

STOCK TAKING OF FISCAL DECENTRALIZATION POLICIES:

CONSOLIDATED REPORT

Final Report

December 2011

Acknowledgements

This document was prepared for the Government of Nepal by Dr. Roy Kelly, drawing on the details and conclusions from two separate reports written under this study on fiscal decentralization aspects of expenditures and revenues written by Dr. Bimal Koirala and Mr. Bansidhar Ghimire, respectively.

All three authors wish to acknowledge the strong support and assistance of Mr. Yam Nath Sharma and Mr. Khim Lal Devkota from the Local Bodies Fiscal Commission (LBFC), Ministry of Local Development Government of Nepal and Dr. Neil Webster from UNDP/UNCDF for their strong support in coordinating various meetings, sharing information, and providing personal insights and guidance to this analytical work.

The team would like to thank Raghu Ram Bista, Under Secretary and Achyut Raj Regmi, Section Officer for their help in field study as well as in logistics management. In addition, the authors would also like to thank the numerous officials and resource persons from the Government of Nepal and especially from the Local Bodies visited for their time and willingness to share information.

The authors would like to emphasize however that the views expressed in this document are purely those of the writers and may not, in any circumstances, be interpreted as stating an official position of Government of Nepal and/or the United Nations Development Programme (UNDP) or the United Nations Capital Development Fund (UNCDF). The Government of Nepal and the UNDP/UNCDF do not guarantee the accuracy of the information included in this study, nor do they accept any responsibility for any use thereof.

Acronyms

ACCDN	Association of District Development Committees of Nepal
ADB	Asian Development Bank
ANRFRR	Allocation of Natural Resources, Financial Rights and Revenues Committee
APM	All Party Mechanism
ARC	Administrative Restructuring Commission
NAVDC	National Association of Village Development Committees
CA	Constituent Assembly
CDO	Chief District Officer
CG	Central Government
DTO	District Technical Office
DTCO	District Treasury Control Office
DG	Disadvantaged Group
DASU	Decentralization Advisory Support Unit
DDC	District Development Committee
DFGS	Determination of Form of Governance of State Committee
DIP	Decentralization Implementation Plan
DIMC	Decentralization and Implementation Monitoring Committee
DOLIDAR	Department of Local Infrastructure and Development of Agricultural Roads (MLD)
DPs	Development Partners
GON	Government of Nepal
HALT	Housing and Land Tax
IPT	Integrated Property Tax
GIZ	Gessellschaft Internationale Zusammenarbeit (German Technical Cooperation)
LB	Local Bodies
LBFC	Local Bodies Fiscal Commission
LDF	Local Development Fund
LDO	Local Development Officer
LG	Local Government
LGCDP	Local Governance and Community Development Program,

LSGA	Local Self Governance Act
LSGA/R	Local Self Governance Act/ Regulation
LBFAR	Local Body Financial Administration Regulations
MLD	Ministry of Local Development
MCPM	Minimum Condition and Performance Measures
MOF	Ministry of Finance
MUAN	Municipal Association of Nepal
NFC	National Finance Commission
NPC	National Planning Commission
OSR	Own Source Revenues
SRDSP	State Restructuring and Division of State Powers Committee
TDF	Town Development Fund
UNCDF	United National Capital Development Fund
UNDP	United Nations Development Programme
VDC	Village Development Committee

Executive Summary

Nepal is in the midst of a major political, administrative and fiscal restructuring reform moving towards a federal government structure to enhance governance and improve public service delivery. A Constituent Assembly (CA) is drafting a democratic and inclusive constitution, with expectations of three levels of government: Federal, Provincial and Local, along with some arrangements for autonomous regions, protected areas and special areas as appropriate.

These ongoing efforts are being formulated against the background of the current sub-national governance structure which is largely based on the 1999 Local Self Governance Act (LSGA). The LSGA was a major decentralization reform at the time, introducing 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), Municipalities (MUNS), and the District Development Committees (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 reestablish the political, administrative and fiscal dimensions of government in order to enhance efficiency, effectiveness and accountability.

To support this ongoing reform process, the Local Bodies Fiscal Commission (LBFC) launched this study to shed light on the state of fiscal decentralization in Nepal. Under the Local Governance and Community Development Program (LGCDP), with funding from the United Nations Capital Development Fund (UNCDF), this study was undertaken to shed take stock of the state of fiscal decentralization as originally intended under the LSGA, identify lessons learned and suggest opportunities for ensuring successful fiscal decentralization policies and transition measures to the governance structures anticipated under the new constitution.

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).

Theory and International Decentralization Reform Experience

Countries everywhere are undertaking reforms to enhance economic and social development. These ongoing decentralization reforms are focusing not only on improving public service delivery efficiency and accountability, 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 success. 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, appropriately tailored to the country-specific context, to maximize the chances for successful achievement of objectives. Countries adopting decentralization must pursue a proactive, intentional 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.

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. Following the cessation of hostilities under the 2006 *Jana Andolan*, the Comprehensive Peace Agreement, and under the Interim Constitution, Nepal is now in **Phase 3 (2006-onwards)**, which will include the adoption of a new constitution based on federalism. Phase 3 is expected to provide a genuine opportunity for Nepal to formally embed the key decentralization principles of devolution and citizen empowerment in the Constitution, to enhance local participatory governance and to improve delivery of efficient and equitable public services needed to further support economic and social development.

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 LB expenditure and revenue functions and provide the underpinnings for strong local autonomy in planning and budgeting.

This 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 anticipated 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 initial LSGA law 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 of primary health, primary education, agricultural and livestock were identified to be included within the first phase of sector devolution through the 2001-02 budget. 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, but there has been no progress to date. 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 and the dissolution of the elected LBs since 2002, leaving a void in locally-elected representatives 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 Peace Agreement 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.

Locally-elected political representatives are a requisite for accountable and responsive decentralization. Field discussions identified that the lack of elected local leaders weakened downward accountability and decision making related to priority setting, planning and budgeting and expenditure oversight. Field observations confirm the need for reestablishing locally elected leaders to strengthen local accountability and ownership. In fact, there is an immediate need to provide continuity in local leadership (e.g., administrative officers and the APM leaders) and introduce / strengthen other forms of downward accountability, while awaiting local elections.

Field observations also indicate that the APM mechanism effectiveness varies considerably within and between categories of LBs. There is a need for further clarification on the APM role in the local planning, budgeting and monitoring process. Overall, there is need to provide clarity and some socialization/training on the roles and responsibilities for all local stakeholders. The current uncertainty and confusion on respective roles hinders the coordination and governance effectiveness.

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 current 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.

Field observations identify the need to clarify the role of the Ministry of Local Development vis a vis the role of the LBs. Most LBs are seen as line agencies of the MLD, with little independent autonomy. 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. One related field observation is the need to clarify the role of the District Technical Office within the DDC.

Despite these major challenges, there was a general agreement sense that 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, 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.

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 with 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 remain 23 sector laws which were identified as conflicting with the LSGA which continue to cause duplication and conflict in the areas of expenditure assignment.

Field discussions indicate that there are many assigned functions under LSGA that are not being exercised by the LBs. 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, field observations showed a mixed picture in the implementation of expenditure assignments. Infrastructure in road networks has been a major priority for LBs. However, 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 scant. 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. Field observations seem to indicate that 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 minorities and marginalized through this planning process. Special care is needed to ensure broad representation of the community in the planning process—perhaps by improving those related incentives under the MCPM performance grant system which encourages participatory planning and budgeting. Field discussions confirm that these MCPM incentives have a major impact on the governance, administrative and financial behavior at the LB levels.

In addition, the local planning process also 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.

Field observations also confirm that 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 the field observations found that greater synergies are needed between the LBs and the line department agencies to improve effective and accountable service delivery.

Field observations also suggest that LBs are often considered more as financing agencies than as service delivery agencies. Some LBs report that they 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.

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. Based on the sample LB’s visited the local own sources of revenue (OSR) is quite small. Although LBs are heavily dependent on central government grants, field visit discussions confirm that 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 compliance, administrative and efficiency costs. This year, the Government has introduced measures to synchronize the administration of the housing rental tax, with discussions underway to sort out similar administrative options for motor vehicle and the presumptive income taxes.

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 Local Development / UNDP / UNEP study (2011), this study identifies that the revenue sharing-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.

A thorough analysis of the LSGA, along with field observations, identified the following: First, 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, 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 fully exercising their responsibility and rights to levy and collect local revenues. Field discussions indicate that the major reason for this low collection effort is a lack of incentives: (1) local leaders, including the APM members, are reluctant to collect local taxes from their local residents for political reasons. (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.

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, development level, fiscal capacity, financial management and discipline. 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, 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 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 various LGCDG and LBFC reports, as well as the field observations under this study, confirm that 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.

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.

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, the visited LBs have not borrowed, except for Janakpur Municipality, from commercial banks or from the market. The reasons given for not borrowing were the lack of suitable capital project and the absence of elected representative. Although the visited LBs did not have any borrowing experience, the LBFC reports that 33 municipalities have exercised borrowing rights, largely borrowing from the Town Development Fund (TDF) and international lending agencies like Asian Development Banks (ADB).

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.

a. 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; cross-sector public

sector reform thus 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 take time to initially implement, 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.

b. Need for Constitution to 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, it is critical to ensure that the principles of democratic and accountable devolution, provincial and local governments are embedded firmly in the Constitution. The details on the political, administrative and fiscal dimensions aspects should then be further elaborated within an overarching organic law which lays 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.

c. Need for National Finance Commission

As recommended by one of the Thematic Committees of the CA, and based on international best practice, it will be important to establish a permanent, independent National Finance Commission which can 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 subnational public financial management issues. 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 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.

d. 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, couple with a transparent and objective formula-based intergovernmental transfer system to achieve the efficiency and the accountability needed for enhanced governance and service delivery.

e. 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 is critically important as part of the sequencing process as Nepal moves from a unitary government to a federal government structure. This transition plan is important not only to 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.

f. 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.

g. 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.

DPs 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 MCPM should be supported and expanded to provide a wider set of incentives and support to further support local 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 DPs 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.

Table of Contents

1. Introduction	1
2. Study Objectives and Methodology	2
3. Framework for Fiscal Decentralization	7
4. Fiscal Decentralization Stocktaking in Nepal	18
5. Lessons and Recommendations for a Federal Nepal	37
Annex 1: Terms of Reference	48

1. Introduction

1.1 Nepal is in the midst of a major restructuring reform moving towards a federal governance structure in order to enhance governance and improve public service delivery. This restructuring process necessarily will involve a combination of political, administrative and fiscal components in order to ensure a comprehensive, holistic, and integrated governance framework. A Constituent Assembly (CA) is drafting a democratic and inclusive constitution, with expectations of three levels of government: Federal, Provincial and Local, along with some arrangements for autonomous regions, protected areas and special areas as appropriate.

1.2 Various CA thematic committees have submitted their reports, with some focused on the allocation of political, administrative and fiscal powers, authority and responsibility across different tiers of government.¹ The ANRFRR Committee has proposed that all government levels be autonomous in their sphere of competence, while cooperating both vertically and horizontally in exercising their respective rights. Two of the Committees (SRDSP and ANRFRR) have proposed lists of expenditure and revenue assignments for each government level. The ANRFRR suggests principles of intergovernmental transfers to manage the anticipated vertical and horizontal imbalances, especially from the federal to the sub-national governments. In addition, the ANRFRR also proposes a National Finance Commission as a constitutional body responsible for issues of intergovernmental transfers.

1.3 The Constitutional Committee of the CA is now drafting the constitution, incorporating the ideas and recommendations of the various thematic committees. The principles of democratic governance, devolution, assignment of functions and revenues are expected to be incorporated into the constitution, along with the various transitional arrangements including the identification of required laws linked to sub-national governance, administration, and finance. Although the broad principles will be included in the Constitution, it is anticipated that many of the more detailed provisions and operational details will need to be articulated in subsequent implementation laws and regulations. There will be a need for framework legislation at the federal level to further clarify the constitutional provisions such that the different government levels will know exactly their rights and responsibilities.

1.4 A separate Administrative Restructuring Commission (ARC) has submitted to the Government a set of recommendations on the administrative structures for the anticipated federal governance structure. The ARC has focused their work on those administrative arrangements needed at the central and provincial levels. Further work is needed on those administrative issues

¹ Committee for the State Restructuring and Division of State Powers (SRDSP), Committee for the Determination of Form of Governance of State (DFGS) and the Committee for the Allocation of Natural Resources, Financial Rights and Revenues (ANRFRR).

related to the sub-national levels of government. This further work on local level functions will be undertaken through a separate study.

1.5 These ongoing efforts, focusing on governance, administration and fiscal structures, are being formulated against the background of the current sub-national governance structure which is largely based on the 1999 Local Self Governance Act (LSGA). The LSGA was a major decentralization reform at the time, introducing 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), Municipalities (MUNS), and the District Development Committees (DDC).

1.6 However, despite these bold initiatives, the governance structure in Nepal remained highly centralized which could not and did not address many of the pressing problems related to governance and service delivery. The underperformance of the LSGA and related reforms to effectively guide and promote effective and accountable decentralization is partially an impetus for the current focus on restructuring Nepal into a federal governance system, seeking once again to clarify the respective political, administrative and fiscal dimensions of government in order to improve efficiency, effectiveness and accountability.

1.7 In light of these various dimensions, the Local Bodies Fiscal Commission (LBFC), as part of the Local Governance and Community Development Program (LGCDP), has commissioned this study to take stock of the state of fiscal decentralization in Nepal. This study, funded through the United Nations Capital Development Fund (UNCDF) is designed to shed light on the state of fiscal decentralization as originally intended under the LSGA, identify lessons learned and suggest opportunities for ensuring successful fiscal decentralization policies under the new governance structures anticipated under the new constitution. This study lays the foundation for some subsequent detailed work on Functional Analysis (also known as Activity Mapping) of sub-national expenditure and revenue responsibilities.

2. Study Objectives and Methodology

2.1 This study was undertaken to take “stock” of the current fiscal decentralization policies and practices in Nepal with respect to provisions in the Local Self Governance Act (LSGA), 1999, vis-à-vis their practice. Focusing specifically on expenditure assignment, revenue assignment, intergovernmental fiscal transfers and local borrowing, the study lays the foundation for a planned functional analysis (activity mapping) of specific sectors across different levels of sub-national governments which will be closely aligned with the work undertaken by the Administrative Restructuring Commission linked to results-based governance and service delivery.

2.2 This study is designed to achieve two major outputs: (1) a stock taking of existing fiscal decentralization policies and practices as per the LGSA 1999 and (2) a set of recommendations on a framework of legislation / policies needed to allow LGs to carry out their given responsibilities, along with possible transition arrangements to facilitate the movement to the new decentralization structures anticipated under the new constitution.

2.3 This study was carried out using a combination of research methodologies, including a detailed analysis of background studies, discussions with central and local stakeholders, field visits, an analysis of the Constituent Assembly (CA) reports and follow up discussions with key various government officials, development partners, and development practitioners.

2.4 Following an initial analysis of various background studies from the Government, development partners, and academic researchers, discussions were held with key central and local level stakeholders including those from the Ministry of Local Development, Ministry of Health, Ministry of Education, and the Prime Minister's Office. In addition, a focus group meeting was held with LB Associations (ADDCN, MUAN, and NAVDC) to garner input into the current issues facing decentralization. Further meetings were held with key decentralization experts and appropriate stakeholders responsible for the various sectors, especially those key devolved sectors such as education, health, agriculture and livestock.

2.5 Field visits were then undertaken to gather information on the extent to which the LGSA is being implemented in practice. At the local level, meetings were held in 23 Local Bodies (LBs): 6 District Development Committees (DDCs), 5 municipalities and 12 Village Development Committees (VDCs) using a focus group approach guided by semi-structured questions.² These consultations were held with the LB administration staff, local politicians (currently the All Party Mechanism), and officials from the de-concentrated line ministry departments. The field visits were conducted using a semi-structured questionnaire in focus groups as well as a more structured questionnaire to capture the planned and actual revenue and expenditures over a three year period.

2.6 As indicated in Table 1.1, the LBs visited represent the diversity in LBs in Nepal, thus the field sample includes LBs from various geographical and ecological regions, resource endowment, state of physical and social infrastructure, MCPM considerations, and economic and human resource development index considered.³ The field visits were guided through the use of a

² Besides the DDCs mentioned in Table 1.1, Dang, Ilam and Jhapa DDCs were visited to verify problems related to district export tax, import tax and sand and stone tax. See MLD, 2011 for detailed analysis of the sand and gravel taxes in Nepal.

³ Unfortunately, due to the small number of field visits, the sample may not represent all the variation in Nepal, but should indicate the current state of decentralization adherence to the LSGA and related decentralization issues linked to expenditure and revenue allocation of responsibilities. This field information was used, along with the cumulative development experience from the Team to identify the conclusions and recommendations contained in this report.

semi-structured questionnaire for the focus group discussions and a more structured questionnaire given to each LB to collect planned and actual revenue and expenditures over a three year period. This semi-structured questionnaire used several questions from the 2004 LBFC Expenditure and Revenue Assignment studies to provide an opportunity for comparison across two time periods with regards to local level expenditure and revenue priorities and a series of questions which guided the field-based focus group discussions. These detailed questionnaires and findings are included in the individual reports on expenditures (Koirala, 2011) and revenues (Ghimire, 2011).

Table 1.1: Local Bodies Field Visit Sites

Development Region	Terai	Hill	Mountain
Eastern	Siraha DDC, Ramnagar Mirchaiya VDC, Ghailaduba VDC	Ilam Municipality Barbote VDC	---
Central	Janakpur Municipality Sapahi VDC	Daman VDC Lubhu VDC	Rasuwa DDC Chilime VDC
Western	Setidovan VDC	Pokhara Municipality Palpa DDC	---
Mid-Western	Virendra Nagar Municipality Uttar Ganga VDC	Salyan DDC Chhaya Chhatra VDC	Jumla DDC Chandannath VDC
Far Western	Kailali DDC Phulbari VDC	Amargadhi Municipality	---

2.7 In addition to synthesizing and analyzing the field trip information, the Team reviewed the draft provisions of the CA committees as they relate to fiscal decentralization and followed up with discussions with various government officials, development partners, and development practitioners. Several workshops were held with senior government officials across various ministries, with mid-to-senior officials within the Ministry of Local Development and with various development partners to present the initial observations, conclusions and recommendations from the study.

2.8 This study produced two stand-alone detailed reports, one on expenditure assignments and one on revenue assignments, intergovernmental transfers and local borrowing. Each of these reports outline the theory and practice of these four pillar of fiscal decentralization, observations and conclusions from the field visits, analysis of the Constituent Assembly reports and

recommended transition measures and recommendations. These detailed reports provide the basis for this Final Report which incorporates the findings and recommendations related to expenditures, revenues, intergovernmental grants and sub-national borrowing in Nepal. Specifically this consolidated report 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 devolved unitary government structure to the expected devolved federal government structure under the new constitution.

2.9 This report seeks to address the following types of questions/issues:

1) **Expenditure assignment**

- Are the expenditure assignments clear enough in terms what the LBs are required to do?
- How have the expenditures been clarified after the devolution of some of the areas like primary education, health, etc.?
- How far are the expenditure items overlapping with the central government & other tiers of LBs?
- To what extent are expenditure items being exercised by the LBs?
- Are there any items that the LBs have not exercised? If the LBs differ in making use of their rights in regards to the expenditure items, what are the reasons?

2) **Revenue assignment**

- Are the revenue assignments clear in terms what the LBs are required to exercise?
- What are the most important sources of own-source revenue?
- How far own-source revenues are being collected and utilized by the LBs?
- How adequate are the own source revenue to meet the expenditures assigned?
- How is the revenue sharing arrangement, both among the local bodies and among the government and the local bodies, functioning?

3) **Intergovernmental Fiscal Transfer**

- How are the grants (conditional and unconditional) being provided to the LBs?
- How far are they being tied up with the expenditure and revenue assignments?
- Do the grants stand against the criteria such as efficiency, adequacy, predictability and equity?

4) **Subnational Borrowing**

- Are the legal provisions adequate in regards to the local borrowing?
- How far have the local bodies been able to use the powers given to them?
- If they are not using the powers given to them, what are the reasons?

2.10 This report also provides a set of recommendations on the kind of framework required to allow local governments to carry out their given responsibilities. In this regard, the draft provisions of the CA committees are discussed as they relate to fiscal decentralization. In addition, this report recommends future work (both at policy and technical fronts) required on the part of government in the new set up, including the transitional management of the local bodies (governments).

3. Framework for Fiscal Decentralization⁴

3.1 Prior to analyzing specific legal provisions and practice of fiscal decentralization in Nepal, this report will briefly outline a framework for fiscal decentralization, outlining the role and international practice as it relates to the movement towards more accountable governance and improved public service delivery. This section will provide the context for the subsequent analysis of the fiscal decentralization reforms in Nepal.

3.2 Countries everywhere are undertaking reforms to enhance economic and social development. These ongoing decentralization reforms are focusing not only on improving public service delivery efficiency and accountability, but also on promoting a more equitable distribution of services and resources across each country and on enhancing more accountable and responsive governance. By bringing key public expenditure decisions closer to the people, governments are attempting to empower communities to more actively participate in prioritizing, implementing and monitoring government expenditures so as to encourage more efficient, accountable and transparent public resource management related to the design and delivery of public services.

3.3 These various decentralization reforms involve a combination of political, administrative and fiscal components. Political accountability mechanisms, along with administrative/institutional capacities and clearly-defined fiscal responsibilities and resources are essential for decentralization to be successful. 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 citizens in the governance process through participatory planning, budgeting, monitoring and social audit. On the fiscal side, LGs must have clear expenditure responsibilities and revenue options including appropriate local own revenues and access to intergovernmental transfers, as well as clarity on local borrowing options.

3.4 These political, administrative and fiscal components need to be designed, implemented and integrated to provide the framework for implementing successful, sustainable decentralization reforms (Boex and Yilmaz, 2010). In addition, these various reform components must be sequenced, appropriately tailored to the country-specific context, to maximize the chances for successful achieving the reform objectives (Bahl and Martinez, 2006). Countries adopting decentralization must pursue a proactive, intentional 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.

⁴ This section draws on R. Kelly and J. Boex (forthcoming).

3.5 As Figure 3.1 indicates, there are several sub-components within each of the political, administrative and fiscal dimensions. The political dimensions focus on such issues as the local political power structure, the structure and quality of the electoral process, the nature of the local party system, and aspects of subnational participation & accountability. The administrative dimensions focus on such issues as planning and regulation of local physical space, local PFM procurement, local human resource administration and efficient and equitable local service delivery. The fiscal dimensions focus on the assignment of expenditure and revenue functions, intergovernmental transfers and subnational borrowing (Boex and Yilmaz, 2010).

Figure 3.1 Matrix of Political, Administrative and Fiscal Decentralization Components

	Central Govt	Local Govt	Local Civil Society
Political Empowerment and Decentralization			
1. Local political power structure			
2. Structure & quality local electoral processes			
3. Nature of political party system			
4. Subnational participation & accountability			
Administrative Empowerment and Decentralization			
1. Planning & regulation of local physical space			
2. Local PFM and procurement			
3. Local human resource (HR) administration			
4. Efficient and equitable local service delivery			
Fiscal Empowerment and Decentralization			
1. Assignment of Functions			
2. Assignment of Revenues			
3. Intergovernmental Transfers			
4. Sub-national Borrowing & Capital Finance			

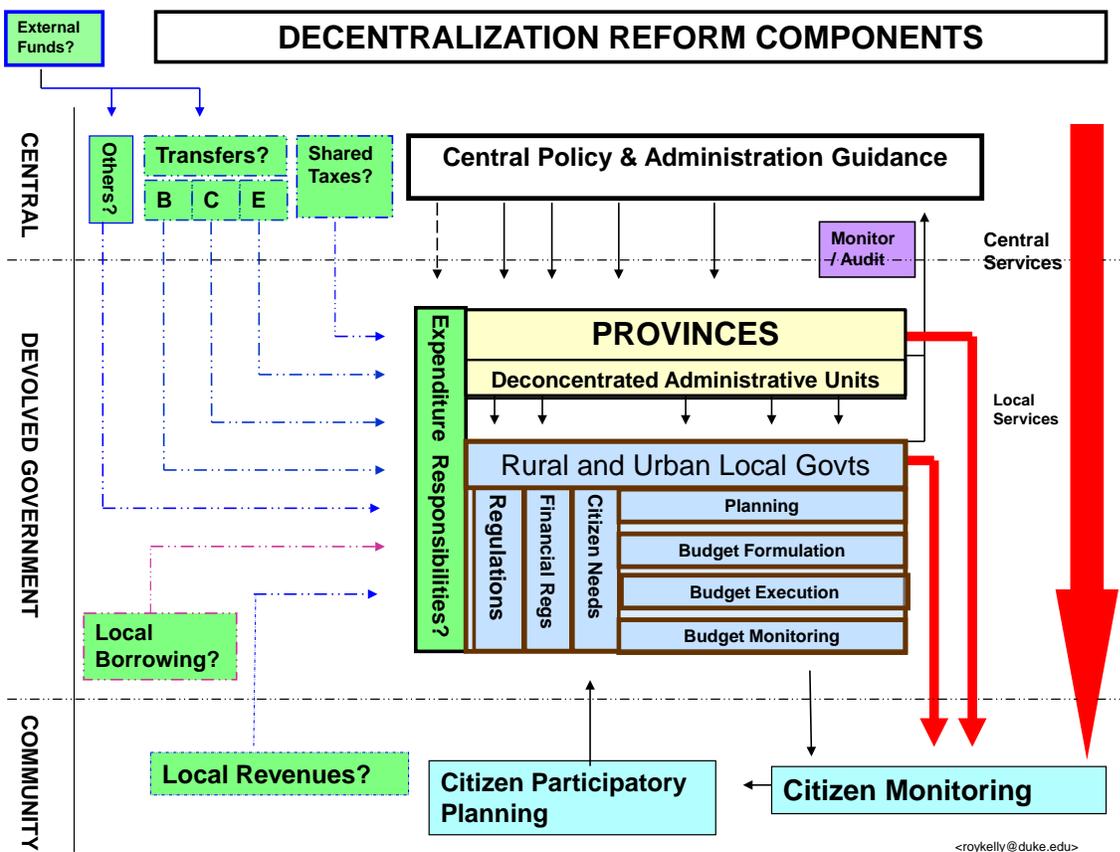
1. Discretion (authority, autonomy, and capacity)
2. Accountability

Source: Boex and Yilmaz, 2010

3.6 These decentralization framework components can be captured diagrammatically to show the integrated holistic nature of decentralization. **First**, local governments must have political and institutional structures at the sub-national level (e.g., provincial and rural/urban local governments) to plan, budget and deliver accountable and efficient local services. These legal, institutional structures must be complete with a political, administrative and fiscal accountability mechanism along with capacity. **Second**, to empower these political and administrative institutions with clear expenditure and revenue mandates, countries must design and implement the key components of

fiscal decentralization focusing on four pillars of expenditure assignments, revenue assignment, intergovernmental transfers and guidelines for local borrowing. **Third**, local governments need to have bottom-up accountability mechanisms in order to mobilize citizen input into the public expenditure management system through citizen participatory planning, analysis and monitoring to establish local government downward accountability. **Fourth**, and at the same time, the central government must have capacity to monitor and audit the decentralization reforms to effectively guide, facilitate and further empower local governments. **Fifth**, but not less important, countries must effectively mobilize and channel development partner funding to further support the decentralization reform process. It is the effective integration of the political, administrative and fiscal components which are essential to enable a country to realize the improved governance and accountable and efficient service delivery.

Figure 3.1 Political, Administrative and Fiscal Decentralization Components



Source: Duke University Program on Fiscal Decentralization and Local Government Financial Management, Lecture Materials on Fiscal Decentralization, 2011.

3.7 Successful fiscal decentralization hinges on effectively integrating the four pillars of fiscal decentralization; namely, the allocation of expenditure functions across various government levels, the allocation of revenue responsibilities, the design of the intergovernmental transfer system and an

appropriate subnational borrowing policy. There is general agreement among decentralization experts that “finance should follow function”, implying that governments must clarify expenditure responsibilities for each level of government before determining the financing structure and mixture of revenues and intergovernmental grants and the borrowing framework (Shah, 1994; Bahl, 1999; Oates, 2005). In this way governments can ensure adequate funding and the appropriate mix of funding (e.g., grants, user fees, taxation) to empower local governments to deliver the expenditure mandates.

3.8 A **first requisite for fiscal decentralization** is the clear allocation of expenditure responsibilities across tiers of government. The first question to answer is “what functions should be performed by which level of government?” 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 which is 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).

3.9 The subsidiary principles argues that most public expenditure functions should be assigned to local governments with the exception of those functions which should necessarily be assigned to higher levels of government for efficiency reasons due to economies of scale and/or to account for jurisdictional spillovers (e.g., national defense, monetary policy, water basin management, among others). Many public services can be provided efficiently at the local government such as street lighting, drinking water, sewerage, solid waste management, local markets, bus parks, and most components of primary health care and education.

3.10 Some public services, such as those related to education and health, require a combination of central and local provision, depending on the “unbundling” of specific sub-functions such as policy, provision and production functions to take consideration of economies of scale, externalities, equity, and heterogeneity of demand.⁵ Under these situations, higher level governments are typically responsible for ensuring an enabling environment for local governments through providing broad policy guidance, institutional support, capacity building, resources and monitoring and oversight, while local governments are empowered to be responsive and accountable to deliver the actual service to the residents.

3.11 Theory and international practice generally identify a typical distribution of expenditure functions as shown in Table 3.1, although with some variation by country. In some countries, there is even an asymmetric approach, recognizing the differences between rural and urban local governments and the diversity among local governments depending on factors such as the levels of

⁵ For application example on ‘unbundling’ primary education in India, see Lant Pritchett and Varad Pande, “Making Primary Education Work for India’s Rural Poor: A Proposal for Effective Decentralization”, World Bank South Asia Series Working Paper No. 95, 2006.

economic development, size and capacity. Countries can therefore assign various expenditure functions differentially across local governments. Recognizing the need to allocate different functions across differential spatial regions has led countries to develop special districts to manage schools, water basins, transportation, sewerage, etc. To balance the respect for diversity and the advantages of economies of scale, many countries have a two-tiered system of local governments in urban areas (metropolitan and urban governments) and one-tiered system in rural areas (ADB, 2009).

Table 3.1 Expenditure Assignment across Three Tiers of Government

Expenditure Category	Policy, standards and oversight	Provision and administration	Comments
Defense	F	F	Benefits and costs national in scope
Foreign Affairs	F	F	Benefits and costs national in scope
International trade	F	F	Benefits and costs national in scope
Monetary policy, currency, banking	F	F	Benefits and costs national in scope
Interstate commerce	F	F	Benefits and costs national in scope
Transfer payments to individuals	F	F	Redistribution
Subsidies to business and industry	F	F	Regional development, industrial policy
Immigration	F	F	Benefits and costs national in scope
Unemployment insurance	F	F	Benefits and costs national in scope
Airlines and railways	F	F	Benefits and costs national in scope
Fiscal policy	F, S	F, S, L	Coordination possible
Regulation	F	F, S, L	Internal common market
Natural resources	F	F, S, L	Promotes common market
Environment	F, S, L	S, L	Benefits and costs national, regional or local in scope
Industry and agriculture	F, S, L	S, L	Significant interjurisdictional spillovers
Education	F, S, L	S, L	Transfers in kind
Health	F, S, L	S, L	Transfers in kind
Social welfare	F, S, L	S, L	Transfers in kind
Police	S, L	S, L	Primarily local benefits
Water, sewage, refuse collection	L	L	Primarily local benefits
Fire protection	L	L	Primarily local benefits
Parks and recreation	F, S, L	F, S, L	Primarily local responsibility, but national and provincial governments may establish own parks
Highways			
Interstate	F	S, L	Internal common market
Provincial	S	S, L	Provincial benefits and costs
Inter-regional	S	S, L	Inter-regional benefits and costs
Local	L	L	Local benefits and costs
Spending power	F, S	F, S	Fiscal transfers to advance own objectives

Notes:

F: Federal responsibility; S: State or provincial responsibility; L: Local responsibility

Source: Shah (1994)

Source: Quoted from ADB 2009, p.29

3.12 The clear assignment and delineation of expenditure functions (also known as functional assignment or activity mapping) is critical (Ferrazzi and Rohdewohld, 2008). The lack of clarity in expenditure assignments can result in contradictory assignment and/or a duplication of responsibilities, leading to confusion, inadequate or excess public services and/or a waste of scarce

public resources. For example, if the expenditure role is assigned “too high”, it may be that local needs and preferences will be ignored, with ownership & accountability unnecessarily weakened. On the other hand, if the expenditure role is assigned “too low”, the service could be underprovided, or provided inefficiently due to missed scale economies and/or that costs and benefits may unfairly be incurred by neighboring jurisdictions through spillover effects. The lack of coordination between local government and across tiers of government can exacerbate these problems. Unclear expenditure responsibilities, combined with limited local capacity and resources, can lead LGs to viewing these mandates as “permissive” functions rather than “mandatory” assignments, with the expectation that the central / state government will step in to deliver the needed public service.

3.13 A **second requisite for fiscal decentralization** success is to ensure an adequacy of revenue resources to fund the expenditure responsibilities allocated to LGs. These revenue resources typically come from a combination of user charges, local taxes, shared taxes and intergovernmental transfers. The exact mix of the financing structure and revenue amounts needed varies by country and time, depending on the nature and the extent of the expenditure responsibilities assigned to each level of government (Bahl and Bird, 2008; Bird, 2011).

3.14 Local own revenues are critical to support decentralization reforms by enhancing local autonomy, governance accountability, ownership and responsibility, while providing an important source of additional funding (at the margin) for local budgets. Local revenues play a critical role in enhancing the state building of democratic government systems, creating a mutual accountability between residents and their locally-elected representatives (Brautigam, Fjeldstad and Moore, 2008). In some LGs, local own revenues can contribute a substantial portion of needed financial resources, while in others, the fiscal capacity may be quite small. Regardless of the relative importance, all LGs need access to and have the responsibility for collecting local revenues to ensure downward accountability.

3.15 The key to local revenues is to ensure that the LG is empowered to levy the tax and has the discretion (even within limits) to set the tax rate which can affect the revenue amounts received. This ensures that the LG has the ability and is accountable (at least at the margin) to raise additional funding to deliver local services identified by the local residents.

3.16 Ultimately it is the combination of central government revenues, along with local revenues, which provide the resource envelope needed to fund LG services. Although central government transfers and shared taxes may dominate, governments everywhere recognize the importance of local own revenues to ensure decentralization governance, autonomy and accountability objectives. Governments everywhere are therefore exploring options to implement appropriate local revenue policy and administrative reforms to enhance local revenue mobilization, usually focusing on improving user charges, property taxes, and local business licenses/taxes, among others.

3.17 Theory and international practice confirms that most tax bases are better levied and administered at the central government level (Musgrave, 1989, McLure, 2001, Bird, 2011). As Table 3.2 indicates, lower level governments tend to raise revenues from those revenue bases with lower mobility and those with clear benefit linkages to local services. However, most other taxes should be allocated to the higher level governments. Countries therefore allocate international trade taxes, VAT, the personal and corporate income taxes, and typically natural resource taxes to the central government level. LGs at the provincial or state levels usually are allocated taxes such as motor vehicle taxes, and sometimes retail sales taxes and personal income taxes; while lower level LGs are usually allocated property taxes and other less mobile tax bases.⁶ Excises are often given to all levels of government, with those at the LG applied to tax bases with relatively low mobility and with less ability for tax exporting (e.g., hotel rooms, entertainment, restaurants, etc.). In addition, theory and practice encourage all levels of government to utilize user charges as appropriate.

Table 3.2 Revenue Assignment

Tax Type	Determination of Base	Determination of Rate	Collection and Admin.	Comments
Customs	F	F	F	International trade taxes
Corporate income	F	F	F	Mobile factor
Resource taxes				
Rent (Profit) tax	F	F	F	Unequally distributive
Royalties Fees				
Severance taxes	S, L	S, L	S, L	Benefit taxes
Production taxes	S, L	S, L	S, L	Environment preservation
Conservation charges				
Personal income	F	F, S, L	F	Redistributive, mobility, stabilization
Wealth taxes	F	F, S	F	redistributive
Payroll	F, S	F, S	F, S	Social programs
Value Added tax	F	F	F	Admin costs, stabilization
Single stage sales				
Option A	S	S, L	S, L	Higher compliance costs Harmonized
Option B	F	S	F	
Sin taxes				
Alcohol, tobacco	F,S	F,S	F,S	Health care shared resp.
Gambling, betting	S, L	S, L	S, L	State and local resp.
Lotteries	S, L	S, L	S, L	State and local resp.
Race tracks	S, L	S, L	S, L	State and local resp.

⁶ International experience does vary considerably—with the federal countries often granting corporate income and individual income taxes to provincial/state levels (e.g., US and Canada). In the US, some local governments also impose an individual income tax (often a payroll tax) (e.g., New York, Philadelphia). Scandinavian countries allow local governments to apply individual income taxes. Most developing countries keep the income taxes at the central government level, but may allow for piggy backing (levying a surcharge). Local governments which do have access to the income tax tend to apply only a payroll tax on wages, not on all income which would include interest, dividends, and rents. Universally the property tax is considered a good local tax because land and buildings are immobile tax bases and because there are clear links between property values on local services and capital improvements. See Musgrave (1989) and McLure (2001) for more details.

Taxation of 'Bads'				
Carbon	F	F	F	Global / national pollution
BTU fuels	F, S, L	F, S, L	F, S, L	By extent of pollution
Motor Fuels	F, S, L	F, S, L	F, S, L	Tolls on road use
Effluent charges	F, S, L	F, S, L	F, S, L	By extent of pollution
Congestion toll	F, S, L	F, S, L	F, S, L	Tolls on road use
Parking fees	L	L	L	Local congestion
Motor Vehicles				
Registration	S	S	S	State revenue source
Drivers license	S	S	S	State revenue source
Business taxes	S	S	S	Benefit tax
Excise	S	S	S	Immobile base
Property	S	L	L	Benefit tax, immobile
Land	S	L	L	Benefit tax, immobile
Frontage/betterment	S, L	L	L	Cost recovery
Poll tax	S, L	S, L	S, L	Non distorting
User Charges	F, S, L	F, S, L	F, S, L	Payment for service

Source: Boadway, Sandra and Shah, 1994 as quoted in Ghimire, 2011

3.18 A **third requisite for fiscal decentralization** success is an appropriate intergovernmental transfer system. Decentralization finance in most countries is heavily dominated by intergovernmental transfers and shared taxes. LGs in most developing countries tend to rely from 60-80 percent on these central government revenue transfers (Schroeder and Smoke, 2003; Shah, 2007), while local own revenues, which can include both user charges and local taxes, tend to be quite small (Bird, 2003a, Bird 2003b, Bahl and Bird, 2008). Striking the appropriate balance and structure of central transfers and local revenues is a major challenge for decentralization reforms.

3.19 Intergovernmental transfers/shared taxes are structured to address vertical and horizontal fiscal imbalance within countries. In addition to strong political objectives, intergovernmental transfers and shared taxes can be designed to help balance vertical funding needs between central and LGs, achieve horizontal equity among LGs of various expenditure needs and fiscal capacity, improve the delivery of national priority merit goods, and compensate for inter-jurisdictional spillovers, among others (Bahl, 2000, Boadway and Shah, 2009).

3.20 All countries face issues of vertical and horizontal imbalance. Central governments tend to have very productive revenue sources which can generate revenues which can exceed their assigned expenditure needs. In contrast, local governments tend to have very limited revenue sources which do not cover their assigned expenditures needs. Although some revenue sources can be reassigned to local governments, there are very rational, economically-efficient reasons for the more productive revenue sources to be collected by the central government, while there are equally, very rational, economically efficient reasons for the large majority of public service expenditures to be delivered through the local governments. This vertical imbalance can best be addressed through a system of block grants from central to local governments, shifting financial resources from the central to local

levels based on a formula basis to take into account issues of horizontal imbalance among local governments.

3.21 At the same time, all countries face issues of horizontal imbalance as there are those LGs which have large fiscal capacity and those which have very low fiscal capacity. This calls for the central government, for reasons of equity, to adopt formula-based transfers to shift financial resources to LGs appropriately. Horizontal imbalance can be best addressed through a system of formula-based block or categorical grants taking needs and fiscal capacity into account.

3.22 As intergovernmental transfers can account for close to 80-100% of available funding for local expenditures in practice, the design and implementation of these intergovernmental transfer systems is critical to the successful achievement of decentralization objectives. Unfortunately poorly designed grant systems can further distort regional inequities, encourage inefficient allocation of resources, and promote poor financial management and governance. Proper transfer design involves linking the specific grant objective to the specific grant type, while addressing the size of the resource pool to be allocated, the allocation formula (derivation and/or formula), and the channeling mechanisms (matching, non-matching, categorical, block, etc.) (Bahl and Linn, 1992; Bahl, 2000).

3.23 Equalization is a commonly stated objective of intergovernmental transfers, with the intention to equalize the ability of LGs to provide a uniform level of public services while paying similar levels of taxes. In practice, equalization grants are quite complicated; as the equalization must take into account both fiscal capacity and costs of service across jurisdictions. With the exception of several OECD countries, most countries do not implement a separate equalization grant but try to incorporate equalizing factors in their respective transfer formulas. For example, indicators based on needs such as population, school age population, geographic area, and poverty are commonly used to allocate basic grants to provide an equalizing effect. Absolute equalization even in OECD countries is typically not done, with OECD countries depending on a relative norm, often only focused on fiscal capacity (Canada) rather than fiscal capacity and costs of service (Australia) (Shah, 2007).

3.24 The key to designing intergovernmental transfers is to ensure that the transfers are adequate, predictable and transparent to improve local level planning, budgeting and implementation. There should be a mix of block and categorical transfers, based on formula, with specific transfer mechanisms designed to achieve specific policy objectives. Increasingly performance-based grants are being used to provide incentives for LG improvement in accountable governance, planning, budgeting and financial management, and overall administrative improvement (Steffensen, 2010).

3.25 A **fourth requisite for fiscal decentralization** is an adequate local government borrowing policy framework. Governments, including local governments, need to borrow 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, while irresponsible, unaccountable borrowing can lead to macroeconomic instability.

3.26 As part of fiscal decentralization, countries typically develop a subnational debt policy which identifies the purposes for allowable local debt, legal debt limitations, disclosure requirements and options for debt recourse in cases of default. These policies tend to include both ex ante controls such as limits on absolute borrowing, limits based on quantitative measures (debt service limits, debt-stock limits, or limits on new borrowing) and/or limits based on qualitative measures. In addition, countries typically put into place a series of ex post controls to deal with cases of default (Ter-Minassian and Craig, 1997; Liu and Waibel, 2008)

3.27 Establishing a financial environment conducive for local level long-term borrowing depends on four essential elements (Peterson, 2000). First, a country must build credit worthy local governments which will allow all borrowing to be demand driven, not supply driven. LGs must have financial credibility, worthy of being able to borrow and repay their debts. This means that they must be serious about their own revenue mobilization, ensure credible accounting, auditing, and a financial disclosure framework, and prepare multi-year rolling capital investment and infrastructure maintenance plan, with a separate capital budget. Second, a country must have a stable intergovernmental fiscal system which will include clear expenditure and revenue responsibilities, stable and predictable intergovernmental transfers and a clear government policy on which projects they will help finance. Third, a country should introduce parastatal intermediaries (e.g., a municipal development fund/Town Development Fund) for local government lending. This will allow CG to mobilize development partner support and/or borrow on the capital market for on-lending. The CG should then issue a debt policy with consistent lending principles and use lending terms to establish the legal basis for broader credit market development. Fourth, a country should build a competitive credit market which will allow local borrowing to continue in a sustainable manner. With few exceptions, most developing countries do now have financially credible local governments meaning that local borrowing will be limited for the foreseeable future. Priority must first be placed on establishing accountable local governments with credible public financial management (PFM) systems.

3.28 Theory and international experience confirms that these four fiscal decentralization pillars, in effective coordination with political and administrative decentralization dimensions, are essential to enable countries to realize accountable governance and efficient public service delivery. International experience also confirms that the design and implementation strategy for decentralization reforms must be country specific in order to account for the unique legal, institutional, and cultural environment within which these public sector management reforms are to be implemented. This strategic design, which identifies and sequences the required transitional stages, is critical to maximize the chance of success, assess risks of wrong sequencing and effectively mobilize the needed political support for adapting, implementing and sustaining these decentralization reforms.

3.29 Within the context of these four key pillars of fiscal decentralization, local governments must have discretion to be able to allocate (at the margin) local resources to meet the needs and preferences of local residents. This ability to allocate resources enables local governments to make efficient decisions, fully internalizing the costs and benefits of expenditure choices. The ability for local level allocation discretion can also enhance political governance and financial accountability, if accompanied by engaged citizens through participatory planning, oversight and monitoring. Theory and international experience confirm the importance of discretion, combined with accountability, to realize the benefits of decentralization (Oates, 2006). Effective decentralization requires a set of accountability mechanisms to ensure that the scarce resources are used in an effective, responsive and accountable manner. High levels of discretion without accountability can lead to corruption and a misuse of scarce public resources (Klitgaard, MacLean-Abaroa and Parris, 1996).

3.30 These accountability mechanisms must include a combination of top down and bottom up accountability measures touching political, administrative and fiscal dimensions. The top-down accountability mechanisms should cover political aspects linked to election issues such as the level of independent candidates, reservations for under-representative segments of the population, legislative oversight, and recall and referendum options, administrative aspects such as civil service and procurement reforms as well as fiscal aspects such as local PFM (planning, budgeting, reporting, internal control/audit, external audit). The bottom up mechanisms should also cover political aspects such as civic awareness campaigns, citizen initiated recall and referenda initiatives, administrative aspects such as citizen reports, score cards, social audits, information campaigns and fiscal aspects as participatory planning & budgeting, expenditure tracking, and independent budget analysis (Yilmaz, S., Y. Beris, and R. Serrano-Berthet, 2010).

3.31 In general, the Government needs to strengthen accountability mechanisms while granting increased discretion to local governments when implementing decentralization reforms. Efforts need to focus on establishing both top down and bottom up accountability measures, developing a cadre of accountable leaders, garnering enhanced community participation, and implementing stronger PFM systems and procedures, combined with a strong, effective and enabling central government monitoring, oversight and guidance. A correct balance between discretion with accountability will enable LGs to enhance the quality of governance and service delivery in an accountable and efficient manner.

3.32 This report will now focus on the specific situation in Nepal, referring to this decentralization framework while identifying the legal framework of the LGSA vis a vis the practice in the field related to the four pillars of fiscal decentralization. The report will then conclude with a set of recommendations for the way forward.

4. Fiscal Decentralization Stocktaking in Nepal⁷

4.1 Decentralization has been championed in Nepal since the early 1960s initially to mobilize citizen participation in the development process. This decentralization process has gone through distinct phases in Nepal (DASU, 2005). **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.

4.2 **Phase 2 (1990-2006)** began with the introduction of multi-party democracy with 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 new Constitution of 1991. During this time, three separate Acts (DDC, Municipality and VDC) 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 enacting the Local Self Governance Act (LSGA) 1999, which replaced and incorporated earlier provisions of the Village Development Committee Act, Municipality Act and District Development Committee Act of 1991. This period from the 1990s onwards was expected to be a period of consolidation and carry forward of decentralization policies in the country (DASU, 2005). However, from the mid-1990s, there was also the emergence of increasing civil turmoil resulting from the Maoist insurgency. Thus, although well intended and hopeful, the decentralization expectations were not fully met as will be discussed later.

4.3 Following the cessation of hostilities under the 2006 *Jana Andolan*, the Comprehensive Peace Agreement, and the Interim Constitution, Nepal is now in **Phase 3 (2006-onwards)**, another exciting time of transition, consolidation and carry forward in the design and implementation of a new constitutional framework. Following the Comprehensive Peace Agreement, the Interim Constitution identified that federalism and decentralization were essential principles upon which the new Constitution will be written, thus there will be a shift from a unitary government structure to a federal government structure with three expected distinct levels of government—Federal, Provincial and Local Governments (Ghai and Cottrell, 2008).

4.4 Phase 3 provides an important window of opportunity to reestablish the priority for more accountable governance and improved service delivery through strengthening effective decentralization. It is anticipated that Phase 3 provides a genuine opportunity for Nepal to formally embed the key decentralization principles of devolution and citizen empowerment within the constitution and the supporting laws and regulations. And, more importantly, Phase 3 provides a

⁷ This section relies heavily on the expenditure and revenue reports, especially those details from the field observations, prepared by Dr. Bimal Koirala and Mr. Banshidar Ghimire as part of this LBFC Fiscal Decentralization Stocktaking study. For further information and details, see Koirala (2011) and Ghimire (2011). See also Kelly, 1999, Jenkins, Rup and Kelly, 2002, Shrestha, 2002, ADB, 2009, Sharma and Muwonge, 2010 and Srivastava 2011, for details on fiscal decentralization reforms in Nepal.

genuine opportunity for Nepal to implement the key decentralization reforms needed to enhance local participatory governance and the improved delivery of efficient public services which can further support economic growth and equity in social and economic development (Sharma, 2009).

4.5 Preparations are underway in Phase 3, which will lay out a Federal-based multi-tiered government structure to which the existing unitary-based government structure will need to transition. A careful analysis of the existing governance structure can identify important lessons not only on the expected challenges and opportunities but also identify on the transition path and strategy for moving from the current structure to the new government structures to be incorporated into the new constitution.

4.6 The current local government structure 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 LB expenditure and revenue functions and provide the underpinnings for strong local autonomy in planning and budgeting.⁸

4.7 The LSGA is a good starting point, a benchmark, for analysis and design of the future devolved government structure anticipated under the new constitution. The LSGA allocation and implementation experience of expenditure and revenues, 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 the subsequent design of a framework and strategy for implementing these governance provisions within the anticipated new federal constitution.

4.8 The LSGA framework provided for a Decentralization Implementation and Monitoring Committee (DIMC) and a DIMC Working Committee to guide the decentralization implementation process, created a Local Bodies Fiscal Commission (LBFC) to guide the fiscal decentralization process and also recognized the establishment of LB associations set up to represent the interests and to support the decentralized LBs.⁹

4.9 In 2001, a Decentralization Implementation Plan (DIP) was adopted laying out a sequencing of activities which would lead to the further decentralization of government activities, expenditures and revenues. The four sectors of primary health, primary education, agricultural and livestock were

⁸ LSGA and regulations can be downloaded in English and Nepali at http://www.mld.gov.np/local_development_act_1999.htm This LSGA embodied the framework for an efficient and accountable local government structure; but, as explained in this report, this local government structure was never fully realized.

⁹ The LBFC is an advisory body to provide independent guidance, analysis and oversight of the fiscal decentralization components related to expenditures, revenues, and financial management. See <http://www.localfinance.org.np/scope.php> for more information on the LBFC mandates

identified to be included within the first phase of sector devolution through the 2001-02 budget. 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 (NPC, 2002, as quoted in DASU, 2005). A number of other initiatives were identified to further support the decentralization reforms (MLG, 2004). Expectations for change were high.

4.10 Despite high expectations and best intentions, however, the LSGA legal framework and the DIP immediately began facing a number of constraints and challenges leading to a slowdown in the roll out of the decentralization process. Although some aspects of the DIP was implemented, a large number of the key elements were not implemented. For example, 23 sector laws, which were identified as conflicting with the LSGA, were to be rationalized; but there has been no progress to date. 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.

4.11 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 and the dissolution of the elected LBs in 2002, leaving a void in the presence of locally-elected 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; MLG, 2004; LBFC, 2005; and DASU, 2005).

4.12 To fill the void left by the absence of locally-elected leaders, the Ministry of Local Development was forced to implement interim measures to appoint the Local Development Officer, Executive Officer and the VDC secretary to serve as head of the respective LBs; thus allowing these officers to serve both the executive and the legislative oversight functions. Following the Comprehensive Peace Agreement in 2006, the Government established an “All Party Mechanism” in 2009 as the interim measure to provide local legislative decision making and oversight functions. This APM mechanism allowed all political parties to assign persons to represent their political party at the local level. Both of these approaches were attempts to overcome the lack of locally elected leaders, but both approaches established an upward accountability structure rather than a downward accountability structure needed to ensure responsive and accountable devolved governance.

4.13 One requisite for accountable and responsive decentralization is the presence of locally-elected political representatives. Field discussions identified that the lack of elected local leaders has

weakened downward accountability and decision making. It appears that the major expenditure decisions are being made with limited community consultation, largely influenced by local elite, appointed administrative officers and/or members of the All Party Mechanism (APM).

4.14 Field observations confirm the need for reestablishing locally elected leaders to strengthen local accountability and ownership. Prior to the reestablishment of local election, there is an immediate need to provide continuity in local leadership (e.g., administrative officers and the APM leaders) and introduce / strengthen other forms of downward accountability (see paragraph 3.29-3.30). Currently the MLD-appointed administrative officers have extremely short tenure in the field. This constant change in administrative leadership makes it difficult to ensure accountable and sustainable planning and budgeting and to establishing good working relationships within the LBs as well as between the LBs and the line agencies. Just recently the tenure of the APM members was extended to provide more continuity in local leadership.

4.15 Field observations indicate that the effectiveness of the APM mechanism varies considerably within and between categories of LBs, but there seems to be a consistent need for further clarification on the APM role in the local planning, budgeting and monitoring process. In fact, there is need to provide clarity and some socialization/training on the roles and responsibilities for all local stakeholders. For example, LB officials need socialization on their role in governance, decision-making and service delivery. APM members need clear orientation with improved and applied mechanisms to secure their performance on their role in decision-making, oversight and adjudication. Line agencies officials need socialization in facilitation, coordination, service delivery and monitoring, while community groups and NGOs need socialization in social mobilization, implementation, oversight and financial of local services. The current uncertainty and confusion on respective roles hinders coordination, governance effectiveness and service delivery.

4.16 Another requisite for realizing decentralization benefits is the granting of local flexibility and discretion at the local level for expenditure decisions. Effective decentralization requires LB to be given discretion to allocate their resources (at the margin) to allocate the scarce resources in accordance with the local preferences in order to maximize expenditure efficiency. Efficiently matching the full costs and benefits of each local expenditure decision allows for the exercise of the 'subsidiarity' principle (see paras 3.8-3.9).

4.17 In principle 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. However, field visit discussions suggest there is a lack of real local discretion in the budgeting process, both on the expenditure and the revenue side. On the revenue side, there is typically a lack of flexibility to set the rates for local own revenues; while on the expenditure side there seems to be substantial central government influence/controls and guidance given to LBs, with heavy explicit or implicit mandates and earmarking which limits local level discretion.

4.18 In the current 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 (see paras 3.29-3.31). As more effective political accountability structures emerge with new elections, local governments should be allowed more discretion to be more responsive and efficient in delivering local public goods and services.

4.19 To obtain the efficiency gains which can result from decentralization, Nepal will need to expand discretion accompanied by improved accountability mechanisms. These accountability mechanisms ultimately will require locally-elected representatives to ensure political downward accountability but will 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.

4.20 Field observations identified the need to clarify the role of the Ministry of Local Development vis a vis the role of the LBs. Most LBs which were visited had signs with their respective LB names, which included reference to the Ministry of Local Development. These signs made it appear that the LBs were line agencies of the Ministry of Local Development similar to the deconcentrated agencies of the line departments such as education, health, agriculture and livestock. This confusion in the appropriate relationship was confirmed by the perception on the part of the line ministries who argued that they will not devolve their roles to the LBs as long as the LBs function as arms of the MLD. 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.

4.21 One related field observation was the need for clarity even within the DDC, for example, on the role of the District Technical Office. Technically the DTO is to be reporting to the head of the DDC to provide technical support on all aspects of local level planning, implementation and monitoring. However, in practice, the DTO is often seen as an arm of the Department of Local Infrastructure and Development of the Agricultural Roads (DoLIDAR under the MLD) operating within the DDCs. The DTO seems to have a dual reporting role—first to the DoLIDAR and secondly to the DDCs. This should be clarified under the current local government system and, of course, further explicitly clarified under the anticipated federal government structure. Clear control of the human resources and their management by the LBs is essential to enable efficient and accountable decentralization.

4.22 But, despite these major challenges, there was a general agreement sense that LBs have been able to begin providing an important governance interface at the local level and playing a role in local economic development, although 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.

Through the LSGA, LBs have been empowered to identify local priorities, plan, 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, with the ever present challenge found throughout the world of ensuring broad local representation and avoiding elite capture. These LBs have been able to mobilize social capital for development to varying degrees, through facilitating various user community groups for delivering, overseeing and monitoring local development activities. In addition, LBs have been able to provide some local physical infrastructure such as roads using grant funds from the central government.

Expenditure Assignment Observations

4.23 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 with the central government. Since passage of the LSGA and related regulations, there has been little attempt to undertake a functional analysis (activity mapping) to further clarify these expenditure responsibilities and resolve the inherent conflict between the central and local bodies as well as between the LBs themselves.

4.24 As indicated earlier, there remain 23 sector laws identified as conflicting with the LSGA which continue to cause duplication and conflict in the areas of expenditure assignment. Although early attempts were made to harmonize these laws, in fact, there has been no progress to date. As Nepal moves towards a new Constitution, with the need to have clarity on the assignment of functions across the various tiers of government, it will be critical to undertake a detailed functional analysis to clearly specify the expenditure assignments across tiers of government and include the requirement, with time deadlines, within the transition clauses of the Constitution, to provide the framework and requirement to resolve these conflicts in a timely and complete manner.

4.25 Field discussions indicate that there are many assigned functions under LSGA that are not being exercised by the LBs. 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 to provide the core services which were historically the responsibility of the central line departments such as education, health, roads, agriculture and environmental management. Most LBs focus 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. This approach has led to variation in the expenditure responsibilities being implemented

by the LBs, being dependent on local choice and taking advantage of the lack of specificity in the expenditure assignments (Koirala, 2011).

4.26 In 2005, the Government initiated sector devolution by shifting key components of education, basic health, agriculture and livestock to LBs. Sector devolution guidelines were sent to the DDCs for implementation, which for the first time entrusted line ministry's responsibilities to LBs. The three concerned ministries, Ministry of Education, Ministry of Health and Population and the Ministry of Agriculture and Cooperatives, developed three different implementation modalities of devolution, which included strong control provisions from the deconcentrated line offices, which unfortunately largely defeated the intent of comprehensive devolution (Koirala, 2011). The following several paragraphs focus on these devolved sectors summarizing the conclusions and field observations as identified in Koirala, 2011.

4.27 The education sector was devolved to LBs with the expectation that LBs would work hard to meet the MDG targets and the national objective of poverty and disparity reduction. The expectation was to intensify investment in education, improve school education quality and make LBs responsive and accountability towards universal primary education. Although well intentioned, the education sector appears to have received relatively low priority from LBs.

4.28 Field observations confirmed that LBs occasionally support primary schools in the form of roofing materials, repair/maintenance and furniture supply, while many visited LBs have allocated financial resources to tertiary education which are not a LSGA specified responsibility. Field discussions suggest that LBs feel that basic education expenses are largely provided by the central government (i.e., salaries and basic other materials), thus LBs do not feel pressure and/or the need to allocate substantial funding for the education sector (Koirala, 2011). Field observations also confirmed that, although the primary teacher salaries are channeled through DDC accounts, DDCs have little control over education planning and budgeting; while the district education offices view this channeling of salary funding through the DDCs as an additional layer of unneeded bureaucracy.

4.29 This is contraction in the decentralization structures for implementing education. Contrary to the LSGA, the Education Act envisages "District Education Committees", chaired by the DDC Chairman, to be entrusted with overall planning/budgeting of education projects/activities. School Management Committees are also set up outside the control of the LBs, thus providing very limited opportunities for education sector coordination with other local level development under the control of the LBs.

4.30 Basic health services were also devolved to LBs. Field observations suggest that LBs support these health services, if necessary, by providing funding for construction, furniture and repair/maintenance. LBs however did not provide any funding for drug supplies and medical equipment. As a national priority, the Government of Nepal has provided the necessary costs of sub-health posts, health posts and health to implement free medical services and free essential drugs

from 2007. Koirala (2011) also reports that health is largely seen by local residents as a central government function, with very little responsibility under LBs.

4.31 Although the LSGA provides for LBs to play a substantial role in primary health, the LBs play a largely insignificant role, relying largely on the central government to provide these services. Field discussions suggest a number of reasons: First, many functions lack clarity; for example, municipal LBs are to provide municipal hospitals even though district hospitals already exist. Greater clarity is therefore needed, clarifying the mandatory from the permissive functions. Second, LBs feel that they have inadequate funding to take on the full responsibility for the LSGA-stipulated health responsibilities; thus selectively chose their expenditures and rely on the central government and the deconcentrated line agencies to provide the majority of funding and support for primary health services. Third, LBs feel disconnected from the health management structure which is envisaged through the Health Sector Devolution Plan to be undertaken through ‘Health Posts Management Committees’, chaired by the LB chairman. Fourth, LBs feel that the lack of elected local leaders and their involvement in these committees weakens LB identity with the responsibility for basic health care.

4.32 Agriculture and livestock sectors were also devolved to LBs. The LSGA clearly provides for active LB involvement in both of these sectors, within the overall policy framework established under the Ministry of Agriculture and Cooperatives. As with the education and health sectors, the central government envisaged the establishment of a District Agriculture and Livestock Development Committee” to be responsible for the development and oversight of the agriculture and livestock plan. Although this Committee is to be headed by the DDC Chairman, the basic functions contradicts the basic role of the DDC itself. Field discussions indicate a strong willingness of the central government ministry to devolve these related functions to the LBs; however, LBs seem reluctant to take on these added responsibilities due to the lack of elected local leaders and the lack of local capacity and limited financial resources (Koirala, 2011).

4.33 In general, field observations showed a mixed picture of the implementation of expenditure assignments. Infrastructure in road networks has been a major priority for LBs. However, 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 scant. 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 (Koirala, 2011).

4.34 Given the variance and diversity across LBs in Nepal, the LSGA allowed the Government to classify VDCs on the basis of population, geographical diversity and facilities with the intention of making “arrangements for the development of those VDCs which have low facilities available and are situated in an undeveloped village development area by making them affluent with means and

facilities on the recommendation of the DDCs” (LSGA, Art. 20). Although well intentioned, discussions with key decentralization experts and policymakers indicated that this approach was never effectively implemented due to the difficulty of classifying the VDCs in an objective and transparent manner. In practice therefore all VDCs are treated as equal in terms of assigned expenditure and revenue functions, and each VDC receives a grant on formula basis which varies from Rs. 1.5 million to Rs. 3 million.

4.35 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. Field observations seem to indicate that the participatory nature of the planning process within some LBs has largely become a ritual over time with inadequate attention paid to adequately incorporating the voice of minorities and the marginalized into this planning process. With the lack of locally elected leaders since 2002 and the lack of an effective participatory planning process, it appears that the local elites and members of APM may be influencing the planning prioritization process (Koirala, 2011). Special care will be needed to ensure broad representation of the community in the planning process—perhaps by improving those related incentives under the MCPM performance grant system which encourages participatory planning and budgeting. Field observations confirm that these MCPM incentives seem to have been playing a increasing impact on the governance, administrative and financial behavior at the LB levels.

4.36 In addition, the local planning process also faces problems that it is not synchronized / coordinated with the planning being undertaken by the line departments of the 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 the sector plans, thus, not integrating them into the LB development plans and budgeting process. There is a need for greater planning harmonization to enable effective local input and oversight into sector plans to ensure adequate local participation and resource contribution to sector plans being locally implemented. Line departments and LBs are also following different planning cycles creating problems of synchronization.

4.37 Field observations also confirm that 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 dependent on personal relationships, not institutional relationships. Some of the coordination constraint appears due to hierarchical structure and level of appointments. At the DDC level, for example, the line department officials have the same civil service ranking as the DDC officials, but at the municipality level and VDC level the civil service rankings are different, often inhibiting communication and cooperation. In general the field observations found that greater synergies were needed between LBs and line department agencies to improve effective and accountable service delivery.

4.38 Field observations also suggest that LBs are often considered more as financing agencies rather than as service delivery agencies. Some LBs report that they 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. In line with decentralization reforms, LBs should assume increasing responsibility for more effective service delivery provision through an effective combination of political and management leadership, administrative and technical capacity and fiscal resources.

Revenue Assignment Observations

4.39 The LSGA also allocates a number of revenue resources to 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 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 LBs and the central government, which, as will be discussed below, are problematic. Intergovernmental transfers play the dominant role in LB finance. Generally speaking, it is possible to say that the revenue assignments under the LSGA are clearer than the expenditure assignments, however, and generally follow theory and international practice with only a few major exceptions.

4.40 LBs rely on a combination of user charges, local taxes, shared taxes and grants to provide the resources needed to meet their expenditures assigned. Based on the sample LB's visited the local own sources of revenue (OSR) is quite small. DDC are generating on average about 16% of revenue and 20% of expenditure. Municipality's average is 37% of revenue and 46% of expenditure. VDC's average is 11.75 % of revenue and 12.20% of expenditure. A further disaggregation reveals extremes variations in OSR. Within 6 DDC visited OSR ranged from 3% in Jumla (mountain) and 23 % in Kailali (Terai) of revenue. OSR expenditure ratio is 3 % and 27% of the same districts. OSR revenue of municipalities varies from 22% Ilam (hill) to 73% of in Pokhara. OSR expenditure varies from 29 % in (Birendranagar Tarai) to 82 % Pokhara (Hill valley). VDC's OSR varies from 1% (Chhayachhetra Hill, Chileme Mountain) and Ghailadubba (Terai), Lubhu (Kathmandu valley) both 31 % of revenue. OSR expenditure varies from 0.28% in Chileme (mountain) and 32 % in Ghailadubba (Terai)

4.41 Although LBs could increase their OSR with improved administration, the evidence in the field suggests that LBs will remain heavily dependent on central government grants to fund their assigned expenditures. This is consistent with international experience where local governments typically receive 60-80 percent of their resources through the intergovernmental transfer system. This said, however, field visit discussions confirm that there is enormous scope for enhancing local revenues through improved local revenue administration.

4.42 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 (Brosio, 2006). 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.

4.43 There are a few areas of confusion and duplication, with a need for reform. As Ghimire (2011) identifies, 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 the compliance, administrative and efficiency costs. This year, the Government has introduced measures to synchronize the administration of the housing rental tax, with discussions underway to sort out the similar administrative overlap for motor vehicle and the presumptive income taxes.

4.44 In addition, there is confusion/problems in the area of shared taxes—those to be shared between the LBs and the CG such as forestry, electricity and tourism and those to be shared across the two tiers of LBs. In general the revenue sharing situation between the LBs and the CG is less problematic than the revenue sharing situation between the LBs. Field observations however confirm that these are problematic areas, with a low level of sharing between the LBs and with limited and sometimes non-transparent sharing between the CG and the LBs.

4.45 In general the 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 coordination across the various stakeholders to ensure effective, transparent and accountable administration. Tax sharing arrangements, if structured properly and implemented as intended, can provide an excellent way to reduce compliance and administrative costs, improve efficiency while maintaining accountability between government and their residents.

4.46 Tax sharing of natural resources between the DDCs and the VDCs is a specific area of concern. A recent Ministry of Local Development / UNDP / UNEP study (2011) provides a detailed analysis of revenue generation from natural resources, focusing on sand, gravel and stones. On the tax sharing aspects, the study concludes that the revenue sharing-sharing arrangements vary considerably between DDCs. While some DDCs appear to use an equitable formula for revenue sharing with VDCs, municipalities and other stakeholders, other DDCs follow a more ad hoc and

inconsistent approach. The 2011 study recommends that MLD provide DDCs with guidance the basis to share these revenues in order to ensure more equitable outcomes. The 2011 study also recommends that MLD consider increasing the minimum proportion shared to above 35%, among other recommendations (MLD, 2011, pgs 57-58).

4.47 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. For example, with the abolishment of the *Octroi* in 1998, the Local Development Levy was created, essentially a transfer to LBs based on a fixed percentage on imports.¹⁰ In 2009, the LDF levy was abolished replaced with a revenue compensation grant. Similarly a revenue compensation grant was provided to replace the *Kawadi*.

4.48 This immediate replacement of local revenues with a compensation grants creates an increasingly over-reliance on central revenue transfers and a reduction in autonomy and accountability.¹¹ Rather than immediately replacing local revenues with compensation grants, Nepal should strategically undertake local revenue reforms, combining the phasing out of inappropriate local taxes with the option of replacing them with a set of more effective local taxes and through improvements in policy and administrative reforms. Revenue compensation grants should only be used strategically, with required sunset clauses, to allow LBs time to building capacity and implement improved revenue realization from strategic local revenue reforms.

4.49 A thorough analysis of the LSGA and related revenue provisions, along with field observations, identified several emerging tax distortions that need resolution. First, there is need to phase out the District (and VDC) export tax to improve internal trade and reduce economic distortions. This can be done through shifting the tax from one based on outputs to one based on the inputs to production, such as land and/or a lump sum business license fee/tax. Second, there is need to eliminate the DDC-level import taxes being implemented under a “Local Development Fee” in certain DDCs. This import tax is similar in nature to the *Octroi* which was previously abolished for municipalities. Similarly this DDC-level import tax should be prohibited. Third, there is need to restructure / improve collection efficiency for such taxes as the housing rental tax, motor vehicle

¹⁰ The *Octroi*, a transit tax collected at the border of each municipality, was abolished in 1998 because the tax generated economic distortions (e.g., cascading tax effect) and was administered in nontransparent and accountable manner.

¹¹ The revenue compensation grants are typically fixed in amount, thus not buoyant over time for the LGs (e.g., Tanzania with the revenue compensation grant for the Local Development Levy in 2005). This means that the local revenue resource will naturally decline over time in real terms. To offset this, countries can either index these compensation grants at least to inflation or perhaps to the real GNP growth rate to allow local resources to increase in real terms overtime. In other countries, the abolishment of local taxes is replaced by a share of a buoyant tax to allow for automatic increases in real revenues (eg, Kenya with the Local Authority Transfer Fund based on 5% of the national income tax which replaced the Local Authority Services Charge in 1999).

taxes and the presumption income taxes/business taxes through better coordination of policy and administration between the LBs and the CG (see para 4.43).

4.50 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). In principle, this is consistent with theory and international experience where property taxes account for 40-60 percent of all local level own revenues (Bird and Slack, 2004, Kelly, 2002). The property tax system options in Nepal, however, are a bit complicated on the policy side with multiple tax bases, exemptions and tax rates and on the administrative side with multiple agencies handling different aspects of administration (tax registration and data management, valuation, liability assessment, billing, collection, enforcement and taxpayer service). The property tax regime needs reviewed, rationalized, simplified and implemented in a systematic and comprehensive manner. In particular, the tax administration needs to be simplified, codified in a procedures manual, piloted, and then rolled out to LBs along with capacity and incentives.

4.51 Revenue assignment includes both the assignment of own revenues as well as a system of shared taxes and intergovernmental transfers. As with most countries around the world, Nepal depends heavily on these intergovernmental transfers to fund the majority of local level public expenditures. Throughout the world, local own source revenues may be able to cover local road maintenance and garbage collection, but tend not to be adequate for funding key social services such as education and health.

4.52 Overall local revenue collection is very low, with most LBs not full exercising their responsibility and rights to levy and collect local revenues. Field discussions indicate that the major reason for this low collection effort is a lack of incentives such as the following: (1) local leaders, including the APM members, are reluctant to collect local taxes from their local residents for political reasons. (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. As identified in para 4.25, the expenditures are largely considered permissive, not mandatory, thus LBs face no consequences for failure to deliver. In addition to the lack of incentives, local revenue collection is low due to the lack of simplified administrative procedures, administrative capacity and taxpayer service/awareness.

Intergovernmental Transfer Observations

4.53 The LSGA (Section 236) provides for a system of intergovernmental transfers to channel needed 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, development level, fiscal capacity, financial management and discipline. 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.

4.54 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, donor agencies and I/NGOs are also providing program-based grants (Ghimire, 2011). Most of the transfers are structured as categorical grants, leaving little discretionary power to LBs to allocate according to competing local priorities. With the exception of the capital block grant through the MCPM system, most financial resources come with strong CG directives.

4.55 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 which is a performance-based system providing incentives to improve local governance, financial management, participation, revenue mobilization, planning, and budgeting, service delivery, among others. The various LGCDG and LBFC reports, as well as the field observations under this study, confirm that the MCPM system is beginning to provide an important set of incentives encouraging LBs to carry out their mandated functions as required under the LSGA and related regulations (Devkota, 2009).¹²

4.56 Despite progress in the design and implementation of formula-based MCPM performance-based grants, there are a number of challenges facing the intergovernmental fiscal system in Nepal. As Figure 4.1 indicates, 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. In addition, 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. That vertical allocation is determined on an annual basis through the budget process, almost as a residual rather than proactively intentional, to support decentralization. Further thought and progress is needed to more clearly identify the “equitable shares” of government revenues which should be systematically allocated to subnational level governments.

¹² The MCPM system was initiated by the GoN from 2004/05. From 2008/09, the MCPM system has been supported from 2008/09 from the Local Governance and Community Development Programme (LGCDP) The LGCDP which is a national program administered through the Ministry of Local Development and supported by supported by a wide range of Development Partners (DPs) such as the ADB, CIDA DFID, DANIDA, GTZ, Norway, SDC, and UN Agencies including UNDP, UNCDF, UNICEF, UNFPA, UNV, UNIFEM etc. The overarching goal of LGCDP is 'to contribute towards poverty reduction through inclusive, responsive and accountable local governance and participatory community-led development'. LGCDP's implementation commenced in July 2008 and will last for four years – July 15, 2012.

4.59 Effective decentralization requires adequate and consistent resources to fund the mandated set of expenditure responsibilities. Consistent with other countries, local governments in Nepal are heavily dependent on central government resource transfers, receiving from 60-90 percent of their resources through intergovernmental grants. To effectively use these grant resources, these funds need to be predictable, timely, and stable to allow LBs to plan, budget and implement in an accountable manner. Field discussions confirm the need to improve the timely flow of the grants, as late and unpredictable flows has created problems for planning, budgeting and implementation. Funds often arrive too late in the FY to allow adequate time to spend the money properly in that FY. This causes LBs to roll over the funds, when permitted, and to reprogram the funding for the subsequent FY. Overtime it is expected that grant fund flows will become more predictable and stable.

4.60 Field discussions confirm that these transfer resources flow inconsistently, often delayed, and are not predictable, making it difficult for LBs to procure and implement the planned and budgeted amounts in an efficient and accountable manner. Funds often arrive late, forcing LBs to roll over these funds into the subsequent FY. LBs can be criticized for not being able to absorb the level of funding given, while in actuality the LBs could possibly absorb the funding but are not given sufficient time to follow the necessary procurement processes for accountable expenditure implementation. Field discussions also indicated that some LBs also receive off-budget funds particularly to the DDCs at the end of the fiscal years, which can disrupt local planning and predictability of resources which can contribute to 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.

4.61 Theory and international experience confirm that linking discretion and accountability with funding decisions is critical at both the local and central government levels. A key pillar in fiscal decentralization is that “finance should follow function.” Funding without a clear assignment of functions can lead to LBs making expenditure allocation decisions which may not reflect the demands and needs of local residents. Unclear assignment of expenditure responsibilities can also weaken the accountability linkage between local bodies and their residents. Thus, a clear structure of expenditure assignments, along with effective public financial management (PFM) systems and procedures are essential to ensure that the intergovernmental grants, along with the local own revenues, are used in a manner which can encourage efficient and accountable expenditures at both the central and local levels under the anticipated federal structure in Nepal.

Local Government Borrowing Observations

4.62 The LSGA (Section 59, 119 and 148) empowers LBs to borrow from banks or financial institution by pledging property or under the guarantee of GON. If they borrow by pledging their property to 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 to borrow has been used only for long term capital projects.

4.63 In practice, the visited LBs have not borrowed, except for Janakpur Municipality, from commercial banks or from the market. The reasons given for not borrowing were the lack of suitable capital project and the absence of elected representative. Although the visited LBs did not have any borrowing experience, the LBFC reports that 33 municipalities have exercised borrowing rights, largely borrowing from the Town Development Fund (TDF) and international lending agencies like Asian Development Banks (ADB).

4.64 Ghimire (2001) reports that DDC do not borrow under the LSGA as the DDC's status is not as autonomous as it is intended to be. First DDC is still an office under MLD both from the viewpoint of public perception and from other practical matters. For example DDC gets expenditure ceiling for planning from MLD and National Planning Commission (NPC) and DDC's account is audited by Auditor general as any other GON offices. Therefore, DDC are required to borrow under the National Debt Act, not under LSGA provisions. However, VDC and municipalities are allowed to borrow under guarantee of GON but loan and guarantee act does not permit third party guarantee of loan. As long as DDC will continue to be regarded as MLD's line office, DDC borrowing will be regulated under the National Debt and Guarantee Act rather than the LSGA provisions.

Some Closing Thoughts on Fiscal Decentralization Stocking for Nepal

4.65 In general, this fiscal decentralization stocktaking study can conclude that the underlying decentralization principles behind the LSGA provide an important opportunity to improve governance and public service delivery needed to promote greater economic and social development in Nepal. Theory and international experience confirm that proper allocation of expenditure and revenue responsibilities, along with an effective intergovernmental fiscal transfer system and guidance on local borrowing, can improve efficiency and accountability of governance and public service delivery. Therefore these fiscal decentralization principles, in combination of political and administrative decentralization components, can lay the framework for Government to undertaking its public functions in an efficient and accountable manner.

4.66 The LSGA was drafted and introduced in 1999, setting high expectations for an improved public sector, with democratically elected leaders who could 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 initial LSGA law would provide the legal framework upon which to phase in the decentralization reforms in a systematic manner, incrementally shifting 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.

4.67 Although well intended, this decentralization strategy ran into immediate difficulties and lost its reform momentum. As identified in this report, various LBFC-related studies were undertaken to monitor the decentralization process, identifying the key constraints and challenges, and making a series of recommendations for reform. These studies show consistency in the conclusions and recommendations that the LSGA intentions were well founded but that the LSGA did have a number of internal inconsistencies in terms of functional assignments, a lack of clarity, and a number of political and institutional aspects which derailed the desired implementation strategy.

4.68 One critical component was the internal civil disorder brought about by the Maoist insurgency, which postponed the further election of accountable local representatives, leaving a major void in the intended democratic decentralization process. This insurgency, which helped derail the decentralization reforms momentum, was largely fighting for goals similar to the decentralization reforms such as citizen involvement and accountability, access to improved services and an equitable sharing of the fruits of development for all citizens throughout Nepal.

4.69 These various challenges affected the momentum for the LSGA-based decentralization reforms, forcing the government to largely maintain a hold steady pattern with only a few incremental adjustments such as the establishment of the LBFC and the introduction of the formula-based MCPM performance grants, among others. All field visits, undertaken under this study and/or through other previous studies, confirm a incongruence between what is written into the LSGA and what is happening on the ground. Although officially the asymmetric approach envisioned in the LSGA was not able to be implemented, in fact, on the ground, the decentralization process is being implemented in largely an asymmetric manner as each LB is differentially implementing elements of the LSGA based on their capacity, available resources, and on the vision and interests of local leaders. This said, the field visits do confirm that there are some consistent patterns in the expenditures and revenue practices across LBs, but with divergence and variation across Nepal.

4.70 With the signing of the Comprehensive Peace Accord in 2005 and the election of the CA , there is now a resurgence of discussions, studies and interest in restructuring Nepal to address the previous grievances and to usher in a new period of sustained economic and social development within a more equitable, efficient and accountable democratic government structure.

4.71 As identified earlier, Nepal is into a new Phase 3 of decentralization transition and consolidation under a new governance reform. To maximize the opportunity for success and to avoid potential pitfalls, it is critical that Nepal learn from the experience of the LSGA and its related decentralization reforms in order to better address the constraints and challenges and chart a way forward to ensure consistent and sustainability implementation of the envisioned governance

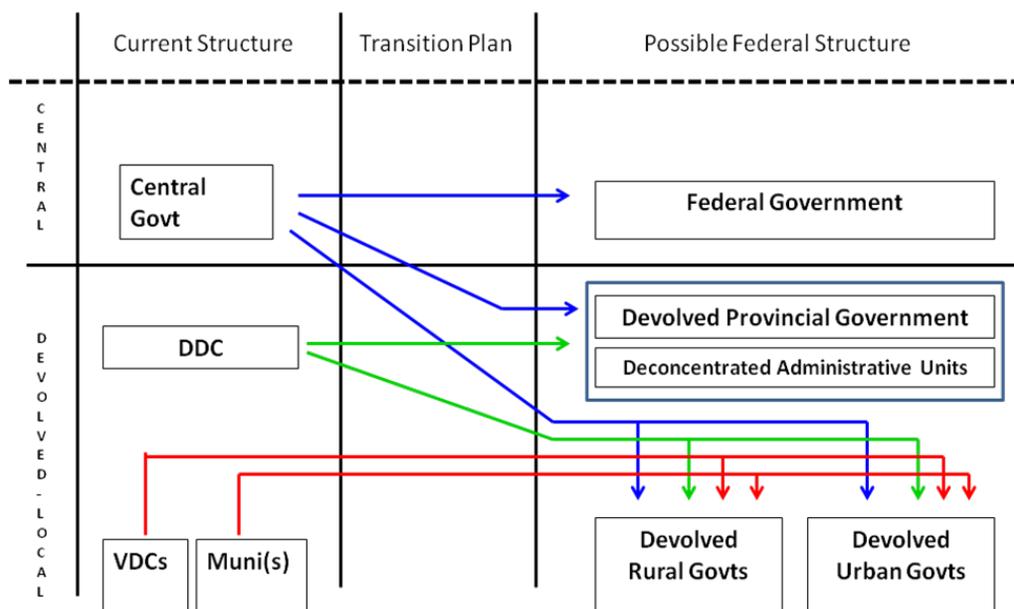
reforms. The following chapter of this report will conclude with several key lessons for the new Nepal.

5. Lessons and Recommendations for a Federal Nepal

5.1 As Figure 5.1 indicates, Nepal is expected to move from its current unitary structure to a new federal structure. The unitary structure has two levels of government, a central government and a devolved two-tier local body structure consisting of DDCs and municipalities and VDCs.

5.2 Although not entirely clear, the new government structure is expected to include three levels of government, a central (federal) government, a devolved provincial government and a set of devolved local rural and urban governments. Depending on the size of the provincial governments, there may be deconcentrated administrative units within each provincial government for administrative and service delivery functions, as appropriate.

Figure 5.1 Transition from a Unitary to a Federal Government Structure in Nepal



Source: Consultant Team, 2011

5.3 To help identify the key components needed for a successful transition in Nepal this concluding section of the report will identify several key lessons and recommendations as follows:

5.4 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, but equally and perhaps most importantly, to ensure widespread accountable ownership for the sustainable realization of the reform results. Public sector reforms, especially those related to decentralization, are 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.

Decentralization reforms is not only the responsibility of a Ministry of Provincial and Local Government, but rather it is the responsibility of the entire country managed at the highest level of government—the Office of the Prime Minister, with active participation of the Chief Secretary and a full time dedicated secretariat to ensure effective day to day coordination, policy analysis and the development of supportive laws and regulations needed to guide the decentralization process. It is only at that highest level that the central, provincial and local government activities can be effectively managed to ensure proper coordination and harmonization, the allocation of adequate human and financial resources and the resolution of potential conflicts.

To ensure successful devolution will require the active participation of the 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-dimensional; cross-sector public sector reform thus requiring 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 take time to initially implement, lots of change management support, and time to absorb and 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.

Effective public sector reforms should incorporate political, administrative and fiscal dimensions to be complete. As identified in paras 3.3-3.4, political accountability mechanisms, along with administrative/institutional capacities and clearly-defined fiscal responsibilities and resources are essential for decentralization reforms to be complete. Partial decentralization, where political, administrative and fiscal powers are not coordinated and sequenced appropriately, can lead to the lack of achievement in the benefits of decentralization (Devaranjan, et.al., 2007; Bahl and Martinez, 2006; Brueckner, 2007).

5.5 Need for Constitution to 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, it is critical to ensure that the principles of democratic and accountable devolution and provincial and local governments are embedded firmly in the Constitution. The details on the political, administrative and fiscal dimensions aspects should be further elaborated within an overarching organic law which lays 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 two decades.

As will be discussed later more specifically the Constitution must include relevant transitional clauses to ensure a clear timeline for harmonizing the existing laws and regulations with the newly adopted system of provincial and local government, as well as for the establishment of the various institutional mechanisms such as provincial and local government elections and the establishment of the National Finance Commission, among other required transition provisions.

5.6 Need for National Finance Commission

As recommended by one of the Thematic Committees of the CA, and based on international best practice, it will be important to establish a permanent, independent National Finance Commission which can provide objective analysis, guidance and oversight needed on the allocation of financial resources across the various spheres of government. Intergovernmental fiscal relations are inherently political, as it deals with the allocation of national financial resources through assignment and coordination of expenditure and revenue functions and the design and allocation of intergovernmental transfers. Therefore, there is 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.

As international experience shows, the NFC must be independent but with strong links to the highest level of government to ensure adoption/implementation of its recommendations. The financial resources allocated must flow on an annual basis in a timely and accountable manner, based on objective and equitable formulae, to all subnational governments. To this end, the NFC must have clear mandates to develop and support grant allocation formula(s),

advise on sub-national taxes and revenues and oversee and support public financial management issues.

5.7 Need for Clear Expenditure and Revenues Assignments

A clear delineation of the expenditure and revenue allocations is critical to improve the 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. Responsibility for expenditures and revenues should be assigned clearly in order to hold that level of government accountable for the level and quality of the service delivery, with clear consequences for failure to deliver those services. Although the basic principles should be included in the constitution, the details on the functions can be included in the organic law, and further regulated through other sector laws and regulations as appropriate.

This detailed clarification is essential to avoid the LSGA implementation experience. 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.

5.8 Need for Strategic Sequencing with Possible Asymmetric Approach

To be effective, resources need to be devolved along with the assignment of devolved expenditure activity and accompanied by capacity to deliver performance. In short, successful decentralization involves allocating functions, finance and functionaries within the context of clear expenditure mandates, with financial and human resources to enable successful implementation, with accountable incentives for performance.

Sequencing the devolution process is critical to match assignment of functions with the capacity to absorb and deliver public service in an efficient and accountable manner. This assignment may best be rolled out to local sub-national governments based on an asymmetric approach matching expenditure responsibility with the capacity and resources as appropriate based on performance, with the central or provincial government providing a necessary back up safety net to provide those underlying core services as needed in selective

local governments while simultaneously building local capacity to enable these LGs to assume the service delivery functions.

Strong institutional and human capacity is crucial for success, thus requiring special attention to development of HR systems needed to ensure sustained and ever more qualified local level human resource management. One important lesson from the LSGA decentralization experience was the need to establish a local body service commission. This failure to establish an appropriate local level HR policy and structure created a number of obstacles to effective decentralization reforms. It is critical that these sub-national government human resource management and capacity development issues be a priority.

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 (see para 3.29-3.31). 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 to ensure achievement of the decentralization objectives.

A transition plan is critically important as part of the sequencing process as Nepal moves from a unitary government to a federal government structure. In this transition, certain expenditure and revenue functions previously under the central government may shift to either devolved provincial government or devolved local governments. Some of those functions will be retained by the central government administered either centrally or through existing deconcentrated line departments.

At the same time, there may be functions currently under DDC responsibilities which may be reallocated to the provincial government or to local governments. DDCs are expected to be phased out entirely under the new federal structure. It is expected that the current LB functions assigned to municipalities and VDCs under the LSGA will be shifted directly to devolved rural and urban local governments.

This transition plan is important not only to clearly identify those functions to be shifted, but also to map out an appropriate transition plan to ensure that the public services, assets and liabilities, human and systems capacity are shifted to the appropriate government levels at minimum administrative costs and at minimum disruption to public service delivery.

5.9 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 delivery of national priority merit goods, and compensating for inter-jurisdictional spillovers, among others.

Theory and international practice confirm the dominant role which intergovernmental transfers play in financing of subnational governments. This means that design and implementation of the intergovernmental transfer system is critically important to realize the decentralization results of accountability and efficiency. As identified in the stocktaking exercise, 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 to provide incentives for improved governance, financial management, etc.

Under the new federal governance structure, there will be a need to restructure the grant system, channeling funds across the three levels of federal, provincial and local governments. 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.

As already identified, the establishment of the National Finance Commission is a critical component to this reform strategy as these reforms are dynamic and ever changing, depending on emergence of stronger institutional and human capacity, top down and bottom up accountability mechanisms, and overall political, administrative and fiscal capacity. This requires a NFC which can monitor, analyze, and adjust the intergovernmental fiscal system to ensure optimal achievement of government objectives.

5.10 Implications for Development Partner Support

Coordination of development partner support to the devolution process is critical to ensure proper synchronization with the ongoing reform structure and sequence. Development partner support typically comes through a combination of policy dialogue, capacity development and/or funding support. Each form of intervention needs to be leveraged to support the ongoing decentralization governance reforms to ensure successful performance results.

Both government and development partners need to recognize the long-term nature of public sector reforms, with the need for integrating 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 government to ensure systematic, sustained, and results-oriented reform, with clear benchmarks for success through such mechanisms as the LGCDP.

Strong and sustained DP support will be needed during and following implementation of the new constitution and transition from a unitary to a federal government structure. This international experience and capacity will be able to provide strong supportive assistance as these public sector reforms are designed and implemented successfully.

DPs 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 MCPM should be supported and expanded to provide a wider set of incentives and support to further support local PFM (e.g., planning, budgeting and procurement, auditing, accounting and reporting) and local revenue mobilization through possible property tax reform.

Coordinated and sustained support to such mechanisms as the LGCDP will enable DPs 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 by engaging government through their other sector-based development assistance in fields of education, health, environment, and infrastructure through policy dialogue, capacity development and funding.

Bibliography:

Asian Development Bank (ADB), 2009, “Nepal: Regional Development Strategy”, Report prepared for the National Planning Commission by M. R. Cyan, C P. Pokharel and C M Adhikari, 2009

Communication and Management Institute (2010), “A Study to Identify Sources of Revenue, Revenue Mobilization Capacity and Expenditure Needs in Mountainous (Himali) Districts”

Decentralisation Advisory Support Unit (DASU/Danida) 2005, “Fiscal Decentralisation in Nepal: Status and the Way Forward. Report prepared by P R. Ligal, Dr. D P. Shrestha, Y K. Chapagain, K K Bista, K K Maharjan.

Bahl, Roy, “Implementation Rules for Fiscal Decentralization.” International Studies Program Working Paper Series 99-01, Andrew Young School of Policy Studies, Georgia State University (1999).

Bahl, Roy and R. Bird, “Subnational Taxes in Developing Countries: The Way Forward” Public Budgeting & Finance (Winter 2008)

Bahl, Roy and J. Martinez-Vazquez, “Sequencing Fiscal Decentralization,” World Bank Policy Research Working Paper 3914, May 2006

Bird, Richard, “User Charges in Local Government Finance,” (Washington, DC: World Bank Institute, 2003 <http://www1.worldbank.org/publicsector/decentralization/June2003Seminar/Bird2.pdf>

Bird, Richard, “Local and Regional Revenues: Realities and Prospects,” (World Bank Institute, Washington, DC, 2003b).

Bird, Richard, “Subnational Taxation in Developing Countries: A Review of the Literature,” Journal of International Commerce, Economics and Policy, Vol.2, No.1 (2011), pp. 139-161

Richard Bird and Enid Slack (eds), International Handbook of Land and Property Taxation, Northhampton, MA: Edward Elgar, 2004.

Boadway, Robin and A Shah, Fiscal Federalism: Principles and Practice of Multiorder Governance, (Cambridge University Press, 2009)

Boadway, Robin, Sandra Roberts and Anwar Shah, “Fiscal Federalism: Dimensions of Tax Reform in Developing Countries”, World Bank Policy Research 1385 World Bank 1994

Boex, J. and S. Yilmaz, “An Analytical Framework for Assessing Decentralized Local Governance and the Local Public Sector”, IDG Working Paper No. 2010-06, 2010.

Brautigam, Fjeldstad and Moore, (eds), Taxation and State-Building in Developing Countries, 2008

Brosio, G. “The Assignment of Revenues from Natural Resources” in E.Ahmad and G. Brosio (eds) Handbook of Fiscal Federalism (Northhampton, MA: Edward Elgar Publishing, 2006)

- Brueckner, Jan K., Partial Fiscal Decentralization (November 2007). CESifo Working Paper No. 2137. Available at SSRN: <http://ssrn.com/abstract=1029581>
- DASU/DANIDA (2002): “Local Governance Strengthening Programme, Nepal” - A Joint Donor Appraisal Report, Kathmandu.
- Devarajan, Shantayanan, S. Khemani, and S. Shah, “The Politics of Partial Decentralization”, World Bank, 2007.
- Devkota, Khim Lal, “A Brief Overview of Minimum Conditions and Performance Measures (MCPMs) of Local Bodies of Nepal” LGCDP, 2009
- Ferrazzi, Gabe and R. Rohdewohld, “Comparative Analysis of Activity Mapping in Himachal Pradesh”, PRI Report 2008-2, GTZ
- Ghimire, Bansidhar “Report on Stock Taking of Fiscal Decentralization Policies (Revenues)” Report prepared for the LBFC, 2011
- Government of Nepal, “Local Self-Governance Act, 1999”, His Majesty’s Government of Nepal, Law Books Management Committee, (1999)
- Government of Nepal, “Local Self-Governance Regulation 1999 and Local Bodies (Financial Administration) Regulation, 1999”, Law Books Management Committee (1999)
- Ghai, Yash and J. Cottrell (eds), Creating the New Constitution: A Guide for Nepali Citizen (Sweden: International Institute for Democracy and Electoral Assistance, 2008)
- Jenkins, G, R. Khadka and R. Kelly, “Central-Local Fiscal Relations” chapter 5 in Reengineering Tax Systems in Low-Income Countries: An Application to Nepal, Glenn P. Jenkins and Rup Khadka (New York: Kluwer Law International, 2002).
- Kelly, Roy, “Intergovernmental Revenue Allocation Theory and Practice: An Application to Nepal” Asian Journal of Public Administration Vol 21, No 1 (June 1999) 86-113
- Kelly, Roy, “Designing a Property Tax Reform for Sub-Saharan Africa: An Analytical Framework applied to Kenya” Public Finance and Budgeting, Vol.20, Number 4, 2000, pp. 36-51.
- Kelly, Roy and J. Boex, “Fiscal Federalism and Intergovernmental Financial Relations” in R. Hemming, R. Allen and B. Potter (eds) Handbook of Public Financial Management (Palgrave Macmillan, forthcoming)
- Klitgaard, Robert, Ronald MacLean-Abaroa, H. Lindsey Parris (1996) “A Practical Approach to Dealing with Municipal Malfeasance”, UMP Working Paper Series No. 7, UN-HABITAT, Nairobi.
- Koirala, Bimal, “Report on Stock Taking of Fiscal Decentralization Policies (Expenditures)” Report prepared for the LBFC, 2011.

LAFC (2000): “Local Authorities Fiscal Commission Report”, Local Authorities Fiscal Commission, Ministry of Local Development, Kathmandu.

LBFC, 2004, “Expenditure Assignment in Study”

LBFC, 2005, “Revenue Assignment and Fiscal Gap Analysis of Local Bodies in Nepal”

Liu, Lili and Michael Waibel, “Subnational Borrowing: Insolvency and Regulations,” Chap 6 in Anwar Shah (ed) Macro Federalism and Local Finance, (Washington DC: World Bank, 2008).

McLure, Charles Jr., “The Tax Assignment Problem: Conceptual and Administration in Achieving Subnational Fiscal Autonomy”, Washington, D.C.: World Bank, 2001. pp.1-21

Mikesell, John, “Developing Options for the Administration of Local Taxes: An International Review”, Public Budgeting & Finance, Spring 2007, Vol. 27 Issue 1, p.41-68

Ministry of Local Development (Government of Nepal), “Policy Paper on Decentralization (NDF-2002,” February 2002

Ministry of Local Development (Government of Nepal), “Policy Paper on Decentralization in Nepal (NDF-2004)” http://www.ndf2004.gov.np/draft_paper/decentralization.pdf

Ministry of Local Development, “A Review of Current Practices of Revenue Generation from Natural Resources for the Local Bodies of Nepal, Published by LGCDP, Ministry of Local Development together with UNDP and UNEP, 2011. <http://www.unpei.depiweb.org>

Musgrave, Richard A. and P. Musgrave, Public Finance in Theory and Practice, (New York: McGraw Hill, 1989)

Oates, Wallace, "Toward a Second-Generation Theory of Fiscal Federalism," International Tax and Public Finance, 12, (2005) pp 349-373.

Peterson, George, “Building Local Credit Systems”, World Bank Urban Management Program, Paper 25 (Washington, D.C.: World Bank, 2000).

Pritchett, Lant and Varad Pande, “Making Primary Education Work for India’s Rural Poor: A Proposal for Effective Decentralization”, World Bank South Asia Series Working paper No. 95, 2006

Schroeder, Larry and P. Smoke, “Intergovernmental Fiscal Transfers: Concepts, International Practice and Policy Issues” Chapter 2 in Paul Smoke and Y.H. Kim, eds, Intergovernmental Fiscal Transfers in Asia: Current Practice and Challenges for the Future (Manila, Asian Development Bank, 2003), pp. 20-51

Shah, Anwar, “The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economies” (World Bank, 1994)

Shah, Anwar, “A Practitioner’s Guide to Intergovernmental Fiscal Transfers” Chapter 1 in Intergovernmental Fiscal Transfers: Principles and Practice (Washington D.C.: World Bank, 2007), pp. 1-53.

Sharma, Yam Nath and A. Muwonge, “Local Government and Service Delivery: In Retrospect and Prospect, A paper prepared for the Eastern Regional Organization for Public Administration (EROPA) International Seminar, 21-25 November, 2010, Kathmandu, Nepal.

Sharma, Guna Nidhi, “National Development Strategy Paper”, Presented for Discussion at the Nepal Development Forum Stakeholders’ Consultation Meeting, 2009.

Shrestha, Manoj “An Overview of Intergovernmental Fiscal Relations: in Nepal”. AYSP Working paper 2002-05, April 2002.

Srivastava, D.K. “Key Elements of a New Fiscal Regime in Federal Nepal”, Paper prepared for the Forum of Federations, Feb 2011

Steffensen, Jesper, Performance-Based Grants - Concept and International Experience, (NY: UNCDF, 2010)

Ter-Minassian, Teresa and Jon Craig, “Control of Subnational Government Borrowing” Chapter 7 in Teresa Ter-Minassian. Op. Cit. Teresa Ter-Minassian, (ed), Fiscal Federalism in Theory and Practice (Washington D.C.: IMF, 1997)

Wegener, Alexander, “Local Government Finance in Nepal: Current situation, challenges and future policy” Report prepared for Deutsche Gesellschaft für Technische Zusammenarbeit, June 2008

Yilmaz, S., Y. Beris, and R. Serrano-Berthet, “Linking Local Government Discretion and Accountability in Decentralisation”, Development Policy Review, 2010.

Annex 1: Terms of Reference

TERMS OF REFERENCE **FOR SPECIAL SERVICE AGREEMENT**

TITLE of the Study: **Stocktaking of Fiscal Decentralization Policies and Practices –**
Team leader and Fiscal Decentralization Expert

AGENCY/PROJECT NAME: **Local Governance and Community Development Programme (LGCDP)**

COUNTRY OF ASSIGNMENT: **Nepal**

1) GENERAL BACKGROUND

With the introduction of the Local Self-governance Act (LSGA), 1999, Nepal entered into a new stage in decentralization. Contrary to the earlier measures in this regard, it focused on fiscal dimension by giving more authorities and resources to the local bodies (LBs), namely the Village Development Committees (VDCs), the municipalities and the District Development Committees (DDCs). Despite this, the government structure remained centralized and unitary which could not address many of the pressing problems and hence the state as a whole is being restructured with federal features, among others. The Local Bodies Fiscal Commission (LBFC), a statutory body playing an important role in fiscal decentralization (FD), is working towards fiscal decentralization in the federal set up too. In this fiscal year (2011/12) Local Bodies Fiscal Commission Secretariat (LBFCs), as a part of Local Governance and Community Development Program (LGCDP) funded through the UN Capital Development Fund (UNCDF), is planning to take stock of the state of the FD, leading to a number of preparatory works for the new set up.

The Constituent Assembly (CA) that has been in place after the longstanding demand of Nepali people has been writing democratic and inclusive constitution along federal line. Nepal will have a new constitution in place by May 28, 2011, with three tiers of governments. All the thematic committees of the CA have submitted their reports. Out of the 10 thematic committees, three committees, namely Committee for the State Restructuring and Division of State Powers (SRDSP), Committee for the Determination of Form of Governance of State (DFGS) and Committee for the Allocation of Natural Resources, Financial Rights and Revenue (ANRFRR) are the major committees dealing with the issue of federalism, and allocation of power and authority across different tiers of governments. As per the draft provisions of the committees, basically there will be federal, provincial and local governments. Besides, special arrangements i.e. autonomous areas, protected areas, special areas have also been envisaged by the SRDSP Committee.

As stipulated by the DFGS Committee, the three tiers of government will derive their authority directly from their respective constituencies. The ANRFRR Committee provisions that

all tiers of government will be autonomous in its sphere of competence, at the same time they will also cooperate both vertically and horizontally in exercising their rights. Two of the committees (namely SRDSP and ANRFRR) have proposed lists of expenditure and revenue assignments to each tier of government. The ANRFRR Committee in particular foresees that there will be vertical and horizontal imbalances between revenues and expenditures assignments and hence suggests principles for intergovernmental transfers, especially from the federal government to sub-national governments. Not only that, it also proposes National Finance Commission as a constitutional body with the main responsibility of looking after intergovernmental transfers.

Currently, the Constitutional Committee of the CA has been drafting the constitution by integrating the provisions contained in the thematic committee reports. It is highly likely each of the three tiers will separately be assigned expenditure and revenue powers allowing each level of government, including the local one, to exercise its authority within its given jurisdiction. However detailed the provisions will be in the new constitution, they will not be sufficient enough to be directly implemented by different spheres of government. They need to be further developed, clarified and eventually defined by subsequent laws and policies. As indicated by the ANRFRR Committee, the framework legislations will be required at federal level in many areas further clarifying constitutional provisions such that different tiers know what exactly their rights and responsibilities are. Similarly, other institutional provisions will be required to be further specified in line with practices in other federal countries.

While further developing the specificities of the constitutional provisions, there will also be the need to consider how to facilitate and manage the transition to federalism. Indeed, a good transitional management plan not only allows federal and sub-national governments to discharge their responsibilities and exercise their powers in the spirit of the constitution, but will serve to minimize any disruption in services to be delivered by respective tiers of government. This is of particular importance for a country like Nepal that has limited experiences in decentralization. The transition management plan and future decentralization policies need to be informed by current practices in fiscal decentralization.

The Administrative Restructuring Commission (ARC) has been working to recommend the government the administrative structures in the new set up as well as the staffing requirements. However, the Commission has been focusing mainly on central and provincial governments.

2) OBJECTIVES OF THE ASSIGNMENT

The assignment is part of a larger study that aims to review the current state of fiscal decentralization and develop future fiscal decentralization policies in Nepal. This will include:

- Take stock of fiscal decentralization policies and practices in the country in particular with respect to the provisions in the LSGA, 1999, vis-à-vis their practice.
- Carry out functional analysis across different tiers and relevant sectors based on the reports of various CA committees as they related to the fiscal decentralization and make recommendations to allocations of responsibilities in light of the new proposed structure,

- Prepare recommendations on policy framework required to implement the constitutional provisions in regards to expenditure and revenue assignments as they relate to the local governments.

3) SCOPE OF WORK

Output One: Taking Stock of Fiscal Decentralization Policies and Practices

The consultant will review the implementation of the LSGA in terms of fiscal decentralization with the support of two national consultants (see separate TORs). In this regard, s/he will assess how far the expenditure and revenue assignments are being exercised by the local bodies (LBs). In doing so, the expenditures and revenues will be categorized in areas as given in the LSGA. In the case of expenditure assignments, for example, they will be broken down by education, health etc.

It is expected that the final report will answer - but is not limited to - the following questions/issues:

Expenditure assignment

- Are the expenditure assignments clear enough in terms what the LBs are required to do?
- How have the expenditures been clarified after the devolution of some of the areas like primary education, health etc?
- How far the expenditure items are overlapping with the government and other tiers of LBs?
- To what extent expenditure items are being exercised by the LBs?
- Are there any items that the LBs have not exercised? If the LBs differ in making use of their rights in regards to the expenditure items, what are the reasons?

Revenue assignment

- Are the revenue assignments clear enough in terms what the LBs are required to exercise?
- What are the most important sources of own-source revenue?
- How far own-source revenues are being collected and utilized by the LBs?
- How adequate are the own source revenue to meet the expenditures assigned?
- How is the revenue sharing arrangement, both among the local bodies and among the government and the local bodies, functioning?

Intergovernmental Fiscal Transfer

- How the grants (conditional and unconditional) are being provided to the LBs?
- How far are they being tied up with the expenditure and revenue assignments?
- Do the grants stand against the criteria such as efficiency, adequacy, predictability and equity?

Output Two:

Based on the findings of the stock-taking of fiscal decentralization policies, the consultant will recommend what kind of framework legislations/policies will be required allowing local governments carry out their given responsibilities. In this regard, s/he will go through the draft provisions of the CA committees as they related to fiscal decentralization. S/he will also recommend future works (both at policy and technical fronts) required on the part of the government in the new set up, including the transitional management of the local bodies (governments).

4) Methodology, DURATION OF ASSIGNMENT, DUTY STATION AND EXPECTED PLACES OF TRAVEL

The methodologies for the study include, but not limited to, the following: The consultant will review the LSGA/R and LBFAR, and a number of earlier studies including Nepal's Choices in Fiscal Federalism, Fiscal Decentralization in Nepal Status and the Way Forward, LBFC report 2000, etc. Policy makers and experts in this regard will be consulted. Structured and unstructured questionnaires will be administered in 10% of the DDCs and Municipalities and one VDC in each of the selected DDCs. In addition, the consultant will review constitutional provisions to be drafted by the Constitutional Committee that related to local governments and analyze the expenditure and revenue assignments and related provisions as proposed by the CA committees namely SRASP and ANRFRR. Stock taking of the works carried out/being carried out by the ARC and draw lessons from other countries that have passed through the similar kind of transition. Sample size of the study will be determined in consultation with the Local Bodies Fiscal Commission Secretariat (LBFC). Finally the consultant will review the relevant international literature and best practices.

The duration of this assignment is for 40 person days of which a minimum of 4 weeks will be in-country over two missions during the period of April to September 2011. The remaining days will be allocated for preparations and report writing from home-base.

The international consultant will be the Team leader for the national experts including National Expenditure Assignment Expert (1) and national Revenue Assignments Expert(1). Since the work calls for a survey to be developed and administered to 10% of the DDCs and Municipalities and VDC (sample size to be decided by the team) within each of the selected DDCs, the team leader will design the questionnaire with the two national consultants and will be field tested before going out to the sample DDC and VDCs to collect the information. The team including the national consultants will then analyze, and produce inception report and status report. The team leader, will be then, responsible for producing write the final report, hold follow up meetings as needed, and present a draft final report. The Government would then provide comments to the draft report and the final report will be produced by incorporating the comments.

5) FINAL PRODUCTS

The Team leader and Fiscal decentralization expert will be responsible for the final outputs as outlined in this TOR, in addition to overall coordination and supervision of each of the national experts (Expenditure Assignment Expert and Revenue Assignment Expert). The team will produce a combined inception and status report. However, a separate report is expected from the national expert in the area of expenditure assignment and revenue assignment, which will be fed into the draft and the final report to be submitted by the TL. The various outputs are described below:

Report, Due Date, No of copies, type & language, Contents

Inception Report

End of 1.5th weeks

- 4 hard copies, English
- Electronic versions
- Revised activities and input plans,
- Comments on ToR (which may lead to change in scope subject to agreement)
- Record of meetings held; and
- Any issues arising.

Status Report

End of 5th weeks

- 4 hard copies, English
- Electronic versions
- Summary of findings based on completed situation assessment;
- Any other issues arising, etc.

Draft Final Report

End of 6th weeks

- 6 hard copies in English
- 6 hard copies in Nepali
- Electronic versions
- Full coverage of TOR
- Other key information as agreed by two parties

Final Report

One week after the comments on draft final report

- 8 hard copies in English
- 8 hard copies in Nepali
- Electronic versions
- As above but accommodating all points recommended by the client group.

Payment Schedule

The payment schedule should be as follows:

- Inception report 20%
- Status report 20 %
- Draft Report 30%
- Final Report 30%

6) PROVISION OF MONITORING AND PROGRESS CONTROLS

The consultant will report to Output Manager Mr. Devi Gwayali, and LBFC focal person Mr. Yam Nath Sharma and will work in close consultation with Dr. Neil Webster, Local Governance and Fiscal Decentralization adviser for UNDP and UNCDF.

The consultant will submit the draft outputs according to the schedule and benchmarks outlined above over the contract period.

7) DEGREE OF EXPERTISE AND QUALIFICATIONS

- A post-graduate degree in public finance, public administration, political science or related subjects;
- At least 12 years' professional experience in fiscal decentralization issues
- Track record of research experiences in *decentralization and local governance is required*
- Fluent command of spoken and written English;
- Working experiences in South Asia is seen as an asset;
- Experience of working in Nepal on local governance and fiscal decentralization issues would be a major asset.

8) REVIEW TIME REQUIRED

4 weeks after the final reports have been submitted to the project.

9) CONSULTANT PRESENCE REQUIRED ON DUTY STATION/UNDP PREMISES

NONE PARTIAL INTERMITTENT FULL-TIME

IF FULL TIME – PLEASE ADD BELOW FOR JUSTIFICATION