

Nepal's fiscal dimension

Who can spend and who can tax in a federal Nepal

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A critical task confronting the designers of Nepal's federal system will be to determine who raises government revenues and who spends them.

Fiscal questions are at the core of the operation of every federal system. They shape the federal dynamics and play a major role in determining the real functioning of the federation.

The laws or constitutional articles governing these tasks are known as "the fiscal regime."

Lawmakers in Nepal will first need to determine the powers of the federal and constituent unit (state or provincial) governments to raise taxes and other government revenues, including debt.

Then they will have to decide which order of government will have the responsibility for delivering and paying for particular services and programs – such as defence, education, roads, and health. If there is a potential mismatch between the responsibility for raising and the responsibility for spending money, there will need to be a way to resolve this problem.

The federal debate in Nepal is still at an early stage. As I suggest in my introduction to this special edition of *Federations*, the debate so far may have been too preoccupied with the number and boundaries of constituent units and not paid enough attention to other important questions. While there seems to be a strong current of opinion that Nepal's federal system will



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Buddhi Lal Maharjan, left, chops ginger with his family at Lachitole in Kathmandu. Agriculture is the main source of food, income and employment for most Nepalese. It employs about 71 per cent of the population and generates 32 per cent of GDP. About 25 per cent of Nepal's land area is suitable for farming.

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be highly decentralized, the practicalities of this decentralization have not been worked through.

A strong case can be made for the federal government dominating the collection of taxes and other revenues, at least for the foreseeable future. In such a system, the constituent units will likely be very largely funded by the federal government in some combination of shared revenues and more discretionary transfers, some of which may be highly conditional for particular programs. A new federal regime will also confront difficult questions regarding the allocation of revenues amongst the constituent units because there may need to be significant transfers from the richer to the poorer parts of the country. Federal dominance of the fiscal regime could have a substantial impact on how decentralized the federation becomes in practice.

Analyzing the current system

To see how this would unfold, start by looking at the current fiscal arrangements with the unitary system of government. With a very low per capita income, the government has had only a limited capacity for raising revenues. As with many developing countries, the size of government is quite small in relation to the economy – currently the revenues raised by the government are only about 12 per cent of gross domestic product. In addition, the international aid community provides the government with additional revenues equivalent to a further four per cent of GDP.

The revenues which Nepal currently raises, in order of importance come from:

- value added tax – 30 per cent
- income taxes, mainly from corporations – 18 per cent
- commodity taxes on foreign trade – 17 per cent
- excise duties, largely on cigarettes and alcohol – 9 per cent
- property and land taxes and fees – 6 per cent
- royalties and sales of government property – 3 per cent
- smaller fees, rents, dividends and taxes – 16 per cent

In addition, foreign assistance provides about one third additional resources.

The first four sources, totalling about 65 per cent of government revenue, are likely to be central revenues in a federal Nepal.

The value added tax is a powerful fiscal instrument, and the decision on who controls it is an extremely important one for Nepal to make. The experience of other federal countries with decentralized VAT regimes is that they are extremely difficult to administer and prone to major problems. The most effective VAT systems have been the ones determined and administered by the central government.

Allocating taxes

Some federations have decentralized or shared corporate and income taxes, but this would be difficult to do, at least initially in Nepal.

Charges levied at the border, such as import duties, are always imposed by the central government in a federation because the imports being taxed may cross the border into one constituent unit but may be sold in other constituent units.

Against this, excise duties on cigarettes and alcohol and property and land taxes could be devolved to the constituent units, as could some of the other small fees and revenues. (The constituent units could set the rates for such taxes, but gain efficiency by delegating their collection to a federal agency.) These revenues might give the constituent units and local governments their own independent revenues of about 20 to 25 per cent of total government revenues.

Longer-term revenues, such as those on hydro-electric resources, could be very important. The current government has an objective of developing 10,000 megawatts of hydroelectric power. This goal would be a huge increase from current levels though still well short of the potential some believe to be possible. Technically, such revenues could be collected by either the federal or constituent unit governments. There are some advantages to giving constituent units a share of such revenues, especially if the developments impose costs on the local region. However, the disadvantage is that the country could end up with enormous fiscal disparities between constituent units if individual constituent units had full ownership and control of hydro-electric resources. This issue will need to be resolved in a new constitution, but its short-term impact on the functioning of the new federation is likely to be minor.

In the end, a federal Nepal would likely be fiscally very centralized. It will not be alone among federations in this regard. Australia, Malaysia and Nigeria are all federations where the central government collects over 80 per cent of all revenues.

Funding the constituent units

But it is likely that the constituent units in a federal Nepal will require revenues well in excess of their own sources to meet responsibilities they may have for local education, health and infrastructure programs. This will require special measures to finance the constituent units from central revenues.

(The issue of foreign assistance is clearly important as well. The constitution will need to determine whether the federal government alone can enter agreements with donors or whether individual constituent units can. The donors themselves will of course need to be agreeable to the new arrangements.)

Some who advocate a very decentralized federation may want the constituent units to be financed entirely through their own sources plus a *set share* of federal revenues. This is essentially the approach in Nigeria. However, the federal government may wish to have more control over some transfers so that it can use the power of the purse to influence some constituent unit-level activities. Thus in India, states are financed from their own sources, plus a share of federally collected revenues, plus strategic investments, plus program-specific investments. The strategic and program-specific investments involve various federally imposed conditions that the states must meet if they are to get the money. (In many federations, the central government can also influence constituent unit activities through shared legislative responsibility, where federal law predominates.)



Street children sniff glue by the roadside in Kathmandu. Nearly one third of the population lives below the poverty line. According to UNICEF there are an estimated 30,000 street children in Nepal, of which 3,700 are homeless.

Detailed fiscal arrangements in federations are hard to fix in constitutions. The appropriate share of spending by the federal, constituent unit and local governments can change dramatically over time, depending on circumstances (such as military conflict, the economic cycle, or the level of development). Similarly, different revenue sources have quite different values over time. So most federations where the constituent units rely very heavily on federal revenues establish basic principles and mechanisms, sometimes in the constitution, and have regular review of the precise allocation or formula.

Determining needs

India is a very relevant example. Every five years the Union government establishes a Finance Commission to review the revenue capacity and needs of the governments in the Indian federation; the commission recommends what share of federal revenues should go to the states and what the allocation to states should be. These funds are one important part of financing for the states, along with strategic and program funds.

If constituent units are to be heavily financed by the central government, should they have some accountability to the central government for how they manage the money? Certainly this would be true for conditional transfers. But even for

unconditional transfers, there may be a case for some controls or sanctions in relation to basic procedures of good budgetary management and reporting. Brazil's financial accountability law is an important example, which involves strict reporting, as well as controls on debt and spending.

South Africa moved to a type of federalism after the end of apartheid. It had a major challenge decentralizing major program responsibilities to the provinces because many of them had so little infrastructure and human capacity. They also found that the sudden shift of spending away from the richer parts of the country to the poorer regions created two problems: the richer areas were hurt by the deterioration of services and infrastructure, while the poorer areas sometimes could not absorb the money and ended up spending it badly. Their experience underlines the importance of a phased approach to moving to a decentralized regime.

At the end of the day, developing a federal Nepal will involve defining a vision for the country and putting in place mechanisms of good governance to serve the public. These are two very large challenges and in both cases, establishing appropriate fiscal arrangements will be central to this task. 