMPLEMENTING THE NEW FEDERALISM**

Governments at all three levels are making progress in removing barriers to the full implementation of federalism, but much remains to be done.

### *Devolution of Government Employment*

The transition management clause of the Constitution (Article 302 (2)) allowed the Government of Nepal to “integrate” some of the existing civil servants into the provincial and local levels when making “necessary provisions to provide services at provincial and local level.” The first attempt at implementation was introduced in the Employees Adjustment Act (2017) through the process of “adjustment,” defined as “installation of the employees in the federal, provincial or

local level service.” This Act put on hold subnational powers of hiring their own staff until completion of the “adjustment” of these 89,825 civil service employees, i.e., some would be physically relocated and become employees of either a provincial government or a local government, and some would remain at the federal government level.

The transition strategy was to transfer federal government civil service employees working in devolved line ministries to match the reassignment of expenditure responsibilities. This process started at the center, which led to dissolving or combining several federal ministries. Employees in the abolished departments, many of whom were already posted outside Kathmandu, switched to the provincial and local government service. While initially envisioned to be completed within six months of determining the total number of positions at each of the three levels of governments by the federal operations and management (O&M) Committee, this process was only completed in 2019, under the terms of the Civil Servant Adjustment Act passed by the parliament in February 2019 to replace the Employees Adjustment Act of 2017.

However, the completion of adjustment did not result in completely filling the total number of positions estimated for sub-national governments. By FY 2021, provincial and local governments had 25 percent fewer employees than were needed (based on the O&M Committee estimates). Neither is the present situation likely to provide enough initial management capacity, with the right skills, to meet the needs of provincial and local governments, especially in technical areas such as engineering and accounting. Until these employment and skill gaps are filled, the promised improvement in public services is unlikely to materialize. Although the Provincial Service Commissions (PSCs) have been established, the necessary federal law—Federal Civil Service Act—has not been adopted. This Act will provide the framework and standards that would allow the provinces to enact their own civil service acts, which will

empower their PSC to hire, fire and promote their employees. As PSCs are not fully functional, the Federal Government has tasked the federal Public Service Commission to process the recruitment of about 10,000 staffs for subnational governments. One implication is that subnational governments might not be able to determine retroactively remuneration and other terms of employment of these new hires, and another has to do with the ability of subnational government to induce performance improvements and accountability from this staff, who might have conflicted loyalties.

### *Institutional and Organizational Arrangements*

The Constitution calls for the empowerment of several institutions that are key to moving the implementation of federalism forward. Two that are crucial for the success of Nepal's decentralization are the Inter-Provincial Council and the National and Natural Resource Fiscal Commission.

The role of the Inter-Provincial Council (IPC) is to settle disputes of a political nature between the federation and provinces, as well as among the provinces. The membership includes the Prime Minister, the Ministers of Home Affairs and Finance, and the Chief Ministers of the Provinces (appointed by a majority vote in the provincial assembly). The inputs of the Inter-Provincial Council in planning for the implementation of the federal system are important. Although the IPC has become more active since 2020, due to the efforts of chief ministers (Devkota 2021), it doesn't meet regularly to discuss federalism implementation challenges. It remains to be seen whether the IPC can successfully carry out its role of resolving intergovernmental conflicts. In July 2020, at the height of the Covid-19 pandemic, Nepal's

national Parliament passed the landmark Intergovernmental Relations and Coordination Act.<sup>15</sup> One of the most notable features of the act is that it enables subnational governments to enact laws—without waiting for federal legislation. In many important sectors, such as education, forestry, agriculture, and natural resources, federal legislation lagged, leaving subnational governments unable to fulfill their roles. The IGR Act has now established the independent authority of subnational governments to legislate as long as their legislations do not conflict with the Constitution or current or future federal law.

The National Natural Resources and Fiscal Commission (NNRFC) is charged in the Constitution with recommending/determining the distribution of revenues to provincial and local governments from the consolidated fund. Fiscal commissions in federal countries are not uncommon (India, Pakistan, and Australia) and are usually charged with making recommendations to the government about changes in the system of intergovernmental finance. However, in the case of Nepal, the wording in the Constitution directs that the vertical shares of intergovernmental transfers and the horizontal distributions "shall be as recommended by the NNRFC" (Art. 60, (3,4)). This is a step further than other countries have gone with the powers given to fiscal commissions (Yilmaz and Zahir 2020).

There have been delays in fully empowering the NNRFC. In March 2019, the President appointed the Chairperson, but the remaining two members were not nominated until December 2020. Even before the appointment of the Chairperson, a Secretariat was established to carry out research, monitoring, and policy analysis for the Commission. This secretariat established an interim system of intergovernmental transfers. At present, the NNRFC functions, but with

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<sup>15</sup> The coronavirus pandemic highlighted the importance of intergovernmental coordination in response to an external shock. There is an urgency of establishing a functional institutional mechanism for intergovernmental relations as soon as possible. As of now, there is no such mechanism established to effectively coordinate and harmonize the relation between provincial and local level governments yet.



inadequate staffing, and has, on occasion, been at odds with the federal government over policy recommendations (Devkota 2020). Not surprisingly, neither the formula nor the actual amounts recommended for FY 2021 by the Commission were followed by the Ministry of Finance, which cited the COVID pandemic and insufficient consultations with the Ministry by the Commission among the reasons (Devkota 2020). However, our analysis of the incidence of grant allocation in Table 5 does not find systematic differences between the amounts recommended by the Commission and the amounts budgeted for FY 2021.

### *Capacity Building and Training*

The expected staff level, including service delivery employees, in the seven provincial governments is about 21,000, and that in the 753 local governments is about 66,000. In addition, there are about 37,000 newly elected local government officers, and 550 elected provincial government officers. Retooling employees and management in Nepal and educating lawmakers about their new duties will be no small job.

As recently as 2019, there was no survey of public sector training needs in Nepal. Nor was there an estimate of how much it might cost to put such a capacity development program and institutional arrangement in place to accommodate the level of training needed. Since that time, the Government of Nepal launched the Provincial and Local Governance Support Programme (PLGSP) under the Federal Ministry of Federal Affairs and General Administration (Government of Nepal, 2020) as the main vehicle for capacity building to strengthen provincial and local government systems, procedures, and intergovernmental relations. Responsibility for training and capacity building for the sub-federal sector was delegated to the Provincial

governments with the newly formed Provincial Centers for Good Governance as the implementing agencies. The expectations are that capacity-building activities will be demand-driven, with provincial and local governments identifying their specific needs and requesting capacity building from the menu of options offered by PLGSP. Thus, it was a full five years after the Constitution became effective before a formal capacity-building program became effective.

### *Budgeting and Financial Management*

The budgeting practices put in place for subnational governments are consistent with the move to a cooperative federalism. In principle, provincial and local governments have a significant degree of autonomy in forming their budgets and do not require approvals from higher levels. Budget requests and project identification come from the ward level, a process that brings government closer to the people and improves accountability. And though wards are not formally local governments in Nepal, local assemblies are made up of elected ward members whose primary concern may be the well-being of their wards.

Expenditure responsibilities are mostly clear and local governments have responsibilities for delivering important local public services. While they are mostly dependent on intergovernmental transfers, they do have an own source revenue base with some discretion to determine tax rates and administer taxes. On the other hand, there are some significant constraints on budget discretion. About half of all intergovernmental transfers carry conditions, the inherited wage levels of transferred central government employees have been determined, and local budgets must serve a number of federal mandates related to implementing federalism.

The extent to which the local government budget system that is now in place will bring full accountability to local voters is still not known.

The performance of local government budgeting under this regime has made progress in the first years of federalism. Most local governments have a consolidated account, voted on a budget on time, executed the FY 2018-20 budgets, and had their accounts audited by the Office of the Auditor General (OAG).<sup>16</sup> On the other hand, budget expenditure disbursement rates have been low in many local governments, and own-source revenue collection rates have been in the 70 percent range. Nor do provincial and local governments have easy access to financial information in a form necessary to plan and manage their budgets in an efficient way, yet expectations for their performance in this area are high. The Constitution and subsequent legislation call on sub-national governments to make estimates of expected revenues and expenditures at the beginning of each fiscal year, to carry out medium-term expenditure forecasts, and to obey a hard budget constraint.

The present state of public financial management practices by sub-national governments does not support reasonable fiduciary guarantees or an acceptable level of service delivery. Procurement capacity is particularly weak, according to the survey of subnational governments discussed below (World Bank 2019). Projects underway have led to successful implementation of the single treasury account, more transparent expenditure reporting, a revenue management information system, and an upgraded audit methodology.

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<sup>16</sup> Article 241 of the Constitution explicitly gives the Office of the Auditor General (AG) powers to audit the accounts of provincial governments and implicitly also the accounts of local governments. In his 2020 annual report, AG stated that, due to the lack of required records, audits could not be completed for FY 2018/19 accounts in 10 and FY 2017/18 accounts in 6 local governments.

## **CAPACITY NEEDS ASSESSMENT FOR PROVINCIAL AND LOCAL GOVERNMENTS**

A major constraint to the devolution of functional responsibility is the inability of local governments to absorb their new responsibilities. To better understand this issue in Nepal, the capacity of subnational governments was assessed in a study carried out by a team comprised of international and local academics from November 2018 through March 2019. All seven provincial governments were assessed through semi-structured interviews, while all 17 cities and a stratified random sample of 98 other municipalities were surveyed with a 300-question instrument administered with face-to-face interviews. The assessment results identify a number of capacity gaps, as summarized below:<sup>17</sup>

- The quality of local government management is problematic, in areas ranging from the absence of planning capabilities to procurement policies.
- About 70 percent of cities felt that their building could accommodate an assembly meeting, in the other categories of local governments many felt that they would have difficulties accommodating a cabinet meeting.
- All cities were connected to the national power grid and had significant generator backup, but 11 percent of urban municipalities and 28 percent of rural municipalities, especially those in the mountainous ecological zone, were not. Most had connections to the internet and had computers and printers in quantities adequate for the present staff counts. No data management systems were available except those used for budget and accounting purposes.

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<sup>17</sup> A detailed version of the results of the capacity needs assessment based on the same sample survey is in World Bank (2019).

- Seconded federal staff filled fewer than one-half of positions in local government offices. More positions were filled with contractual staff who tended to be either general public administration or support staff, and many high-skill technical positions, such as engineers, lawyers, and accountants, remained vacant.
- About one-half of local governments had written job descriptions available for all positions envisioned in their organizational structure. Less than one-third of local governments reported having their own laws/policies for managing their staff in terms of leave approval, performance appraisal, reporting rules, etc.

## **POLITICAL ECONOMY DYNAMICS IN THE IMPLEMENTATION OF FEDERALISM**

After years of armed conflict and political uncertainty, Nepal moved from a century of very centralized governance to a more decentralized federal governance model. Federalism was less a product of a natural evolution than it was a political reaction to a highly centralized system that brought high levels of social and economic inequalities. Nepal's federalism is still young, but it is intended to tackle centuries-old political economy constraints to the country's social and economic development: decentralizing power away from Kathmandu and introducing citizen participation in decision making.

"Nepal's federalism process is vulnerable, which could be derailed, manipulated and influenced by different interest groups during the period of implementation" (Adhikari 2020:

p.4).<sup>18</sup> Invariably, there is a level of fear among the Nepalese elites<sup>19</sup> about the loss of power to provincial and local elites (Thakali et al. 2018). The caste system, ethnicity, and economic interests are intertwined in the definition of elites. In the past, Brahmins dominated the political power structure, and other groups, especially Dalits, had very little representation in the national Parliament. The Federal system provides more opportunities to the lower castes and different ethnic groups to be active in the political and social life of the country. In the past, local elites played a limited role in local decision-making processes. Since there had been no elections at the local level until 2017, local bureaucrats were very powerful (Hatlebakk 2017). However, with provincial and local elections, subnational elites grew stronger and demanded more autonomy.

Newly elected provincial and local politicians are eager to get on with assuming their newfound powers and to prove their merit to voting populations who were expecting public services to improve quickly. Predictably, this has led to disputes with the central government over the speed with which the new powers were devolved and disputes over constitutional intent, and further slowed the progress.

Because of the sweeping reform in governance that it called out, the implementation of federalism in Nepal was bound to take time. And because the reform promised a significant redistribution of power, implementation was certain to face numerous political and bureaucratic hurdles. In order to deliver on the objectives of the federal system, the Nepalese public administration system has gone through a major restructuring and devolution. Subnational

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<sup>18</sup> According to Adhikari (2020) the demand of federalism was neither a part of the agenda of Comprehensive Peace Agreement nor was it a part of the demand of 2005-2006 movement. The demand for a federal restructuring of the country emerged for the first time during the Terai movement of 2007-2008.

<sup>19</sup> Political parties are the main forces behind national elites. There are three political forces behind the national elites: Congress Party, Unified Marxist Leninist and the Maoists, each receiving shifting support from the monarchist parties, and/ or the regional Madhesi parties (Hatlebakk 2017). Political parties are closely linked to businesses which operate as monopolies in many sectors as political leaders own shares in businesses (Hatlebakk 2017).

governments are still in the early stages of improving service delivery. The objectives of the decentralized federal system are to give significant budgetary and operational autonomy, and voice, to the subnational governments and to make strong provisions for more equality of opportunity. Nepal is in process of putting the institutions in place to achieve these goals, but it will require time and practice before the final impacts can be measured and evaluated. To date, there is only anecdotal evidence of the progress.

### **LESSONS FOR THE PRACTICE**

Perhaps the main lesson learned from Nepal's experience is the clarity of purpose that guided the reform design. Nepal's decentralization was driven by a goal of national cohesion while the country recovered from an internal conflict, and by concern over the unmet needs and lack of representation of a large share of the population. By taking the form of a cooperative federalism, Nepal kept the focus on third-tier local government autonomy and may have avoided the problem of state capture of the political and fiscal system, as in India.

Nepal's transition to a highly decentralized system could also be relevant to unitary countries that are redesigning their intergovernmental system. Cambodia, for example, has been pursuing a very cautious approach to decentralization since 2001. Although, the Cambodian government has produced a myriad of legislative and regulatory documents that underpin the intergovernmental fiscal system, there has been very little progress in implementation. A major policy decision in Cambodia which had a detrimental impact on progress was to leave the process of decentralization to sector ministries. Nepal's experience in pursuing intergovernmental reform in a consultative manner with all stakeholders provides a good example for Cambodia.

Another positive lesson from the Nepal experience is the clarity that was brought to the assignment of expenditure responsibility to the different levels of governments. Nepal followed the model used in some other low- and middle-income countries of applying a detailed "unbundling" exercise and by making provision for an interprovincial council to resolve disputes. The problem of a lack of clarity in expenditure assignments is one that has plagued many expenditure decentralization programs, notably the ones in Indonesia and in Pakistan, where "concurrent" functions were decentralized.

There also are lessons to be drawn from the policies and implementation practices in Nepal's federalism reform that have not turned out so well. Addressing these problems and issues remains a high priority issue for the government. First, and most importantly, a full implementation plan for the new Constitution should have been prepared by a blue-ribbon commission of experts drawn from all stakeholder representatives. Such a plan could have been updated periodically and could have been made available as a public document. This would have allowed the government to set a timeline for the rollout of the full reform, and in so doing, it would have cooled the high expectations that the public had for a quick fix. It also would have steered the government toward focusing on the correct sequencing of reforms rather than cherry-picking those deemed most feasible (Bahl and Martinez-Vazquez 2013). As things turned out, the full implementation plan and calendar were not yet in place by 2020, nearly five years into the process.

Second, there should have been some provision in the implementation strategy to recognize the different capacities of the 760 subnational governments (seven provinces and 753 local governments) to absorb the new federalism, instead of endowing all with the same



functions and powers. As discussed above, there are great capacity differences between the larger urban jurisdictions and those in backward areas that will not be overcome for many years.

Third, a lack of proper planning and strategic thinking hindered federalism implementation. In the absence of a well-thought-out strategic plan for federalism implementation, the subnational governments were left to their devices in terms of planning, efficiently and effectively mobilizing resources to meet the overall socio-economic development goals of the country. Besides the planning problems, there is a paucity of benchmark statistics at the subnational levels. In the absence of quality statistical data, it was very difficult to develop effective strategies at the subnational levels.

Fourth, the implementation strategy should have included a capacity development plan, including institutional arrangements and financing. At the time of the enactment of the Constitution in 2015, it was clear that the human resource capacity (both numbers of employees at each level of government and the mix of qualifications needed) was inadequate to meet the new expenditure assignment responsibilities. It was not until 2020 that a plan for training was completed.

Finally, provision for the data and other information needed to monitor the economic development, expenditure needs, and fiscal performance should have been an early activity. A data system and analytic cell should have been put in place to monitor and evaluate the intergovernmental fiscal system beginning with the first year of implementation. There is provision for fiscal monitoring and evaluation in the NNRFC and in the Ministry of Finance, but the extensive database that is necessary for this is still not in place.

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