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Editorial

Nepal has got the new democratic federal constitution after an exhaustive and daunting political polemics that lasted for over a decade. The controversies captured and dominated the canvas of the first constituent assembly so fruitlessly and brazenly that it had to embrace dissolution without producing the much awaited basic law of the land. As a result, the election had been held for the constituent assembly for the second time in 2013. The constituent assembly finally drafted and enacted the constitution of Nepal on September 20, 2015. Accordingly, Nepal is undergoing the process of restructuring for federal recasting and redesigning of the state. The constitution has, indeed, laid out the design for a federation. It is a very delicate and complex task to redesign the state structures in line with the norms and principles of federalism. Moreover, though the constitutional blueprint is very important, it is not at all adequate, sufficient and complete. The provisions provided in the new constitution should be further prescribed, elaborated and illustrated by a number of supplementary laws and by-laws. These laws and bylaws are needed to support the constitution to enter into effect. These laws should not only reflect the norms and spirit of the federal constitution but also create a broader space and supportive environment for the implementation of the constitution. It is said that around two hundred new legislations should be enacted to give effect to the new constitution. Some existing laws should be amended as well. Moreover, there is an utmost need to clarify the constitutional allocation of fiscal authorities and competencies among the three tiers of government namely the federal, provincial and local. Needless to repeat, the assignment of responsibilities, competencies to raise and mobilize revenues to the different levels of government is a key question of federalism. Moreover, in line with the principles and norms of fiscal federalism, more functions and competencies need to be devolved to the lower echelons of the government. The strengthening of local government is therefore crucial and important. As they are closer to the people, the local governments can have better knowledge about the tastes and preferences of the people living within their jurisdiction.

As Nepal has shifted to the federal governance from the unitary framework only recently, it has, nonetheless, gathered enormous and useful experiences through implementation of deconcentration and decentralization since early 1960s. But it needs to be mentioned that, Local Self Governance Act enacted in 1999 alone constitutes the milestone in the annals of the Nepal's trysts with the destiny of decentralization for long. But the practice and implementation of decentralization in the country has been very weak as it was plagued with several bottlenecks and constraints.

The local bodies (LBs) have remained institutionally and organizationally very weak while the central government has been always reluctant to transfer reources and authority to the local institutions. Unless and until the centralized mindset and power usurping tendencies are transformed, neither can we produce decentralized governance and appropriate development outcomes nor build democratic institutions to support implementation of federalism in Nepal.

Needless to say, local bodies- VDCs, municipalities and DDCs- in Nepal are exercising a very low level of revenue autonomy where more than 90 percent of the total revenue is collected by Center and less than 10 percent is left to them. They are faced with high quantum of vertical fiscal imbalance. Likewise, as the LBs have the different and disproportionate level of revenue sources and capacities, there exists a horizontal fiscal imbalance as well. Unless these problems were corrected well, equitable and symmetry based distribution of resources and capacity to achieve a balanced development will not be possible .When we look at the provisions for revenue assignment to the provinces and local level in the new constitution, there is also a need to enhance capacity of local governments and provinces to collect and mobilize the tax and non-tax resources While an increased revenue autonomy to sub-national governments is important, intergovernmental fiscal transfer, can be an important tool for correcting the fiscal imbalances. In other words, sharing of revenue authority and distribution of available resources between center and sub-national governments have been the two important means of fiscal decentralization. In this process, transferring the authorities and funds should not be limited to the provinces- the intermediate tier of the governemnt as observed and found in some federal countries, but it should go down to the level of local governments as well. Though not all subjects can be similar and contextual, we need to learn from the past decentralization experiences and tackle the issues that otherwise could prejudice and affect the intergovernmental relations. In order to set strong basis for implementation of fiscal federalism, an objective analysis of revenue autonomy and revenue sharing, and expenditure assignment was needed. It can be attained when we move ahead heeding to the lessons drawn from the national and international experiences on these issues.

What are the shortcomings of the current revenue sharing and grant allocation formula? Should the existing basis of revenue sharing and the indicators used in the grant formula be retained or modified? If so, how? What type of expenditure autonomy can lead to the efficient and effective public service delivery? These are some of the critical and important issues. These need to be carefully assessed to arrive at prudent design of fiscal federalism. At this backdrop, the Local Body Fiscal Commission (LBFC) has taken a modest step to publish- ***"The Journal of Fiscal Federalism"*** to offer a platform of discussion among the national and international experts on relevant and pressing issues appertained to implementation of fiscal federalism with particular reference to the Nepalese context and international perspectives. The views and opinions dealing with different perspectives and practices of fiscal federalism can provide substantive inputs to deliberate and structure an efficient and effective fiscal system, and arrangement that could be transparent, predictable, and productive. Moreover, this volume of the Journal is our first attempt and we heartily expect your valuable comments and feedback to help us make it a real and effective contribution to promote discourse and inquirty into federalism in general and fiscal federalism in particular. Finally, we would like to offer gratitude to the authors, contributors and supporters who assisted us in different ways to bring out this volume in this form. We expect readers' inputs and contribution to make this journal a lively forum for discussion on the issues of federalism in general and fiscal federalism in particular.

July, 2016

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Stock-taking of Fiscal Decentralization Policy in Nepal*

Prof. Dr. Roy Kelly[1]

1. Background

Nepal is in the midst of a major political, administrative and fiscal restructuring and reform. It is moving towards building a federal government structure in order to enhance governance and improve public service delivery. The Constituent Assembly (CA) elected in 2013 has drafted and promulgated a democratic and inclusive constitution-"Constitution of Nepal (2015)", with the provision of three levels of government namely federal, provincial and local, along with some arrangements for autonomous regions, protected areas and special areas. As stipulated in the new constitution, Nepal has to restructure the units of the local governments and decide for the acts and regulations assigning new responsibilities and authorities to them.

These efforts are being accomplished against the background of the current sub-national governance structure which is largely based on the Local Self Governance Act (LSGA), 1999. The LSGA was a major decentralization reform in Nepal, that introduced a number of key reform initiatives. One important component was the focus on fiscal dimensions giving more expenditure and revenue authority and resources to local bodies (LBs), namely the Village Development Committee (VDC), Municipality (MUN), and the District Development Committee (DDC).

Despite these bold initiatives under LSGA, however, the Nepalese government structure remained highly centralized, unable to address many of the pressing governance and service delivery problems. In fact, the underperformance of the LSGA and related reforms was partially an impetus for the ongoing effort to restructure Nepal into a federal governance system, seeking to clarify and re-establish the political, administrative and fiscal dimensions of government in order to enhance efficiency, effectiveness and accountability.

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* This article is the synopsis of 'Stock Taking of Fiscal Decentralisation Policies: Consolodated Report' prepared in 2011, submitted to Government of Nepal by Prof. Roy Kelly.

1 Dr. Kelly is a Professor of the Practice (Public Policies), Duke University, Sanford School of Public Policy/ Duke Center for International Development.

This study highlights the extent to which the local bodies are exercising the fiscal decentralization provisions provided under the LSGA and identifies key recommendations needed to facilitate the effective transition with regards to fiscal decentralization from the current unitary government structure to the expected devolved federal government structure under the new constitution. The study lays the foundation for further detailed work on the functional analysis of sub-national expenditure and revenue responsibilities which will be closely aligned with the work undertaken by the Administrative Restructuring Commission (ARC).

2. Decentralization Reform Experience

Countries everywhere are undertaking reforms to enhance economic and social development. These ongoing decentralization reforms are focusing not only on improving the efficiency and accountability of public service delivery, but also on promoting a more equitable distribution of services and resources across each country and on enhancing more accountable and responsive governance.

These various decentralization reforms involve political, administrative and fiscal components. Political accountability mechanisms, along with administrative/institutional capacities and clearly-defined fiscal responsibilities and resources are essential for the success of these reforms (Boex and Yilmaz, 2010). On the political side, local governments (LGs) must have mechanisms for being responsive and accountable to their local residents including a system of elected local representatives. On the administrative side, LGs must have capacity to plan, budget, deliver and account for government services, with opportunities for active citizen participation in planning, budgeting, monitoring and social audit. On the fiscal side, LGs must have clear expenditure and revenue responsibilities including appropriate local own revenues and access to intergovernmental transfers, as well as clarity on local borrowing options.

These political, administrative and fiscal components need to be designed, implemented and integrated to ensure successful, sustainable decentralization reforms. In addition, these various reform components must be sequenced and appropriately tailored to the country-specific context to maximize the chances for successful achievement of objectives (Bahl and Martinez, 2006). Countries adopting decentralization must pursue a proactive, clear cut transition strategy to empower, enable and facilitate devolved local governments to assume the responsibilities and to deliver enhanced governance and improved service delivery in an accountable and efficient manner.

3. Decentralization Reform in Nepal

Decentralization reforms have been championed in Nepal since the early 1960s initially to mobilize citizen participation in the development process. These decentralization efforts have gone through distinct phases in Nepal.

Phase 1 (1960-1990) was seen as the "transition phase" which included the articulation of a formal decentralization policy framework in 1962 and the enactment of the Decentralization Act, 1982 and Decentralization Regulations, 1984.

Phase 2 (1990-2006) began with multi-party democracy and high-expectations that decentralization would be the means for "ensuring optimum participation of people in governance and hence enjoy the benefit of democracy" as articulated in the Constitution of 1991. Three local government acts were enacted in 1991, followed by local democratic elections in 1992, and the initiation of a fiscal transfer system from 1993. Subsequently in 1999, the Government consolidated its local government system through the enactment of the Local Self Governance Act (LSGA), 1999. This period from the early 1990s was expected to be a period of deep decentralization consolidation in the country. However, from the mid-1990s, increasing civil turmoil emerged resulting from the Maoist insurgency.

Phase 3 (2006-onwards) would be the very crucial and important phase for the establishment of the autonomous decentralized local governance system in Nepal. Following the cessation of hostilities after the 2006 Jana Andolan *(People's movement),* the Comprehensive Peace Agreement was the great achievement and under which the Interim Constitution, was promulgated in Nepal. Phase 3 is expected to provide a genuine opportunity for Nepal to formally implement the key decentralization principles of devolution and citizen empowerment provided inthe Constitution of Nepal (2015), to enhance local participatory governance and to improve delivery of efficient and equitable public services needed to further support economic and social development through the effective laws and by-laws.

4. Fiscal Decentralization in Nepal

The current local government structure in Nepal is embodied in the Local Self Governance Act (LSGA), together with the Local Self Governance Regulations (LSGAR) and the Local Bodies (Financial Administrations) Regulations (LBFAR). These laws and regulations lay the legal basis for the current local government structure in Nepal and define the various local body (LB) expenditure and revenue functions and provide the under pinnings for strong local autonomy in planning and budgeting.

The LSGA is a good benchmark for the design of the future devolved government structure anticipated under the new constitution. The LSGA experience with the allocation of expenditure and revenue responsibilities, their degree of clarity, specificity and possible overlap between different tiers of LBs and between LBs and the central government, and the legal provision and practice of intergovernmental transfers and borrowing can provide important lessons for designing a framework and strategy for implementing governance provisions under the new federal constitution.

The LSGA was drafted and introduced, setting high expectations for an improved public sector, with democratically elected leaders, empowered to be responsive, accountable and able to deliver tangible improvements in local economic development. Recognizing that decentralization reforms is a process and not an event, the expectation was that the LSGA would provide the legal framework upon which to phase in the decentralization reforms in a systematic manner, incrementally shifting the devolution of selective sectors in a possible asymmetric manner, while clarifying expenditure and revenues assignments, introducing effective intergovernmental transfer systems and building capacity.

The plan was to have this process managed by a high level Decentralization Implementation and Monitoring Committee (DIMC), complete with a working group and with the technical support needed to effectively roll out the proposed Decentralization Implementation Plan of 2001. The LSGA also created a Local Bodies Fiscal Commission (LBFC) to guide the fiscal decentralization process and also recognized the establishment of LB associations to represent the interests of and support decentralized LBs.

In 2001, a Decentralization Implementation Plan (DIP) was adopted laying out a sequencing of decentralization activities. The four sectors, namely, primary health, primary education, agricultural and livestock were identified to be included within the first phase of sector devolution through the 2001-02 budget. In 2004, rural infrastructure sector was also devolved to DDCs. Then, in line with the commitment towards decentralization, the Tenth Plan (2002-2007) emphasized that decentralization was a key strategy for poverty reduction to be accomplished by enabling local people through their participation in the decision-making and governance process. A number of other initiatives were identified to further support the decentralization reforms.

Despite high expectations and best intentions, the LSGA legal framework and the DIP immediately faced a number of constraints and challenges leading to a slowdown in the roll out of the decentralization ideals. A large number of the key DIP elements were not implemented. Twenty-three sector laws identified as conflicting with the LSGA were to be rationalized. There were also bureaucratic rigidities which did not fully support the intended sector devolution. There was a lack of clarity in some expenditure and revenue assignments, with overlapping responsibilities, duplication and confusion. And there were local capacity and local resource constraints which affected the LB ability to absorb the newly mandated responsibilities. In addition, the LSGA was enacted and expected to be implemented during a period of increasing internal civil disorder brought about by the Maoist insurgency. This uncertain political environment led to the postponement of local elections since July 2002, leaving a void in local bodies which significantly weakened downward accountability.

To fill the void left by the absence of locally-elected leaders, the Ministry of Local Development implemented interim measures to appoint the Local Development Officer, Executive Officer and the VDC secretary to serve as head of the respective LBs. Following the Comprehensive PeaceAgreement in 2006, the Government established an "All Party Mechanism" in 2009 as the interim measure to provide local legislative decision making and oversight functions. Both approaches established an upward accountability structure rather than the downward accountability structure needed to ensure responsive and accountable devolved governance.

Another requisite for realizing the decentralization benefits is the granting of flexibility and discretion at the local level for expenditure decisions. Effective decentralization requires that LBs be given discretion to allocate their resources (at the margin) in accordance with local preferences in order to maximize expenditure efficiency. Although the LSGA provides a set of mandates on both the revenue and expenditure aspects, including greater discretion in the planning and budgeting of those responsibilities, field visits suggest a lack of real local discretion in the budgeting process, both on the expenditure and the revenue side.

In the absence of strong bottom-up political accountability mechanisms, Nepal will need to focus on strengthening the other administrative and fiscal aspects of bottom up accountability as well as providing a strong enabling environment of top down administrative and fiscal accountability. As the political accountability structures emerge with new elections and 'voice' mechanisms, local governments should be given more discretion to allow improved responsiveness and efficiency in local public goods and service delivery.

As part of the broader decentralization socialization at both the central and local government levels, it will be important to distinguish between devolved LBs and deconcentrated line departments. It is also important to clarify the role of the District Technical Office within the DDC.

Despite these major challenges LBs have been able to provide a local level governance interface and play a role in local economic development, although the experience varies considerably across LBs and over time. The LSGA empowers LBs to identify local priorities, plan, and budget and play a supportive role in delivering key public services such as primary health, primary education, local feeder roads, and agricultural services, among others. The LSGA provides a framework for LBs to mobilize local priorities, and to provide some local physical infrastructure such as roads using the grant funds from the central government.

5. Expenditure Assignment Observations

The LSGA assigns a number of expenditure functions to LBs that tend to be those that affect the daily lives of local residents ranging from education to health to water supply and sanitation to agriculture. Unfortunately, these LSGA functions are not clearly specified in sufficient detail causing some confusion and overlap between tiers of local government and the central government. Since passage of the LSGA and related regulations, there has been little attempt to undertake a functional analysis to further clarify these expenditure responsibilities and resolve the inherent conflict between the central and local bodies as well as between the LBs themselves. There were 23 sector laws which were identified as conflicting with the LSGA thatcontinued to cause duplication and conflict in the areas of expenditure assignment.

LBs tend to see the expenditure assignments as more permissive than mandatory, taking advantage of the lack of clarity and the resulting confusion. And, due to limited local resources and absorptive capacity, LBs therefore tend to selectively choose those expenditure responsibilities which are most clear, which are easy to implement with minimal accountability, and which are most desired by those making local decisions. The LBs then assume that the central government will continue providing the core services which were historically the responsibility of the central line departments such as education, health, roads, agriculture and environmental management. Most LBs focused on expenditures linked to durable assets likes roads and furniture, as opposed to those "softer" services such as education, health and agricultural and livestock extension.

In general, expenditure on road networks has been a major priority for LBs. However, issues enhancing income generation, gender equality, entrepreneurship development, youth and intelligentsia mobilization, supervision, monitoring and follow-up have been placed as low priority. Agriculture and livestock development plays a pivotal role in the change of economic life in many rural areas but spending in these areas is very limited. Motivation for LBs to focus on these needy areas is a must and reform in these areas could be implemented by redesigning incentive structures, such as those within the MCPM grant system.

The LSGA provides for a 14-step local body planning process to encourage citizen interaction in the planning and budget implementation process. Although well-intended, this planning process faces a number of challenges. The participatory nature of the planning process within the LB has largely become a ritual over time. In some LBs, inadequate attention is paid to adequately incorporate the voices of the minorities and marginalized through this planning process. The Ward Citizen Forums (WCFs) have been playing very pivotal role to strengthen the local democracy at grass root level in the absence of elected representatives in LBs. Likewise, the Citizen Awareness Centers (CACs) have also been playing role in making local bodies more accountable and responsive.

However, the local planning process faces problems that it is not synchronized/ coordinated with the planning being undertaken by line departments of devolved services such as education, health, agriculture and livestock. This creates coordination problem in the planning, budgeting and implementation process. LBs tend to become "rubber stamps" approving sector plans, thus, not integrating them into the LB development plans and budgeting process. Line agencies and LBs are following different planning cycles creating problems of synchronization.

There is a need to improve overall coordination between line agencies and the LBs. The level of cooperation varies dramatically across LBs, but appears largely to be dependent on personal relationships, not institutional relationships. Some of the coordination constraint appears due to hierarchical structure and level of appointments. In general, greater synergies are needed between the LBs and the line department agencies to improve effective and accountable service delivery.

The LBs are often considered more as financing agencies than as service delivery agencies. Some LBs are approached by the Chief District Officer (CDO), police, line agencies, politicians and NGOs requesting monetary contributions for different purposes, leading some LBs to report that providing financing is one of their important responsibilities.

6. Revenue Assignment Observations

The LSGA also allocates revenue resources to the LBs as fees and charges, local own source taxes, shared taxes and intergovernmental transfers. For most own source revenues (fees and charges/taxes), the rates are defined centrally, although in some cases the LBs can define their own rates within prescribed limits. In addition, there are a number of shared revenues, both between tiers of LBs and also between the LBs and the central government, which have been problematic. Intergovernmental transfers play the dominant role in LB finance. There is very little local level borrowing.

LBs rely on a combination of user charges, local taxes, shared taxes and grants to meet their expenditures assigned. The own source revenue (OSR) of LBs is quite small as compared to government grant. Although LBs are heavily dependent on central government grants, there is enormous scope for enhancing local revenues through improved local revenue administration. LBs receive a portion of their revenues through a system of revenue sharing, both revenue sharing between the central government and local bodies as well as between local bodies themselves. For example, there is revenue sharing between central government and the DDCs in the form of land registration fees, royalties of mines, forestry, water and other natural resources, and the entrance fees for tourists. In general, these revenue sharing arrangements are relatively clear in the law with one major exception on mining royalties. The LSGA provides for revenue sharing while the mining regulation imposes a special 10% additional royalty on mining to be given to the DDCs. There is no direct revenue sharing between the central government and municipalities or VDCs.

There are three areas of direct overlap/duplication between the LBs and the central government, namely, the housing rental tax, the motor vehicle taxes and the presumptive income tax (GoN) and the local business tax (LB). These need to be clarified, with greater coordination in the administrative affairs to reduce non-compliance, administrative and efficiency costs.

In addition, shared tax structures are not functioning well, with a need to clarify that shared taxes are not "optional" payments but mandatory payments, with a need for more effective oversight and sanctions against non-compliance (perhaps incorporating an incentives within the MCPM system), and with a need for more effective coordination across various stakeholders to ensure effective, transparent and accountable administration.

Tax sharing of natural resources between the DDCs and the VDCs is a focused area of concern. As with the recent Ministry of Federal Affairs and Local Development / UNDP / UNEP study (2011), this study identifies that the revenue sharing arrangements vary considerably between DDCs and recommends DDCs be provided with guidance on how to share these revenues in order to ensure more equitable outcomes.

As with many countries, Nepal has a tendency to undertake local government revenue reform in a partial manner, typically replacing abolished taxes with compensation grants, with no accompanying introduction and/or strengthening of existing local revenues (*Octroi*in 1998, Local Development Levy in 2009, Kawadi in 2010). This immediate replacement of local revenues with a compensation grant creates an increasingly over-reliance on central revenue transfers and a reduction in autonomy and accountability. It will be important for Nepal to strategically undertake local revenue reforms, combining the phasing out of inappropriate local taxes with replacing them with a set of more effective local taxes through improved policy and administrative reforms.

Firstly, there is need to phase out the District (and VDC) export tax to improve internal trade and reduce economic distortions. Second, there is need to eliminate the DDC-level import taxes being implemented under a "Local Development Fee" in certain DDCs. Third, there is need to restructure / improve collection efficiency for such taxes as the housing rental tax, motor vehicle taxes and the presumption income taxes/business taxes.

The LSGA empowers LBs to collect property-related taxes such as the Housing and Land Tax (HALT), the Integrated Property Tax (IPT), land tax and *Malpot* (land revenue). Although consistent with theory and international experience, the property tax system in Nepal is a bit complicated. The property tax in Nepal has tremendous potential, and about 50 municipalities out of 58 have been implemented IPT so far, but its regime needs reviewed, rationalized, simplified, and implemented in a systematic and comprehensive manner.

Overall local revenue collection is very low, with most LBs not full exercising their responsibility and power to levy and collect local revenues. The major reason for this low collection effort is a lack of incentives: (1) Absence of elected representatives in LBs (2) LBs have easier access to formal government transfer funds and/or project based grants from line ministries and development partners and (3) LBs do not face hard budget constraints with pressure to collect local revenues to deliver services. The expenditures are largely considered permissive, not mandatory, thus LBs face no consequences for failure to deliver. In addition to lack of incentives, local revenue collection is low due to the lack of simplified administrative procedures, administrative capacity and taxpayer service/awareness.

7. Intergovernmental Transfer Observations

The LSGA provides for a system of intergovernmental transfers to channel resources to LBs. The central government is required to provide LBs each year with a minimum grant and also additional grants based on such factors as population, geographic area, cost index, poverty index and internal revenue mobilization efforts. Details are left for subsequent regulations, allowing flexibility to design and implement appropriate block and categorical grants, formula(s) and channeling mechanisms to deal with the vertical and horizontal equity and efficiency issues.

In practice, LBs are receiving a minimum grant as per the LSGA as well as recurrent grants to pay for the salary and allowances of employees and to meet minimal operational expenditures at the LB level. In addition, they are receiving a mixture of capacity enhancement grants and social mobilization grant. Various line ministries, development partners/donor agencies and I/NGOs are also providing program-based grants. With the exception of the capital block grant through the MCPM system, most financial resources come with strong Central Government (CG) directives, leaving little discretionary power to LBs to allocate according to local priorities.

In the mid-2000s, Nepal made progress with the introduction of formula-based grants, along with a performance element, which was rolled out nationwide in 2008. Under these provisions, the Government has been able to design and implement various formula-based transfers, including the Minimum Condition Performance Measures (MCPM) development grant. The MCPM system is beginning to provide an important set of incentives which is encouraging LBs to carry out their mandated functions as required under the LSGA and related regulations.

There are a number of challenges facing the grant system in Nepal. First, the flow of grants can be quite complicated, with multiple channels of recurrent and capital grants flowing directly to LBs, in addition to the program-based grants through line departments development partners and I/NGOs. The MCPM Impact Study carried out by LBFC in 2014 has strongly recommended for the revision of the current process oriented MCPM indicators by replacing result oriented/ based indicators.

Second, the grant system in Nepal continues to be determined in a quite ad hoc manner, at least with respect to the vertical division of resources between the central government and the LBs. Third, the flow of funds is often late and not complete making it difficult for LBs to plan and implement their approved budget in a timely and transparent manner. Fourth, some LBs receive off-budget funds, particularly the DDCs, at the end of the fiscal years, which can disrupt local planning and predictability of resources and contribute to a lack of accountability and an inefficient use of resources. In general, more timely and predictable flow of central-local transfers by the central government will provide an environment for improving the quality and accountability of local planning and service delivery.

8. Local Government Borrowing Observations

The LSGA empowers LBs to borrow from banks or financial institution by pledging its property or under the guarantee of GON. In practice, this legal provision has not been implemented by most of the LBs in Nepal. The reasons given for not borrowing were the lack of suitable capital project and the absence of elected representatives. Of the total 58 old municipalities, on an average, 35mmunicipalities have exercised borrowing rights, largely borrowing from the Town Development Fund (TDF) and international lending agencies like Asian Development Banks (ADB).

9. Lessons and Recommendations for a Federal Nepal

Theory and international experience suggests the following key lessons and recommendations for a successful transition from a unitary to a federal government structure in Nepal.

9.1. Need for Highest Level Political and Administrative Support

- Broad public sector governance and management reforms require the highest level of political and administrative support to ensure widespread stakeholder participation in the initial design and implementation and to ensure widespread accountable ownership for the sustainable realization of the reform results. Public sector reform, especially those related to decentralization, is multi-dimensional involving political, administrative and fiscal components. They involve all stakeholders, across all levels in society such as central and local elected politicians, central and local government officers, bureaucrats and technical staff, cutting across all line ministries and their deconcentrated line departments, NGOs and CSOs, and all citizens within the country and all supportive development partners. To ensure a common vision and coordination of effort requires the highest level leadership to ensure success.
- To ensure successful devolution requires the active participation of the Office of the Prime Minister, key commissions, ministries and agencies such as the National Planning Commission (NPC), Ministry of Finance, Ministry of Local Development, the various line ministries, the national audit

authority, and others. Ultimately devolution is a dynamic, multi-dimension and cross-sector public sector reform. It requires active engagement of all key stakeholders coordinated at the highest level under the Office of the Prime Minister.

- Public sector restructuring involves political, administrative and fiscal components, with sufficient time for institutionalizing changes with results. These reforms need lots of change management support, and time to absorb and to be institutionalized for sustainability. Structuring and supporting the reform through various political elections cycles is critical to ensure consistency in the move forward to better governance and service delivery. Public sector reforms must be dynamically sustainable and implemented to realize the intended result objectives.

9.2. Need for laws and By-laws to Properly Recognize Devolved Local Governments

- The new constitution will provide the legal cornerstone for all political, administrative and fiscal dimensions in Nepal, including those aspects of democratic governance, accountability and ownership. Given its foundational role, the new constitution has tried to ensure that the principles of democratic and accountable devolution, provincial and local governments are embedded firmly in it. However, the details on the political, administrative and fiscal dimension aspects need to be elaborated further within an overarching organic law and by-laws which lay out the functions and provisions for the Provincial and Local Governments.
- The Constitution, in combination with the Organic Law, will provide the supreme structural framework under which all other laws must be made consistent. This will avoid the problem faced during the current LSGA-based decentralization process where the conflicting laws were never made consistent with the LSGA thus perpetuating confusion and inherent contradictions over the last two decades.

9.3 Need for Effective Functioning of National Natural Resources and Finance Commission

- New federal republic constitution of Nepal, has structured an independent and constitutional National Natural Resources and Finance Commission which is aimed to provide the objective analysis, guidance and oversight needed on the allocation of financial resources across the various spheres of government, advise on sub-national taxes and revenues and oversee and support the sub-national public financial management issues. The commission should function effectively learning from the past international and national experiences in the practice of fiscal decentralization.

- Intergovernmental fiscal relations are inherently political, as it deals with the allocation of national financial resources through the assignment and coordination of expenditure and revenue functions and the design and allocation of intergovernmental transfers. Therefore, there is a need for a balanced representation of the various stakeholders from both the central and sub-national levels, with the analytical independence needed to minimize political interference.

9.4 Need for Clear Expenditure and Revenues Assignments

- A clear delineation of the expenditure and revenue allocations is critical to improve efficiency and accountability of service delivery and revenue functions. Theory and international experience confirm the advantages of allocating functions based on the 'subsidiarity' principle. To do this successfully requires a detailed functional analysis, also known as activity mapping, to unbundle each public service to take into account principles of economies of scale, externalities, equity and heterogeneity of demand.
- Expenditures and revenues responsibilities need to be unbundled, clearly defined and assigned to the respective tier of central, provincial and local governments, with clarity on the mandatory and permissive functions. Through a detailed functional analysis, it will be possible to more accurately unbundle and assign the appropriate sub-functions to the appropriate tier of government, matching to the extent possible the expenditure and revenue responsibilities, coupled with a transparent and objective formula-based intergovernmental transfer system to achieve the efficiency and the accountability needed for enhanced governance and service delivery.

9.5 Need for Strategic Sequencing with Possible Asymmetric Approach

- Successful decentralization involves the allocation of functions, finance and functionaries within the context of clear expenditure mandates, accompanied with the financial and human resources to enable successful implementation, along with accountable incentives for performance.
- Sequencing the devolution process is critical to match the assignment of functions with capacity to absorb and deliver public service in an efficient and accountable manner. Nepal should consider a possible asymmetric approach which would match expenditure responsibility with capacity and resources as appropriate, based on performance, while simultaneously building local capacity to assume service delivery functions. Strong institutional and human capacity is crucial for success.
- Theory and international best practice emphasize the importance of accountability mechanisms which range from political, administrative and fiscal mechanisms structured either through a top down or bottom up accountability structure. At the same time, local discretion is needed to

improve efficiency. The key is to find the right balance to ensure adequate local discretion within an appropriate accountability structure in order to achieve the decentralization objectives.

- A transition plan with new laws is critically important as part of the sequencing process as Nepal has already moved (after promulgation of new constitution in 2015) from a unitary government to a federal government structure. This transition plan is important not only to further clearly identify those functions to be shifted, but also to map out an appropriate transition plan to ensure that public services, assets and liabilities, human and systems capacity are shifted to appropriate government levels at minimum administrative costs and at minimum disruption to public service delivery.

9.6 Need for Transparent and Equitable Intergovernmental Transfer System

- All countries require an effective system of intergovernmental transfers to address vertical and horizontal fiscal imbalance within countries. In addition to strong political objectives, these intergovernmental transfers and shared taxes can assist in balancing vertical funding needs between central and LGs, achieving horizontal equity among LGs of various expenditure needs and fiscal capacity, improving the delivery of national priority merit goods, and compensating for inter-jurisdictional spillovers, among others.
- The design and implementation of the intergovernmental transfer system is critically important to realize decentralization results of accountability and efficiency. The grant system in Nepal is currently quite complicated, with multiple grant channels dominated by categorical grants, with an ad hoc determination of the annual grant pool, and with only the recent introduction of a formula-based allocation mechanism and the use of performance indicators.
- International best practice would call for a simplification of the grant system, a move towards a reliance on formula-based transfers for both recurrent and capital grants, and a dynamic balance between a mix of block and categorical grants in line with accountability and capacity for delivering performance. In addition, the establishment of the National Finance Commission is critical to monitor, analyze, and adjust the intergovernmental system to ensure optimal achievement of government objectives.

9.7 Implications for Development Partner Support

- Coordination of development partner support is critical to ensure proper synchronization with the ongoing reform structure and sequence. Both government and development partners need to recognize the long-term nature of public sector reforms, with the need for an integration of political, administrative and fiscal aspects. In line with the Paris Declaration on Foreign Aid Coordination, it is essential that development partners coordinate their support, working closely in partnership with the government to ensure systematic, sustained, and results-oriented reform, with clear benchmarks for success through such mechanisms as the LGCDP.

- Developmnet Partners can support the Government to maintain successful reforms initiatives such as the MCPM performance based grants which is making a real impact on the behavior of local governments in Nepal. The Minimum Condition and Performance Measures (MCPM) should be supported and expanded to provide a wider set of incentives and support to further support local Public Finance Management (PFM) (e.g., planning, budgeting and procurement, auditing, accounting and reporting) and local revenue mobilization such as through possible property tax reform.
- Coordinated and sustained support to such mechanisms as the LGCDP will enable Delopment Partners to leverage these ongoing decentralization and local government reforms to support broader cross cutting reforms such as PFM and civil service reforms efforts. In addition, DPs can leverage their support to decentralization reforms through their other sector-based development assistance in the fields of education, health, environment, and infrastructure through policy dialogue, capacity development and funding.

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Performance-Based Grant Systems: Concept and International Experience*

Jesper Steffensen[1]

1. Background

As Intergovernmental Fiscal Transfers (IGFTs) are one of the main sources of local government (LG) revenue in developing countries, often accounting for more than 60 % of total LG revenues, it is of utmost importance for the success of the overall decentralisation process that such transfers achieve their objectives and provide the right incentives. The way the transfer systems are designed impacts on the likely success of the overall system of local government finance and decentralisation as a whole.

A comprehensive publication on performance-based grant systems (PBGSs) was published in 2010[2] is aimed at providing a detailed overview of and evidence-based insights into the design and implementation of PBGSs for LGs. This article summarizes the main points and lessons learned from the introduction of PBGS. PBGSs are intended to be integrated into national systems of IGFTs, with a view towards providing LGs with tangible incentives to improve their overall institutional, organisational and functional performance, thus reducing the risks associated with IGFTs and making decentralisation become more effective, efficient and responsive as a strategy for the delivery of public goods and services. Among other agencies, United Nations Capacity Development Fund (UNCDF) and more recently other development partners such as Danida, World Bank and European Union (EU) have been actively involved in piloting the use of performance-based grants – and the experience gained from supported projects and programmes has generated significant lessons about the design and implementation of PBGSs in developing, low- and middle-income countries.

* This article is synopsis of 'Performance Based Grants Systems : Concepts and International Experience' prepared for UNCDF by Jesper Steffensen in 2010.

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2. Overview

2.1 Conceptual Clarity of PBGS

What does a “typical” PBGS look like? Although there are many variants, in essence, a PBGS operates such that the extent to which LGs access transfers from central government is conditioned upon their overall performance.

In most PBGSs, LGs need to show that they have complied with basic or Minimum Conditions (MCs) in order to access their grants (or a part of them). MCs, are usually based on statutory provisions and are either complied with or not (there is no “half-way house”), are intended to measure the basic capacity of a given LG to perform its functions. Unless LGs can demonstrate this, they are unable to access all or part of their (most often, capital development) grants. However, when LGs are able to demonstrate compliance with MCs, which are designed to ensure that there, is a minimum capacity available to handle grants, they become eligible to receive their grants. Many MCs are designed as basic safeguards to bring down fiduciary risks to an acceptable level.

Many PBGSs, however, go one step further – by either increasing or decreasing the size of basic LG grants in relation to the assessed performance of LGs. This performance is usually based on assessing pre-determined and agreed Performance Measures (PMs). Here, and in marked contrast to MCs, the measurement of performance is more nuanced and “qualitative” – LG performance (as measured through PMs) is *more or less* good/bad, whereas MCs are not relative but absolute (the LGs either do or do not “qualify” to become eligible for all or part of their grants). PMs are assessed for all LGs, but assessment results only impact on those LGs that (by virtue of having demonstrated compliance with MCs) are eligible to receive grants – the size of which is either increased or decreased depending upon their performance across a range of measures.

What is vital to note here is that a PBGS is intended to operate as a set of incentives for improved LG performance. Good LG performance, whether “absolute” (as in the case of MCs) or “relative” (as in the case of PMs), is rewarded through eligibility for grants and/or through access to larger or smaller grants.

By linking the level of funding that LGs receive in the form of fiscal transfers to their performance, a PBGS can provide incentives for LGs to improve themselves in a range of areas (such as revenue collection, planning, budget execution, downward/upward/horizontal accountability, financial management, good governance in general). Given the “right” arrangements and context, the calibration of IGFTs to LG performance can give LG capacity building more meaning and greater purpose, encourage LGs to do better all round, and significantly reduce the fiduciary and other risks associated with fiscal decentralisation. However, getting things “right” (and avoiding some major pitfalls) is indispensable in making the most of the potential offered by PBGSs and the incentives that they provide for improvements in LG performance.

PBGSs need to be distinguished from other types of LG performance measurement (such as credit rating systems or performance budgeting) – which can often be complementary, but which operate in very different ways. It is also important to properly situate and contextualise PBGS percepts within the overall framework of intergovernmental grants. PBGSs can be distinguished from one another along two dimensions: i) the type of performance which they try to leverage – generic performance (such as overall LG financial management, governance, and the like) or sector output performance; and ii) the use of funds (discretionary as opposed to earmarked or conditional). PBGSs have most often been developed for multi-sector (or general purpose) block grants, the use of which is largely discretionary but generally directed at financing capital investments. In addition, PBGSs tend to focus on leveraging generic aspects of LG performance (such as planning, budgeting, PFM, governance, etc.), where improvements to such "processes" can impact on a broad spectrum of end-outputs or outcomes. Nonetheless, PBGS principles can be applied to more sector-specific grants – which may focus on such generic performance areas and/or more sector-specific dimensions to performance (such as sector-specific deliverables).

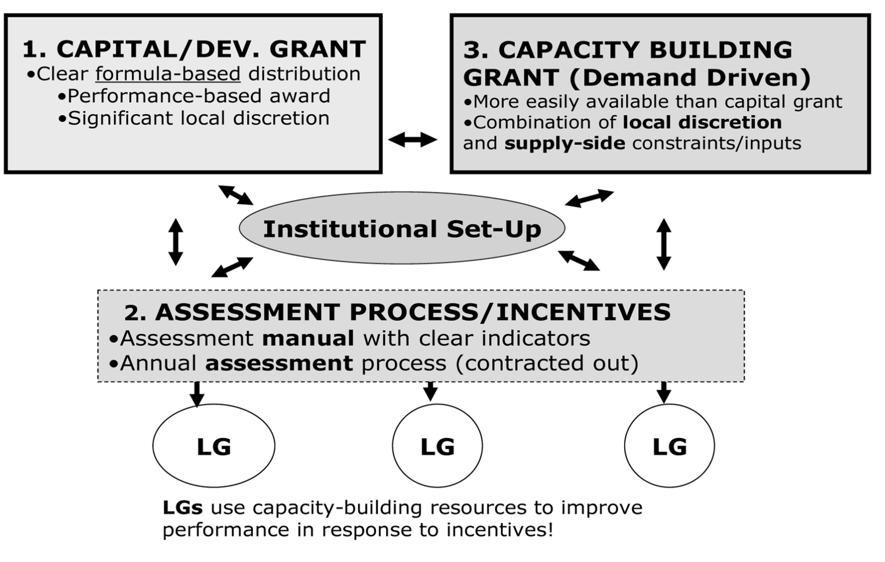
PBGSs typically consist of several inter-related and mutually reinforcing elements, *inter alia*:

- The capital grant scheme itself, which usually covers multi-purpose and largely discretionary grants. Transfers need to be of a size such that gaining access to them (or part of them, or increases/decreases in them) operates as a significant incentive for LGs to meet conditions that determine their access to the grants (or variations in the size of grants);
- A performance assessment process, which most commonly relies on the use of indicators that measure general, institutional or functional performance, and which are measured on a regular annual basis. PBGSs usually rely on two types of indicators: (i) Minimum Conditions (MCs), which are categorical ("yes/no" triggers), and which need to be complied with in order to gain access to basic grants; and (ii) Performance Measures (PMs), which are more "qualitative" and "calibrated" than MCs, and which allow LG performance to be assessed in a scaled manner, resulting in increases or decreases in the size of any grants allocated to LGs. Getting the indicators "right" is fundamental here, so as to ensure that LGs are being assessed against actions or failures for which they are genuinely responsible and to ensure that the indicators are targeting intended performance areas in a balanced manner. And, perhaps as importantly, the process whereby indicators are assessed/measured needs to be robust, technically sound, credible, transparent and politically neutral;

- LG capacity building (CB), which is usually a combination of: (i) supply-driven and mandatory activities; and (ii) demand-driven, more discretionary activities (tailored to the specific needs of individual LGs). Demand-driven CB is increasingly ensured through the provision of CB grants to all LGs (irrespective of their compliance with MCs). The CB component of a PBGS is important because it enables LGs to respond to the weaknesses that are identified in the regular performance assessments. It also enables non-compliant LGs to obtain the CB services they need to improve their performance and thus access basic grants or receive larger grants. Moreover, the PBGS approach also provides concrete incentives for LGs to utilise CB support more efficiently.

Ideally, a mutually reinforcing triangle should be established between three components: 1) the capital development grant scheme; 2) the performance incentive system (including the assessment system and process); and: 3) the capacity building support (demand and supply driven), facilitated by robust institutional arrangements (including support to a sound system for assessment – in a neutral, objective and professional manner) and supported by an effective coordination of the entire system by the central government in close consultation with LGs and other stakeholders.

Figure 1: Mutually Strengthening Components of a PBGS



A general description of each of these components is given below.

2.2 Capital Development Grant Component

The capital development grant component (performance grants) is the number one cornerstone of any PBGS. These grants need to be of a sufficient size (relative to other sources of finance) to give LGs a real incentive to improve their performance. Although the aggregate transfer amount will obviously be partially determined by the total number of LGs that are being targeted in a country and the total available funding pool, each LG needs to benefit (or lose) meaningfully if it is to comply (or not comply) with the system[3]. The investment menu (eligible expenditures to be funded from the grant) may vary from country to country, but generally includes a broad non-sectoral menu and a short negative list of non-eligible expenditures.

3. Assessment System and Process

3.1 Assessment System and Measures

PBGSs generally include an annual assessment of LG performance using a set of indicators that are clearly defined in an assessment manual/tool. The process of assessment is equally crucial for the success of any PBGS.

Most countries have divided these indicators/measures into two categories:

Minimum Conditions (MCs) – these are the basic conditions with which LGs need to comply in order to access their grants, and are formulated to ensure that a minimum absorptive capacity/performance (e.g. in terms of planning, financial management and administration) is in place to handle additional funds. They are most often formulated as on-off triggers for the release of funds, and ideally the entire set of MCs should be complied with before LGs can access their performance grants.

Performance Measures (PMs) – are more qualitative and variable measures of LG performance, and will typically go into more detail within each functional area, such as the quality of the planning, quality of environmental management, etc. The measures are used to adjust the level of funds made available to LGs as and when they have complied with the basic MCs.

There are many pitfalls in the design of these indicators. In defining indicators for minimum conditions and performance measures, the following principles need to be borne in mind:

- Utilise the experience gained from previous testing and piloting, and from other countries which have introduced similar systems with encouraging results;
- Support LG compliance with statutory requirements (government laws and regulations). Although this is a guiding principle in most places, the

3 It should be noted that many countries have started with limited and modest PBGSs and then gradually expanded the system.

performance measures may also target areas outside of these (be ahead of the legal framework), particularly with respect to good governance and transparency indicators. But in these areas, it is important that LGs, through capacity development activities or various other kinds of guidance, receive support and advice on how to improve performance before the assessment is conducted. It is not advisable to assess compliance with very complicated new requirements and systems, if LGs have not been sensitized and trained in their utilization and/or informed about these;

- Try to ensure good coverage of the existing government assessment systems and M&E indicators and results (such as those used by the inspection function, statistical surveys, available audit reports, etc.), and make use of these results to the extent possible with sufficient quality assurance. This will reinforce subsequent efforts to harmonise and align the systems and ultimately help move towards the use of a single common assessment tool for LG performance;
- Use a combination of Minimum Conditions (MCs), designed as on-off triggers, with which compliance provides some basic safeguards against the misuse of funds, and more qualitative performance measure (PMs), used to adjust the size of the grants) to promote better performance. However, some countries have begun their PBGSs by focusing only on the core MCs to keep things simple in the first phases;
- Endeavour to ensure that the core areas are well targeted and avoid too many indicators of minor importance. However, some such indicators may be included to raise future awareness and identify capacity building gaps, and these may be increased over time;
- Start with the core generic areas of performance under LG control, such as financial management, participation, transparency and good governance. Generally, it seems more appropriate to avoid indicators of service delivery outputs in the initial stages of establishing a PBGS, as these types of indicators: (i) often cover aspects of performance that are not under LG control; (ii) can make the system overly complex; and (iii) can bias LG-funded investments into certain sectors and away from others;
- All the indicators should cover functions or activities that are under the control of LGs and for which performance is genuinely attributable to LG management. In other words, the system should not use indicators of sector outputs and outcomes in countries with a limited level of decentralisation, precisely because these areas are still largely outside of LG control. However, as and when sector functions are genuinely devolved to local governments, it may become appropriate for a PBGS to use indicators of sector outputs and outcomes as measures of LG performance, particularly for sector grants;

- Seek to identify performance priorities and then weight the indicators accordingly. Thus, participatory planning and revenue mobilization may be seen as some of the core areas where improvements are most urgently required – and indicators for them can therefore be allocated a higher scoring weight relative to other, less important, performance indicators. Identifying such performance priorities and then according them greater prominence is one of the key PBGS design issues to address. This will often require a detailed prior review of LG performance in various areas, and identification of weaker areas, benchmarked against international/regional standards;
- Whilst a PBGS is designed primarily to provide incentives for improvement in LG performance, it is also intended to identify capacity building gaps and provide input to the overall Monitoring and Evaluation (M&E) system of LGs. Ensuring linkages between the PBGS and other M&E systems and their indicators is therefore critical;
- Ensure that a PBGS addresses LG functional weaknesses, as identified through consultations with various stakeholders and through previous piloting;
- The requirements imposed by minimum conditions and performance measures should be realistic, achievable and objectively verifiable, i.e. clearly defined, but still sufficiently demanding to promote improvements;
- Try to design a PBGS in a manner whereby the system can progressively cover specific sectors (and sector grants), using the generic indicators as the core basic framework, but adding sector-specific indicators for sector grants,
- The system should be based on a clear and simple scoring system. More qualitative indicators (e.g. levels of participation in planning) require more field testing and control than more simple quantitative indicators.

The definition of MC/PM indicators and the way the scoring system is structured have an important bearing on the acceptance and credibility of the PBGS when applied at the local level. The main guiding principles for the final selection of appropriate indicators will typically be the need to achieve grant *objectives*, combined with practicality and *simplicity* in the selection of various options and the need to harmonise different assessment systems so as to avoid duplication and confusion. Too simplified a system may lead to lack of buy-in and alternative (and more sophisticated) performance measurement systems, designed by other agencies. In any case, it is important that the indicators are clear, transparent and cover key performance areas consistently, promoting the overall objectives of the transfer scheme.

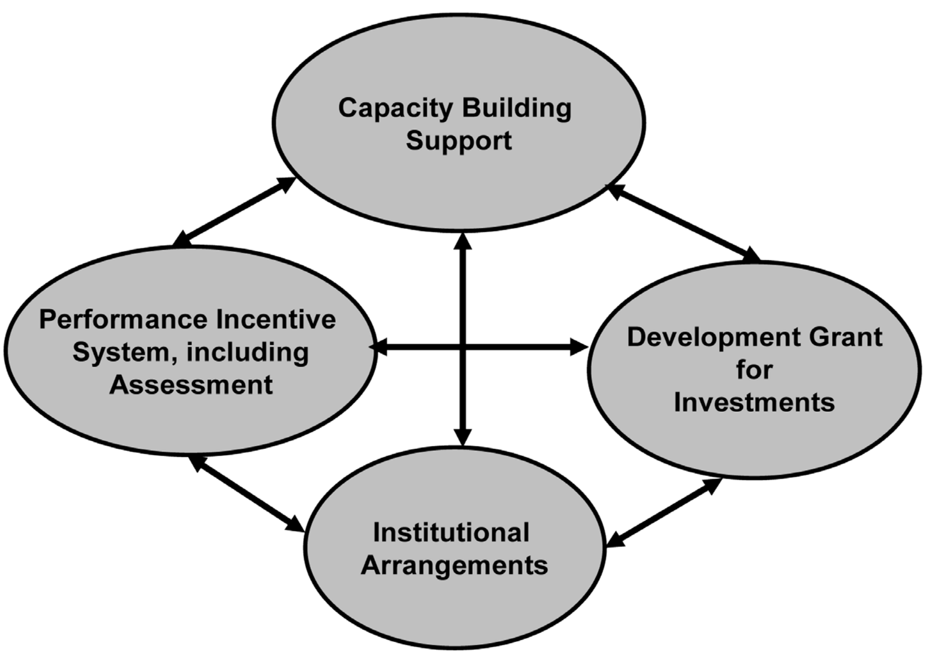
3.2 Capacity Building

To be most effective, a performance-based (capital) development transfer scheme needs to be backed up by well-designed options for capacity building for LGs (e.g. in the form of capacity building grants) to enable them to address weaknesses in capacity and to improve performance, and support them in preparing appropriate capital investment projects (planning, feasibility studies, monitoring, etc.).

The performance measures should promote better LG performance in the area of development activities, whilst the capacity building support should enable LGs to address the functional gaps, identified during annual assessments, in an efficient and targeted manner. Furthermore, the assessment system provides good incentives for the LGs to utilise CB support in an efficient manner. The PBGS will typically require more sophisticated management arrangements, including staffing capacity in the responsible agencies, than more simple formula based systems. Assessments and monitoring alone will require planning and implementation capacities – whilst the CB component also requires significant support and coordination. But experience has shown that investing in a well-managed PBGS yields a high rate of return in terms of improved LG performance in core areas of importance for the management of development projects (from planning, budgeting to project implementation and monitoring).

As it appears from the figure below, capacity building support will provide the necessary means and incentives to improve LG performance:

Figure 2 – Components in a Performance Based Grant Allocation Scheme



The local development grant for investments, the capacity building support and the built-in performance incentive systems should ideally be designed to be mutually reinforcing and have a significant impact on LG service delivery. One way of doing this is to introduce, alongside the capital component of the performance grant system, a *capacity-building grant scheme*. This grant will often be much smaller than the capital/development grant and would be used to fund various capacity building activities (such as training, purchase of minor equipment items, etc.), rather than 'hard' investment activities. CB grants should be more easily accessible than the capital grants, to enable all LGs to improve their performance. In other words, whilst one expects a certain number of LGs to fail to access the capital grant every year (due to non-compliance with MCs), all LGs will usually be able to access their capacity building grants, provided that they have shown signs of commitment (for example, through developing simple plans and budgets for capacity building).

The idea pursued in the PBGSs is that LGs should be allowed significant discretion both over what sorts of capacity need to be built and where the inputs should be sourced – precisely because they are often better-placed than central government to identify needs and inputs.

For quality control purposes, certain limits may be placed on this discretionary power, with central Ministries playing a fundamental role in determining training standards and vetting vendors/suppliers, ensuring transparency in procurement, etc. In addition, there may also be scope for some supply-driven CB efforts as long as supply and demand side imperatives are balanced and mixed[4].

The supply-driven side of CB typically also provides LGs with mandatory training in priority areas and usually includes support for developing basic systems and procedures for *core* activities, such as planning, budgeting, procurement and reporting. LG participation in these supply-driven CB activities may even be considered a prerequisite for access to development grants under certain circumstances (e.g. the case of Solomon Islands). It is for their residual capacity development needs that LGs will need sufficient autonomy for local choice and decision-making.

3.3 International Experience

Although the use of incentives in IGFT frameworks is not new, their systematic inclusion as an integral part of the grant allocation process (as is the case with PBGSs) is relatively recent. Uganda was an early innovator, and (with UNCDF support and technical backstopping) began piloting its PBGS in the mid/late 1990s in 4 districts with a gradual expansion in the number of LGs covered. By 2003, Uganda's PBGS had been scaled up on a nation-wide basis, covering all of the LGs in the country. Other countries have since followed suit – today (2015), at least 15 countries are using a

4 E.g. the design of Ghana's PBGS includes a combination of supply driven/mandatory CB support and demand-driven discretionary capacity building grants in the ratio 40%/60%.

PBGS approach, either on a pilot basis or nation-wide, and several other countries are planning to use similar approaches. There is now considerable on-the-ground international experience of using PBGSs, providing many evidence-based lessons about how such systems function, what their impact has been, and the conditions under which they seem to work optimally.

3.4 General Patterns and Common Issues

In looking at 15 different developing and middle income countries in which PBGS approaches have been used, a number of patterns and issues emerge, *inter alia*:

- Although a few countries have tried out (or are in the process of trying out) PBGSs that apply to specific sectors and earmarked grants, the majority have applied PBGS principles to multi-purpose capital (or "developmental") grants, and mostly relied upon generic indicators (e.g. planning, financial management, fiscal effort, transparency, etc.), rather than output-based indicators of service delivery, to assess local government performance;
- The grants to which PBGSs apply have been of varying size, but have usually been relatively modest (averaging around USD 1-4 per capita per year, although there are examples of a much higher allocation in e.g. Bhutan and in the new urban LG programs in Africa). Nonetheless, the size of the grants appears to have been sufficient to generate adequate incentives;
- All countries have included a capacity building component in their PBGS, with a tendency over time to move towards the allocation of CB grants to LGs and more demand-driven CB approaches;
- The use of Minimum Conditions (MCs) has been near-universal, thus providing LGs with incentives to demonstrate compliance with indicators that point towards a basic level of absorptive capacity. This, in turn, implies that basic fiduciary and other safeguards are in place before grants are made available to LGs. In almost all cases, MCs have been derived from statutory requirements for LGs;
- A majority of the countries included in the survey use Performance Measures (PMs) to measure qualitative differences in performance – with individual LG scores resulting in alterations to their grant allocations. LG performance against PMs is usually measured through a "balanced" scoring system (which encourages better performance across the board, rather than just in specific areas), with a few countries measuring individual LG performance relative to that of other LGs' level. PMs have tended to focus on planning and public financial management processes, improvements in LG accountability and transparency;
- Most PBGSs have been progressively refined over time, with more MC/PM indicators being introduced and with modifications to budgetary "consequences" taking place (in some countries) to ensure that LGs access

minimum levels of funding regardless of their performance, but ideally accompanied by more intensive mentoring and supervision;

- Although most countries use fairly robust and relatively intensive performance assessment processes (detailed assessment manuals, out-sourced assessment teams, training of assessors, etc.), some have sought to "internalise" the process by making assessments into "in-house" functions (with the potential risk of forgoing impartiality);
- Over time, there has been a tendency for governments to tie their own budgetary allocations to PBGS procedures and for the share of development partner funding to decrease – signifying an important degree of national buy-in;
- In several countries, PBGSs (precisely because of the safeguards that they establish) have helped in encouraging donors to opt for direct budgetary support and sector-wide approaches as a way of financing decentralised service delivery.

4. Achievements and Benefits

Although PBGSs have often only been in place for a few years, there is considerable evidence that the incentives they provide have resulted in genuine improvements in local government performance, especially in core administrative and financial areas. Major areas in which LG performance has improved have included:

- Core administrative functioning (meeting culture, keeping of records, etc.) and compliance with basic statutory requirements, both of which are invariably used as indicators for MCs;
- Public financial management by LGs appears to have dramatically improved following the introduction of PBGSs, which use indicators such as quality of the planning process, compliance with procurement regulations, timely accounting, audit processes, outcomes and responses, etc. to measure LG performance;
- Where improvements in fiscal effort and increased local financial contributions have been included as indicators of LG performance, there is evidence (in some countries) that LG own-source revenues have increased – although this has sometimes been undermined by inconsistent changes in the revenues assigned to LGs;
- Local government transparency and accountability (both of which are invariably measured – through a variety of indicators – by MCs and PMs) also seem to have improved in many cases, thus contributing to a more meaningful interface between LGs and citizens and better informed dialogue, and other improvements in downward accountability. Horizontal accountability (between local civil servants and elected officials) also appears

to have improved as a result of the introduction of PBGSs, which provide elected officials with a good indication of how well (or badly) LG employees have been performing. Finally, upward accountability can be and has been strengthened through PBGS, which provide incentives for LGs to comply with national laws and regulations, to report on a more timely basis, etc. and which provide opportunities for greater dialogue between the central and local levels;

- Incentives established by PBGSs have also led to improvements in the way that LGs handle cross-cutting issues such as gender, social inclusion, poverty targeting and the environment. Such issues have often been embedded in the performance indicators used by PBGSs – and have thus contributed to greater sensitivity towards them by LGs;
- PBGSs, by design, can be powerful tools for making capacity building (CB) more effective and efficient. Firstly, performance assessments help in identifying the areas within which LG performance is weak, thus enabling CB activities to be better targeted. Secondly, the linkages between performance and grants that are an integral part of any PBGS provide real incentives for LG officials to apply their acquired skills and knowledge – and thus improve performance. Finally, and when combined with CB grants, the PBGS approach provides LGs with the resources to procure CB services and facilities on a demand-driven basis – which enables each LG to meet its specific (rather than generic) needs;
- There is considerable evidence to the effect that PBGSs facilitate greater coordination between and amongst development partners – the safeguards associated with PBGSs allow DPs to more easily enter into basket funding arrangements, which may later evolve into genuine "sector" budget support for decentralisation (using SWAps). In addition, PBGSs often provide an initial entry point for wider decentralisation reform processes;
- Although it is early days yet, there are indications that the use of a PBGS usually leads to positive infrastructure and service delivery outputs – in terms of allocative efficiencies, better implementation, cost efficiency and sustainability. Underlying these outcomes are two key factors – the extent to which a PBGS (through the safeguards that it ensures) encourages Central Government and DPs to provide discretionary grants to LGs (thereby fostering local level prioritisation and thus greater allocative efficiencies) and the incentives provided for improved planning, budgeting and costing, design, contracting, project implementation and supervision and operations & maintenance.

Despite the evidence for these achievements and benefits, it remains nonetheless important to bear in mind that most PBGSs are still in the early stages of implementation – and that many other factors may also be at play.

5. Challenges and Limitations

Experience has shown that there are a number of challenges for and limitations to performance-based funding systems for LGs, *inter alia*:

- Because of their tendency to focus on "process" and "intermediate output" indicators, PBGSs cannot directly measure service delivery outcomes (such as poverty reduction). To do so, would require considerably more sophisticated and costly assessment methods; moreover, measuring outcomes is highly problematic given attributional problems. In addition, measuring the outcomes of local service delivery may also be antithetical to the discretionary nature of multi-sector block grants by "steering" local decisions in certain directions, rather than leaving priority setting to locally accountable institutions. Finally, value-for-money audits and other reviews have shown a clear link between improvements in LG processes (PFM, governance etc.) and service delivery performance;
- A range of external factors can also dilute the impact of PBGSs and impede their implementation – such factors include severe conflict, very weak "horizontal" controls over LG staff, poorly defined expenditure assignments (which blur LG accountabilities), inappropriate or inadequate revenue assignments (which constrain LG resource mobilisation), significant levels of parallel funds which are not tied to performance (thus reducing the leverage exerted by PBGS-modulated grants), delays in disbursements and disjuncts with the annual budgeting cycle, and so on. An overwhelming focus on the technical aspects related to PBGS design runs the risk of overlooking such fundamental challenges and reform issues;
- The implementation of PBGS-type arrangements in some countries has also run into difficulties associated with weak management capacities at the central level, resulting in delays and uncertainties. Although this is by no means unique to PBGS-type reforms, it is particularly challenging for them as they often require more robust institutional and support arrangements than do other, simpler, grant systems;
- A major challenge faced in some countries has been the lack of political will to implement the consequences of poor LG performance – which usually take the form of funds being withheld or cut back. Political pressures from LGs often weaken the resolve of central level officials or politicians to follow through with sanctions or funding reductions – and this can seriously compromise the integrity of the system. Whilst measures can be taken to make politically tough decisions more palatable, ultimately central government needs to discipline itself here.
- Designing the assessment methodology (indicators, scoring system) requires careful thought so as to avoid a variety of pitfalls and inconsistencies. Selecting the wrong indicators, for example, can be unfair (when they

measure actions beyond the control of LGs) or lead to perverse outcomes (when they encourage LGs to focus on certain things but not others);

- Ensuring that the assessment process and its results are of high quality is also a challenge common to PBGSs. The process needs to be seen (by all stakeholders) as credible and impartial if the PBGS incentive structure is to function properly. Establishing adequate quality assurance systems is of great importance here;
- Finally, and perhaps most importantly, the PBGS approach – in isolation – should not be seen as a panacea for all the potential problems that are often associated with decentralisation. The overall policy environment, confusing or contradictory institutional arrangements, civil service constraints and other such factors can make it very difficult for a PBGS to achieve the desired and hoped for results. This highlights the need to keep sight of the wider picture in designing performance-based grant systems for LGs.

6. Conclusions and Recommendations

6.1 Conclusions

There are plenty of reasons to argue that PBGSs can and do have a positive impact on LG performance and thus on decentralised infrastructure and service delivery. Over a relatively short span of time and in several countries, the implementation of PBGS approaches has produced tangible and positive results, *inter alia*: i) better LG compliance with legal and statutory requirements; ii) improved planning and public financial management at the local level; iii) greater attention being paid to, and improved performance in cross-cutting areas such as gender mainstreaming, environmental management, good governance and transparency; iv) more focused LG capacity building; and v) consistent use of capital grants to finance investments in core poverty alleviation areas. There is also some encouraging evidence that PBGSs impact positively on areas such as the cost efficiency of service delivery and targeting of poverty alleviation.

Although the PBGS approach is not the only way to promote improvements in LG performance, it should be seen as an innovative and encouraging move away from earlier systems of central government ex-ante, micro-management to a more targeted, ex-post, and results-based framework. By moving away from systems, characterised by tightly earmarked sector grants, towards systems based on relatively discretionary cross-sectoral grants, PBGSs foster an increased level of local autonomy. On condition that such flexibility is accompanied by sound and unambiguous guidance, clear requirements, capacity building and other support, PBGSs can help central governments to move away from heavy-handed and transaction costly ex-ante oversight. Experience has shown that if the right incentives are provided to LGs, sector-wise control and earmarking of funds can be relaxed without compromising national targets and priorities, while at the same time fostering good local governance. Hence, the PBGS approach can enhance local discretion while strengthening downward, upward and horizontal accountability.

International experience has also shown that PBGSs are valuable and innovative elements in overall reforms of intergovernmental fiscal relations, and that they have the potential to impact positively on the overall reform agenda in many countries.

However, it is important to note that the PBGS approach is not an all embracing panacea – and PBGS reforms need to be complemented and coordinated with other measures, such as Human resource (HR) and payroll reforms, legal, fiscal and institutional reforms. PBGSs are not equally effective in all environments or circumstances and are most useful and effective when the following pre-requisites, among others, are in place:

- Strong policy support for performance incentives and the political will to cope with pressure from those LGs that are performing poorly;
- Based on solid analytical work, documentation of strengths and weaknesses of previous approaches;
- The PBGS is robustly and carefully designed (see below) with significant involvement and buy-in from key stakeholders – core ministries, development partners, LGs, etc.;
- The overall LG framework is conducive for a PBGS approach, particularly in terms of HR management (with LG staff being at least partly accountable to local political bodies or a strategy and means to encourage that the LG officials pay attention to the results), LG finance arrangements, the legal framework and the overall system of coordination of the decentralisation reform process. LGs need to have a certain level of autonomy to improve their performance;
- Capacity building arrangements are appropriate, linked to performance assessments, and allow for a sensible mix of supply- and demand-driven approaches;
- PBGS operations, measures and outcomes are highly transparent and publicly disclosed, particularly with respect to the results of regular LG performance assessments;
- The support provided to LGs – both fiscal and non-fiscal – by Government and Development Partners (DPs) is stable, timely, long term, predictable and well-coordinated.

Needless to say, the “perfect” environment for a PBGS is far from the norm – and it is important to note that the actual implementation of PBGSs can itself contribute towards establishing the “right” context.

6.2 Recommendations

Beyond those prerequisites (many of which are "external"), there is a need to adhere to a variety of fundamental principles and considerations in the design and implementation of any PBGS. Although there are many challenges to face and potential pitfalls to avoid in designing and implementing PBGSs, experience to date provides the basis for a series of key recommendations. These are summarised as below.

6.2.1 Recommendations for the Design of PBGSs

- Invest sufficient resources and time in proper design, as PBGSs are technically demanding;
- Ensure effective linkages between the PBGS and other dimensions to the overall decentralisation reform process (the IGFT system, public sector reforms, particularly in the field of human resource development and management);
- Ensure – from the outset – that all stakeholders understand the potential benefits, but also the challenges, associated with implementing a PBGS approach;
- If pilots are being tested out, these should be realistically and strategically designed so as to optimise opportunities for subsequent roll-out;
- Ensure that the indicators used in a PBGS are appropriate, measure performance that can be genuinely attributed to LGs, focus on key LG performance areas and PBGS objectives, and – as far as possible – are derived from statutory and regulatory frameworks;
- Start with a relatively simple system, focusing on critical and core LG performance areas (PFM, governance, planning, etc.), which can be adjusted, refined and expanded in the light of experience;
- Ensure that all guidelines and procedures (for assessments, for grants, etc.) are clear, coherent, user-friendly and widely disseminated;
- Establish a robust, neutral, transparent, predictable, fair and highly professional/credible performance assessment process that is aligned with the LG planning and budgeting cycle and subject to external quality assurance;
- Ensure (and, if need be, establish) effective coordinating bodies to endorse assessment outcomes and to oversee implementation of the system;
- Integrate into PBGS design a clear strategy for CB support, which combines supply- and demand-driven approaches and ensures high quality CB services;
- Given the innovative nature of the approach, establish sound M&E systems

to track their results and outcomes, and to thus provide the basis upon which to adapt, adjust and fine-tune the processes, procedures and methods associated with PBGSs.

6.2.2 Recommendations for PBGS Implementation:

- Seek to minimise exemptions and deviations from the general "rules of the game", as these tend to establish precedents and compromise the integrity of the entire system;
- Ensure transparency and extensive communication in all phases of PBGS implementation (e.g. public disclosure of assessment results);
- Provide well-coordinated, effective and continued technical and capacity-building support to core agencies responsible for PBGS implementation;
- Ensure that the PBGS is institutionally well-anchored in central policy making bodies;
- Ensure a gradual expansion of the multi-sectoral grants (vis-à-vis sector grants) as LG capacities grow. The challenge experienced by many countries is to increase LG discretionary powers (thereby optimising decentralisation outcomes) either by expanding the size of multi-sectoral grants or by linking them with sector grants;
- Regularly review and follow-up on the implementation arrangements;
- Follow-up and use M&E information address complaints and regularly adjust the system in transparent ways and in consultation with all stakeholders.

Overall, it is important to note that PBGS implementation is (and should be) an iterative exercise in itself. Governments and their development partners need to continuously monitor activities and impacts, learn from experience and – in the light of lessons learned and experience gained – review and adjust PBGSs and related processes and procedures (assessment methods and approaches, performance indicators, incentive frameworks, IGFTS, and the like).

Reference

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Fiscal Federalism in Nepal: Opportunities and Challenges

M. Govinda Rao[1]

1. Introduction

Nepal has undergone a painful transition to democracy and after the end of a decade conflict in 2006, elected the Constituent Assembly in 2008 to draft the Constitution. The Constituent Assembly elected in 2008 promulgated Nepal as a democratic federal republic. However, it failed to complete the task of drafting the Constitution even after four years of deliberations. Although initially the Constituent Assembly was supposed to get the Constitution ready in two years, its term was extended repeatedly for four years and yet, it failed to reach consensus on the critical issue of determining the number of states. However, the second constituent assembly has promulgated the new federal constitution. This is the time to effectively implement the new constitution accommodating multiple diversities and reconciling conflicting views.

Needless to say, Nepal is a country diverse in a variety of ways. There are regional, linguistic, ethnic and cultural diversities. And promoting harmonious development in an inclusive manner requires a number of policy instruments and institutional arrangements, besides restructuring governance. According to 2001, census there were as many as 103 social groups in Nepal. Surely, centralized administration of such a diverse country may not be the desired solution as governmental levels closer to the people can respond to the diversities better. At the same time, it is necessary to realize that federalism alone cannot solve all the problems arising from multiple identities and additional policy instruments and institutions will have to complement the new governance system. The new Constituent Assembly will have to incorporate the lessons from the past impasse in drafting the Constitution and move forward by

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creating the necessary complementary systems to deal with problems arising from multiple identities.

In this paper, the lessons from the theory and contemporary experiences has been discussed with a focus on fiscal federalism or efficient organization of the multilevel system. While it is not altogether impossible to completely shun the political elements, focus is on the fiscal federalism aspects mainly. While it may be necessary to refer to political elements, for a federal system cannot be created by economic factors alone, the focus is on the economic factors.

2. Costs and Benefits of Fiscal Federalism

Fiscal federalism is considered to be an optimal institutional framework for the provision of public services. As observed by Alexis de Toqueville more than a century ago, "The federal system was created with the intention of combining the different advantages which result from the magnitude and littleness of nations" (1980, Vol. 1, p. 163). The gains from the magnitude and littleness can be realised only when the functions of different levels of governments and various units within each of the levels are clearly specified according to their comparative advantage. The system allows reaping gains from the common market and economies of scale in the provision of national public goods. This is achieved by providing public services according to the diversified preferences of people.

Much of the fiscal federalism literature is actually about decentralization and not federalism. As Stated by Wallace Oates, "…the term *federalism* for the economist is not to be understood in a narrow constitutional sense. In economic terms all governmental systems are more or less federal: even in a formally unitary system" (Italics in the original; Oates, 1977; p. 4).[2] Similarly, Bird (2000, p. 135) states, "… in the traditional world of *fiscal federalism* in principle everything – boundaries, assignments of finances and functions, the level and nature transfers and so forth – is malleable."[3]

The above formulation, clearly blurs the difference between decentralisation and federalism. As stated by Breton (2000), most of the benefits and costs attributed to federalism is actually those of decentralization. Thus, provision of services according to diversified preferences of people, greater accountability in the provision of public services to the people, greater propensity to innovate from intergovernmental competition, greater participation of the people in public affairs – all these are gains attributable to decentralization. Similarly, problems arising from spillovers and overlapping jurisdictions, the cost of coordination between and among different

2 Not surprisingly as Breton (1981, p. 253) States, "Political scientists who know better, have in their more generous moments treated economists as poor souls with a model in hand in need of an application"

3 Bird (2000) makes a distinction between fiscal federalism and federal finance. In his formulation, under fiscal federalism everything - boundaries, assignments, and the transfers - is malleable, under federal finance these must be taken to be fixed at some earlier (constitutional) stage and not open to further change under normal circumstances.

levels of government, costs of signaling the preferences for different services including inter-jurisdictional mobility are the costs attributable to decentralization, and not federalism.

The critical difference between decentralization and federalism lies in the ownership and permanence of the powers assigned to them. In unitary states, powers are owned by the national governments, in confederal states, the powers are owned by the member states and in federal states, powers are divided between the Central government and states/provinces. In federal systems, the powers are owned by the level of government to which powers are assigned. They cannot be extinguished or taken away. Although it is difficult to find the classical federalism conceptualized by Wheare (1964) in which, the participating governments are "coordinate and independent", the federal system entails that the assignment system is determined independently. There should an effective system of checks and balances to ensure autonomy and to prevent encroachment. Assignment of the powers by independent authority, setting up systems and institutions to enforce and monitor the assignments (providing for checks and balances), to prevent encroachments and ensure a measure of permanency involves cost. In other words, all federal systems are decentralized whereas all decentralized systems are not federal. The Constitution and other institutions independent of the central executive set up to ensure checks and balances and to safeguard the domains of different levels of government are inherent components of a federal system.

The political theories make out the case for federalism on the basis of freedom and representation[4], safeguarding group identities and ensuring security and stability through bargains. On the other hand, economic theories of federalism focus on creating multilevel public sector governance systems to improve efficiency. The traditional approach or what has come to be known as the first generation theories of economic federalism implicitly assume that governments are "benevolent" and are "custodians of public interest" and they seek to maximize social welfare and therefore, are responsive to the preferences of the people, The new approaches to fiscal federalism or the second generation theories consider the assumption of benevolent governments unrealistic and take that agents within the governments (bureaucrats and politicians) have their own objective functions operating within the constellation of incentives and constraints depending on the given fiscal and political institutions (Oates, 2008). Nevertheless, closeness of the governments to the people ensures greater accountability. They model the inter-governmental behaviour in terms of principal-agent relationship, underline the importance of hard budget constraints and focus on the importance of competition – both vertically between different levels of government and horizontally among different units within the same level to enhance efficiency in the delivery of public services.

4 For a review of various political theories of federalism, see Rao and Singh (2005).

Both the first and second generation theories help us to identify the important pre-requisites for the efficient functioning of multilevel fiscal systems. First, there should be clarity in the assignment system and assignments should be according to comparative advantage. When there is some overlapping in the assignment system, there should be systems and institutions to resolve them. Second, it is important to assign revenue raising powers to the states to forge a link between decisions on revenues and expenditures at the subnational level. This is necessary for reasons of both efficiency and accountability. Assignment of revenue powers is also necessary to ensure fiscal autonomy and hard budget constraint. Third, while fiscal transfers are necessary to resolve vertical fiscal imbalances and to enable comparable levels of public services at comparable tax rates across the federation, it is important to ensure that the transfer system does not provide the incentive to "raid the fiscal commons". In addition, in respect of some services considered nationally important, either for reasons of externalities or spillovers or for strategic or redistributive reasons, specific purpose transfers may be needed to ensure minimum outlays on such services. While designing the transfer system it is important to ensure proper incentive structure to prevent fiscal laxity and profligacy. It is necessary that the transfer system should not enable the states to pass on the burden of their public services to non-residents.

Fourth, a major advantage of a federal system is the large common market, but the benefit from this can accrue only when not only all impediments to trade in factors of production as well as commodities are removed, but also mobility of commodities, capital and goods is facilitated. Ensuring a common market is at the heart of creating dynamism in fiscal federalism. Impediments in maintaining the common market can be posed by the policies restricting the movement of labour, capital and commodities.

Fifth, the literature on market promoting federalism shows that it is important to avoid soft budget constraints at both national and subnational levels. Efficient credit markets, a mature banking system and well developed credit rating institutions are important preconditions for the Centre to keep itself away from bailouts. Similarly, well developed land and property markets and unhindered mobility of factors and products can prevent public decisions that impede the development of markets. These will promote intergovernmental competition and minimize incentives for bailouts. It is important to discourage protectionist policies at subnational levels. Legislatively imposed constraints on deficits and requirement to balance the current budgets, will place a limit on fiscal expansion and ensure more productive public spending. Limitations placed on borrowings can also help to contain perverse incentives for fiscal expansion. A well designed set of bankruptcy laws that specify the fiscal crises and the way they need to be handled is another important institutional requirement.

Sixth, there can be gains from intergovernmental competition. Competition can lead to efficiency gains in public service provision; it can also motivate innovations and productivity increases in public service delivery. However, to reap these gains, it is important to ensure that there is a measure of competitive equality and predatory competition does not take place. Unequal competition could be destabilizing and can, in the extreme, break up the federation. This is particularly important in the context of globalization as the states with more developed markets and infrastructure can reap higher benefits from access to domestic and international markets and grow faster than those with less developed markets and infrastructure. It is also important to regulate the competition, provide a negotiating platform and resolve inter-state and centre-state conflicts.

3. Federalism Design Issues: Lessons and Experiences

Under what circumstances should a country choose a federal form of government? Most common people are not clear why should they prefer a federal form over a unitary or a confederal system. In fact, the concept of federalism can invoke varying emotions. There are countries such as Sri Lanka where the word "federalism" in some circles can evoke unpleasant if not hostile, response. In India, the constitution refers to Indian republic as a "Union of States" and not a federal country. In Nepal, however, most political parties view federalism as a concomitant of democracy itself. Nevertheless, even after four years of herculean effort, the Constituent Assembly failed to reach consensus on the basic parameters that federalism demands. Consensus could not be reached on the basic issue of the number of states.

Interestingly, common people seem to be not fully informed about what federalism is about. The recent survey conducted by the Washington D.C based independent advocacy agency - Vision for Nepal Foundation has shown that of the 2500 respondents in electronic polling, only 58 per cent of the people stated they were aware of federalism and the stakes involved in state restructuring. Only 42.9 per cent of the respondents favoured federalism as a form of governance whereas almost 39.3 per cent completely rejected the idea. This shows that there is considerable gap in the knowledge among the people about how federalism will pan out in the country and what it entails. At the same time, in a situation where there is considerable inter-personal, inter-ethnic and inter-regional diversities and disparities in the levels of living, if federalism is advocated in terms of improving the living conditions of the disadvantaged and reducing the disparities, failure to achieve them may bring in a lot of dissatisfaction leading to chaos and return of retrograde system of governance. Federalism is not a panacea for all ills afflicting the society. As mentioned earlier, it cannot be designed to solve all types of diversities. It is important for the political parties and intellectuals to educate the public that federalism is only a governance system. At the same time, it is important to ensure that federalism is properly designed and implemented to reap the benefits the "magnitude and littleness of nations". This implies that complementary systems and institutions must be put in place to deal with various types of diversities to complement federalism reforms.

Nepal is a country with significant economic, social, linguistic and ethnic diversities. As already mentioned, there are over 100 social groups speaking about 100 languages in the country, though almost 80 per cent of the people speak Nepali language. Extreme inter-district economic disparity is exemplified the fact that in 2005-06, 12 districts around Kathmandu collected over 94 per cent of the total revenues and the remaining 63 districts collected the balance 6 per cent. In fact, Kathmandu alone collected 42 per cent of the revenues indicating the concentration of economic activities predominantly in urban agglomerations, particularly in the capital region (Budhathoki, 2012). Accommodating economic, social and ethnic diversity in evolving an appropriate system of governance is a major challenge.

In terms of organization of governance system, the country has the Central government and local administrations and the latter has a two-tiered system namely district development committees and village development committees. With elections not being held for the local administrations, there is hardly any participatory decentralized system in place. In fact, local governments have very little role in raising revenues and implementing expenditure programmes. In 2005-06, they raised just about 5 per cent of the total revenues and their share in total expenditures was just about 8 per cent (Budhathoki, 2012). Surely, such a centralized assignment system in a country with large diversity is not sustainable. Dissatisfaction of the people towards the existing governance system may also be due to the fact that the country registered a meagre 2.7 per cent growth during the period 2000-12, which was only marginally higher than the growth of population of 1.7 per cent. Therefore, greater decentralization and more particularly federalism is not just an option, but an imperative.

Once a Westminster style parliamentary system of government is chosen, at least eight important factors need to be taken into account for an effective federal system. These include (i) drawing of boundaries; (ii) creating institutions of legislature, executive and independent judiciary at both Central and State/provincial levels; (iii) assignment of legislative domains of the Centre and States/provinces including tax powers and expenditure functions; (iv) Asymmetric arrangements for some of the states/regions within the states; (v) Protection of and ensuring access to services and opportunities to the minorities/ethnic, linguistic and other identities through a system of affirmative actions; (vi) Transfer system which is stable, independent, equitable and sustainable; (vii) An independent institutional mechanism to determine the system of transfers; (viii) independent institutions to ensure accountability, safeguard the autonomy, enable intergovernmental bargaining, monitor and regulate intergovernmental competition and conflict resolution. Each of this requires some elaboration.

Historical factors have played an important role in determining the governance structure of many countries. If the American war of independence gave birth to the American federalism, the civil war ensured its consolidation. Similarly, Canada would not have been a federation had it not been a fact that Quebec comprised of a majority of French speaking population and Ontario was made up of the Empire Loyalists faithful to the British Crown who fled the United States at the time of independence. India chose federalism mainly because centralized administration was too unwieldy, even the British colonial rule had to create divided heads with separate functions assigned to the States right from 1919 and consolidation of a large number of princely states required ceding significant powers. Nevertheless, the Constitution that came to be adopted was highly centralized for many observers to characterise it as a quasi-federal system.

One of the most difficult and often contentious issues is that of determining the number of states in a federation. The problem is less when different countries come together to constitute a federation or when there is a strong motivation for the constituent regions to live together due to historical factors or costs associated with the break up and gains from living together. The difficulties are manageable when there is a strong motivating force to form a federation. In Indian context, for example, the euphoria of gaining independence after nearly two centuries of colonial rule and the motivation to accelerate economic growth after virtual stagnancy and draining of resources by the colonial rulers created favourable environment for the adoption of the Constitution without much rancour for the number of states. In fact, major reorganization took place six years after the adoption of the Constitution was promulgated in 1950. With Article 3 of the Constitution providing scope for the creation of new States, over the years additional states were created by dividing the existing states. Unlike the genuine federations which are characterised as "indestructible union of indestructible states", In India, only the Union is Indestructible and Article 3 empowers the Union Parliament to form a new State, change the area of a state, alter the boundaries of a state or the name of a state by merely referring the bill to the state for its opinion.

The problem in the context of Nepal had been much more contentious (Ranjitkar, 2014). The issues posed debated in the main relate to whether the number of states should depend upon their economic viability versus identity based division. Still the issue of number of provinces is valid. Economic viability cannot be the sole criterion and given the pattern of regional income distribution and variations in the capacity to raise revenues, going by economic viability alone would reduce the number to only a few. At the same time, it is impossible to determine the number of states based on different identity groups because, perfect mapping of different identities with regions is impossible, and their protection and equal access throughout the country is the responsibility of the government. Federalism requires the creation of the three organs of government at both Central and State levels. These are institutions that are important to ensure checks and balances in the system. The house of States in the Parliament should really work towards safeguarding the interests of the States. The Bundesrat in Germany is a powerful body. In the U. S and Australia too, the upper houses in the Parliament represent the interest of the states and each state irrespective of its size is given equal representation. In India, the upper house as *Rajya Sabha* was intended to give a voice to the States. However, the purpose is lost as the voting is done on party lines contrary to what the founding fathers of the Constitution envisaged.

Another important issue is the determination of the legislative domains of the Centre and States. India has the Seventh Schedule to the Constitution which lays down their respective legislative domains. This should be relatively easy as the Constituent Assembly has the benefit of a number of Constitutions from which guidance can be taken. At the same time, there should be sufficient care to ensure that overlapping is minimised, systems and institutions are created to ensure harmonious working in concurrent areas and more importantly, safeguards against encroachment of the legislative domains of the states by the Centre.

It is neither feasible nor is it desirable to have separate states provinas to representing every identity or ethnic group. At the same time, it is important to ensure safety and security to each of the groups and provide them with equal social and economic access. The issue of the number of states can be resolved in a more harmonious manner if various groups have the confidence and trust that their interests will be adequately taken account of in the new Constitution through asymmetric arrangements and provisions for affirmative actions.

Equally important is the mechanism for ensuring adequate, predictable, equitable and sustainable fiscal transfer system determined in an objective manner. Transfers are necessary to offset both vertical and horizontal imbalances. The assignment system according to comparative advantage necessarily results in vertical fiscal imbalance. The assignment of macroeconomic stabilization and redistribution functions predominantly to the Centre implies that broad based taxes, borrowing powers and seignorage are assigned to the Centre. At the same time the states are better placed to implement most expenditure programmes. This implies that the transfer system has to play an important role in resolving vertical imbalance. Furthermore, given the large differences in the capacity to raise revenues and cost of providing public services among the states, it is important to offset revenue and cost disabilities through the transfer system to enable comparable levels of public services at comparable tax rates (effort).

An important precondition for a successful federation requires an independent institutional mechanism to objectively determine fiscal transfers. In India, the Constitution provides for the appointment of the Finance Commission every five years and this institution has worked as an impartial arbiter in determining the tax devolution and grants between the Union and States and among the States *inter se*. The Commission comprises of a Chairman and four other Members who are known professional experts in economics, accounting, or Law and over the years. Despite some limitations, the system has worked well and both the Union and States have shown confidence in the Commission. In contrast, the Finance Commission in Pakistan is chaired by the federal Finance Minister and the Finance Ministers of the provinces are the Members of the Commission. Acceptability of the recommendations requires unanimity and given the political character of the Commission, there have been inherent difficulties in arriving at a consensus. There have been seven Finance Commissions in Pakistan so far as against 14 in India. The Commonwealth Grants Commission in Australia is a permanent body making recommendations on the transfer system. While the total amount to be transferred is determined by the political mechanism in which the Prime Minister of the country and Premiers of the States participate (fist ministers' conference), the relative shares of different states are determined by the Commission based on its detailed studies on revenue capacities and expenditure needs of the states. The Commission is a professional body undertaking continuous research in intergovernmental finance and is respected by both the Commonwealth and State governments. In South Africa, the Financial and Fiscal Commission makes the recommendations, but the Ministry of Finance determines the transfers and takes the recommendations of the Financial and Fiscal Commission only as a background material. Thus we have a variety of experiences. The constitution of Nepal provids for Commission with permanent secretariat comprising of fiscal experts and espcialists intergovernmental finance engaged in continuous research and have the Commission making recommendations appointed until the new Commission is appointed.

Another important requisite for a sustainable federation is the institutional mechanism to ensure accountability and to provide for intergovernmental bargaining and conflict resolution. In a decentralized system, accountability of the governments is for people and for higher level governments. The office of the Comptroller and Auditor General is necessary to undertake independent audit which can be debated in the legislatures and fix accountability. In addition, it is important to have an institutional mechanism for harmonizing conflicting policy stances both vertically and horizontally and to promote intergovernmental bargaining and conflict resolution. This, in fact, is a major lacuna in India fiscal federalism and Nepal should have such an independent institution. One possible way is to have a permanent Finance Commission which also can be entrusted with these tasks.

4. Conclusion

There are a variety of motivations for having a federal form of governance. In some cases different countries come together to form a confederation for a common interest which may eventually evolve as a federation to reap the gains from common security and common market. In other cases, the dissatisfaction with the existing centralized administrations in dealing with economic, social, political and linguistic diversities and a feeling of exclusion in terms of the opportunities can be a motivating factor. In a rapidly growing economy where employment and income earning opportunities expand, the feeling of being excluded is less.

In the case of Nepal, the motivation for adopting federal system of governance comes from both relatively slow growing economy where opportunities do not expand fast enough and the feeling of exclusion from various groups. The federal governance will help to accelerate the pace of economic growth to expand the opportunities. It is necessary to underline the fact that calibrating policies and creating institutions to accelerate the inclusive development of the economy must complement the creation of federal governance system for the stability and sustainability of the federation.

Creating a federal system entails considerable work besides drawing up the boundaries and naming the states. Federal system has to be created with adequate checks and balances. This is a formidable challenge, particularly when there is considerable ambiguity on what federalism can do and enormous expectations that it is a panacea for all ills. Even when all the preconditions are met, as the jurists say, Constitution is a living entity and federalism, however well it is crafted, is a work in progress.

The political parties in Nepal have a historic opportunity to play the role of constructing an inclusive, responsive, and effective and growth oriented governance system in the country through new federal system. Failure to play this role will make the people cynical of democracy itself. This is the time to abandon the narrow political and sectarian considerations. The leaders have the responsibility to act in a statesmanlike manner to build the edifice of federal governance system. Much of the groundwork required for meeting preconditions will have to be worked out by technical experts, but the leaders have to look at the broader picture of enabling balanced growth in the country and create opportunities for the development of all sections of community rather looking at electoral gains and power politics.

It is also important to realise that while federalism can deal with regional issues, it is necessary to realise that federalism cannot be a solution to all types of diversities. The governance system may have to be supplemented by additional measures to ensure level playing field for all groups and these may include asymmetric arrangements within a federation and affirmative actions for historically disadvantaged groups. Additional policy instruments and institutions would have to complement federal system of governance to accelerate economic growth and enable equal access to economic opportunities for all diverse groups. The government will have to pay particular attention to make investment in connectivity. A network of roads can open up markets and enhance labour mobility. Availability of power can help in making investments in labour intensive agroprocessing industries. Creating tourism infrastructure in important places of tourist interest, including religious and adventure tourism can create employment, increase tax revenues and generate foreign exchange. In other words, it is important to put in place a comprehensive development strategy to complement institutional and governance reforms in the country.

It is assumed that the new constitution will provide tremendous forum to exercise and strengthen democracy in Nepal. However, in doing so, it is required to keep the interest of the people as paramount. At the end, one cannot help quoting Oates when he said (1999, p. 1145), "While the existing literature on fiscal federalism can provide some general guidance, …my sense is that most of us working in the field feel more than a little uneasy when proffering advice on many of the decisions that must be made on vertical fiscal and political structure. We have much to learn".

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An Overview of Federal Fiscal System in Nepal

Dr. Rup Khadka

1. Background

Nepal was transformed from a unitary system of government to a federal system after the promulgation of current constitution on September 20, 2015. The federal system has three tiers viz., central, provincial and local. The governments of all these layers have been bestowed with powers to carry out various functions in their respective areas. While some responsibilities are exclusively assigned to one level of government, others are assigned to different levels of government. For example, matters of national and international importance as national defense, foreign affairs, border control and immigration are assigned to the central government. Similarly, programs operated to stabilize the economy, such as large investment and social welfare programs are dealt with the central government. On the other hand, local governments will be responsible for locality-specific issues such as garbage collection, street cleaning, beautification of local areas and streets/ traffic lighting in their respective areas.

The governments of all the levels have been authorized to mobilize revenues to undertake their responsibilities. While taxes suitable for economic stabilization, progressive/ redistributive taxes and tax bases distributed highly unequally between jurisdictions are assigned to the central government, taxes that have bases with low mobility between jurisdictions and cyclically stable taxes are assigned to the subnational governments. On the other hand, both the central and lower level governments are given authority to generate revenue from various non-tax sources.

The constitution also has made provision for different kinds of grants. Provincial governments will get grants from the central government while local governments will get grants from both the central and provincial governments. Both central and sub-national governments can also borrow money to finance deficits.

A National Natural Resources and Finance Commission will be set up to review and recommend measures relating to the distribution of revenue, including natural resources revenue among various levels of government, and grants from higher level to the lower level of government.

2. Expenditure Assignment

The Current Constitution has accorded varied expenditure responsibilities to the central, provincial and local governments. Some responsibilities have been fully delegated to the governments of one level while others remain as shared responsibilities. Annex-5 of the Constitution provides the exclusive powers of the central government while Annex-6 and Annex-8 include the list of exclusive powers of provincial and local governments, respectively.

As indicated in Annex 1, responsibilities of the issues of national and international importance, such as defense, foreign affairs, international trade, immigration and citizenship have rested with the central government. Moreover, the responsibilities of monetary policies, exchange policies and fiscal policies also lie with the central government. Exclusive responsibilities of provincial government include land management, maintaining records of land, mineral exploration and management, province-level electricity, irrigation and drinking water supply service, transportation, trade within the province, provincial universities, higher education, libraries and museums. The main exclusive responsibilities of local governments involve activities related to basic health, sanitation, local market management, local road, rural road, agriculture road, irrigation etc.

Shared responsibilities of the government of different levels have also been prescribed in the Constitution. Annex-7 of the Constitution provides concurrent powers of the central and provincial governments while the list of concurrent powers of the central, provincial and local governments has been given in Annex-9. Concurrent powers of the governments of different levels are reproduced in Annex 2. As mentioned in this Annex, the concurrent powers of the central, provincial and local governments include education, sports, newspapers/magazines, health, agriculture, cooperative, electricity, irrigation, mines and minerals, disaster management, social security and poverty alleviation, squatter management, personal incidents, birth, death, marriage and statistics, archaeology, and tourism, drinking water supply, sanitation, and motor vehicle licensing centre. Similarly, tourism, drinking water supply, sanitation, law relating to family affairs, property acquisition, land acquisition and rights over it, planning, family planning and population management, social security and employment, functions relating to rights of laborers and labor disputes, poverty alleviation and industrialization, casino, lottery, motion pictures, cinema hall, sports, scientific research, development of science and technology and human resources, forests, mountains, forest conservation areas spreading inter-provinces, water use, land policies and laws relating to thereof, employment, unemployment assistance etc. fall under the concurrent powers of the central and provincial governments. Concurrent powers of the government of different levels are provided in Annex 2.

While various responsibilities are included in the concurrent list, it is not clearly stated as to what activities should be carried by what levels of government. It needs to be made clear by laws. In general, the central government should be made responsible for the determination of overall policies and standards. The responsibility of provincial governments should be to conduct oversight over the implementation of these policies while local governments will be obliged to provide services. For example, it is expedient to formulate plans of welfare programs at the central level, but as the government of central level cannot rightly identify the beneficiaries of the welfare programs, it is appropriate to implement them at the local level. In the field of education, central government can better manage educational standards and curriculum development on educational affairs while provincial governments can handle higher education properly. Similarly, local governments can deal with primary education more efficiently. On road affairs, central government can manage inter-provincial road networks whilst provincial governments and local government can manage the roads under their respective responsibility areas.

A clear borderline need to be drawn in relation to the powers and responsibilities of the governments of different levels so as to determine what works should be done by whom and how to bear the costs. Or else, it is likely to create confusion over the roles of different levels of governments, prompt them to pass one's responsibility onto another, cause duplication of works, and increase cost unnecessarily. Therefore, provisions should be made in such a way to promote efficiency and accountability by mentioning clearly the responsibilities of each level.

3. Revenue Assignment

The current Constitution has conferred the governments of different level powers to mobilize revenue from various tax and non-tax sources (Annex 3). As customs duty is levied on the goods exported and imported via the border of the country, it is naturally a subject within the jurisdiction of the central government. On the ground of economic and administrative efficiency, it's better to levy VAT, excise duties and income tax at the central level. This is also supported by the international common practices. The Constitution of Nepal has also adopted these norms. Taxes like house/land registration fee and motor vehicle tax have been listed under the jurisdiction of the provincial governments while the powers to collect land revenue/land tax and property tax lie with the local governments.

Authorities provided to the various levels of government to mobilize the tax and non-tax revenue under the current constitution are provided in annex 3 :

The Constitution has also made a provision that any level of government may impose any tax as fixed by the federal law. There is a need to streamline some revenue powers granted to various levels of governments. For example, as remuneration tax is a part of the individual income tax to be levied by the central government, it is not necessary to mention it as a separate tax. Both the provincial and local governments are authorized to levy house/land registration fee, motor vehicle tax, entertainment tax and advertisement tax. As it is not appropriate to impose the same taxes at two levels, it is better to make the provisions of levying the first two taxes at the provincial level and last two taxes at the local level. Generally, the responsibility of managing the land and motor vehicles rests with the provincial governments in the federal system around the world. Therefore, the provincial governments may levy house/land registration fee and motor vehicle tax while entertainment tax and advertisement tax may be imposed by the local government. Other alternatives may be that these taxes could be developed as shared taxes or collection of tax of one level by another level or to be imposed as surcharges. Further, taxes such as presumptive tax, stamp duties and tax on gambling/lottery/casino can be added to the provincial list while tax on boats, cable car, bullock carts, *tanga* (pony carriage) and animals and parking charges can be included in the list of local taxes.

With respect to non-taxes, the Constitution has mentioned passport fee, visa fee, tourism fee, service charge and fines as non-tax sources. There is a need to include many other sources, along with income obtained from property, income obtained from the sales of goods and services, and other capital revenues, as the non-tax sources of revenue of the various levels of government.

4. Inter-Governmental Fiscal Transfers

Inter-governmental transfers are received in the form of revenue sharing and grants. While the Constitution has made a provision of conditional, complementary, equalization and special grants, it has not stipulated the provision of unconditional grants, which is also known as Block Grant. As such a grant does not come with string and boosts the fiscal autonomy of grant receiving governments; it needs to be included in the list of grants.

Equalization grants play an important role in reducing fiscal disparity under the federal system. This grant is provided to those provinces whose tax base is lower than the national average, but the expenditure need is higher than the national average. That is to say that the central government provides the equalization grant to resource poor provinces/local levels. In some countries, such grants are also provided by resource rich provinces/local levels to their resource poor counterparts.

The constitution has not made clear provision relating to the revenue sharing, which is an important element of the federal fiscal system. Under the revenue sharing, revenue collected from specified taxes is divided between two or more than two levels of government. The share of the central government is deposited to the central consolidated fund while the share of the provinces is deposited in the divisible pool and is divided between the provincial governments on the basis of specified formulae. While this is generally not common to share revenue between central and local governments, there are practices in a few countries.

The revenue authority entrusted to subnational governments seems not to be following the functional assignments provisioned to them. Hence, it can lead to the significant fiscal deficit of subnational governments. To minimize this deficit, VAT and excise duty may be used as a shared tax and revenue collected from these taxes be divided among the center and the provinces. The central government's share of revenue, obtained from these taxes, has to be deposited in its consolidated fund while the share of provincial government be deposited into the divisible Pool of the province and be divided among the provincial governments on the basis of definite principles/formulas. The provision of this kind will help the provincial governments to obtain the share of revenue collected from VAT and excise duty in a transparent manner. This will also make it easy for the provincial governments to prepare the provincial budget as per the requirement of their respective provinces.

5. Loans

The Constitution has authorized the central, provincial and local governments to receive the loans. The central government may receive both the internal and external loans. While obtaining a foreign loan, provision has it that the loan should be obtained in a manner to maintain macroeconomic stability of the country. Provincial and local government may obtain loans under the central laws only. Provincial and local government may obtain an internal loan only and are not permitted to obtain a foreign loan.

There is a tendency, in comparison to the central government, among the provincial and local governments to impose less tax, obtain more loan and make more expenditure. As the central government may bail out them when they face financial crisis, they are tempted to obtain more loan. Soft budget constraints and inter-provincial competitions worsen the problem of moral hazard. It is, therefore, necessary to develop clear legal provisions relating to the loan to be obtained by the governments of different levels, taking into consideration the principles and international best practice related to loans.

6. National Natural Resources and Finance Commission

There is a practice of forming a fiscal commission in federalism to review the issues concerning the fiscal allocation and recommend reform measures thereto. Fiscal commission makes recommendations on detailed basis and mechanism for revenue sharing between the governments of different level, grants to be provided by the governments of higher level to the governments of lower level or by the resource rich governments to their resource poor counterparts and obtaining loan by the governments of different level.

The constitution of federal Nepal has provisioned a National Natural Resources and Finance Commission consisting of a chairperson and members not exceeding five in number. Its tenure is fixed as six years and main responsibilities are: to determine basis and mechanism regarding the distribution of revenue from the central consolidated fund to the federal, provincial and local level of government, make recommendations on distribution of grants to the provincial and local governments, make recommendations regarding the measures of reforms on responsibilities of expenditures and revenue generation, make recommendations about the ceiling on internal loans the government of different levels may take and make suggestions on distribution of natural resources.

7. Conclusion

Nepal has been transformed into a federal system. It is time now to formulate and implement an appropriate federal fiscal system for an effective execution of the federal system. The federal fiscal system encompasses the issues relating to income and expenditure of the government of different levels, which are complex and important issues of day-to-day concern.

The tentative layout of the federal fiscal system has been provided in the Constitution, which needs to be further developed by the federal fiscal laws. It is required to enact laws such as federal fiscal arrangement act, model provincial revenue act, model local revenue act and finance commission act. Similarly, there is a need to develop and implement agreements/memorandum of understanding (MoU) to be entered into between the central and provincial or provincial and provincial or provincial and local or local and local governments relating, particularly, to revenues. These laws, agreements and MoUs will not only make the federal fiscal system clearer and more transparent, but bring about uniformity, coordination and harmony in the overall fiscal system of the country too.

A provision of classifying revenue, expenditure and accounting/recording system on a single basis at the central, provincial and local levels should be made. It is also necessary to establish a system of reporting of income and expenditure of various levels of government to the Ministry of Finance/Federal Affairs and Local Development regularly on a single basis.

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Annex 1: Division of expenditure responsibilities among the governments of Various Levels

Central Level	Provincial Level	Local Level
• Defense, army, war and defense • Arms and ammunition • Police, secret service, investigation and peace/security • Foreign affairs • International treaties, polices and borders • International trade, exchange, port and quarantine • Citizenship, passport, visa and immigration • Central planning, central bank, currency, banking, monetary policy, foreign assistance and loan • Environment, carbon service, national parks, wildlife reserves and wetland areas • Nuclear energy, atmosphere and space • Transnational and inter-provincial electricity transmission lines • Air flight and international airports • Telecommunications, transmission and postal service • Social security and poverty alleviation • Insurance policy, securities, and regulation of cooperatives • Conservation of water resources, policies and standards relating to multidimensional use • Large electricity, irrigation and other projects of central level • Mine excavation • Land use policy, settlement development policy, and tourism policy • National transportation policy, management of railway and national highways • Intellectual property • Standard and metrology • Security press • Places of archaeological importance and ancient monuments • Central university, academy of central level, university standards and regulation, central library • Health policy, health service, health standards, quality and monitoring, specialized service providing hospital, traditional treatment service, control of communicable diseases • Central statistics • Federal Parliament, Federal Executive, affairs relating to local levels, special structures • Supreme/Higher/District courts and laws relating to the judiciary • Federal civil service, judiciary service and other government services • Constitutional bodies, commissions of national importance • Formulation of criminal and civil laws	• Provincial police administration and peace/security • Operation of financial institutions in compliance with the policies of Nepal Rastra Bank • Co-operative organizations, foreign assistance and grants at the consent of the center • Operation of radio, FM, television stations • Provincial civil service and other government services • Provincial statistics • Electricity, irrigation and drinking water supply and transportation of province level • Provincial university, higher education, library, museum • Health services • Provincial Assembly, Provincial Council of Minister • Trade within the province • Provincial highway • Provincial Investigation Bureau • Physical management of provincial government offices and other necessary issues • Provincial Public Service Commission • Land management, maintaining records of land • Mineral exploration and management • Protection and use of language, script, culture, fine arts and religions • Use of national forest and water resources and environment management within the province • Agriculture and livestock development, factories, industrialization, trade • Management of business, transportation and trust	• Municipal police • Cooperative organizations • FM operation • Management of local services • Maintaining local statistics and records • Development projects of local level • Basic and secondary education • Basic health and sanitation • Management of local market, environment protection and bio-diversity • Local roads, rural roads, agriculture roads, irrigation • Village Assembly, Municipal Assembly, District Assembly, local court, management of reconciliation and arbitration • Management of local records • Distribution of house/land ownership certificates • Agriculture and animal husbandry, management of agricultural products, veterinary, cooperatives • Management of senior citizens, persons with disabilities and incapacitated persons • Data collection of unemployment • Management, operation and control of agricultural expansion • Drinking water, micro hydroelectricity project, alternative energy • Disaster management • Conservation of watershed, wildlife, mines and minerals, protection and development of language, culture and fine arts

Source: The Constitution of Nepal, 2015

Annex 2: List of concurrent powers of governments of different level

List of concurrent powers of federal and provincial levels	List of concurrent powers of federal, provincial and local levels
• Tourism, drinking water and sanitation • Medicines and pesticides • Preventive detention with respect to the security issues of the country, prison and custody management and arrangements of peace/security • Transfer of accused, inmates and prisoners from one province to another • Laws relating to family affairs • Property and land acquisition and rights over them • Relating to contract, partnership and agency • Relating to bankruptcy and insolvency • Planning, family planning and population management • Social security and employment, settlement of industrial disputes, functions relating to rights, interests of laborers and labor disputes • Poverty alleviation and industrialization • Legal service, audit, engineering, medicines, Ayurveda medicines, veterinary, *amchi*(traditional Tibetan medical practitioner) and other professions • Provincial border, river, waterway, environment protection, bio-diversity • Relating to media • Industries and minerals and physical infrastructure • Casino, lottery • Natural and non-natural disaster preparedness, rescue and relief and recovery • Motion picture, cinema hall, sports • Operation and management of insurance business • Scientific research, science technology and human resource development • Forests, mountains, forest conservation areas, water use spreading to inter-provinces • Land policies and laws relating to thereof • Employment and unemployment assistance • Criminal and civil procedures, and evidences and oath • Supply, distribution, price control, quality and monitoring of essential goods and service	• Education, sports and newspapers/ magazines • Health • Services like electricity, drinking water, irrigation etc. • Forest, wildlife, birds, water use, environment, ecosystem and bio-diversity • Agriculture • Cooperatives • Mines and minerals • Disaster management • Social security and poverty alleviation • Squatter management • Personal incidents, birth, death, marriage and statistics • Archaeology, ancient monuments and museums • Royalty collected from natural resources • Motor vehicle licensing

Source: The Constitution of Nepal, 2015

Annex 3: Revenue assignment among various levels of governments

Central	Provincial	Local
• Customs duties • Excise duties • Value Added Tax • Corporate income tax • Personal income tax • Remuneration tax • Passport fee • Visa fee • Tourism fee • Service charge • Fines	• House/land registration fee • Motor vehicle tax • Entertainment tax • Advertisement tax • Tourism fee • Agriculture income tax • Service charge • Fines	• House/land registration fee • Motor vehicle tax • Entertainment tax • Advertisement tax • Property tax • House rent tax • Service charge • Tourism fee • Business tax • Land revenue/land tax • Fines

Source: The Constitution of Nepal, 2015

Practice of Financial Decentralization in Nepal and Its Lessons for Fiscal Federalism

Purusottam Nepal[1]

1. Introduction

Decentralization has been a world-wide trend towards improving governance system and service delivery in recent years. Many countries have implemented devolution of governance system and administrative, political and fiscal responsibilities to lower levels of government, both under unitary and federal political system. On the political side, local governments (LGs) are being made responsive and accountable to their local residents through a system of elected local representatives. On the administrative side, LGs are empowered with authorities and responsibilities for planning, budgeting and delivery of public services at local level, along with opportunities for active participation of citizens in the governance process through participatory planning, budgeting, monitoring and social audit systems. On the fiscal side, LGs are supplied with such fiscal framework that includes all four pillars of fiscal decentralization: expenditure responsibilities, revenue raising power, access to intergovernmental transfers, and options for local borrowing.

The trend towards decentralisation can be observed in the countries with federal as well as unitary systems, and across the developing as well as developed countries. The ongoing decentralization reforms are focusing on improvement of public service efficiency, promotion of local democracy, enhancing equitable distribution of resources and confirming the more accountable and responsive governance (Kelly, 2011). By bringing key public expenditure decisions closer to the people, through the process of decentralization, governments are attempting to empower communities for their active participation in the prioritization, implementation and monitoring

1 Mr. Nepal is the Joint Secretary of Government of Nepal. He is currently working as Member Secretary in Local Body Fiscal Commission.

of government expenditures so as to encourage more efficient, accountable and transparent public resource management.

Nepal is undergoing the process of restructuring reform and moving towards a federal governance structure in order to enhance good governance and improve public service delivery. This restructuring process includes a combination of political, administrative and fiscal components in order to ensure a comprehensive, holistic, and integrated governance framework. After the agreement between then seven political parties and radical Communist party- then CPN (Maoist)- through the historic Peace Accord, 2006, the election to the constitutional assembly was held in 2008 to structure and promulgate a federal and inclusive constitution. However, the Constitution Assembly (CA) -I could not produce a consensus on promulgation of a new constitution and ended its extended tenures leaving this main responsibility for the future. Subsequently, the Constitution Assembly-II elected in 2013 has promulgated a federal democratic constitution in September 2015 with the provision of three levels of government: Federal, Provincial and Local.

The new constitution has made provisions to follow the principles of democratic governance and devolution, and has assigned the functions and responsibilities to all three levels of governments, along with the various transitional legal arrangements. This paper, using a simple descriptive approach, tries to highlight the existing practice of local government finance and its constraints, which can provide the background in the process of organising the federal set up ahead.

2. Decentralization in Nepal

The existing practice of decentralization in Nepal is based on the unitary governance system, administrative structure, socio-cultural condition of the country and its past experiences. Nepal has been undertaking the practice of participatory local self-governance, basically, since the promulgation of the Local Self Governance Act (LSGA), 1999, which was carried out a decade later after the restoration of democracy in 1990. However, the participatory democracy at local level has been deteriorating since last one and half decade because of absence of elected representatives in local bodies. All LGs are being operated without a political mandate – essentially under the leadership of government staff. Though the government is committed to hold local election in this year and has approved the work plan and budget for local election and the leading political parties are also showing their interest in favor of holding local elections after restructuring the local government units, there is no certainty of election due to political instability caused due to frequent change of government. Moreover, due to disagreements of some political parties and controversies among political parties about holding the election either before or after restructuring the local units, there is limited possibility of election being held in accordance with the work plan proposed by former government.

The current local government structure is provisioned in the Local Self Governance Act (LSGA), 1999. The LSGA along with its regulations, has laid the legal basis for current local government structure and has defined the expenditure and revenue responsibilities to LBs. It has also provided the foundations for strong local autonomy in planning and budgeting.[2]

3. Expenditure Assignment of Local Governments (LGs)

Fiscal decentralization begins with the clear allocation of expenditure responsibilities across levels of governments. Principally, the assignment of functions should be based on the principle of subsidiarity, which states that government service provision should be undertaken at the lowest level of government and should be able to capture the full economic costs and benefits of those services. Efficient economic decisions can then be achieved when a decision is based on a full "correspondence" between the economic costs and benefits of delivering a service (Oates, 2005).

One of the most important preconditions for a successful fiscal federalism is clarity in the assignment system. Clarity in assignments does not imply merely the assignment of revenue and expenditure powers, but also needs to ensure that the functions of different functionaries within a level are unambiguous. In a democratic polity, the elected representatives should be responsible for making expenditure decision and bureaucrats for its implementation. However, this principle has been derailed in case of LGs in Nepal because of the armed conflict at the beginning and the inefficient transitional management thereafter.

In Nepal, the formal assignment of expenditure responsibilities to the different levels of LGs has been provisioned in the LSGA, firstly. Table 1 gives a snapshot of the expenditure assignments to different tiers of local governments in Nepal.

Table 1: Functions of LBs according to LSGA, 1999.

Village Development Committee	Municipality	District Development Committee
a) Agriculture	a) Finance	a) Agriculture
b) Rural water supply	b) Physical development	b) Rural water supply and settlement
c) Works and transport	c) Water resources	c) Hydropower
d) Education and sports	d) Education and sports	d) Works and transport
e) Irrigation, soil erosion and river control	e) Culture	e) Land reform and management

2 LSGA and regulations can be downloaded in English and Nepali at http://www.mld.gov.np/local_development_act_1999.htm

Village Development Committee	Municipality	District Development Committee
f) Physical development	f) Works and transport	f) Women's development and handicapped
g) Health services	g) Health services	g) Forest and environment
h) Forest and environment	h) Social welfare	h) Education and sports
i) Language and culture	i) Industry and tourism	i) Labour wage
j) Tourism and cottage industry	j) Approval of building design	j) Irrigation, soil erosion and river control
k) Miscellaneous	k) Miscellaneous	k) Information and communication
	Optional works	l) Language and culture
		m) Cottage industries
		n) Health services
		o) Tourism
		p) Miscellaneous

***Source*: LSGA, 1999.**

Though the functional assignment provisioned in LSGA is a good initiative, the functions provisioned in LSGA are mostly vague and leading to some confusion. And these functions also overlap with functions between tiers of local governments and with the central government through sectoral Acts and legislations. There are lots of concurrency in the functions allocated to the three types of LBs. There has been little attempt to undertake a functional analysis to further clarify these expenditure responsibilities and to resolve the inherent conflict between the central and local bodies as well as between the LBs themselves (Kelly, 2011). There are 23 "sector laws" conflicting with the LSGA that continue to lead to duplication in expenditure assignment (LBFC, 2001).

New constitution of Nepal, 2015 has also provisioned the functional authorities of different levels of government in its annexes: Annex 5, 6, 7, 8 and 9 (power of federation, the power of a province, concurrent power of the federation and the province, the power of local level and concurrent power of all levels of governments, respectively). Appendix, Table 1 provides the glimpse of expenditure responsibilities to across levels of governments under the new federal system in Nepal (Constitution of Nepal, 2015)

According to the new constitution, authorities related to defence, foreign affairs, currency and monetary policy, international trade, customs, foreign debt, air transport are exclusively provided to the central (federal) government. Likewise, security forces, large programs/projects of central level, central education and health policies and institutions, functions related to nuclear energy and space affairs, immigrations, metrology are also the competencies falling under the central government only. Federal legislative, executive and judicial affairs and structures; national development policy, all the constitutional and national commissions, national forests, parks and wildlife reserves and policies there of, intellectual property rights etc., also are authorized to the centre (for detail, see annex 5, Constitution of Nepal, 2015).

Annex 6 of the new constitution of Nepal has provisioned the list of functions allocated to provinces. According to this, the provinces are authorized to manage the police security, government services, statistics, infrastructures, educational and health services, land management, natural resource management, trade and business, banking services etc. at province level. However, the authorities concurrent between federation and province provisioned in Annex 7 are: criminal and civil legal procedures, jail management; supply and price control; related to national security; framing the family law; professional regulations; industry, mines and physical infrastructure; interprovincial use of natural resources; land use policy; science and technology; insurance and social security; employment, poverty alleviation, communication etc.

Authorities, like, managing local security and local court; local services; basic and secondary education, basic health and agricultural services; local physical infrastructures; small hydro and disaster management, natural resource conservation; house, land and vehicle registration and land ownership certificate distribution; managing local record and statistics, local programs/projects; cooperatives; managing senior citizen and disables; etc. are listed under the jurisdiction of the local level as mentioned in the annex 8 of the new constitution. Annex 9 proposes the concurrent authorities of federation, provincial and local level. Under this, area such as cooperatives; services like education, health, agriculture, electricity, drinking water, irrigation etc.; natural resource and disaster management; keeping personal records; social security, poverty alleviation and squatter management etc. are provisioned to all three levels of government.

There is a need for clarity among the power and responsibilities of different level of government provided in the concurrent lists and the individual lists. Otherwise, it may create confusion and cause disputes among the levels of governments. Likewise, probability of duplication of assignments may lead to ambiguity and corruption during execution.

4. Revenue Assignments to Local Governments (LGs)

Another important implementation rule of fiscal decentralization is the clear revenue assignment that eases financially the effective implementation of functional responsibilities (Bahl, 2002). Principally, finances should follow the functions so that the sub-national governments can vary the public services across jurisdictions, according to the preferences of the people by varying taxes levied on them. Revenue assignment is necessary for a strong link between the decision to spend and the decision of raising revenues to finance the spending that imparts greater efficiency and accountability in public service provision. A critical factor in improving fiscal autonomy of local bodies is to enhance their own source revenues, which is extremely important to promote both efficiency and accountability in the service provision (Kelly, 2011). The main components of own source revenue of LGs are: tax revenue (from local taxes authorized to LGs) and non-tax revenue (from service charges, fees and fine, and sales). However, LGs receive fund from general and specific purpose grants, revenue sharing and local borrowing. Though LGs are provided with the authority to collect local taxes, most of the tax policies of the LGs are dictated by the central government. LGs have very little role in determining the tax bases and tax rates, which they are authorized to tax.

LSGA has made a provision of tax, fees, and some other sources as the revenue instruments for the local governments as given in the Table 2. .

Table 2: The revenue instruments of local governments (LGs) of Nepal

Resource	DDC	VDCs	Municipalities
	Internal Sources		
1. Tax	– 5 indirect tax sources and 25 percent shared land tax from VDC and Municipalities	– 11 direct local tax sources	– 9 direct tax sources
2. Service charge	– Service charges of different services provided by it.	– Service charges of different services provided by it.	– Service charges of different services provided by it.
3. Fee	– Fees for regulatory services provided by DDC	– Fees for regulatory services provided by VDC	– Fees for regulatory services provided by Municipality
4. Sales	– Sales of different natural and other resources	– Sales of different natural and other resources	– Sales of different resources
5.Income generating activities	– Rent, interest, sales of movable and immovable assets, other income generating activities	– Rent, interest, sales of movable and immovable assets, other income generating activities	– Rent, interest, sales of movable and immovable assets, other income generating activities
6. Users contribution	– As per the agreement with Users Committee	– As per the agreement with Users Committee	– As per the agreement with Users Committee

Resource	DDC	VDCs	Municipalities
	Internal Sources		
	External Sources		
1. Loan	– Borrowing from banks or other institutions with or without collateral with approval from the District Council	– Loans from bank or other institution with approval from Council, with or without collateral and on government guarantee	– Loans from bank or other institution, with approval from Council, with or without collateral and on government guarantee
2. Revenue sharing on a derivative basis	– Land registration (5 to 90 percent) – Mine (50%), Forestry (10%), Hydro Power (50%), and other natural resources (30%) – Tourist entrance fee in national parks and hunting reserves (30%) – Mountaineering royalty (30%) – Tourist entrance fee in the district (30%)	– 35 to 90 percent of DDC tax and sales revenue on derivative basis	– 35 to 90 percent of DDC tax and sales revenue
3. Grants	– Minimum – Additional (Conditional and unconditional) – Conditional formula based (HDI-25%, Population-40%, Area-10% and Cost –25%) – Sector Grant (sector devolution)	– Minimum – Additional (Conditional and unconditional) – Conditional formula based (Population-60%, Area-10% and Cost –30%) – DDC Grant	– Minimum – Additional (Conditional and unconditional) – Conditional formula based (poverty 25%, Population 50%, Area-10% and tax efforts 15% – DDC Grant – Local Development Fee shared to all municipalities now provided as a grant

***Source*: LSGA, 1999 and LSGR, 1999.**

The newly promulgated federal constitution has clearly spelled about the revenue sources assigned to all levels of governments. Table 2 of appendix gives the details of revenue sources allocated to federal, provincial and local level of government.

The allocation of revenue sources to different levels of government is made through a constitutional provision to limit the discretion of any authorities of the central government (federation) in the government days to come. It is perhaps a definite legal authority and can help to lead toward the smooth and successful implementation of federalism. The allocation of revenue sources is in accordance with the international practices. The allocation is based on nature of tax sources, administrative feasibility and efficiency, controlling capacity, stake of local citizens, and volume of mobilization. The custom duty, corporate and personal income tax, regulatory taxes, passport and visa fee, are under the central jurisdiction. Similarly, ownership transfer of property, agriculture tax, tourism tax, entertainment tax and advertisement tax are under the provincial jurisdiction. More stable and administratively easier revenue sources such as land tax, property tax, entertainment tax, vehicle tax, house rent tax, professional tax are assigned under local jurisdiction.

There are some sources listed under both provincial and local jurisdictions, which needs to unbundle and re-allocate among them. The revenue sources mentioned in concurrent list are required to unbundle, and be allocated to federal, provincial and local level separately through federal law. The major sources under this list are natural resource royalty and registration of different activities under all sectors such as business registration, arms registration, educational and health facility registration, casino and recreation activity registration and others.

5. Intergovernmental Fiscal Transfer

The intergovernmental fiscal transfer is a third requisite for the success of fiscal decentralization. This is the mechanism of transfer of funds from higher levels of government to the lower levels of government. It includes revenue sharing, grants in aid, subsidies and expenses for specific purposes. Decentralized finance in most of the countries is heavily dominated by intergovernmental transfers/shared taxes. Intergovernmental transfers/shared taxes are structured to address the vertical and the horizontal fiscal imbalance between the levels of government.

The LSGA provides a system of intergovernmental fiscal transfers to channel the resources needed to the LBs. The central government provides with a minimum grant to LBs, each year. Likewise, an additional grant is also provided on the basis of factors such as population, development level, fiscal capacity, financial management and discipline. However, the transfers are not sufficiently transparent, predictable, stable and equitable and hence losing the character of good transfer system (Panta, 2015). Moreover, the Act does not spell out the character and category of the grants hence the details are left for subsequent regulations, allowing flexibility to design and implement appropriate block and categorical grants, formula(s) and channeling mechanisms to deal with the vertical and horizontal equity and efficiency issues (Kelly, 2011).

a. Vertical and Horizontal Imbalance and the Local Grants

Vertical fiscal imbalance is the situation where the assigned revenue raising power is unable to raise required resources to equilibrate the expenditure responsibilities assigned to each subnational government. The statistical information about the vertical imbalance is given in Table 3.

Table 3: Aggregate vertical imbalances in Nepal (2011/12 - 2014/15)

Revenue and Expenditure	FY 2011/12		FY 2012/13		FY 2013/14		FY 2014/15	
	Rev.	Exp.	Rev.	Exp.	Rev.	Exp.	Rev.	Exp.
Of Central Government	97.24	88.47	97.60	91.72	97.63	91.66	97.58	92.92
Of Local Government	2.76	11.53	2.40	8.28	2.37	8.34	2.42	7.08
Total public revenue and expenditure	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: **Economic Survey, 2015/16.**

The horizontal fiscal imbalance is the asymmetry between expenditure responsibilities and fiscal capacity of subnational government to undertake the assigned expenditure responsibilities across the same level of governments. Table 4 below reflects the trend of aggregate horizontal fiscal imbalances in Nepal, regarding the case of local governments, namely, municipalities in particular.

Table 4: Horizontal fiscal imbalance in municipalities of Nepal 2008/09 (Rs.)

Measures of Variation	Per Capita Total Revenue	Per Capita Own Source Revenue	Per Capita Capital Expenditure
Average	1742.66	658.10	910.95
Minimum	254.35	230.14	234.07
Maximum	3887.40	1702.90	1981.96
Standard Deviation	630.55	382.05	394.33
Coefficient of Variation	36.18	58.05	43.29

Source: **Panta, 2015.**

As stated above, to overcome this resource gap (vertical and horizontal fiscal imbalance), the central government provides the grants to the subnational governments. LGs in Nepal are receiving a minimum grant as per the LSGA, as well as, recurrent grants to pay for the salary and allowances of employees and to meet minimal operational expenditures of LBs. Most of the transfers are structured as categorical grants, leaving minimal discretionary power to LBs to allocate for the projects of local priorities. With the exception of the capital block grant based on

MCPM system, most financial resources come with strong CG directives. However, there is no fixed divisible pool in order to determine the amount to be transferred to LBs. A lump sum amount is fixed each year on an ad-hoc basis, taking the previous year's grant as the minimum grant.

Though there is no formula to determine the divisible pool, the Government of Nepal (GoN) began providing block grants to DDC, VDCs and municipalities in the early nineties without any pre-defined criteria. Over time, these have been increased and the pooled amount is allocated to the LBs in accordance with the formula given in table 5 below.

Table 5: Basis of formula for grants to local bodies (LBs)

Local Bodies	Population	Area	Poverty	Cost	Tax efforts
DDC	40%	10%	25%	25%	
Municipality	50%	10%	25%		15%
VDC	60%	10%		30%	

Source: Local Resource Mobilization and Management Guideline, 2069

Similarly, the provision of municipal development grant only for the municipalities having own source revenue less than 10 million rupees and on the basis of population and area shows the efforts of the central government to minimize the horizontal fiscal imbalance among the municipalities.

b. Minimum Condition and Performance Measure (MCPM) and the Local Grants

Furthermore, some part of the general block grant and the topping up grants are subject to minimum conditions and performance measures (MC/PMs). These cover several conditions categorized into broad areas of activity and performance (Table 6). Each year, evaluation of each LG's performance of the preceding year against these conditions and measures is assessed, and the results are used to decide the additional grants to be provided for the succeeding financial year[3].

3 Thus assessments were done in 2014/15 of the performance in 2013/14. This assessment influenced the release of topping up grants in 2015/16.

Table 6: Minimum Condition and Performance Measure (MCPM) criteria

District Development Committees		Municipalities		Village Development Committees	
MC (9)	**PM (46)**	**MC (10)**	**PM (40)**	**MC (7)**	**PM (13)**
Planning and Management (4)	Planning and Budgeting (8)	Planning and Management (5)	Planning and Programme Management (8)	Planning and Management (3)	Planning and Management (2)
Financial Management (4)	Fiscal resource mobilization capacity (11)	Financial Management (3)	Financial Management (11)	Financial Management (3)	Financial Management (4)
	Budget release and programme execution (6)				
Transparency (1)	M&E, Communication and Transparency (12)	Service delivery and transparency (2)	Local Self Governance (8)		Transparency and Accountability (4)
	Organisations, service delivery, property management (9)		Organisations, and human resource development (5)		Inclusive Development (1)
			Urban Basic Service management (8)	Social security distribution (1)	Social security and Vital Event Registration (2)

***Source*: Compiled from MCPM guidelines and reports, LBFC, 2012.**

c. Comparative Local Expenditure and the Local Grants

A comparision of revenue and expenditure between the national government and local government shows that the central revenue has an increasing trend each year compared to gross domestic product (GDP) and increased from 16 percent to 19.14 percent in four years. Whereas, local revenue does not follow this trend, it is fluctuating each year, and less than 0.5 percent compared to GDP. Similarly, the central government grants to local bodies also decreasing, which reflect the unpredictable situation of resources at local level. The rudimentary picture of local public sector finances is captured by Table 7. Furthermore, the grants cover almost 90 percent of local expenditures.

Table 7: Comparative public sector finances at central and local level in Nepal

	FY 2011/12		FY 2012/13		FY 2013/14		FY 2014/15	
Description	Amount (Rs.)	As % of GDP	Amount (Rs.)	As % of GDP	Amount (Rs.)	As % of GDP	Amount (Rs.)	As % of GDP
GDP	152734.40		169264.30		194162.40		212047.00	
CG Grants to LGs	4416.05	2.89	3181.93	1.88	3826.52	1.97	3829.23	1.81
CG Revenue	24437.40	16.00	29602.11	17.49	35662.07	18.37	40586.64	19.14
LG Internal Revenue	693.93	0.45	729.29	0.43	865.93	0.45	1006	0.47
Total Revenue	25131.33	16.45	30331.40	17.92	36528.00	18.81	41592.64	19.61
CG. Expenditure	33916.70	22.21	35863.80	21.19	46505.00	23.95	53155.00	25.07
LG Expenditure	4419.67	2.89	3237.60	1.91	4229.53	2.18	4048.11	1.91
Total Expenditure	38336.37	25.10	39101.40	23.10	50734.53	26.13	57203.11	26.98

Source: Economic Survey, 2015/16, Ministry of Finance, Nepal.

6. Local Borrowings

Local borrowing is the fourth pillar of fiscal decentralization. An adequate local government borrowing policy framework is needed for short term cash management and to fund longer-term capital investments. Effective local level debt financing can encourage local economic development, fiscal discipline, and revenue mobilization. Prudent demand-driven borrowing can play an important role in public finance. However, irresponsible, unaccountable borrowing can lead to macroeconomic instability.

The LSGA (Section 59, 119 and 148) empowers LBs to borrow from banks or financial institutions by pledging property or under the guarantee of the Government of Nepal (GON). If they borrow by pledging their property to the financial institution as the law stands, they do not need prior approval of GON to borrow money from within the country. The provisions do not explicitly allow for the free floating of bonds in the market and there are no specific provisions to borrow for short term cash management. The provision of borrowing has been used only for long term capital projects. Except the cases of few Municipalities, borrowing from commercial banks or from the market is not observed in practice in the case of local bodies of Nepal.

According to LBFC, 33 municipalities have exercised this right, largely borrowing from the Town Development Fund (TDF) and international lending agencies like Asian Development Banks (ADB).

7. Challenges and Constraints in LSGA Implementation

Despite high expectations and best intentions, the LSGA legal framework has been facing a number of constraints and challenges leading to a slowdown in the rolling out of the decentralization process. A large number of other laws which are identified as conflicting with the LSGA needs to be rationalized. Likewise, the bureaucratic rigidities to support the intended sectoral devolution; lack of clarity in some expenditure and revenue assignments with overlapping responsibilities, duplication and confusion; and local capacity and local resource constraints have affected the LG ability to absorb the mandated responsibilities.

Additionally, the political uncertainty during a period of intense internal conflict (2001- 2006) and during the constitution making period (2007-2015) led to the absence of local elections since 2002, leaving a void of elected local representatives which has significantly weakened downward accountability and decision making related to local priority setting, planning and budgeting and expenditure oversight. This lack of locally elected leaders has reduced downward political accountability, while the lack of other effective "voice" mechanisms has made it difficult for LBs to fully connect and be responsive to their residents (LBFC, 2001, Joint Donor Review, 2002; LBFC 2004; MLD, 2004; LBFC, 2005; and DASU, 2005).As an interim measure, the Ministry of Federal Affairs and Local Development (MoFALD) appointed the Local Development Officer, Executive Officer and the VDC secretary to serve as head of the DDC, Municipalities and VDCs respectively, thus allowing these officers to serve both the executive and the legislative functions. On the other hand, the centrally appointed administrative officers have extremely short tenure in the field due to frequent transfer. This change in administrative leadership makes it difficult to ensure systematic, accountable and sustainable planning and budgeting and to establish a good cooperation among the LBs as well as between the LBs and the line agencies. With the absence of locally elected peoples' representatives, the major expenditure decisions are being made with limited community consultation, largely influenced by local elites, administrative officers and/or representatives of the local political parties.

In principle, the LSGA provides a set of mandates to LBs on both the revenue and expenditure aspects, including a considerable discretion in planning and budgeting of those responsibilities. However, there is a lack of real discretion in the local budgetary process, both on the expenditure and the revenue side. On the revenue side, there is typically a lack of discretion to set the base and rates of own source revenue of LBs; while on the expenditure side there seems to be substantial central government influence/controls and guidance given to LBs leading to the limit in local level discretion.

There is a need of clarification of administrative officers and representatives of local political parties appointed by MoFALD on their role in decision-making, supervision and adjudication. However, officials of line agencies need socialization in facilitation, coordination, service delivery and monitoring. Similarly, the community groups and NGOs need socialization in social mobilization, implementation, supervisionand auditing of local public services. The ongoing uncertainty and confusion in the respective roles hinders the coordination and effectiveness of local governance.

As the political accountability structures emerge with the new elections, more discretion should be given to local governments to allow them to be more responsive and efficient in delivering local public goods and services. To achieve the efficiency gains which can be resulted from decentralization, Nepal needs to expand the discretion accompanied by improved accountability mechanisms. These accountability mechanisms ultimately require the locally-elected representatives to ensure political downward accountability, but also require other non-political accountability mechanisms such as stronger local level PFM regulations and capacity, broader and more effective local social participation in the various stages of the public expenditure management cycle.

Despite these major challenges, there was a general consensus that LBs have become able to initiate for providing the governance interface at the local level and playing a role in local economic development, though the experience varies considerably across LBs and over time. In general, LBs provide an accessible governance interface for local residents, facilitate communication, and create a sense of participation and ownership in the governance process. LSGA provides a framework for LBs to mobilize local priorities, along with the ever present challenge of ensuring broad local representation and avoiding elite capture. These LBs have been able to mobilize social capital for development, through facilitating various user groups for delivering, overseeing and monitoring local development activities. A number of lessons can be learned from these issues which may provide the guidance in framing the new laws following the new federal constitution.

8. Conclusion

Nepal is undertaking restructuring of the political, administrative and fiscal structure of units of governance system as a part of transition from unitary to federal rule. In this process, the past experience of decentralized governments and its shortcomings could be the point of take-off. As discussed in the paper, LSGA, 1999 is supposed as the milestone in the practice of decentralization. However, political instability and frequent change of government leading to the absence of elected representatives in LBs constrained the practice of decentralization and participatory democracy. Likewise, some of the expenditure assignments are unclear and created confusion and overlapping among the responsibilities of different level of government. The 23 sector laws contradicting with LSGA posed hindrances in decentralization process of Nepal. Though LSGA has assigned some authorities to LBs to raise the local revenue, limited authority in collecting taxes has led to fiscal imbalances (both vertical and horizontal) and fiscal dependency of LGs to the central grant. Similarly, local public finance is observed to be highly dominated by earmarked grant and delegated expenditure, leaving very low discretion to the LGs in expenditure decision.

Intergovernmental transfers that include the conditional and unconditional block grants, and revenue sharing seem not to be predictable, transparent, stable and equitable, though the formula based grants and MCPM criteria are adopted to decide the amount of grants to LBs for the later period. Hence, the revenue assignment of LGs is losing the character of a good tax system, good transfer system and finally a good revenue system. In Nepal, limited practice of local borrowing (which is a pillar of fiscal decentralization) is in practice (only in case of some municipalities).

A number of challenges are observed during the implementation of LSGA. Political instability and absence of elected local representatives; conflicting laws and limited authorities on expenditure and revenue assignments of LGs; bureaucratic hurdles and lack of socialization etc. are found hindering the downward accountability and efficient service delivery of LGs leaving the space for elite capture and corruption at local level. Nepal is all set to enact new laws and by-laws according to the new constitution. Hence, it is appropriate to learn from the lapses experienced during the practice of local governance and decentralization in the past.A learning from the lesons of the past can lead us to build an appropriate administrative, legal and fiscal structure of local government in a new federation that maintains both upward and downward accountability; and enhances effective and efficient local public service delivery.

Appendix

Table 1: Lists of the authorities allocated to the all levels of government provisioned in Constitution of Nepal, 2015.

SN	Federation	Province	Federation & Province	Local Level	Federation, Province and Local Level
1	Defense; War and Defense, Arms				
2	Internal Security	Police, law and order	Criminal and civil procedures; Jail and Custody	Police	
3	Communication	Radio, FM, television operation	Newspapers/ Magazines; Mass Communication; Movies, cinema halls	FM Operation	
4	Taxation	Taxation	Casino, Lottery	Local Taxation	Taxation, Royalty received from natural resources
5	National Economic Policy	Bank Operation	Supply, distribution, bankruptcy and insolvency	Management of local markets, environment conservation and biological diversity	
6	Public Administration	Civil service and other government service		Management of local services	
7	Water resources, Electricity	Electricity, irrigation, drinking water and transport	Water Resources and Biodiversity	Conservation of Watershed, wetland, wildlife, mines and minerals	Services like electricity, drinking water, irrigation
8	Statistics	Statistics	Planning,	Local statistics and record keeping	Cooperatives
9	Mega Projects	Infrastructure management		Local development projects and programs	Disaster management
10	University	University	Land policy and related legal provisions	Basic and secondary education	Education, and sports

SN	Federation	Province	Federation & Province	Local Level	Federation, Province and Local Level
11	Health Policy	Health	Medicine and pesticides; family planning and population management	Basic health and sanitation	Health
12	Federal Law	Parliament and Cabinet	Laws related to family affairs; Professionals Regulation	Distribution of land, building ownership certificates	
13	International Trade	Trade and Business	Labour and Employment; Employment and aid to unemployed	Management of local records	Permission for vehicles
14	National Transport Policy, Civil Aviation	Highways	Inter-provincial forest, wildlife, birds, mountains, national parks and water uses	Local roads, rural roads, agriculture roads, irrigation	Forest, wildlife, birds, water use, environment, ecology and biodiversity
15	Foreign Affairs, International Treaties	Investigation bureau		Collection of statistics of unemployed people	
16	Mining, exploration	Mines Exploration and Mgmt	Industries and minerals and infrastructures	Management of senior citizens, people with physical disability and disabled	Mines and minerals
17	Constitutional bodies and commissions of national importance	PSC	Sports	Village assembly, Municipal assembly, district assembly, local courts, dispute settlement and mediation	
18	Courts	Agriculture and livestock development, factories, industrialization, business, transportation		Management, operation and control of agriculture extension	Agriculture

SN	Federation	Province	Federation & Province	Local Level	Federation, Province and Local Level
19	Citizenship, passport, visa, and immigration	Culture and Language	Tourism, drinking water and sanitation	Preservation and development of language, culture and fine arts	Archaeology, ancient monuments and museums
20	Nuclear energy, atmosphere and space related		Scientific research, science and technology and human resource development	Drinking water, small electricity projects, alternative energy	
21	Intellectual property	Land management, record-keeping of the land	Poverty alleviation and industrialization	Farming and livestock, agricultural production management, livestock health, cooperative	and poverty alleviation; Management of landless
22	Standards and Metrology		Insurance operation and management		
23	Ecology	Forest, Ecology and Water Resources	Disaster	Disaster management	
24	Policies sector related	Guthi	Contracts, Cooperatives and Collaborations	Cooperatives	
25	Social Security				Social security; Registration of personal incidents, birth, death, marriage and statistics

***Source*: Based on the Constitution of Nepal (Annex 5-9), 2015.**

Table 2: Revenue sources of different level of governments in Federal Nepal

Federal Level	Province Level	Local Level	Concurrent to all levels
Customs,	Vehicle Tax	Vehicle Tax	
Excise Duty	Entertainment Tax	Entertainment Tax	
Value Added Tax	Advertisement Tax	Advertisement Tax	
Corporate Income Tax		Property Tax	
Individual Income Tax	Income Tax on Agriculture Income	Land Tax	
		Business Tax	Royalty Received from Natural Resources
Visa Fee		House Rent Tax	
Tourism Fee	Income Tax on Tourism Income	Tourism Fee	Tourism Fee
Passport Fee	Land and House Registration Fee	Land and House Registration Fee	Registration Fee
Service Charge	Service Charge	Service Fee	Service Fee
Penalty and Fines	Penalty and Fines	Penalty and Fines	Penalty and Fines

***Source*: The Constitution of Nepal, 2072.**

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Grant Equalization Design for Local Bodies of Nepal*

Khim Lal Devkota, PhD [1]

1. Introduction

With the promulgation of the new constitution, Nepal has formally become a federal democratic republic. The constitution provides for a bi-cameral parliamentary form of government with the President as the constitutional head.

The new constitution has drawn up provisional boundaries for seven provinces but their names are to be decided by their elected legislative assemblies and a commission has yet to fix their final boundaries. Most Nepalese seem to be quite happy with this latest development as they hope that the statute will pave the way for political stability. At its core is the federal architecture, comprising of seven provinces and an unspecified number of Local Governments (LGs), which have also been given a constitutional position, as '*Gaonpalika*' in rural areas and *Nagarpalika* (Municipality) in urban. In the new set up, 'GaonPalika' will replace the present local institution of Village Development Committee (VDC) while existing institution of Municipality will remain the same (Sharma, Raghunandan & Devkota, 2015). The constitution has replaced the existing District Development Committees (DDCs) by District Councils/Assemblies. The mandates of District Council/Assembly are just to coordinate among federal and provincial government offices, and GaonPalika and Municipality and to monitor the development and construction activities carried within its jurisdiction. However, no mandates for financial assignments are given to the District Council/Assembly.

In Nepal, intergovernmental fiscal transfers are the important sources of revenues for the Local Bodies. The Local Self Governance Act (LSGA), 1999 addresses the

* This article is the synopsis of 'Grant Equalisation Formula for Local Bodies of Nepal', prepared for LBFC by Dr. Khimlal Devkota in 2016.

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provision of central government grants to LBs in section 236. As per the act, "the Government of Nepal shall have to provide the LBs each year with minimum grant prescribed and also with additional grants on the basis such as population, level of development, possibility and capability of mobilizing resources, necessity of financial resources, regular record keeping of incomes and expenditures, situation of auditing and financial discipline of the concerned LBs." In practice, LBs are receiving a minimum grant as per the LSGA as well as recurrent grants to pay for the salary and allowances of employees and to meet minimal operational expenditures at the LBs level. In addition, they are receiving various types of grants such as unconditional, conditional, program based budget, etc.

Under intergovernmental fiscal transfer system, two mechanisms are used in Nepal for distributing LBs block grant: Minimum thresholds and the formula-based. Of the total block grant, around 30 percent goes for the basic entitlements/minimum threshold and the rest for the formula-based approach. According to categories of LBs the allocation of the basic entitlement is same for all LBs. For example, the DDCs and municipalities have been receiving Rs four and Rs three millions each, respectively, since 2010/11. Similarly, as for the minimum grant VDCs are receiving Rs 1.5 million each. The formula based grant is channelized against the performance[2] of LBs. There are separate formulas adopted for each category of LBs[3].

In principle, the grant allocation formula should be simple and transparent so that everyone can understand it. Many studies have questioned on the complexities of the existing formula (Kelly, 2011, Boex 2012, Devkota, 2015). Additionally, they argue that local bodies in relatively remote and underdeveloped areas are not getting their "fair share" from the existing formula.

Article 60 (4) of new constitution spells-"the Government of Nepal shall distribute fiscal equalization grants to province and local level entity on the basis of their expenditure need and their capacity in generating revenue".

On this background, this paper is prepared to suggest the grant formula that can be simple in nature and can address the need of remote and underdeveloped districts, which finally may contribute for intergovernmental fiscal transfer policy to be designed in the future.

2 Indicators of performance comprises: planning and budgeting, financial management, fiscal resource mobilization, communication and transparency, budget release and programme execution, monitoring and evaluation, etc. The performance of local bodies is measured through two tools called as Minimum Conditions and Performance Measures. Minimum Conditions take into account the basic functions of local bodies, which serve as threshold criteria, That is to say, if a local body fails to meet any of the conditions, it will not be eligible for receiving grants. Performance indicators cover additional functions that determine how much more or less grants a local body will receive if it meets all minimum conditions.

3 Formula for grant to Village Development Committees comprises the weightage as: population 60%, area 10 % and weighted cost 30%. Similarly, for Municipality: population 60%, weighted poverty 25%, area 10% and weighted tax effort 15% and for District Development Committees: population 40%, weighted poverty 25%, area 10% and weighted cost 25%.

The rest of the paper proceeds as follows. Section 2 highlights the research methodology and data analysis. Section 3 critically analyzes the existing grant allocation procedures. Section 4 proposes a new allocation formula for the LBs. Section 5 presents summary and findings and finally, section 6 concludes with recommendations.

2. Research Methodology and Data Analysis

This paper is based on both primary and secondary data. The secondary information was collected from the various government institutions. Basing on meetings and discussions with senior government officials and other experts, key horizontal disparity variables were selected. An underdevelopment[4] index across the districts is derived. With reference to these variables in this paper, the underdevelopment index is synonymous of equalization index. A basic rule of statistics and econometrics is strictly followed in designing composite indicators. To assess the robustness of the composite indicator, sensitivity analysis is also performed. Correlation and regressions are carried out at the relevant places.

The underdevelopment index designed in this paper includes the following seven sub-components : (i) Per Capita Income, (ii) Female Literacy Rate, (iii) Infant Mortality Rate, (iv) Household Amenities[5], (v) Remoteness[6] , (vi) Connectivity (Access of road network), and vii) Deprived Caste/ Ethnic Group[7].

Most of the data represent a single time interval; year or census. Therefore, they have been normalized separately with scale adjustment ranging between zero and one (see OECD, 2008 for detail empirical analysis for normalization procedure). Per Capita Income, Female Literacy Rate, Household Amenities and Connectivity are normalized

4 In general, underdevelopment is a situation where quality of life of people is poor. The level of quality of life may be measured in term of increase in per capita income and improvement in socio-economic indicators such as literacy rate, life expectancy, infant mortality rate, household amenities, infrastructures, etc. In recent years, caste/ethnicity has also become a major social variable in understanding the process of social inclusion/exclusion and the level of socio-economic development of the people of a country.

5 Housing is one of the basic needs of human life and an important indicator of social welfare. It needs to have some essential services such as cooking fuel and electricity, safe drinking water, and sanitation. On top of these facilities, modern households should have a variety of consumer durable goods, such as radios, televisions, vehicles, internet, mobile phone etc. Possession of these household amenities shows the quality of life and reflects the living standards and the level of socio-economic development of the country. However, for this paper purpose only two household amenities, i.e. access in safe drinking water and toilet facilities is used. Safe drinking water and toilet are fundamental to health, survival, growth and development.

6 As per the proxy of remoteness Cost Index is used. The Cost Index has been prepared on the basis of the cost incurred for labor and materials like cement, MS rod, stone, sand, glass, stone aggregates, pipe, timber, bricks, etc. The index at the district level was designed using a basket of items consisting of construction materials and service cost of personnel. The topographical differences in Nepal cause the cost of construction to differ widely from one place to another. The remoteness of the Mountain and Hill districts necessitates spending huge amounts of money for transporting goods, both construction materials and consumables. This makes construction activities in these districts very expensive. Remote districts therefore need extra funds for carrying out the same task that could be done in the Terai districts, at lower costs because of accessibility.

7 According to Nepal Human Development Report, 2014, Dalits (Terai, Hill) are the most deprived among the caste/ethnic groups in Nepal. Therefore, Dalit population is also included as one of the sub-component of the indicator used in this paper.

in such a way that the highest values represent higher degree of development. Further, each of these indices is subtracted from 1 (one) so that underdevelopment indices can be accomplished. The rest of the indicators are normalized to range between zero and one, where one represents higher degree of underdevelopment. Normalization is necessary to ensure no indicators have a disproportionate weight in the overall index. The normalization indicators are calculated as follows;

$$I_{qi}^{t} = \frac{x_{qi}^{t} - \min_i (x_q^{sa\,t})}{\max_i (x_q^{sa\,t}) - \min_i (x_q^{sa\,t})}$$

Where x_{qi}^{t} is the value of indicator of q for district i at time t (original indicator). $x_q^{sa\,t}$ is the scale adjustment value at time t. I_{qi}^{t} is the normalized one.

The pair-wise correlations between the different indices of indicators are presented in table 1 below. These indicators are aggregated to create an overall index of underdevelopment. In overall, correlations across indicators are found positive. All indicators have been assigned equal weights for calculating overall index for the districts. The correlation between indices is 0.9823.

Table 1: Pair-wise correlation of indicators

	Per Capita Income	Female Literacy rate	Infant Mortality Rate	Household Amenities	Connectivity	Remoteness	Deprived caste
Per Capita Income	1						
Female Literacy rate	0.48*	1					
Infant Mortality Rate	0.54*	0.70*	1				
Household Amenities	0.58*	0.77*	0.63*	1			
Connectivity	0.32*	0.35*	0.26*	0.34*	1		
Remoteness	0.15*	0.33*	0.16*	0.31*	0.40	1	
Deprived Caste	0.58*	0.32*	0.30*	0.41*	0.34*	0.22*	1

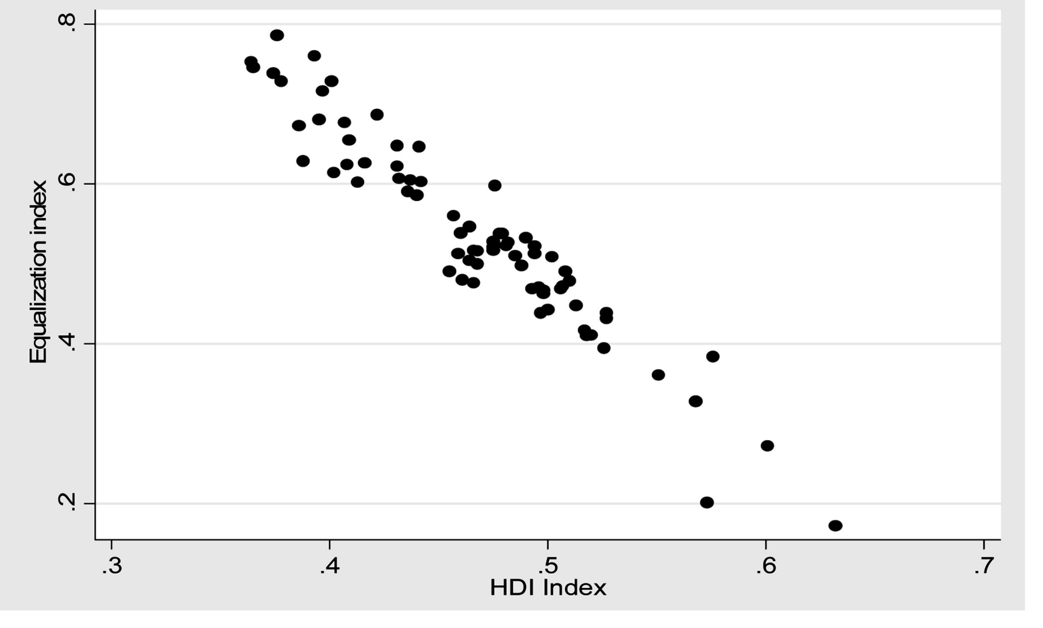
* Statistically significant at 1 percent level.

Source: **Author's analysis, 2016.**

Cross districts underdevelopment indices is presented in annex 1. The average level of underdevelopment index for the country is 0.54. Notably, there is significant dispersion across the districts with minimum and maximum values of 0.17 and 0.79. The standard deviation and coefficient of variation are 0.12 and 0.23 respectively.

The index is strongly and negatively correlated with the HDI with a correlation coefficient of -0.95. The higher value of HDI indicates the higher level of development unlike the equalization index where higher values denote greater underdevelopment. The relationship is presented in figure 1.

Figure 1: Correlation between Underdevelopment Index and HDI



Source: **Author's analysis, 2016.**

3. Brief Analysis of Existing Allocation Formula

Principally, the cost index is included in the formula (see annex 2) so that remote districts (inaccessible with the road network and far away from the key market centers) will be benefitted more on equity basis. However, the allocation shows that the remote districts are getting lower per capita grant. Bajura is the poorest and remote district (NHDR, 2010/11) and it takes almost two days to reach district headquarter of Bajura from the Kailali (Far western Terai) district. However, in cost allocation, Bajura receives three times less than the Kailali. Similarly, Bhojpur is the remote district locating in the eastern region. It takes around one and half day to reach district headquarter of Bhojpur from the Morang (eastern Terai). In cost allocation, Morang gets more than three times higher than the Bhojpur district. In poverty criteria allocation, Bajura and Bhojpur receive five times less than the Kailali and Morang respectively.

Likewise, almost all districts in Karnali are poor and inaccessible to the road network. The only mode of transport facility for these districts is the airplane (air transport) through either Banke (Nepalgunj) or Sukhet districts. But unfortunately, in cost allocation, (poverty too) these districts receive less than the Banke. In eastern Terai, Jhapa, Morang and Sunsari are developed districts and Saptari and Siraha are the poorer ones (NHDR, 2010/11). However, in both poverty and cost allocations the poorer districts are getting lower grant and vice versa. Similarly, Manang is the most remote district in the western region where consumption goods and production materials are over three times expensive than in the nearest market center-Besi Shahar (District Headquarter of Lampung). However, in cost allocation, Manang gets three times less than the Lamgunj. In poverty allocation it gets 26 times less than Lamgunj. Therefore, neither the cost nor the poverty indices are supportive to the poorer and remote districts. Similarly, the correlation coefficient also informs that the existing grant distribution indicators are not statistically sound (Table 2). This table shows that the correlation coefficient between the population and weighted poverty is 96 %. Similarly, the correlation between population and weighted cost is 95 %. Likewise, the correlation between weighted poverty and weighted cost is 93 %. The correlation between population and area is only 33 %. The numerical information also clearly reveals that the existing grant formula for DDCs (VDC and Muns as well) is not statistically sound.

Table 2: Correlation across the indicators

	Pop	Area	Weighted poverty	Weighted cost
Pop	1			
Area	0.33	1		
Weighted poverty	0.96	0.32	1	
Weighted cost	0.95	0.07	0.93	1

Source: **Author's derivation, 2016**

4. Proposal for New Grant Allocation Formula

Population and geographical area are mostly used need based indicators for horizontal grant allocation across the countries. In case of Nepal, -40 % and 10 -% weightage are given for population and geographical area respectively in DDCs grant allocation.

The basic principle that should guide the design of a system of fiscal transfers is- the purpose of transfers is not only to finance particular government entities rather to contribute to effective provision of public services. Since much of government spending is on basic public services meant for citizens – education, health, and social services, the need for these services will depend on the demographic size. The number of people who reside in a jurisdiction is one of the main indicators of local need in that area. Quite simply: if we have twice as many people in our jurisdiction, all else equal, we have to provide public services to twice as many residents (Devkota 2015, Bird, R.M. and Vaillancourt, F. 2006, Shah A. & Robin B. 2007, Boex 2012).

Holding everything (including the number of residents) equal, a jurisdiction with a larger land area will typically have greater expenditure needs in order to provide the same level of services. In such jurisdictions, the roads will need to be longer and there will be a need for more (albeit, probably smaller) schools, clinics, and other infrastructures. In addition to the greater need for infrastructure, it is likely that the infrastructure (as well as delivery of public services) will be more expensive. In many cases, a larger land area means higher canals/irrigation, road/transportation, electricity, etc. costs. It can also result in higher service delivery costs because scale economies are harder to achieve in low density areas, or when it is more costly to entice public officials to reside in rural areas (Boex 2012 as cited in Devkota 2015). The similar version is from Dafflon (2004) who gives an example of Switzerland and argues needs are approximated by two criteria: the larger the proportion of mountainous areas in each canton and the lower the population density, the more “needy "the canton. Box 1 gives a brief information how per capita expenditure is higher in the remote districts in Nepal. As suggested by various high level government officials, this paper assigns 70 percent of weight to district share in population and 30 percent share to geographical area.

Box 1 : More per capita expenditure cost in remote districts

There is an argument for an increased grants allocation to the remote districts like Dolpa, Humla, Bajhang and Bajura which have large areas but with smaller size of population. As observed at the field level, the district headquarters of Bajura and Bhojpur districts still do not have access to the black-topped road network.

As argued by Mr. Devi Pd. Pandey, chief of District Technical Office-DTO of Bajura, it costs an average Rs 3.3 million to open one kilometer road network in Bajura. Nearly same amount (Rs three million) requires in Bhojpur district (argument of Local Development Officer-LDO Bhanubhakta Neupane and DTO chief Lalu Giri) as well. However, in Teraian districts like Rupandehi, it takes a nominal amount for the same. Mr. Yubaraj Subedi, LDO of Rupandehi DDC, informed that it takes around Rs 740 hundred thousand. This reveals that cost for construction of a road is almost five times expensive in remote areas than in the accessible area and the government should not discriminate whether there are 100 inhabitants or 1000 inhabitants. Further, the prices of construction materials are quite expensive in remote districts. For example, the price of one bag cement in Bajura and Bhojpur is Rs 1800 and Rs 1400 respectively. Its price in Rupandehi is Rs 700 and in Kathmandu Rs 800. Similarly, the prices of other construction materials like iron rod, brick, wires, pipes (Polythene, Hume, fitting etc.), etc. are four-five times expensive in the remote districts.

Similarly, there are fixed costs of building health posts, schools, drinking water projects, canals for irrigations, etc. However, these infrastructure should have to be built around the people so that these services might be utilized. Therefore, remote and underdeveloped districts with low population and large areas will have the burden of creating more per capita infrastructure cost.

Based on the previous analysis and review, this section proposes new allocation formula for the DDCs/districts. The equation for allocation formula for district *i* is as follows:

$$Y_i = \alpha_i + (\beta_i X_i)\gamma_i$$

Where,

Y = Total fiscal transfer/ equalization transfer

α = Minimum threshold[8] (the pool of minimum threshold has not been changed. It is 30 % (similar to the existing formula) basic allocation and the rest 70 % goes for the need based allocation).

X= Need based variables used in the fiscal transfers. Here, population and geographical area are used for expenditure/ need based variables.

β = Coefficients of need based explanatory variables

γ =Under-development/ equalization index

Further, the methodology for the need based allocation is presented as follows:

{70 % Share of Population of district *i* + 30 % share of geographical area of district *i*} X {Underdevelopment index for district *i*}

The allocation share of grant to the districts on need based approach is presented in Annex 3. There is considerable dispersion across the districts. The shares range from 0.30 percent to 2.78 percent with a standard deviation of 0.64 percent. It may be noted that allocation shares are determined not only by the index of under-development but also by their population and area. Here, the weightage for population has been given nearly two times of weightage given in the existing DDCs grant allocation formula. Going to these criteria, large districts truly get higher allocation.

Annex 4 shows allocation share of Rs One billion. The annex shows that the large populated districts namely Dhanusha, S`arlahi, Kailali, Rautaht, Morang, Siraha and Saptari receive large share of grant. On the contrary, Manang and Terathum receive lowest share followed by Bhaktpur, Rasuwa, Parbat and Dhankuta.

8 The LSGA ensures the provision for minimum allocation (Section 236) for LBs. The MoFALD has already established 30 percent minimum grant for the LBs. Literature on grant allocation also suggest on providing minimum threshold grant during horizontal allocation that is necessary for carrying out minimum service delivery. Even in India, 30 percent budget goes to special category states (see: Planning Commission India, 2012).

Box 2: Formula rewards underdeveloped districts

The grant simulation informs that the largely populated districts, namely, Dhanusha, Sarlahi, Kailali, Rautaht, Morang, Siraha and Saptari receive greater amount. However, very interesting feature in the simulation is- the formula rewards the under-developed districts, like Humla, Jajarkot, Bajura, Bajhang, Kalikot, Dolpa, Acham, Mugu, Rahutahat, Siraha,Saptari, Mahotari and Dhanusa more for an improvement in the underdevelopment index a necessary feature in the formula, since the most under-developed districts tend to lose more allocation as they become developed.

Since allocation to large populated districts decline on per capita terms, while the smaller and remote districts no longer seem to be disfavored. Those remote and inaccessible districts, namely, Dolpa, Mustang, Manang, Humla and Mugu receive the highest per capita allocation respectively.

In addition to the local government grant, the federal government can provide additional form of resources to the districts that are particularly underdeveloped. Box.3 presents an opportunity for additional resource allocation.

Box 3 : Opportunity for additional allocation

The under-developed/equalization index provides an opportunity for additional resource support to the under-developed districts. The index having more than 0.6 can be used as the least developed districts and below 0.4 the developed ones. Districts which score in between 0.4 and 0.6 can be labelled as less developed. Based on these methods currently there are 24 districts which are least developed. The name of these districts are: Humla, Jajarkot, Bajura, Bajhang, Kalikot, Dolpa, Acham, Mugu, Dailekh, Rolpa, Doti, Rautahat, Siraha, Jumla, Saptari, Mahotari, Rukum, Salyan, Dhanusa, Sarlahi, Baitadi, Kapilbastu, Dadeldhura and Pyuthan. These districts can be targeted for specific additional support.

Based on assumptions used in Box 2, only seven districts are comprised in the developed categories which are: Kathmandu, Bhaktpur, Lalitpur, Manang, Chitwan, Kaski and Ilam.

The grant distribution before and after equalization across the different regions, are presented in Table 3. The table shows that the central Terai, Mid and Far-western Hill benefit more after introducing equalization index. Further, all mountainous regions are also benefitted. The finding is completely consistent in NHDR, 2014. In the allocation, under-developed districts/regions receive more per capita allocation. Further, grant allocation to all districts before and after the equalization is presented in Annex 5.

Table 3: Grant distribution to the districts before and after equalization (Percentage)

Region	Before equalization	After equalization	Note
Eastern Terai	8.27	6.55	Only three districts namely Jhapa, Morang and Sunsari
Central Terai	18.51	19.42	Included Siraha and Saptari and excluded Chitwan
Western Terai	7.00	6.40	
Mid-western Terai	5.43	5.31	
Far-western Terai	4.39	4.27	
Chitwan	1.98	1.36	
Eastern Hill	6.33	5.84	
Central Hill	14.31	9.18	
Western Hill	10.75	10.18	
Mid-western Hill	7.38	9.05	
Far-western Hill	3.80	4.62	
Eastern Mountain	2.40	3.00	
Central Mountain	2.35	2.53	
Western Mountain	0.64	1.01	
Mid-western Mountain	3.90	7.47	
Far-western mountain	2.56	3.80	
Total	100.00	100.00	

Source: **Author's derivation, 2016.**

VDCs and Municipalities are the grassroots level local governments in Nepal which have different characteristics than the DDCs/ intermediate level local government. The same formula cannot be applied to all levels of local governments. However, Kelly (2011), Boex (2012) have recommended for using same set of formula for each LBs. The similar version is from the associations of LBs, officials of LBs and development practitioners. This paper also advises for the allocation of grants using the same set of formula and methodology proposed for the district/ DDCs. The need based allocation and simulations are as follows;

VDC: {70% share of population of VDC i + 30% share of geographical area of VDC i} X {Underdevelopment index for district i}

Municipalities: {70% share of Population of municipalities i + 30 % share of geographical area of municipalities i} X {Underdevelopment index for district i}

5. Summary and Findings

a) Based on seven indicators in various areas, namely, human, economic and social, a glimpse of under-development picture across the districts is derived. In terms of per capita income, Manang, Kathmandu, Mustang and Lalitpur districts comprise the highest position, respectively. Similarly, Bajhang, Bajura,Acham and Baitadi are placed at the lowest categories. Kathmandu, Kaski, Lalitpur and Bhaktpur districts comprise the highest female literacy rate. However, Rautahat, Humla, Mahotari and Sarlahi districts are situated at lowest female literacy rate. Bhaktpur, Lalitpur, Rasuwa and Kathmandu districts include the lowest percentage of Dalit population. However, the ratio is highest in districts, namely, Accham, Jajarkot, Dailekh and Lamjung. Similarly, in infant mortality rate, Manang, Bhaktpur, Kaski and Lalitpur districts comprise the lowest rate. However, the rate is highest in districts, namely, Rautahat, Dhanusa, Bajura and Dolpa.

   In household amenities, Kaski, Chitwan, Bhaktpur and Syanga districts are placed in better position. Salyan, Bajhang and Rolpa districts are situated in worse position. In road connectivity, Bhaktapur, Kathmandu, Lalitpur and Dhanusa score better position. However, Dolpa, Mugu, Humla and Solukhumbu districts score poorer position. In overall ranking, Kathmandu, Lalitpur, Bhaktpur and Chitwan districts are placed at the better position. These districts can be labeled as the most developed ones. However, Bajura, Bajhang, Jajarkot and Kalikot districts are placed at the lowest categories. These districts should be ranked as the most underdeveloped ones.

b) Principally the cost index is included in the formula so that the remote districts (inaccessible with the road network and fare way from the key market centers) will be benefitted more on equity basis. However, existing grant simulation informs that the remote districts are getting less per capita amount. For example, the Bajura is the poorest district and it takes almost two days to reach district headquarter- Bajura from Dhangadi (Kailali-neighboring Terai district) market centre. However, in cost allocation, Bajura is receiving three times less than the Kailali district.

c) Further, the pairwise correlation between the indicators shows that the correlation coefficient between the population and weighted poverty is 96%. Similarly, the correlation between population and weighted cost is 95%. Likewise, the correlation between weighted poverty and weighted cost is 93%. The correlation between population and area is only 33%. The numerical information also clearly reveals that the existing grant formula for DDC (VDC and municipality as well) is not statistically sound. The key objective of fiscal transfer system in Nepal is to correct vertical fiscal imbalance between the central government and the LBs and correcting horizontal imbalances in fiscal capacities among the LBs. It is concluded that the existing fiscal transfer system is not supportive to those remote and poorer LBs/regions.

d) The pair-wise correlations between the different indices of indicators are aggregated to create an overall index of underdevelopment. In overall, correlations across indicators are found positive. All indicators have been assigned equal weights for calculating overall index for the districts. The correlation between indices is 0.9823. The average level of equalization index for the country is 0.54. Notably, there is significant dispersion across the districts with minimum and maximum values of 0.17 and 0.79. The standard deviation and coefficient variation are 0.12 and 0.23 respectively.

e) The underdevelopment index is strongly and negatively correlated with the HDI with a correlation coefficient of -0.95. The higher values of HDI denote higher level of development unlike equalization index where higher values denote greater underdevelopment. There are fixed costs of building health posts, schools, drinking water projects, canals for irrigations, etc., but these infrastructure should have to be built around the people so that these services might be utilized. Further, the priority should be given to the remote and poorer areas. Therefore, remote and underdeveloped districts with low population and large areas will have the burden of creating more per capita infrastructure cost.

f) This paper assigns 70% of weight to district share in population and 30 % share to geographical area. Further, population and area are weighted with underdevelopment/equalization index. The same methodology is followed to grassroots levels local governments- VDCs and Muncipalities.

g) The grant simulation of proposed formula for districts/ DDC informs that the large populated districts, namely, Dhanusha, Sarahi, Kailali, Rautaht, Morang, Siraha and Saptari receive greater amount. However, very interesting feature in the simulation is that the formula rewards under-developed districts, like, Humla, Jajarkot, Bajura, Bajhang, Kalikot, Dolpa, Acham, Mugu, Rahutahat, Siraha,Saptari, Mahotari and Dhanusa more for an improvement in the underdevelopment index (a necessary feature in the formula) since the most under-developed districts tend to lose more allocation as they become developed.

h) The under-development/equalization index provides an opportunity for additional resource support to the under-developed districts. The index having more than 0.6 can be used as the least developed districts and below 0.4 the developed ones. Districts which score in between 0.4 and 0.6 can be labeled as the less developed ones. Based on these methods, currently, 24 districts are least developed.

6. Recommendations

a) It is recommended that the under-development/ equalization indices (Annex1) need to be followed in the equalization formula for the LBs.

b) It is advisable to assign 70% of weight to district share in population and 30 percent share to geographical area. The same weight is proposed for the grassroots level local governments the VDCs and Muns.

c) It is proposed to follow the following allocation methodology in the fiscal transfer/equalization system ;

The equation for allocation formula is as follows:

$$Y_i = \alpha_i + (\beta_i X_i)\gamma_i$$

Where,

Y = Total fiscal transfer

α = Minimum threshold, X= population and geographical area,

β = Coefficients of need based explanatory variables,

γ = Under-development/ equalization index

d) The least developed districts mentioned in summary and finding section should be targeted for specific additional support.

e) The proportions of poverty and cost index are included in underdevelopment indices itself. Therefore, it is recommended not to use poverty and costing indices in the allocation.

f) It is strongly recommended to use poverty index derived by Small Area Estimation study if the existing poverty weight and the formula is to be continued. In that case the coefficients of population and area should be changed from the existing 40% to 60% and 10% to 15% respectively. Further, the weighted of poverty is same, i.e. 25%. The allocation pattern will be similar to the paragraph described in 'c' above.

g) The key objective of this article is to recommend to design equalization index for the district/ DDCs. The designed index is more robust and it would also be very much useful to the federal and provincial governments as well. However, it is advised to update the index in every five years.

h) As per the article 60 of constitution, the federal government is assigned to distribute fiscal equalization grant to the provincial and local governments. The proposed formula can also be used to fulfill the constitutional provision as well.

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Annex 1

Underdevelopment Indices of districts

S.N.	District	Under-development index	S.N.	District	Under-development index
1	Taplejung	0.508	41	Manang	0.328
2	Panchthar	0.463	42	Mustang	0.491
3	Illam	0.395	43	Myagdi	0.533
4	Jhapa	0.410	44	Parbat	0.479
5	Morang	0.459	45	Baglung	0.538
6	Sunsari	0.479	46	Gulmi	0.504
7	Dhankuta	0.417	47	Palpa	0.443
8	Terhathum	0.432	48	Nawalparasi	0.473
9	Shankhuwasabha	0.498	49	Rupandehi	0.469
10	Bhojpur	0.538	50	Kapilvastu	0.607
11	Solukhumbhu	0.489	51	Arghakhanchi	0.527
12	Okhaldhunga	0.516	52	Pyuthan	0.602
13	Khotang	0.522	53	Rolpa	0.681
14	Udayapur	0.521	54	Rukum	0.648
15	Saptari	0.652	55	Salyan	0.647
16	Siraha	0.668	56	Dang	0.510
17	Dhanusha	0.646	57	Banke	0.528
18	Mahottari	0.648	58	Bardia	0.521
19	Sarlahi	0.631	59	Surkhet	0.598
20	Sindhuli	0.589	60	Dailekh	0.687

S.N.	District	Under-development index	S.N.	District	Under-development index
21	Ramechhap	0.500	61	Jajarkot	0.760
22	Dolakha	0.502	62	Dolpa	0.729
23	Sindhupalchok	0.512	63	Jumla	0.655
24	Kavrepalanchok	0.411	64	Kalikot	0.739
25	Lalitpur	0.272	65	Mugu	0.715
26	Bhaktapur	0.201	66	Humla	0.786
27	Kathmandu	0.173	67	Bajura	0.753
28	Nuwakot	0.476	68	Bajhang	0.745
29	Rasuwa	0.480	69	Achham	0.729
30	Dhading	0.480	70	Doti	0.677
31	Makwanpur	0.439	71	Kailali	0.539
32	Rautahat	0.673	72	Kanchanpur	0.517
33	Bara	0.560	73	Dadeldhura	0.603
34	Parsa	0.547	74	Baitadi	0.626
35	Chitwan	0.361	75	Darchula	0.591
36	Gorkha	0.523	Average		0.54
37	Lamjung	0.511	Max		0.79
38	Tanahun	0.469	Min		0.17
39	Syangja	0.439	SD		0.12
40	Kaski	0.384	CV		0.23

Source: Author's derivation, 2016.

Annex 2

Block grant allocation formula for LBs (in percent)

Indicators	VDCs	Municipalities	DDCs
Population	60	50	40
Weighted poverty	-	25	25
Area	10	10	10
Weighted cost	30	-	25
Weighted tax effort	-	15	-
Total	100	100	100

Source: LBFC

Annex 3

Allocation share to the districts (in percent)

S.N.	District	Percentage share	S.N.	District	Percentage share
1	Taplejung	1.043	41	Manang	0.297
2	Panchthar	0.668	42	Mustang	0.714
3	Illam	0.837	43	Myagdi	0.779
4	Jhapa	1.930	44	Parbat	0.445
5	Morang	2.554	45	Baglung	1.098
6	Sunsari	2.069	46	Gulmi	0.933
7	Dhankuta	0.486	47	Palpa	0.816
8	Terhathum	0.334	48	Nawalparasi	1.926
9	Shankhuwasabha	1.068	49	Rupandehi	2.320
10	Bhojpur	0.807	50	Kapilvastu	2.154
11	Solukhumbhu	0.887	51	Arghakhanchi	0.767
12	Okhaldhunga	0.599	52	Pyuthan	0.995
13	Khotang	0.864	53	Rolpa	1.263
14	Udayapur	1.248	54	Rukum	1.402
15	Saptari	2.438	55	Salyan	1.155
16	Siraha	2.447	56	Dang	1.999
17	Dhanusha	2.746	57	Banke	1.783
18	Mahottari	2.296	58	Bardia	1.525
19	Sarlahi	2.749	59	Surkhet	1.621
20	Sindhuli	1.444	60	Dailekh	1.304
21	Ramechap	0.809	61	Jajarkot	1.311
22	Dolakha	0.897	62	Dolpa	2.364

S.N.	District	Percentage share	S.N.	District	Percentage share
23	Sindhupalchok	1.245	63	Jumla	1.002
24	Kavrepalanchok	1.010	64	Kalikot	1.007
25	Lalitpur	0.680	65	Mugu	1.179
26	Bhaktapur	0.317	66	Humla	1.923
27	Kathmandu	1.543	67	Bajura	1.149
28	Nuwakot	0.871	68	Bajhang	1.720
29	Rashuwa	0.392	69	Achham	1.418
30	Dhading	1.168	70	Doti	1.251
31	Makwanpur	1.339	71	Kailali	2.775
32	Rautahat	2.618	72	Kanchanpur	1.494
33	Bara	2.191	73	Dadeldhura	0.790
34	Parsa	1.939	74	Baitadi	1.157
35	Chitwan	1.363	75	Darchula	0.928
36	Gorkha	1.443	Average		1.33
37	Lamjung	0.766	Max		2.78
38	Tanahun	1.044	Min		0.30
39	Syangja	0.836	SD		0.64

***Source*: Author's derivation, 2016.**

Annex 4

Allocation Share (Rs 1 billion)

S.N.	District	Rs '000'	Per Capita (Rs)	S.N.	District	Rs '000'	Per Capita (Rs)
1	Taplejung	10429	82	41	Manang	2966	454
2	Panchthar	6683	35	42	Mustang	7138	531
3	Illam	8371	29	43	Myagdi	7792	69
4	Jhapa	19297	24	44	Parbat	4448	30
5	Morang	25539	26	45	Baglung	10975	41
6	Sunsari	20687	27	46	Gulmi	9333	33
7	Dhankuta	4863	30	47	Palpa	8162	31
8	Terhathum	3340	33	48	Nawalparasi	19265	30
9	Shankhuwasabha	10681	67	49	Rupandehi	23199	26
10	Bhojpur	8071	44	50	Kapilvastu	21542	38
11	Solukhumbhu	8873	84	51	Arghakhanchi	7675	39
12	Okhaldhunga	5986	40	52	Pyuthan	9949	44
13	Khotang	8636	42	53	Rolpa	12633	56
14	Udayapur	12485	39	54	Rukum	14024	67
15	Saptari	24383	38	55	Salyan	11553	48
16	Siraha	24470	38	56	Dang	19985	36
17	Dhanusha	27464	36	57	Banke	17830	36
18	Mahottari	22963	37	58	Bardia	15250	36
19	Sarlahi	27488	36	59	Surkhet	16212	46
20	Sindhuli	14445	49	60	Dailekh	13042	50
21	Ramechap	8087	40	61	Jajarkot	13110	77

S.N.	District	Rs '000'	Per Capita (Rs)	S.N.	District	Rs '000'	Per Capita (Rs)
22	Dolakha	8968	48	62	Dolpa	23635	644
23	Sindhupalchok	12451	43	63	Jumla	10015	92
24	Kavrepalanchok	10100	26	64	Kalikot	10074	74
25	Lalitpur	6803	15	65	Mugu	11785	213
26	Bhaktapur	3174	10	66	Humla	19230	378
27	Kathmandu	15427	9	67	Bajura	11489	85
28	Nuwakot	8709	31	68	Bajhang	17198	88
29	Rashuwa	3920	91	69	Achham	14182	55
30	Dhading	11679	35	70	Doti	12513	59
31	Makwanpur	13390	32	71	Kailali	27754	36
32	Rautahat	26176	38	72	Kanchanpur	14939	33
33	Bara	21914	32	73	Dadeldhura	7903	56
34	Parsa	19387	32	74	Baitadi	11569	46
35	Chitwan	13627	23	75	Darchula	9278	70
36	Gorkha	14433	53	Average		13333	70
37	Lamjung	7663	46	Max		27754	644
38	Tanahun	10437	32	Min		2966	9
39	Syangja	8365	29	SD		6423	108
40	Kaski	12486	25	CV		0.48	1.54

***Source*: Author's derivation, 2016.**

Annex 5

Grant Distribution before and after equalization (%)

S.N.	District	Before equalization	After equalization
1	Taplejung	0.81	1.04
2	Panchthar	0.75	0.67
3	Illam	1.04	0.84
4	Jhapa	2.68	1.93
5	Morang	3.10	2.55
6	Sunsari	2.49	2.07
7	Dhankuta	0.61	0.49
8	Terhathum	0.39	0.33
9	Shankhuwasabha	0.90	1.07
10	Bhojpur	0.79	0.81
11	Solukhumbhu	0.70	0.89
12	Okhaldhunga	0.62	0.60
13	Khotang	0.90	0.86
14	Udayapur	1.23	1.25
15	Saptari	2.18	2.44
16	Siraha	2.20	2.45
17	Dhanusha	2.54	2.75
18	Mahottari	2.18	2.30
19	Sarlahi	2.67	2.75
20	Sindhuli	1.21	1.44
21	Ramechap	0.83	0.81
22	Dolakha	0.83	0.90

S.N.	District	Before equalization	After equalization
23	Sindhupalchok	1.23	1.25
24	Kavrepalanchok	1.27	1.01
25	Lalitpur	1.40	0.68
26	Bhaktapur	0.89	0.32
27	Kathmandu	4.85	1.54
28	Nuwakot	1.03	0.87
29	Rashuwa	0.29	0.39
30	Dhading	1.29	1.17
31	Makwanpur	1.54	1.34
32	Rautahat	2.38	2.62
33	Bara	2.30	2.19
34	Parsa	2.06	1.94
35	Chitwan	1.98	1.36
36	Gorkha	1.24	1.44
37	Lamjung	0.70	0.77
38	Tanahun	1.17	1.04
39	Syangja	1.02	0.84
40	Kaski	1.67	1.25
41	Manang	0.24	0.30
42	Mustang	0.40	0.71
43	Myagdi	0.58	0.78
44	Parbat	0.52	0.44
45	Baglung	1.04	1.10
46	Gulmi	1.04	0.93
47	Palpa	0.98	0.82
48	Nawalparasi	2.22	1.93
49	Rupandehi	2.77	2.32
50	Kapilvastu	2.02	2.15
51	Arghakhanchi	0.77	0.77

S.N.	District	Before equalization	After equalization
52	Pyuthan	0.91	0.99
53	Rolpa	1.03	1.26
54	Rukum	1.07	1.40
55	Salyan	0.98	1.16
56	Dang	2.10	2.00
57	Banke	1.76	1.78
58	Bardia	1.58	1.52
59	Surkhet	1.38	1.62
60	Dailekh	1.13	1.30
61	Jajarkot	0.88	1.31
62	Dolpa	1.00	2.36
63	Jumla	0.67	1.00
64	Kalikot	0.71	1.01
65	Mugu	0.62	1.18
66	Humla	0.90	1.92
67	Bajura	0.75	1.15
68	Bajhang	1.10	1.72
69	Achham	1.16	1.42
70	Doti	0.93	1.25
71	Kailali	2.80	2.78
72	Kanchanpur	1.58	1.49
73	Dadeldhura	0.63	0.79
74	Baitadi	1.09	1.16
75	Darchula	0.71	0.93
		100.00	100.00

Source: **Author's derivation, 2016.**

Elite Capture and Corruption : Obtacles to Local Public Service Delivery

Krishna Raj Panta, Ph.D.[1]

1. Introduction

Efficient resource allocation and implementation are, among others, the conditions for social welfare maximization through decentralised local public service delivery. Otherwise, misallocation and misappropriation of available resources will hinder pro-poor service delivery and thus prevent the goal of poverty reduction from being achieved (Keefer and Khemani 2005; Boex et al. 2006). On decentralised Literatures, on decentralied public service delivery have been concerned about the chances of elite capture and corruption at local level. These phenomena are considered as significant demerits of fiscal decentralization (Prud'Homme, 1995; Tanzi, 1996; Bardhan and Mookherjee, 2011). These are referred to as policy failure cases in Kumar (2002). It seems like the decentralization of corruption as well, along with decentralization of authorities and resources from centre to local. Lack of transparency, accountability, and existence of elite capture, ambiguity and so on contribute directly or indirectly to corruption and illicit income generation which hinder the efficient public service delivery at local level. Not only the quantity, this further degrades the people's trust on local public services, generating the doubts on the quality of those services.

Elite capture is the possibility of capture of local resources by well-informed non-poor at the cost of the ill-informed poor. The level of elite capture may increase with "local poverty rate", *ceteris paribus,* since the latter widens the gap of awareness between poor and non-poor (Bardhan and Mookherjee, 2011). In the same way, corruption at the local level hinders the "allocative and production efficiency" of local government via the supply of services to those who pay bribes (instead of the needy poor) and the use of ineffective technology leading to waste of resources and time (Prud'Homme 1995). Ambiguity and misuse of local resources adversely affect public service provision resulting in inefficient services in terms of both quantity

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and quality. Along with these aforementioned problems, the process of fiscal decentralization and public service delivery may also be constrained by other flaws (both in law and practice). They will obstruct the smooth translation of the products of fiscal decentralization to poverty reduction outcomes through local public service provision.

2. Elite Capture, Corruption and Local Public Service Delivery: A Theoretical Consideration

The efficiency and effectiveness of public services largely depend on the accountability in the delivery mechanism- accountability of government that provides the services to its locals. Absence of accountability in service provision leads to "sub-optimal utility" in different aspects (Kumar 2002), deteriorating the relationship between service providers and its receivers. It affects the cost, quality and quantity of public services along with inter or intra community targeting as well. The proponents of decentralization argue that there is more accountability in decentralised (bottom-up approach) service delivery system than in the traditional centralized (top-down approach) delivery system. One of the main crux of the argument is less efficient service delivery in a centralized delivery system due to the indulgence of centrally appointed and authorized bureaucrats in corruption during their functioning for local service provision. On the contrary, in a decentralised delivery system, it is said that there will be no such cases as local people monitor the activities of elected officials of local government through the electoral pressure.

It is argued that local people, being able to scrutinize the case of bribery, over-costing and black marketing due to their proximity to the local officials (Bardhan and Mookherjee, 2011), can respond to these misappropriation by rejecting those alleged officials through social penalties, even by election procedure. However, these processes are viable if and only if under the assumptions of well-functioning democracy and a certain level of literacy and awareness of residents, which are only idealistic in the case of developing countries, more so for poor countries. Prud'Homme (1995) pointed out that the decision of electorates during election procedures in developing countries are found to be guided by the exogenous factors: personal, political, communal, cultural factors (sometimes monetary benefits to the voters) as well, rather than the endogenous capacity of the candidate and his/her performance in local service provision. This provides the space for the possibility of electing a corrupt candidate as well (probably time and again).

Instead of ensuring transparency and accountability, developing countries are found to be suffering from the problems of elite capture and corruption at local level that minimize the positive effects of decentralization on efficient local public service delivery. Appropriators of black income (mostly through the process of elite capture and corruption) lead to undermining of accountability and the functioning of various democratic institutions (Kumar, 2002) making the country a "high cost and low-quality economy" (Kumar 2013). The extent of the welfare consequences of decentralization in these jurisdictions, thus, rests on the extent of elite capture and level of corruption. Similarly, a number of cases of ambiguity in legal provision and practice also exist in these countries that hinder the targeting of local expenditure and provide space for corruption. Various triads can be observed at the local level as well to be working to complete the process of elite capture and corruption.

Local governments try to maximize the welfare of their citizens. However, it may be subject to local capture (by non-poor). The local officials also try to maximize the black income by syphoning and selling the goods meant for the poor to non-poor in the black market. Meanwhile, local elites (non-poor) try to maximize their benefit by increasing their share in existing local public services. For this, either they capture the decision making procedure or acquire the cheap goods by paying bribes to the local officials. Here, "the greater the extent of local capture, the greater the extent of cross-subsidization and over-delivery to non-poor" (Bardhan and Mookherjee, 2011). In addition, if the scale of supply of pro-poor goods is higher than the demand for the poor (exceeding their *first-best allocation*), then the poor themselves start to siphon out the excess goods to non-poor (where non-poor are supplied less than their *first-best allocation* or equal to market price) to get monetary gain from them, creating the black market for non-poor. Such cases are common in developing countries (as in the case of India) in public distribution system that is implemented by targeting the poor.

However, under uncertainty of local costs or needs, (especially, for high local costs and low local needs, in this situation of inferior market demand for non-poor), the non-poor try to divert funds towards the goods in favour of them which has more value, and room for misuse and corruption.[2] For example, in most cases at the local level, the local elites or local officials try to select the construction projects where they can get bribe during the procurement or get an advantage by altering the scale and the price of purchased equipment and materials. But, this situation prevails mostly in the case of local budget with untied grant.

As the negative consequences in society, under the environment of poor transparency and accountability, black income generation from elite capture and corruption degrades the efficiency of the local public services – both by extracting out certain portions of the project cost and through inferior service provision. Contrary to the norms of decentralization, it also adds to the transaction cost in service provision. It also leads to policy failure in social service provision such as education, health, drinking water, sanitation, housing etc.

2 If the value of market demand of the good to non-poor will not exceed the total value of local supply through untied grant, there will be case of certainty that the non-poor would equate the benefit from diverting the fund with the benefit from procurement and diversion of goods in their own favour (Bardhan and Mookherjee, 2011). So, in this case, they may not be in favour to choose first option, i.e. diverting the fund to their pocket or towards the purchase of goods of their choice, for their benefit.

In other way, elite capture and corruption degrades efficiency of local public service delivery by hindering the cost-effectiveness, inter-community targeting and intra-community targeting of local public expenditure (Bardhan and Mookherjee, 1998). The black economy then has demand-side consequences led by budgetary deficit due to tax evasion and siphoning out from the project fund; and supply-side consequences led by low quantity and quality of services hurting the poor and antipoverty programmes implemented through decentralization. In other words, two faces of policy failure would exist: inadequate allocation and ineffective expenditure (Kumar 2002), in the case of local governance as well. However, the developing countries are more rampant with these problems of elite capture and corruption and controlling corruption is more complex phenomenon in these countries, even the "carrot-stick model" does not work properly on curbing the elite capture and corruption as there is a lack of practice of "governance by rule."

3. Data and Methodology

In the absence of adequate quantitative data, the study has made use of qualitative information as well. Here, mixed method of analysis is used in this research. Some information was taken from the data collected through the survey of six different Village Development Committees (VDCs) with various geographic, demographic and socio-economic characteristics-Pakali, Laukahi, Balambu, Chilime, Mijhing and Thabang[3]. Next, secondary data and information on all three types of LBs[4]collected from different reports of government and non-government sources, such as Ministry of Federal Affairs and Local Development (MoFALD), the Carter Center, different news media etc. This article consists of more descriptive discussion than analytical statistical inference. Mostly, descriptive statistics are used to discuss the aforesaid issues followed by some narratives as well.

4. Empirical Evidences from LBs

4.1 Lack of Transparency and Accountability: Major Sources of Corruption

Lamichhane et al. (2013) carried out a study under Local Governance and Accountability Facility (LGAF) that depicted a picture of the level of transparency in local governance.[5] According to the report, among the 160 sample LBs, 85 percent are found to publish their annual programmes, half of them failed to practice public

3 For detail, see (CBS 2011).

4 There are three types of local bodies (LBs) in Nepal, namely, District Development Committee (DDC), Village Development Committee (VDC) and Municipality.

5 Association of District Development Committees Nepal (ADDCN), Municipal Association of Nepal (MuAN) and National Association of VDCs in Nepal (NAVIN) jointly carried out a study on Local Governance and Accountability Facility (LGAF) as a part of LGCDP implemented by Ministry of Federal Affairs and Local Development Nepal. The LGAF was implemented under the coverage of 14 DDCs, 538 VDCs and 16 municipalities and through 133 Civil Society Organizations (CSOs) selected on the merit basis of their performance. To study on the public hearing and the compliance monitoring, information was collected through interview of 8565 service users of 166 LBs. For detail, see Lamichhane et al. (2013).

hearing on their activities, 51 percent managed citizen charter and 42 percent positioned information board in their offices. Moreover, 37 percent of VDCs failed in the timely distribution of social security allowances, 76 percent failed to manage complaints box and 64 percent did not have grievance handling mechanism. In addition, among the 260 LBs, only 38 percent were found to publish financial audit reports, and 39 percent failed to address the recommendation of Ward Citizen's Forum (WCF) in their annual plan. This reveals the problems in accountability of LBs in their service provision.

In another way, the ambiguity produced by unclear and contradictory legal provisions leads to confusion in revenue and expenditure assignment of the LBs and the central line agencies creating the space for misuse and corruption through the overlapping of responsibilities and duplication of the projects.[6] Next, extra-institutional expenditures (expenditure by different institutions such as the Poverty Alleviation Fund and other NGOs/INGOs) at local level are not properly accounted in national accounts and it possesses characteristics of incomplete information.

Measured by Minimum Condition and Performance Measurement (MCPM)[7] analysis-2011/12, District Development Committees (DDCs) of Nepal scored only 62 percent in communication and transparency sector: PM sector-6, but poor performance in social auditing. Out of 3915 VDCs, 340 VDCs could not follow the indicator 5 (MC-5) that failed to publicize last year's income and expenditure statements. However, 314 VDCs failed to comply with the indicator 6 (MC-6) that implies timely completion of final audit of the previous fiscal year and publicizing the audit report. Municipalities score less than 50 percent in the PM indicator 11: actual income/expenditure and budget management (PM-11). In case of indicator 9: social audit and public hearing (PM-9) and indicator 26: public audit (PM-26), municipalities are found to score 68 percent and 80 percent respectively.

The MCPM achievements of LBs in the accountability criteria seem to be average and need further improvement. For example, budgeting and financial reporting system of Dhankuta and Dhanusa DDCs consists of only the brief list of projects and the level of financing for the projects that narrow down the accountability and the details of ordering during the selection of projects and sectors (World Bank 2014). Similarly, the column of expenditure of the previous year was found blank in the annual plan document of Pakali VDC (from the survey observation carried in 2012). This reflects the absence of transparency and accountability that could have promoted the chances of corruption during the execution of local projects leading to less efficient local public services as discussed in theoretical section.

6 There are 23 sectoral laws contradicting with LSGA, 1999. For detail, see (Koirala 2011).

7 Each year Local Body Fiscal Commission (LBFC) Nepal analyses minimum condition (MC) and performance measurement (PM) to rate the performance of LBs which also serves a criterion of resource allocation to LBs.

4.2 Elite Capture and Corruption: Problems in Local Service Delivery

The capture by political elites is more visible in developing countries, most visible in Nepal due to the absence of elected representatives in LBs since 2002. Practice of All Party Mechanism (APM), as the interim management, which was scrapped, under the chairmanship of the chief official since 2009, as the successor of elected local body, is found to be more corrupt and problematic in some of the local jurisdictions in Nepal. Members of the APM, though they are from diverse political backgrounds (i.e. political parties), are found to come to consensus in the misappropriation of local budget and to indulge in corruption by taking over the decision making power and choosing those projects that are more feasible for misuse and corruption. Even if they are not corrupt, they try to channelize more resources to projects of their priority to achieve the political incentives, i.e. to satisfy those interest groups that helped them in their political campaign. We can also observe the capture by the elites of different target groups such as women and *Dalits*. Here, the more aware of them try to divert the targeted expenditure towards the projects of their personal interest with similar objectives of other elites. A statement of a *Dalit* wage labour (65), from a sample VDC- Pakali, illustrates the case of corruption and elite capture in VDC level. He briefs:

> "Seven party mechanism and VDC secretary allocate resources and no information is provided to the local people…after consensus in budgeting they go to the restaurant to enjoy….we are not informed about the projects decided even after they allocate funds. *Dalits* are not informed on their targeted budget and there is monopoly only of *Dalit* elites with the collusion of VDC secretary and all party mechanism (APM)……They manipulate not only the price, but also the quality and the quantity of materials…In the case of gravelling, if there is a purchase of 2 tractor trips of gravel @ Rs.1000 they submit the bill of 3 trips@ Rs. 1500..There is corruption at three levels: DDC, VDC and users' level...Nobody hears our voice… once, we informed the correspondent of a national daily newspaper, he came and noted all the complaints but did not publish that" (Interview, 09/07/2012).

Overall, 14-step local body planning process is only formal in Nepal, failing to integrate the voice of minorities and marginalised effectively in planning, budgeting and project implementation processes due to capture of local elites and APM members (Koirala 2011; Kelly, Koirala, and Ghimire 2011).

Without the local election, the treatment of these problems through a voting mechanism as explained in the Tibeout model of "voting with their feet" and the Downsian model of "government decision making" have become impossible in Nepal. Hence, the situation still continues to maintain the monopoly of political leaders in local planning and allocation of resources.[8] The situation ignores the "voice" of the poor and a dominated section of the non-poor. The nature and dimension of political

8 For details of these two models, see Tiebout (1956) and Downs (1957) respectively.

capture, according to Bardhan and Mookherjee (2011), move in the same direction with the local poverty rate as well as the awareness gap between the poor and non-poor, where the poor are more uninformed voters. However, the survey study carried by author observed local perception of more capture in low poverty zone as well.[9]

The local officials and political elites, in the case of Nepal, are found to exhibit *rent-seeking behaviour*. Corruption and competitive lobbying are two important examples of rent seeking practice preferred by public decision-maker.[10] Corruption and elite capture in governance, especially in local governance in our case, represent the aforesaid two processes of rent seeking practices which leads to outward diversion of fund from targeted projects for the benefit of the parties involved in the rent seeking activities. These two phenomena are complementary in action and results. So, they are mostly discussed simultaneously. Mostly, elites indulge more in corruption because they are more informed about the incentives from and ways of corrupt practices. As stated earlier, most of the cases of corruption are held in the field of procurement: tender of construction projects, purchase of equipment or materials etc. In Nepal, corruption and bribery during the provision of day to day local services are rarely visible, but corruption at the local level is found mostly delineated from the programme expenditure of local government institutions.

Against the norms of decentralization, a number of cases of corruption can be observed in the local governance of Nepal, during a decade and half of absence of elected local representatives. For example, the price manipulation of hiring a Dozer (a machine) by users' committee, in case of a VDC of Khotang district (Dhakal and Bhandari 2014).[11] Next, corruption of Rs. 22.7 million, by a District Development Officer of Bara district, from the DDC projects (Shah 2013), irregular advance payments drawn by officials of Kathmandu Metropolitan City (KMC) (K.C. 2010), etc. Another case, (The Carter Center 2014) observed irregularities in the case of social security allowance as well by VDC secretaries in Sindhupalchowk district and diversion of funds earmarked for disadvantaged groups to other projects (as in Kanchanpur and Sindhupalchowk district).

Unlike in the normal day to day service, local officials receive bribes in the valuation of properties for tax and other purposes by altering the value according to the need of service receiver as observed in the Madhyapur Thimi Municipality in the urban Bhaktapur district (Gyawali 2013) and collecting the allowances beyond the local body rules and regulations as practiced by officials of Nanglebhare VDC of

9 It is discussed in Panta (2015) describing the survey results obtained from survey of six sample VDCs.

10 The competitive lobbying is operated through the political campaign or advertisement rather than monetary transaction as in the case of corruption. In this rent seeking practice, there will be difference between "optimal decision" and "actual decision" which lowers social welfare (Lambsdorff 2002) that the benevolent government (as a principal) tries to maximize through the decision of its official (as an agent).

11 A talk with Dinesh Thapaliya, a joint secretary of MoFALD by Setopati correspondence (a newspaper article published in Nepali paper-Setopati Online on March 16, 2014).

Kathmandu Valley (Paudel 2013). Moreover, misappropriated (beyond the provision of guidelines) expenditure from higher to users' level is also normal in local project implementation. In addition, demand for bribes by VDC and DDC technicians as a certain share of budget while providing the final approval of the project works has been a common practice in most of the districts of Nepal. Furthermore, forceful siphoning off of funds from the projects by local gangs (or Dons) in some districts is also prevalent. A secretary of a sample VDC from Eastern Terai said, "We mostly have to switch off our mobile during budgeting and during festivals to avoid unnecessary pressure from political parties and other interest groups (sometimes armed and criminal groups, in these areas) for project selection and economic assistance" (Interview, 11/10/2012).

All these irregularities not only lead to generate illicit income, but also to inferior quality and quantity of services produced and delayed completion or no-completion of local projects. These cases exemplify how the local political elites and local officials indulge in corruption. The information mentioned above allows us to conclude- elite capture and corruption inversely affect the local public service delivery hindering the cost-effectiveness, inter-community targeting and intra-community targeting of local public expenditure (Bardhan and Mookherjee, 1998) through the siphoning out of project fund resulting to the reduced quantity and inferior quality of public services.

4.3 Absenteeism: A Corrupt Practice and Problem in Local Service Delivery

Absenteeism is a serious problem in service delivery as it hinders the opportunity of service receivers from availing their services provided by government through local officials. There exist two types of absenteeism in local service institutions. First, absenteeism because of vacant posts resulted by scarce financial or human resources or due to deputation or training, etc. Second is the illegal absenteeism, i.e., absence of public officials in their defined duty using their position and time to produce an extra income. In the second case, public officials sell their services in the private market at the cost of their public duties (Widmalm 2008). It is taken as corruption because a government employee "accepting the salary and not being on the job is also a type of corruption" as viewed by Amartya Sen (Varadarajan 2005; Widmalm 2008).

In Nepal, till March 8, 2014, about 493 VDCs were facing the problem of shortage of secretaries causing an additional burden to the secretaries in duty who had to serve more than two VDCs each (Himalayan News Service 2014). A survey of 747 health workers of 15 selected districts of Nepal found that, 21.1 percent of absenteeism was due to the deputation, 13.3 percent because of training and 30.5 percent because the employees were on leave (SOLID Nepal and Merlin Nepal 2012). Whatever was the cause, absenteeism of health workers has seriously hindered the health services to local people who were in need. Next, most of the health in-charges serve from their clinics after 2.00 pm instead of remaining in their duty till 5 pm as defined in their job description.

Absenteeism of VDC secretaries in a number of districts constrained the access of locals to government facilities such as registration works, distribution of social security allowances, necessary recommendations and facilitation of project activities. (The Carter Center 2014) observed this type of problem in 23 VDCs out of 33 VDCs of its sample. However, the problem of absenteeism is found higher in remote hills, mountains and Terai regions of Nepal. The secretaries are generally found in the district headquarters. VDC secretaries of remote hills, mostly attend their local offices only during the annual meeting of the VDC Council for annual planning and budgeting and selection of development projects (Field observation, 2012).

In the absence of elected representatives, it has weakened the monitoring of absenteeism of VDC secretaries and instead of being accountable to locals, the latter are observed to follow upward accountability. The locals link some of their frequent transfer and absenteeism with opportunities for covering their corrupt activities and avoiding protest against their irregularities. Some VDC employees were found to be engaged in own alternate business in market centres instead of attending the remote offices regularly (Interview with some local people along with a Headmaster from a sample VDC from Terai region). Hence, the absenteeism obstructs the right and opportunity of local people from getting better and prompt public services in their place affecting their day to day life.

4.4 Lack of Elected Representatives: More Chances for Corrupt Practices

Just over two years of promulgation of Local Self-Governance Act (LSGA) 1999 and its regulation 1999, LBs have become vacant of elected representatives since June, 2002. There has been no election to LBs in Nepal for over one and half decade. Provision of All Party Mechanism (APM) and other alternatives had been adopted during the period. However, APM was dissolved in 2012 by MoFALD, following the official directives of CIAA because of its controversial role in decision making, indulgence in corruption, nature of partisan, etc. (The Carter Center 2014). The situation is continuing even after the succession of APM by local body council (formed of local officials of line agencies under the chair of the chief of the local body). All are being accountable towards the centre (the practice of upward accountability), presence of rampant corruption, irregularities and inefficient service provision became problematic in local governance, contrary to norms of decentralization. Hence, people could not experience the *de facto* benefits of LSGA and decentralization through the Decentralization Implementation Plan (DIP).

Instead of being helpful in local governance, APM became unpopular and burdensome due to party capture of projects and resources. Though it is not as exact as the case of trade union influence on legislation in U.S. for economic regulation, there exists a practice of *interest group theory*, i.e. the influence of interest groups on public spending through their lobbying with local officials.[12] Political parties, in their interest, are found to pressurize VDC officials to lower the local tax base and rate, and exceed the expenditure caps leading to unnecessary expenses and failure of VDC to meet MCPM criteria (The Carter Center 2014). During the absence of elected representatives, high degree of capture by local elites and appointed officials, and the members of APM or leader of political parties in expenditure assignment and project selection, have reduced the benefits of decentralization and induced corrupt practice at local level (Kelly, Koirala, and Ghimire 2011). These activities of the leaders of political parties has demand-side consequences led by budgetary deficit due to tax evasion and siphoning out from the project fund; and supply-side consequences led by low quantity and quality of services.

The election provides room for "voice" mechanism as the practice of Tiebout's model of "voting with their feet". Tiebout's model and *median voter theory*[13]of public choice both remain unpracticed due to the absence of local elections for a long period. Here, in this situation, the underlying assumptions: "competition for votes" and the "income distribution" (political parties follow these assumptions targeting the success in the election) (Buracom 2011) both lose their importance. Similarly, absence of elections has also affected the *political business cycle theory*[14] at local level as self-interested political parties are increasing local spending pursuing more private monetary benefit rather in the view of manipulating more voters for their success in local election. In other words, APM and local official then are found to choose upward accountability, and the principal-agent relationship seems to be prevailing between central government and local bodies. But, with the voter, they assess the dominant relationship through "partisan, patron-client and pork-barrel politics"(World Bank 2014) which provides the ground for corruption at local level in the absence of proper accountability, finally resulting to poor quality and quantity of local public services.

4.5 Delayed Release of Budget: Room for Local Level Corruption

Late release of transfers from the Centre to the DDCs and further delay while releasing to the VDCs from the DDCs affects the procedure of local expenditure assignments-planning, budgeting and implementation of the projects. The inconsistent flow of funds leads to questions of efficiency, transparency and accountability in implementation

12 Robert D. McCormick and Robert E. Tollison observed the direct relationship between number of registered trade unions (interest groups) and extent of economic regulation within a state in U.S (Buracom 2011). However, in our case, political parties act as the interest groups to alter the tax-expenditure mix to achieve their economic or electoral benefit, given the rules and regulations.

13 Anthony Downs, A.H. Meltzer, and S.F. Richard developed *median voter theory* which conceptualises that governments try to address voter's demand, in order to win elections (Buracom 2011).

14 Martin Paldam and Alberto Alesina and N. Roubini proposed the possibility of *political business cycle* created by government or election procedure between political parties where they increase government budget expenditure just before election to influence the voters in their for (Buracom 2011).

procedure, mostly, difficulties in timely absorption of fund, completion of projects and leaves room for low production efficiency and corruption. Off-budget funds to DDCs have even more problem as it is released at the last moment of the fiscal year.

Mostly, local officials, as we observed, grab the residual budget by submitting false documents of project completion such as forged bills, receipts, monitoring reports, etc. at the end of fiscal year acceding high chances of graft (The Carter Center 2014). Late procurement and collusion among the contractor, local officials and political agents also are found to compromise for producing low quality of service and to indulge in corruption, i.e. diversion of some fund to their pocket. The improper use of funds, i.e. using funds beyond the target or value-for-money purpose and improper accounting during the project implementation is found to lead to *fiduciary risk* (i.e. process risk and result risk) in Public Financial Management (PFM) of LBs (MoFALD 2012). VDC secretaries of sample VDCs of this research also consider late release of budget as an important barrier in efficient project management and implementation that is required for producing efficient local public services.

4.6 Two Types of Triads: Mostly Visible at Local Level

There exists a kind of collusive nexus among local officials and political representatives in misappropriation of fund (by producing fake approval papers) that leads to a situation where projects are never completed due to shortage of resources. The Carter Center observed that the people's perception of such cases in Dhanusha and Mahottari districts in addition to practice of "fake receipts" or "fake public reports" in Gorkha, Kanchanpur and Bardiya districts as well (The Carter Center 2014).

As discussed in (Kumar 2002) about the role of triad in corruption and illicit income generation, mostly a triad exists between local political elites, local officials and contractors to complete a corruption procedure in case of local construction projects. Among them, local officials are more informed and have more authority (these days), they establish strong contact with contractors, leaving loose attachment with the local political elites as far as possible, to increase their share in corrupt benefits. At the users' committee level, a triad between the chief of the local users' committee, local officials and technicians act altogether in misappropriation of quantity and quality of work to acquire private monetary benefit through overvaluation and overstating of the expenditure of the project. Somewhere, we can observe the corrupt role of media as well where media deny to uncover the cases of corruption. The statement of a *Dalit* labour of Pakali VDC as mentioned in the previous section also exemplifies the triads working for local capture and corruption, including the role of media. All these phenomena lead to degradation of efficiency of the local public services – both by extracting out certain portions of the project cost and through the inferior service provision as explained in the theoretical discussion.

4.7 Ineffective Monitoring Mechanism: A Cause for Policy Failure

Monitoring and evaluation of the local fiscal assignments are one of the foremost issues to enhance the transparency and accountability during project implementation. This procedure provides disincentives for the misappropriation of the project fund and incentives for effective service delivery. Monitoring and evaluation provide the knowledge on shortcomings in project implementation and room for further correction to achieve effective and efficient service delivery as targeted by the benevolent local government.

Nepalese LBs are facing problems of ineffective monitoring and evaluation of their implemented projects. Though the LBs emphasize on project implementation, they give low priority to the supervision, monitoring and follow-up of the project works (Kelly, Koirala, and Ghimire 2011). There is provision of monitoring and evaluation mechanism from the central level to user's level. In the centre, the provision in LSGA exists for Decentralization Implementation Monitoring Committee (DMIC) to induce the effective implementation of DIP 2002. District level monitoring committees in DDCs are authorized to monitor and evaluate the implemented programmes and projects all over the district. Similarly, VDCs and municipalities form a monitoring committee in their respective levels including local APM representatives. At the bottom, both executive and monitoring committees are formed simultaneously at the users' level in an inclusive manner. Besides these, CDO and District Administration Office (DAO) as the district agency for CIAA, representatives of the Office of Auditor's General Nepal (OAGN) and district level agent of the National Vigilance Centre (NVC) also sometimes monitor the project activities under the LBs.

Besides these layers of monitoring mechanism, the monitoring and evaluation of local development projects is still fragile and ineffective. According to a survey study, (The Carter Center 2014), local monitoring committees are only formal and ineffective, in some cases. Somewhere, these are formed outside the project area and by VDC itself. However, they are found to be considered as an effective and essential mechanism in some district as they are working well by publishing regular monitoring reports and public hearings. Most remarkable flaws are observed that if the users' committee feels uncomfortable with monitoring mechanism, then it ignores the mechanism and tends to bribe technical staff and get approval by creating "fake papers".

Mostly, public audit seems to be irregular and ritual in most of the LBs. MCPM results produced by LBFC give a picture of situation of monitoring and evaluation in LBs.. According to the field survey, weak monitoring exists due to the pressure on monitors from the users either through monetary greed or through other pressures such as threats, proximity etc. as well. Thus, ineffective monitoring and evaluation mechanism allows for the poor accountability and chances for corruption. It results into degrading the quantity and quality of local public services leading to the policy failure in local governance through inadequate allocation and ineffective expenditure.

5. Conclusion

The level and nature of local service delivery rests on efficiency of local governments, i.e., efficiency in mobilisation, allocation and utilisation of resources. However, such efficiency is limited by flaws in local governance and fiscal decentralization in developing countries like Nepal. Along with low revenue raising power, resource deficit, and lack of functionaries, absence of elected representatives, unclear assignments, Nepalese LBs face the problem of poor accountability and transparency, mostly manifested in elite capture, corruption and black economy. These shortcomings impede the effectiveness of local public service delivery because of the weak allocation procedure and productivity. Also the efficiency of the local public services, both in quantity and quality that creates distrust on the public services. Next, the poor are more dependent on inferior public services (which are cheap) as they are unable to purchase costly private services. Hence, it further narrows down the impact of local public services on poverty reduction.

Information obtained from primary and secondary sources (discussed earlier) show the existence of these maladies which are degrading the quality and quantity of local public services. It questions the efficiency and the effect of fiscal decentralization on poverty alleviation in Nepal. In other words, the presence of elite capture, corruption and lack of other factors (such as proper targeting) has a negative impact on the pro-poor nature of the projects. Moreover, lack of transparency and accountability in project targeting and implementation has prevented the benefits of local public services from reaching the poor (who are more in need of public services). Instead, they benefit the non-poor more. It seems as if the decentralization of corruption is spreading to the local level leading to abuse the decentralized authorities and misappropriation of funds by local stakeholders.

Hence, increased local public expenditure did not improve the quality of life of the poor as much as it should have and reflected in low quantity and quality of local public services level of which is determined by the level of corruption and elite capture at the local level those generating illicit income. There is the need of the policies and actions to tackle these problems to achieve the efficient local public services to produce positive outcome on poverty reduction through it. Lastly, the process of decentralization and local service provision through it is not *de novo,* but regular reforms in these sectors would better serve the goal of multi-dimensional poverty reduction by a benevolent government through decentralization of public service delivery. There is need to address various problems discussed in this article while constructing the laws and by-laws on local governance and, programs and policies during its implementation in new federal set up of Nepal.

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Contribution of Expenditure of Local Bodies to Economic Growth in Nepal

Hem Raj Lamichhane[1]

1. Introduction

Several arguments have been advanced in favour of the decentralized governance especially due to the fact that it enhances efficiency, accountability and promotes autonomy. Needless to say, for the better service, there is the need of government being closer to the people and the people should have the right to vote for the categories and the quantity of public services they need (Stigler, 1957). The efficiency of service delivery increases at local level (Musgrave, 1959). The decentralization helps to increase efficiency because local governments have better information about the tastes and preferences of its locales than the central government (Tiebout, 1956). Likewise, according to the decentralization theorem, each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision" (Oates, 1972).

Decentralized governance is one of the most important vehicles to reduce poverty and inequality in both rural and urban sector. Furthermore, the local government should be more functional, for that, devolution of function to local government with more tax authority is necessary. The local government should be given a share of revenue generated from extraction of resources within their area (World Bank, 2000). More specifically, local self-government deals with needs of every citizen to solve her or his day-to-day problems because it aims to be as closer as possible to people. It also forms sense of responsibility for solving local problems and prompts people to be active.

The main goal of fiscal decentralization is to move governance closer to the people, and this does require strengthening local government finances. It means that fiscal decentralization requires local government with autonomy to make independent

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fiscal decisions. A very important feature of public finance is fiscal federalism. It is more convenient if some services are under the responsibility of state and local authorities. It is because it ensures a better connection of the real needs of the people (World Bank, 2000). The *subsidiarity* principle (decentralization principle) recommends- competencies in the provision of public service should be vested to the lowest possible level in the fiscal hierarchy (Bardhan, 2002). Finance can very well express a federal government structure because the fair and balanced distribution of government spending and public revenue is essential for smooth functioning of a federation.

2. Review of Theoretical Perspectives

The first generation theory of fiscal decentralization says that the local governments act in best interest of constituents because it focuses on allocative efficiency gain and economic reality (Oates, 1972). Besides, political behavior of local officials is a very important aspect for decentralization. The second generation theory of fiscal decentralization, if political and economic reality are congenial and not appropriate, assumes that local government may not act in local interests of constituents (Oates, 2005).

The expenditure policies may be implemented locally but the expenditure can be financed nationally. One of the major functions of government is efficient allocation of resources where sub-national governments can play pivotal role because local governments have better information with regard to the demand, expectations, and needs of their own residents (Sewell, 1996). The notion of good governance is not new. It is primarily concerned with the proper 'exercise' of economic, political and administrative authority to manage a country's affairs at all level of governments (UNDP, 1997). In addition to raising revenues, local revenue mobilization has the potential to foster political and administrative accountability by empowering communities (Oates, 1999).

Decentralization can be defined as the means to achieve the democratic and development outcomes. It is neither good nor bad. The successful decentralization improves the efficiency and responsiveness of public sector. Therefore, the success of decentralization depends on its use and design. Ultimately, decentralization means the transfer of political, fiscal and administrative power to sub-national units of government (World Bank, 2000). The purpose of decentralization is to deepen democracy, enhance local participation, ownership and autonomy and to promote partnership between state and society. On the other hand, purpose of ideal decentralization is to democratize lower levels of government as a substitute for democratization at the central level, off-load tasks that the central government finds costly or inconvenient and obtain local resources that are exploited by party bosses or to please donor agencies (OECD, 2004). Moreover, decentralization is the transfer of authority and responsibility from the central government to local government which ultimately contributes to empowerment of people through their effective engagement and participation in the affairs of local government (Boex et al, 2005).

The first generation theory of fiscal federalism argues that the central government should take the lead in macroeconomic stabilization policy, introduce basic measures for income redistribution, and provide efficient levels of output of national public goods (Oates, 1972). Moreover, fiscal federalism is directly related to the division of public sector functions and finance in all layers of government (King, 1984). The role of fiscal federalism is to define the appropriate tasks and finances of local government for effective service delivery that helps to maximize the social and community welfare (Bird, 1986).The traditional theory of fiscal federalism argues a general normative framework for the assignment of functions to different levels of government and the appropriate fiscal instruments for carrying out these functions (Musgrave 1959; Oates 1972). Furthermore, "local public goods" can be provided by local government that meets the demands of the residents of their respective jurisdictions (Oates, 2004).

Fiscal decentralization is meant to strengthen finance (Taxation power and expenditure responsibility) of local government. Local government should have autonomy to make independent fiscal decision. To carryout decentralized functions effectively, an adequate level of resources either mobilized and collected locally or transferred from the central government and the authority to make decision on expenditure are needed. There are four forms of fiscal decentralization such as (i) self-financing or cost recovery through user charges (cost recovery pricing), (ii) Co-financing or co-production arrangement through which the users participate by monetary or labor contribution, (iii) Inter-governmental transfers from central and provincial to local government, and (iv) authority of borrowing through loan guarantee (World Bank, n.d.).

The fiscal decentralization refers to the degree of independent decision-making power in the provision of public services at different levels of government (Oates, 1972).The degree of fiscal decentralization may be defined by three criteria: (1) the importance of local taxes relative to central taxes, (2) the importance of local expenditures relative to central expenditures, and (3) the importance of central subsidies to local resources (Prud'homme, 1990).

The theorem on fiscal federalism argues that local government can provide public services more efficiently and be more responsible to their residents through competition among local government (Aoki, 2008).The fiscal federalism helps to improve the living standard of people in terms of good governance; acceleration of economic growth; reduction of poverty; achieving gender balance; empowerment of backward, marginalized, and disadvantaged group of the society by the efficient use of resources and inclusive participation in decision making process at the lower level of governance (Sharma, 2009).

The conventional theoretical studies say that the fiscal decentralization has a positive effect on economic growth (Akai and Sakata, 2002). The result states that capital expenditure has higher contribution to GDP compared to recurrent expenditure. However, there is negative impact of miscellaneous and contingency expenditure to GDP. The findings of the second model was that one hundred percent changes in TE (total expenditure) cause GDP to increase nearly by fifty percent and the hundred percent changes in gross investment bring about 16 percent positive changes in GDP models (Mainali, 2012). There is a positive impact of LSGA provisions related with financial devolution on GDP in the districts of Nepal. The fiscal decentralization is significantly enhancing GDP (economic growth) in the districts of Nepal (Devkota, 2013).

There are two different schools of thought about the contribution of government expenditure on economic growth- whether the government spending helps or hinders economic growth. One argument is that government programs provide valuable "public goods" such as education and infrastructure. So, increase in government spending can help for economic growth by empowering the people and putting money into their pockets. On the other hand, the opposite view is that government is too big and that higher spending undermines economic growth by transferring additional resources from the productive sector of the economy to government, which uses them less efficiently (Daniel, 2005).

3. The Pillars of Fiscal Decentralization

There are 'four pillars' or 'building blocks' of fiscal decentralization. They are (i) expenditure responsibilities, (ii) revenue assignments, (iii) Inter-governmental fiscal transfer, and (iv) sub-national borrowing (Boex, 2001, Kelly, 2010) The four pillars are explained very briefly in the following ways.

3.1 Expenditure Responsibility

The expenditure assignments are the base of fiscal decentralization. Without functional roles and responsibilities, there is no need of revenue assignment. The functions should be assigned on the basis of principle of efficiency. Revenue assignment without solid expenditure assignment would weaken the decentralization process. Therefore, expenditure assignment is the first step in designing an intergovernmental fiscal system (Martinez, 1994).

3.2 Revenue Assignments

Revenue assignment is the second but very important feature of fiscal decentralization. The sub-national governments have the authority and responsibility to raise and allocate finance for local services. There is no ideal division of revenue assignments between central and lower levels of government. Nevertheless, the three major functions need to be determined as revenue assignment (Musgrave, 1959). The functions relating to the macroeconomic stabilization (maintenance of high employment and price stability) and income redistribution (maintenance of equitable geographical allocation of economic resources) should be assigned to the central government and the function of allocation of resources is better to assign to the sub-national government. Moreover, in response to revenue assignments, a set of 'tax-assignment rules has been developed in the traditional fiscal federalism theory (Oates, 1972). However, while talking about revenue assignment in developing countries, the administrative capabilities of local government in revenue design (that is, deciding on revenue bases and setting rates) must be taken into consideration (Bird, 1990). Moreover, in large and diverse countries the issue of revenue harmonization between jurisdictions is important when assigning taxing powers.

3.3 Inter-Governmental Fiscal Transfers (IGFT)

Inter-governmental fiscal transfer is the third pillar of the fiscal decentralization. It has many names such as grants, subsidies, subventions etc. Through this process, financial resources are transferred from the higher level of government to the lower level, and shared between the lower level of governments to correct both vertical and horizontal fiscal imbalance (Bahl, 1999). The intergovernmental fiscal transfers are important tool of public sector finance in both industrial and developing countries in three major reasons (Shrivastave, 2002). First, the central government will have opportunity to raise more revenue and maintain good relationship with the sub-national governments and on the other hand, sub-national governments will have advantages to deliver quality services as required by the people in a transparent and efficient manner. Second, in most cases, there are considerable differences in revenue-raising capacity between sub-national governments. If they were fully autonomous to mobilize revenue and solely depend on their own revenue, higher income jurisdictions would be capable to spend more on public services as compared to the lower income jurisdictions. Hence, IGFT has both equity and efficiency implications in service delivery process of sub-national government. The transfer is used to ensure that LGs have adequate revenues to discharge designated functions (expenditure needs) because there is a fiscal gap between expenditure assignment and revenue assignment at sub-national level. The revenues from taxes, user fees, charges cannot be generated adequately by sub-national government due to the fact that major taxes are mostly considered as suitable for the central government level (Bird and Smart, 2001).

The "piggybacking" approach may be appropriate to the tax sharing to sub-national governments. From the theoretical point of view, the asymmetric decentralization relates to a transfer of different "dosages" of fiscal powers, authorities and responsibilities in different local governments taking into consideration of the conditions and requirements for each particular country and local development. There are inherent trade off between central government control and local flexibility. Moreover, there are several implications of center-local fiscal instruments. The major purposes are- to shut the vertical gap, to minimize the horizontal gap by equalizing across sub-national governments (SNGs), to compensate for spillovers and externalities, to encourage SNG expenditure in national priority areas, to build SNG capacity and encourage SNG performance and to help remove political discretion, patronage and corruption. The major types of IGFT instrument are- share of a national tax (share may be distributed to SNGs by area of derivation or a formula base system), unconditional block grants based on formula for general SNG expenditure like administrative and development, specific (conditional) grants which is more or less tied on specific service, cost reimbursement for delegated functions, targeted transfers for national priority programmes and so on (Shotton, 2010).

3.4 Sub-National Borrowing

Sub-national borrowing is the fourth and important pillar of fiscal decentralization. Sub-national governments are entitled to receive borrow/debt from the finance companies and institutions to finance the development activities of the jurisdiction. Generally, there are two school of thoughts on sub-national borrowing. According to the first view, if the own source revenue of sub-national government doesn't meet their public expenditure need, they should have right to borrow to meet the expenditure assignment. Further, borrowing is one of the most important and preferred option to meet the gap between expenditure and revenue. So, the sub-national governments should have authority to meet the development expenditure through borrowing (Mica, 2000).

4. Functions, Duties and Powers of Local Bodies in Nepal

In addition to executing or causing to be executed decisions and directions of the respective councils, according to the provisions of LSGA, VDCs, municipalities and DDCs shall be responsible to perform assigned functions as prescribed in LSGA. The functions of VDCs, municipalities and DDCs (local government bodies of Nepal) are clearly prescribed. Basically, there are 11 areas for VDCs and municipalities and 14 areas of DDCs to be accomplished at the local level. These are broadly agriculture, rural water supply and habitation development, physical development, education and sports, health services, hydropower, irrigation, soil erosion and river control, tourism and cottage industry, forest and environment, language and culture, tourism and land reform and land management and information and communication.

The Constitution of Nepal, 2072 has guaranteed constitutional competencies to local level through the distribution of state power namely the executive rand the legislative power. According to the constitution, the powers assigned to the local level are: town police; cooperative institutions; operation of FM radio; management of the local services; collection of local statistics and record; local level development plans and projects; basic and secondary education; basic health and sanitation; local

SNG = Sub National Government, VDC = Village Development Committee, DDC = District Development Committee, MUNs = Municipalities, LSGA = Local Self Governance Act, GDP = Gross Domestic Product.

market management, environment protection and bio-diversity; local roads, rural roads, agro-roads, irrigation; management of village assembly, municipal assembly, district assembly, local courts, mediation and arbitration; local records management; distribution of house and land ownership certificate; agriculture and animal husbandry, agro-products management, animal health, cooperatives; management of senior citizens, persons with disabilities, and the incapacitated; collection of statistics of the unemployment, management, operation and control of agricultural extension; water supply, small hydropower projects, alternative energy; disaster management; protection of watersheds, wildlife, mines and minerals; protection and development of languages, cultures and fine arts.

5. Revenue sharing between Central and Local Government in Nepal

About a decade after the restoration of democracy in 1990, Local Self Governance Act (LSGA) was promulgated in Nepal in 1999. This act was hailed as the milestone in promoting decentralization in Nepal.The Act entitles the District Development Committee to receive the certain percentage of revenue collected in districts by central government as part of a revenue sharing. The details of the vertical sharing (from central to local) and horizontal sharing (from DDC to VDC and Municipality) and vice versa are mentioned as follows (LSGA, 1999):

1. DDC shall receive the following percent share from registration fee to be obtained by government of Nepal for the purchase and sale of house and land.

1.1	Up-to 5 million	90%
1.2	From 5-10 million	60%
1.3	From 10-20 million	30%
1.4	From 20-30 million	20%
1.5	From 30-50 million	15%
1.6	From 50-100 million	10%
1.7	More than 100 million	5%

2. DDC shall receive 50%out of the amount to be obtained by the Government of Nepal for royalty of mines,
3. DDC shall obtain 10% of the revenue collected from the forest resources,
4. DDC shall get 50% out of the amount to be obtained by government of Nepal from hydropower production and sale. Out of 50%, 12%shall be obtained by the DDC where hydro power plant is installed and remaining 38% for the DDCs of the respective development region at the proportional rate[2].

2 Amended by the second amendment of LSGR on 2061/09/26 BS

5. DDC shall get 30% out of the amount of entrance fee to be obtained by Government of Nepal for entry of tourists into the district development area[3], royalty of mountain climbing[4], entry of tourists into national park, and pad yatra/ trekking.[5]The Constitution of Nepal, 2072 has made local level governments responsible to raise local taxes, i.e., land taxes (wealth tax, house rent tax, land and building registration fee, motor vehicle tax), service charge, fee, tourism fee, advertisement tax, business tax, land tax, (land revenue), penalty, entertainment tax, land revenue collection. The constitution has also provisioned the National Natural Resources and Fiscal Commission which is responsible for determining the detailed basis and modality for allocation of resources between the federal, state and local governments out of the Federal Consolidated Fund in accordance with the constitution and law. Similarly, the commission will be responsible to make recommendation about the equalization grants to be provided to the states and local Governments in accordance with the policies and programs, norms/ standards and situation of infrastructure development. It is also accountable to determine detailed basis and modality for the distribution of revenues between the state and local Governments out of the State Consolidated Fund and to recommend measures to meet expenditures of the federal, state and local governments, and to reform revenue collection procedures. The commission will set the bases for determination of shares of the Government of Nepal, state governments and local governments in investments and returns, and in the mobilization of natural resources.

6. Fiscal Decentralization and Budget

One of the important rules of fiscal decentralization is "finance follows the functions". It is very important that expenditure assignment of local governments should be followed by the revenue responsibilities. The very necessary conditions of fiscal decentralization are the assignments of expenditure and revenue responsibilities, budget autonomy and hard budget constraint of the local governments (Bahl, 1999). Although the classical economists opine that *'every tax is an evil'* and *'every public expenditure is unproductive',* modern states should be considered as welfare states whose responsibility is to ensure maximum social welfare for the people and public expenditure is good for welfare state. So, it is compulsory contribution of citizen to the state and also the personal obligation to pay tax. Therefore, a government collects the revenue through taxation and makes public expenditure (Lekhi, 2001). The following two measures are mostly used to calculate the fiscal decentralization variable using the ratios of government revenues and the ratios of government expenditures (Boex et al., 2005).

3 Added by the second amendment of LSGR on 2061/09/26 BS
4 Added by the second amendment of LSGR on 2061/09/26 BS
5 The amount to be obtained from the revenue sharing shall not be used in the administrative expenses by the DDCs.

1. The expenditure decentralization is measured as a ratio of sub-national government (regional and local) spending to general government (central, regional, and local) spending. This ratio measures the responsibility of local government bodies for administering and delivering services.
2. The revenue decentralization is calculated as a ratio of sub-national government revenue to general government revenue. This ratio measures the power of local government to finance their services.

7. Inter-Governmental Fiscal Transfer in Nepal

The following provisions, regarding the grants to be provided to local bodies by the Government of Nepal, have been made in the Local Body Resource Mobilization and Management Procedure 2012 brought into implementation by the government pursuant to the LSGA, 1999 and LSGR, 2000.

(a) Recurrent grant

The Government of Nepal provides both conditional and un-conditional recurrent grant (and grant for administrative expenses) to each local body. This grant is used for the salary, allowances, travel and per diem cost of civil servant deployed in local bodies by the Government of Nepal and staff under administration grant approved by ministries; and the office operation cost, capacity development cost and social mobilization cost.

(b) Capital grant

The Government of Nepal provides both minimum and formula based unconditional capital grant to local bodies annually. The limit of minimum conditional grant to each VDC, DDC and municipality is NRs. 1.5, 4.0 and 3.0 million respectively. There is a provision that the minimum grant to be made available to the local bodies shall not exceed 30% of the total capital grant. In addition, the Government of Nepal provides formula based capital grant on the basis of the result of Minimum Condition (MC) and Performance Measures (MCPM) assessment. The criterions of formulas based grant system for DDCs are 40% weightage for population, 10% for geographic area, 25% for weighted cost and 25% for weighted poverty. Similarly, for VDCs, formula is fixed that 60% weightage for population, 10% weightage for geographic area and 30% for weightaged cost. For municipalities, it is fixed that 50% weightage for population, 10% for geopgraphic area, 25% for weightged poverty and 15% for wieghtaged internal tax effort

(c) Other grants

In addition to the unconditional recurrent and capital grant, the local bodies have also been receiving conditional grant to meet the target set by the central government. These are sectoral conditional grant, program or project based conditional grant, technical grant, local development fee provided to municipalities by the ministry and grant for the project run under spare fund/reserved fund (Jageda Kosh) on cost sharing basis and other grants received by local bodies.

8. Basis of Distribution of Unconditional Capital Grant for Local Bodies in Nepal

(1) The DDCs not meeting the minimum conditions (MCs) shall not receive additional unconditional capital grant except minimum grant.

(2) The DDCs meeting the minimum conditions (MCs) but not getting minimum marks in the area of performance measures (PMs) shall get additional unconditional grant deducting by 20%.

(3) The top three DDCs that have passed MC and secured the highest marks in PM shall get additional unconditional grant adding by 20%.

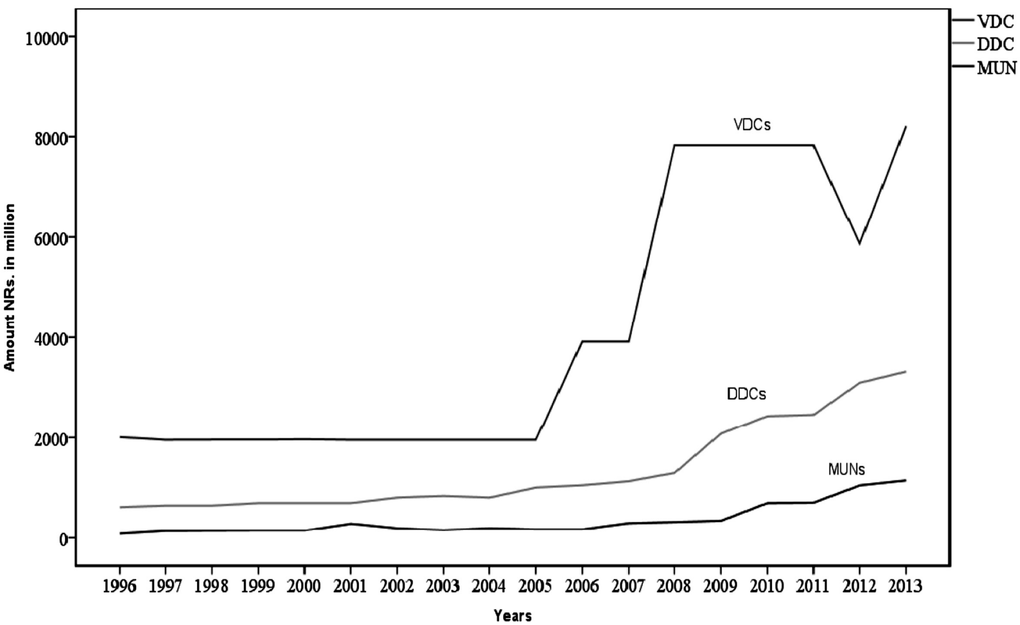
(4) Remaining DDCs will be provided additional unconditional grants as follows:

- Top 25% DDCs securing highest marks shall receive extra 15%.
- 25% DDCs of second category shall receive extra 10%.
- 25% DDCs of third category shall receive unconditional capital grant by deducting 10%.
- 25% DDCs of last category shall receive unconditional capital grant by ducting 15%.

9. Trend of Local Bodies Expenditure in Nepal

The Figure 1 shows that there is a gradual increase of budget expenditure of DDCs and municipalities from FY 1996/97 to 2013/14. However, the budget expenditure of VDCs was constant from 1996/97 to 2005/06. The expenditure of VDCs was raised from 2005/06 to 2006/07 and continued till 2011/12. The expenditure was substantially reduced in 2012/13. In 2013/14, the expenditure of VDCs was again picked up equal to 2011/12. The VDCs on an average used to receive 0.5 million grant annually from 1996/97 to 2005/06. The Government of Nepal doubled the VDC grant in 2006/7 and each VDC used to receive one million till 2007/08. Once again government of Nepal decided to increase the VDC grant and provide two million each from 2008/09 till 2015/16. The grant increasing process is continued. The Government of Nepal has proposed to double the grant. According to the new provision, each VDC will receive, on an average, four million in FY 2016/17 as grant.

Figure 1: Trend of expenditure of local bodies in Nepal



Source: Author's sketch based on the data available from Economic Survey and expenditure estimated of the Ministry of Finance for several years.

10. Objective of the Review

The specific objective of the study is: to assess the contribution of local bodies' (VDCs, DDCs, municipalities) expenditure (actual expenditure both capital and recurrent) to economic growth in Nepal.

11. Methodologies

All the grant annually provided by the Government of Nepal to District Development Committees (DDCs), Village Development Committees (VDCs) and Municipalities are assumed to have been spent. The study is based on the time series data of last 18 years from FY 1996/97 to 2013/14 collected from the Economic Survey and Red Book published by the Government of Nepal, Ministry of Finance. Data on GDP is also obtained from Economic Survey of various years. Relations between GDP and local bodies' actual expenditures are analyzed using Statistical Package for Social Science (SPSS) program. The Pearsons correlation and ordinary least squares (OLS) regression analysis (linear regression analysis) have been performed during analysis. Least squares method for regression analysis is used to find the best means for fitting a straight line to the data. Least-squares method a relatively simple mathematical technique that ensures the straight line, will best represent the relationship between X and Y (Zikmund, 2006). The ordinary least square has some very attractive statistical properties that have made it one of the most powerful and popular methods of regression analysis (Gujarati, 2004). There are two different models finally obtained from stepwise method which is generally used for variable screening to select the most important variables that contribute to the response variable. Issues such as multi-collinearity, outliers and influential points, and missing data that can affect the model are checked. Graphic tools and statistical tests are used to detect model "lack of fit" such as violation of assumptions, invalidity of inferences, outliers, influential observations and unequal variances. Normal probability plot for checking assumption of normality is done for residual tests and diagnostic plots. The unconditional recurrent and capital grant received by the local bodies from Ministry of Federal Affairs and Local Development is treated as government grant to local bodies. The conditional grant provided by various agencies of Government of Nepal, development partners, NGOs/INGOs and LBs' own source revenues are not included in the analysis. The GDP is influenced by many variables like households consumption, total government spending, private investment and net exports (total exports minus total imports). The component of central government spending is not taken into account in this article. This article seeks to assess the contribution of local bodies spending on GDP. It is because the spending of local bodies is also a support to promote economic activities, infrastructure development and income generating activities are the local level. Therefore, two separate models are used to see the influence of DDCs, VDCs and municipalities on GDP in Nepal. The models are as follows:

Process of checking stationary in the models

In practice, series can be stationary such as (1). If series is stationary without differencing I (0) which is known as I knot, (2) If series is stationary with integrated or differentiated of order 1, I (1), and (3) If series is stationary with integrated or differentiated of order 2, I (2).

Unit root test

Empirical work based on time series data assumes that the underlying time series is stationary. Otherwise, the regression results become spurious (Gujarati, 2004). In order to test the unit root, the following equation can be examined.

$Y_t = \rho Y_{t-1} + u_t \qquad -1 < \rho < 1 \qquad (1)$

$Y_t - Y_{t-1} = \rho Y_{t-1} - Y_{t-1} + u_t \qquad (2)$

$= (\rho - 1)\, Y_{t-1} + u_t$

$\Delta Yt = \delta Y_{t-1} + ut \qquad (3)$

Where,

$\delta = (p - 1)$

ut = White noise error term

If, $\delta = 0$, (3) will become

$\Delta Y_t = (Y_t - Y_{t-1}) = ut \qquad (4)$

Let's take the first differences of Y_t and regress them on Y_{t-1} and see if the estimated slope coefficient in the regression (= $\hat{\delta}$) is zero or not.

If (= $\hat{\delta}$) is zero, it can be concluded that Y_t is non-stationary. If (= $\hat{\delta}$) is negative, it can be concluded that Y_t is stationary.

Model 1: GDP = f(DDCs' expenditure, VDCs' expenditure)

The GDP is the function of DDCs and VDCs expenditure. The equation of model 1 is as follow:

$$Y=\alpha+\beta_1 X_1+ \beta_2 X_2+\varepsilon \text{ .... } (1)$$

Y = represents total GDP at current price (dependent variable)

X_1= represents expenditure of District Development Committees of Nepal (predictor or independent variable)

X_2= represents expenditure of Village District Development Committees of Nepal (predictor or independent variable)

α =Y intercept (average value of Y when predictors are absent)

β_1=The partial regression coefficient of X_1 on Y (It is the change in Y (GDP) for a unit change in X_1 (expenditure of District Development Committee)

β_2= The partial regression coefficient of X_2 on Y (It is the change in Y (GDP) for a unit change in X_2 (expenditure of Village Development Committee)

ε= represents error terms which is the simple difference between the actual and estimated Y values (Gujarati, 2004)

Model 2: GDP = f(MUNs' expenditure, VDCs' expenditure)

GDP is the function of municipalities' and VDCs' expenditure. The equation of model 2 is as follow:

$Y=\alpha+\beta_1X_1+\beta_2X_2+\varepsilon$ .... (2)

Y= represents total GDP at current price (dependent variable)

X_1= represents the expenditure of municipalities (predictor or independent variable)

α=Y intercept (average value of Y when predictors are absent)

X_2= represents the expenditure of Village Development Committees (predictor or independent variable)

β_1=The partial regression coefficient of X_1 on Y (It is the change in Y (GDP) for a unit change in X_1 (expenditure of municipalities)

β_2=The partial regression coefficient of X_2 on Y (It is the change in Y (GDP) for a unit change in X_2 (expenditure of Village Development Committee)

ε= represents error terms which is the simple difference between the actual and estimated Y values (Gujarati, 2004)

Research Hypothesis

The research hypothesis (H_1) is that there is significant contribution of DDCs', VDCs' and municipalities' expenditure in GDP.

Normality Test of the Model

An assessment of the normality of data is a prerequisite for many statistical tests because normal data is an underlying assumption in parametric testing. The Kolmogorov–Smirnov test (K–S test or KS test) is a non parametric test of the equality of continuous, one-dimensional probability distributions so one-sample K–S test is used to compare a sample with a reference probability distribution. According to Table 3, GDP was normally distributed because the significance value of the Kolmogorov-Smirnov Z is .564 (P value) which is greater than 0.05 significance level. It indicates that the GDP data is normally distributed.

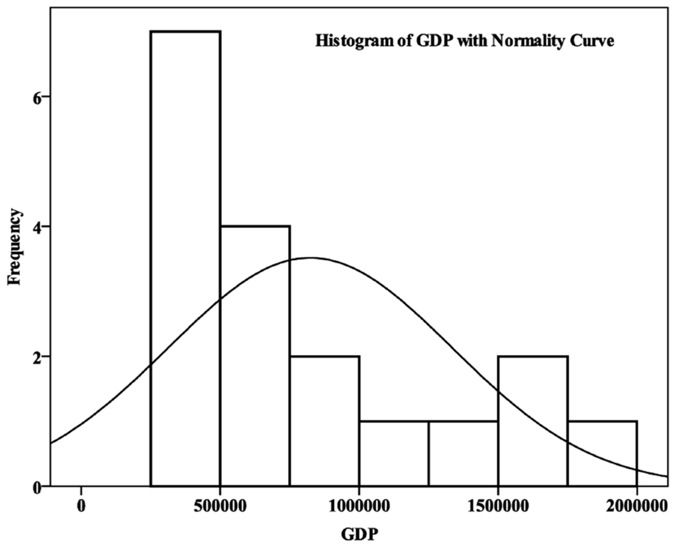
Table 3: One-Sample Kolmogorov-SmirnovTest

	Kolmogorov-Smirnov		
	Statistic	**df**	**Sig.**
GDP	.186	18	.564

Source: Self constructed based on the data available from Economic Survey and Estimates of Expenditure of Government of Nepal of various years .

Histogram and Normal Q-Q Plot

Figure 2: Histogram of GDP with Normality Curve



In order to determine the normality test, the Stem-and Leaf plot, Q-Q plot and detrended Q-Q plots are used. If the data are normally distributed, the data points will be close to the diagonal line. If the data points stray from the line in an obvious non-linear fashion, the data are not normally distributed. As we can see from the normal Q-Q plot below, the data is normally distributed. If it is at all unsure of being able to correctly interpret the graph, rely on the numerical methods instead because it can take a fair bit of experience to correctly judge the normality of data based on plots. Exploration of GDP is done to identify the nature of its distribution using histogram as in Fig. 2. It reveals slightly positively skewed as its right tail is slightly longer than left tail. It means that the GDP is slightly deviated from normality. But, when its distribution is tested using Kolmogorv-Smirnov (K-S) test, it shows the normality nature since p-value of K-S test (0.564) is more than 5 percent level of significance. This identification of GDP facilitates to use a multiple regression model with least-square method on a given predictor variables.

Correlation Analysis

Correlation between sets of data is a measure that indicates how well the variables are related. The most common measure of correlation in statistics is the Pearson Correlation. The full name is the Pearson Product Moment Correlation or PPMC (http://www.statisticshowto.com...). It shows the linear relationship between two sets of data. Correlation that simply indicates the relationship (positive or negative) of one variable to another is simple correlation. A coefficient correlation indicates both the magnitude of the linear relationship and the direction of the relationship (Zikmund, 2006). The correlation analysis is across DDCs' expenditure, VDCs' expenditure, Municipalities' expenditure (actual expenditure both unconditional capital and recurrent) and GDP to assess the degree of their relationship and to detect collinearity effect if present.

The Table 4 demonstrates the number of observation for Pearson's correlation using data of 18 fiscal years from 1996/97 to 2013/14across the aforesaid variables with the significant test at 1 percent level. The GDP has strong, significant, positive and linear correlation with DDCs' expenditure, VDCs' expenditure, municipalities' expenditure with correlation coefficient greater than 0.88. In addition to this, it also seems a greater degree of collinearity between three predictor variables. There are at least 0.75 significant correlations among them. This situation may pose problems while calibrating the model.

Table 4: Pearson's correlation analysis:

Pearson's Correlation				
Variables	**GDP**	**VDCs' expenditure**	**DDCs' expenditure**	**Muns' expenditure**
VDCs' expenditure	.889**	1		
DDCs' expenditure	.987**	.853**	1	
Muns' expenditure	.947**	.750**	.962**	1
***. Correlation is significant at the 0.01 level (2-tailed).*				

Note: VDCs=Village Development Committees, DDCs=District Development Committees and Muns = Municipalities

Source: Author's calculation based on the data available from Economic Survey and Estimates of Expenditure of Government of Nepal of various years.

The Table 4 of correlation analysis confirms that the increment in VDCs', DDCs', and Muns' expenditure has direct contribution to increase GDP. Therefore, it can be said that there is an incredibly positive contribution of local bodies' expenditure for economic growth in Nepal. To know the degree of contribution of local bodies' expenditure to GDP or economic growth, regression analysis of two models is performed.

12. Result and Discussion

The Model 1:

According to the Table 5, the calculated value of adjusted R square is 0.98. It means that the independent variables (DDCs and VDCs expenditure) explain 98% of variation in dependent variable (GDP).In other word, 98% of variation in dependent variable (GDP) is explained by the variation in independent variables (DDCs and VDCs expenditure). It can readily be verified that the slope coefficient is statistically significant.

The rule of thumb of Durbin-Watson calculation (DW) is that if d is found to be 2 in an application, it may be assumed that there is no first order autocorrelation either positive or negative in the residual. But, if d=0, it means that there is greater evidence of positive correlation. The value of Durbin-Watson calculation (DW) or the estimated d value is .915, which lies below d_L. It suggests that there is first order positive auto correlation in the residual.

Table 5: Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.991[a]	.982	.980	72949.71148	.915

a. Predictors: (Constant), DDCs' expenditure, VDCs' expenditure

b. Dependent Variable: GDP

The F-value is the Mean Square Regression divided by the Mean Square Residual, yielding F=408.892. The Table 6 shows that the p-value associated with the F value is very small (p-value < 0.0001) which is less than alpha level (typically 0.05). So, we can conclude that the independent variables (DDCs' expenditure and VDCs' expenditure) reliably explain the variations in dependent (GDP) variable. In other word, the model is significant for predicting GDP based on a group of independent variables in the model.

Table 6: Analysis of variance (ANOVA)

Model		Sum of Squares	df	Mean Square	F	Sig.
Regression		4351968685635.973	2	2175984342817.986	408.892	.000[b]
Residual		79824906064.527	15	5321660404.302		
Total		4431793591700.500	17			

a. Dependent Variable: GDP

b. Predictors: (Constant), VDCs' expenditure and DDCs' expenditure

To assess the contribution of each of predictors, the standardized coefficients (Beta) are considered for each of the above models. The Table 7 shows that the standardized coefficient of DDC is 0.838 and that of VDC is 0.174. This model indicates a higher contribution of DDCs' expenditure on GDP compared to VDCs' expenditure since the higher contribution of DDCs' expenditure may be due to accumulated effect of economic growth of VDCs and MUNs' expenditure on the economic growth of DDCs' expenditure although the budgets are distributed independently.

The estimates presented in Table 7 shows that relationship between independent variables and dependent variable. These estimates tell the amount of increase in the GDP (dependent variable) that would be predicted by a 1 unit increase in the predictor (independent variable).

The coefficient for VDCs' expenditure is significant at 5% confidence interval because its p-value 0.019 is less than alpha value 0.05. Similarly, the coefficient for DDCs' expenditure is significant at 5% confidence interval because its p-value (0.00) is less than 0.05 alpha values. So, the model is statistically significant. It means that the changes in the predictors' values (VDCs' and DDCs' expenditure) are significantly related to the changes in the response variable (GDP).The diagnostic factors of tolerance and variance inflation factor (VIF) help to examine the multi-collinearity among the independent variables. The tolerance values of both VDCs' expenditure (0.272) and DDCs' expenditure (0.272) are greater than 0.1. Here, the value of VIF (3.670) is less than 10 but greater than 2.5 that means there may be a cause of concern of multi-collinearity. However, the VIF greater than 10 is often regarded as indicating multi-collinearity. So it can be said that there is no issue of multi-collinearity among the independent variables in the model.

Table 7: Coefficients[a]

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	44591.694	32659.204		1.365	.192		
VDCs' expenditure	33.322	12.686	.174	2.627	.019	.272	3.670
DDCs' expenditure	475.762	37.687	.838	12.624	.000	.272	3.670
a. Dependent Variable: GDP							

The fitted equation for model (1);

Model 1: GDP = 44591.694 + 475.76 DDCs' expenditure + 33.32 VDCs' expenditure

Std. Error (37.69) (12.69)

It can be said that estimated parameter is statistically different than zero or statistically significant. For example, in the above fitted equation, the t-statistic for estimated β_1 is 475.76/37.69 = 12.62>2 and t-statistic for estimated β_2 is 33.32/12.69 = 2.626>2. Therefore, it can be very confidently said that the true relationship between GDP and expenditures of DDCs and VDCs is positive.

β_1 represents the difference in the predicted value of Y (GDP) for each one-unit difference in X_1 (DDCs expenditure), if X_2 (VDCs expenditure) remains constant. This means that if X_1 differed by one unit, and X_2 did not differ, Y will differ by B_1 units on an average. In other word, the GDP increases by 33.322 million rupees for every one million rupees increases in VDCs' expenditure on an average and the GDP increases by 475.76 million rupees for every one million rupees increases in DDCs' expenditure on an average.

The Model 2

The calculated value of adjusted R square is 0.96 (Table 8). It means that the independent variables (Muncipality's and VDCs expenditure) explain 96% of variation in dependent variable (GDP). In other word, 96% of variation in dependent variable (GDP) is explained by the variation in independent variables (Muncipality's and

VDCs' expenditure). It can readily be verified that the slope coefficient is statistically significant. The value of Durbin-Watson calculation (DW) is 1.279, which lies below d_L. It means that there is little positive autocorrelation into first difference regression.

Table 8: Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.985[a]	.970	.966	94728.47917	1.279

a. Predictors: (Constant), Muncipality's expenditure, VDCs expenditure

b. Dependent Variable: GDP

Table 9 shows that the p-value associated with the F value is very small (0.000) which is less than alpha level (typically 0.05). So it can be concluded that the independent variables (Muncipality's expenditure and VDCs' expenditure) jointly explain variations in dependent (GDP) variable.

Table 9: Analysis of variance (ANOVA) of model 2

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	4297191320207.063	2	2148595660103.531	239.438	.000[b]
Residual	134602271493.438	15	8973484766.229		
Total	4431793591700.500	17			

a. Dependent Variable: GDP

b. Predictors: (Constant), Muncipality's expenditure, VDCs' expenditure

Model 2 is validated through various tests. Unstandardized residual is normally distributed in model 2 which is measured through the graph and scatter plot (BIVAR). To assess the contribution of each of predictors, the standardized coefficients (Beta) are considered for each of the model. Table 10 shows that the standardized coefficient of VDCs' expenditure is 0.410 and that of Muncipality's expenditure is 0.640. This model indicates a higher contribution of Muncipality's expenditure on GDP compared to VDCs' expenditure.

The coefficients for VDCs' expenditure and Muncipality's expenditure are significant at 5% confidence interval because their p-values (0.000) are less than alpha value 0.05. So the model is statistically significant. It means that the changes in the predictors' values (Muncipality's and VDCs' expenditure) are significantly related to the changes in the response variable (GDP). The tolerance values of both VDCs' expenditure (0.438) and Muncipality's expenditure (0.438) are greater than 0.1 and the value of VIF is less than 2.50. So it can be said that there is no issue of multi-collinearity among the independent variables in the model.

Table 10: Coefficients[a]

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	143658.365	41366.085		3.473	.003		
VDCs' expenditure	78.269	12.998	.410	6.021	.000	.438	2.285
Municipality's expenditure	1012.719	107.707	.640	9.403	.000	.438	2.285
a. Dependent Variable: GDP							

The fitted equation for model (2);

Model 2: GDP = 143658.37 + 78.27 VDCs expenditure + 1012.72 MUNs' expenditure

Std. Error (12.99) (107.71)

In the above fitted equation, the t-statistic for estimated β_1 is 78.27/12.99 = 6.03>2 and t-statistic for estimated β_2 is 1012.72/107.71 = 9.40>2. Therefore, it can be very confidently said that the true relationship between GDP and expenditures of VDCs and Muncipality's is positive.

β_1 represents the difference in the predicted value of Y (GDP) for each one-unit difference in X_1 (VDCs' expenditure), if X_2 (VDCs' expenditure) remains constant. This means that if X_1 differed by one unit, and X_2 did not differ, Y will differ by B_1 units, on average. In other word, the GDP increases by 78.27 million rupees for every one million rupees increases in VDCs' expenditure on an average and the GDP increases by 1012.72 million rupees for every one million rupees increases in Muncipality's expenditure on an average.

The differentiation of order 2 of dependent variable

The Durbin-Watson d test of both models showed the autocorrelation. In order to current autocorrelation, the second difference method is applied because it is found that series is stationary with integrated/ differentiated of order 2, I (2).

In the fitted equation of model 3, the t-statistic for estimated β_1 is 29.850/3.842=7.756>2 and t-statistic for estimated β_2 is 62.951/11.448= 5.498>2. Therefore, it can be said that there is a true relationship between DGDP and expenditure of VDCs and DCCs. Similarly, the t-statistic for estimate β_1 in model 4is 38.077/4.215=9.033>2, and the t-statistic for estimate β_2 is 108.110/34.910=3.096>2. Therefore it can be said that there is a true relationship between DGDP and expenditure of VDCs and Muncipality's (Table 11).

The model 3 indicates that if VDCs' expenditure differs by one unit and DDCs' expenditure does not differ, DGDP will differ by 29.850 units on an average. Similarly, if DDCs expenditure differs by one unit and VDCs expenditure does not differ, DGDP will differ by 62.951units on an average. The Beta value of VDCs expenditure is .603 which is greater than the Beta value .417 of DDCs expenditure. It suggests that there is a higher contribution of VDCs' expenditure compared to DDCs' expenditure to DGDP (Table 11).

The model 4 indicates that, on an average, if VDCs expenditure differs by one unit and Municipality expenditure does not differ, DGDP will differ by 38.077 units. Similarly, if Muncipality's expenditure differs by one unit and VDCs expenditure does not differ, DGDP will differ by 108.110 units on an average. The Beta value of VDCs' expenditure is .769 which is greater than the Beta value .264 of Municipality's expenditure. It suggests that there is higher contribution of VDCs' expenditure compared to Municipality's expenditure to DGDP (Table 11).

Table 11: Regression result after 2nd difference of GDP

Dependent variable DGDP (2nd difference of GDP)			
Model 3		***Model 4***	
DGDP=α+β$_1$VCDs' expenditure+β$_2$DDCs' expenditure+ε		*DGDP=α+β$_1$VCDs' expenditure+β$_2$Muncipality's expenditure + ε*	
Constant	*-31173.277 (-2.871)* *Std. Error= 10858.854*	*Constant*	*-17809.832 (-1.222)* *Std. Error= 14578.971*
VDCs' expenditure	*29.850 (7.770)* *Beta= .603* *VIF = 3.395* *Std. Error = 3.842*	*VDCs' expenditure*	*38.077 (9.031)* *Beta= .769* *VIF = 2.135* *Std. Error =4.215*
DDCs' expenditure	*62.951 (5.499)* *Beta= .417* *VIF= 3.395* *Std. Error = 11.448*	*Muncipality's expenditure*	*108.110 (11.448)* *Beta (.264)* *VIF = 2.135* *Std. Error = 34.910*
F-value	*275.694*	*F-value*	*140.929*
R^2	*0.977*	*R^2*	*0.956*
Significance	*0.000*	*Significance*	*0.000*
D-W	*1.905*	*D-W*	*2.218*

Note: Parentheses are the t-statistics of coefficients

Beta = Standardized coefficients

B = Unstandardized coefficients

DGDP = GDP at 2nd difference

12. Conclusion

The share of central government grant to municipalities is very low as compared to DDCs and VDCs. This point explains that municipalities have been exercising more fiscal autonomy as compared to DDCs and VDCs in Nepal. On the other hand, VDCs are more dependent on the central government grant among the three local bodies in Nepal. Although municipalities are relatively more autonomous than VDCs and DDCs in resource mobilization, in totality, local government in Nepal deeply rely on the central government grant to deliver services at local level. The policy implication of the analysis is that GDP, expenditure of VDCs, Municipalities and DDCs are closely related. In other word, the changes in VDCs', Muncipality's and DDCs' expenditure will contribute to increase GDP in Nepal. It is also found that there is higher contribution of VDCs' expenditure to increase GDP compared to DDCs' and Muncipality's expenditure in Nepal. Therefore, it can fairly be said the fiscal decentralization will have a positive contribution for economic growth in Nepal. It has broader policy implications. It is recommended to substantially increase grant for local bodies to achieve better economic growth and development results in Nepal.

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Practice of Performance Based Grant System in Nepal

Kalpana Shrestha[1]

1. Introduction

The Performance Based Grant System (PBGS) was introduced by the Government of Nepal from 2004/05 and piloted in 20 DDCs with the technical and financial support of Decentralized Financing and Development Programme (DFDP). It is also known as assessment of Minimum Conditions and Performance Measure (MCPM). The aims of the implementation of PBGS were to improve performance of local bodies (LBs) through proper incentives, adjusting the size of grant based on the individual performance of LBs, identifying the capacity gaps of LBs and strengthening the monitoring and evaluation system of LBs (LBFCS, 2011). The Minimum Conditions (MCs) and Performance Measures (PMs) assessment of District Development Committees (DDCs) and municipalities started from 2007/08 (assessment for 2006/07) and 2008/09 (assessment for 2007/08); respectively as country-wide. However, the MCs assessment system was introduced in all Village Development Committees (VDCs) from 2008/09 (assessment for 2007/08). In case of DDCs and municipalities, the assessment result of the MCPM of the previous two fiscal years directly affects the capital grant for the current fiscal year. Similarly, for VDCs, those VDCs fail in MC assessment, they will lose the topping up grant (ibid.).

2. Minimum Conditions and Performance Measure (MCPM) and Grants to the LBs

According to the MCPM report published by Local Body Fiscal Commission (LBFC), i.e. Local Bodies' Financial Analysis Report, 2015, the effects of MCPM result are as follows.

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1. VDCs, Municipalities and DDCs which fail MC will lose the entire addition capital grant and receive only minimum unconditional capital grant earmarked by law. The current provision of minimum unconditional capital grant is that, in annual basis, each VDC, the municipality and DDC will receive at leat NPR. 3.6 million, 3.0 million and 13.8 million, respectively.
2. The DDCs and municipalities that pass MC but do not receive minimum marks in each functional area of PM indicators will lose 20 per cent of the additional capital grant.
3. DDCs and municipalities having highest marks in PM with MC being placed first, second and third position will obtain 20 per cent top-up grant as an additional unconditional capital grant.
4. Other provisions are as follows:
   a) 25% DDCs and municipalities that pass MC and having higher marks in PM (first ranked group) will receive 15% top-up capital grant as an additional unconditional capital grant,
   b) 25% DDCs and municipalities that pass MC and having higher marks in PM (second ranked group) will receive 10% top-up capital grant as an additional unconditional capital grant,
   c) 25% DDCs and municipalities that pass MC and having higher marks in PM (third ranked group) will lose 10% additional unconditional capital grant,
   d) Remaining 25% DDCs and municipalities that pass MC and having lower marks in PM (last category group) will lose 15% additional unconditional capital grant.

3. Minimum Conditions and Performance Measure (MCPM) of LBs: An assessment

The assessment of the MCs and PMs of local bodies in Nepal is presented in Table 1. It shows the years of assessment of minimum conditions (MCs) of VDCs, assessment years, the total number of VDCs assessed and percentage of the successful VDCs. In 2007/08, 89% VDCs passed in MCs assessment while in 2014/15 only 60% VDCs have passed. The percentage of VDCs having passed the MCs are gradually decreasing from the initial phase to 2014/15.

Table 1: MC assessment result of VDCs

FY of assessment of MCs	Assessment years	Total number of VDCs assessed	Number of VDCs passed	Percentage of VDCs passed
2007/08	2008/09	3830	3409	89
2008/09	2009/10	3626	3356	92
2009/10	2010/11	3733	3344	89

FY of assessment of MCs	Assessment years	Total number of VDCs assessed	Number of VDCs passed	Percentage of VDCs passed
2010/11	2011/12	3915	3406	87
2011/12	2012/13	3915	3076	78
2012/13	2013/14	3915	3079	78
2013/14	2014/15	3625	2545	70
2014/15	2015/16	3157	1882	60

Source: **Annual publication of MCPM result of LBFC (various years).**

The assessment results of MCPM of DDCs from 2004/05 to 2014/15 are presented in Table 2 below. In the first assessment of MCPM in 2004/05, about 15% of DDCs had not been able to meet the required performance in minimum conditions, and in an average 55 marks were obtained by the DDCs. However, in the second year (2005/06) of assessment, about 82% DDCs failed in MC assessment. Although there is no consistency in result of MCs and average marks obtained by DDCs during 11 years of assessment, the percentage of the failed DDCs has gradually decreased from 37 % in 2006/07 and to 9% in 2014/15. The average marks obtained by DDCs stand between 42 and 66 during the period of 11 years.

Table2: MCPM assessment result of DDCs

FY of assessment of performance	Assessment years	Total number of DCCs assessed	Number of DDCs failed	Perecentage of DDCs failed	Average marks obtained
2004/05	2005/06	20	3	15	55
2005/06	2006/07	55	45	82	42
2006/07	2007/08	75	28	37	56
2007/08	2008/09	75	8	11	66
2008/09	2009/10	75	12	16	62
2009/10	2010/11	75	14	19	60
2010/11	2011/12	75	11	15	59
2011/12	2012/13	75	6	8	63
2012/13	2013/14	75	8	11	64
2013/14	2014/15	75	5	7	57

FY of assessment of performance	Assessment years	Total number of DCCs assessed	Number of DDCs failed	Perecentage of DDCs failed	Average marks obtained
2014/15	2015/16	75	7	9	58

Source: **Annual publication of MCPM results of LBFC (various years).**

The MCPM Assessment Results of municipalities of seven fiscal years are presented in Table 3. The assessment system was started from 2007/08. All 58 municipalities were assessed in 2007/08 where 2 municipalities (about 3%) failed and an average mark obtained by municipalities was only 49 out of 100 full marks. The results of MCPM assessment of municipalities was also not consistent. However, municipalities have been performing good results in MC results and securing better marks in performance measurement between 2007/08 and 2013/14. But, the result of MC in 2014/15 reduced substaintially and about 17 percent municipalities could not comply with the indictors of minimum condition. Municipalities have received average marks between 49 and 74 from 2007/08 to 2014/15.

Table3: Result of MCPM assessment of municipalities

FY of assessment of performance	Assessment year	Total number of municipalities	Number of municipalities failed	Percentage of municipalities failed	Average marks obtained
2007/08	2008/09	58	2	3	49
2008/09	2009/10	58	5	9	55
2009/10	2010/11	58	7	12	63
2010/11	2011/12	58	4	7	66
2011/12	2012/13	58	5	9	74
2012/13	2013/14	58	1	1	68
2013/14	2014/15	58	0	0	66
2014/15	2015/16	58	10	17	67

Source: Annual publication of MCPM result of LBFC (various years).

4. Minimum Conditions and Performance Measure (MCPM) Results and Local Grants

Result of PM assessment and its effect on the formula based unconditional grant of the last two fiscal years are presented in Table 4 below. The PM result shows that the number of DDCs getting top-up formula based grant is increased in 2014/15 compared to 2013/14. In case of VDCs, there is no provision of performance measurement and provision of receiving additional grant at the rate of 20%, 15% and 10%.

Table 4: Number of LBs receiving top-up formula based grant

Local Bodies	2013/14			2014/15		
	20% top-up	15% top-up	10% top-up	20% top-up	15% top-up	10% top-up
DDCs	4	10	10	6	10	10
Muns	4	13	12	4	11	10
VDCs	-	-	-	-	-	-

Source: MCPM result published by LBFC (2015 & 2016).

In 2013/14, five DDCs namely Jhapa, Lamjung, Salyan, Achham and Darchula had lost 100% of formula based unconditional grant. And there was no any municipality under this category. However, in 2014/15, 7 DDCs like Sunsari, Sarlahi, Rautahat, Bara, Parsa, Mugu and Achham DDCs could not meet MC indictors. Similarly, 10 municipalities such as Ilam, Triyuga, Siraha, Jaleshor, Malangawa, Dhulikhel, Kathmandu, Lekhnath, Tikapur and Tulsipur also could not comply with the MC indicators in the same period. It indicates that the performance of DDCs and the municipalities has not improved in 2014/15 compared to 2013/14. There is also a mixed result of losing from 20% to 10% of two fiscal years. In case of VDCs, only MC result effects in grant allocation. If VDCs fail in MC assessment, they will lose 100% of unconditional grant and just receive a minimum grant ear marked by the Ministry of Federal Affairs and Local Development. The minimum earmarked budget for each failed VDC was Rs.1.50 million in 2014/15 and Rs. 3.6 million in 2015/16. The status of gain and loss of the grant by local bodies in Nepal is presented in Table 5.

Table5: Number of LBs affected from MC and PM result in the formula based grant

Local Bodies	2013/14				2014/15			
	100% loss	20% loss	15% loss	10% loss	100% loss	20% loss	15% loss	10% loss
DDCs	5	27	9	10	7	21	11	10
Muns	0	10	8	11	10	5	8	10
VDCs	885	-	-	-	1275	-	-	-

Source: MCPM result published by LBFC (2015 & 2016).

5. Conclusion

Minimum Conditions and Performance Measure (MCPM) is an important tool for measuring the overall performance including efficiency and accountability of LBs. The result of MCPM assessesment will also support to identify the capacity gap of the LBs.It creates the environment for improving the performance of LBs through the incentives, grants and strong process of monitoring and evaluation. According to the MCPM assessment performed by LBFC, there is gradual decrease in the percentage of VDCs' result of MCPM. Moreover, the result of MC of DDCs seems to be very poor in 2013/15 compared to 2014/15. It suggests implementing capacity development programme to the failed DDCs. More specifically, it requires the loal level election so that the elected representatives will take ownership and leadership to ensure the good performance of DDCs. The average marks that obtained by DDCs (i.e. maximum 66 during the 11 years of period) in MCPM assessment indicates the need of further improvement of the quality of performanceof DDCs. Among the LBs, municipalities are observed to possess good MCPM results with better marks (i.e. maximum 74 in average during 8 years) that refer the comparatively better position of municipalities among the three LBs of Nepal. However, in 2014/15, 10 municipalities (about 17%) could not meet minimum condition. It is not good system of municipalities' complaiance of MC. Because of the poor internal revenue capacity and pressure of hiring additional personnel, most the the municipalities could not comply with the limit of recurrent expenditure in 2014/15. 7 DDCs, 10 municipalities and 1882 VDCs could not comply with the MC indicators in 2014/15. This scenario depicts that there is need of the assessment that explores the causes and remedies of the weak performance of LBs in Nepal. That can be the point of departure in improving the quality and accountability of local governance which can be taken as the lessons for local governance in the forthcoming federal structure.

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