

FISCAL DECENTRALIZATION AND MUNICIPAL TAXATION IN NEPAL

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By

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RECOMMENDATION LETTER

We hereby recommend that this dissertation, entitled **“FISCAL DECENTRALIZATION AND MUNICIPAL TAXATION IN NEPAL”** prepared by Mr. Som Lal Subedi under our supervision and guidance, be accepted by the research committee for the final examination in fulfillment of the requirement for the degree of doctor of philosophy in Political Science.

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Date: March 28, 2013

DECLARATION

I hereby declare that this dissertation entitled **FISCAL DECENTRALIZATION AND MUNICIPAL TAXATION IN NEPAL** submitted to Faculty of Humanities and Social Sciences, Tribhuvan University, is an entirely original work prepared under the supervision of my supervisor Prof. Krishna Prasad Khanal. I have made due acknowledgement to all items and information borrowed from different sources in the course of writing this dissertation. The results presented in this dissertation have not been presented or submitted anywhere else for the award of any degree or for any other purposes. No part of the contents of this dissertation has been published in any form before. I shall be solely responsible if any evidence is found against my declaration.

Date : March 28, 2013

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The idea for undertaking this study sprouted in me some time on October 2000 when I was involved in preparing the first local Authorities Fiscal Commission's report. It was the first corporate effort on fiscal decentralization focused on complying the Local Self-Governance Act 1999 with adequate fiscal resources as well as required capacity. In course of discussion on the local fiscal issues under the commission when I was engaged in the secretariat in the Ministry of Local Development, I got the opportunity to study the literature on fiscal decentralization. The scope and idea of this kind of study struck into my mind and then I discussed the subject matter with Mr. Khem Raj Nepal and Dr. Hikmat Bist and I started to collect reading materials. I continued to work under the Ministry of Local Development for more than one decade in the capacity of undersecretary and joint secretary instead of moving into other institutions. Other inspiring incidents are the participation in the budget discussion in National Planning Commission, and Ministry of Finance and repeatedly noticing the short fall of the fund to meet the expenditure needs when I was Local Development Officer in different four districts (Surkhet, Nawalparasi, Kavrepalanchowk and Baglung).

Similarly, when I was engaged in designing the structure of the Local Bodies Fiscal Commission and fulfilling the responsibilities of the Member Secretary of the Commission, my determination became strong to undertake the study. In any country, the issues pertaining the fulfillment of given tasks to local bodies, available fiscal resources to them and matching expenditure responsibilities with the fiscal resources are the critical elements of designing fiscally devolved governance system . In Nepal highly centralized governance is the main constraint for decentralized governance. The theoretical perspectives and the practical experiences in the different capacities during the past fourteen years under the Ministry of Local Development are the driving forces to complete this study.

To bring this study to this shape, a range of extremely helpful, positive and cooperative people have contributed immensely to whom I owe so much that I cannot express in words here. I would like to take this opportunity to express my sincere gratitude and

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ABSTRACT

This study analyzed policies, institutional variables and their relationship with fiscal system with specific reference to fiscal decentralization and municipal taxation in Nepal. Specifically, this study reviewed fiscal decentralization practice in Nepal; evaluated government's resources allocation to municipalities; assessed the efforts made by the municipalities; analyzed revenue potentiality, institutional capacity, management practices and revenue mobilization; and made recommendations for effective taxation system in municipalities. It has analyzed fiscal decentralization on the ground of its four pillars namely, expenditure assignment, revenue assignment, fiscal transfer, and local borrowing.

The study was conducted in 5 municipalities including Biratnagar, Kathmandu, Gorkha, Pokhara and Nepalganj with a total of 213 persons including 59 municipality officials and other stakeholders, 12 local politicians, and 45 policy makers belonging to state and non state sectors. The remaining 97 municipality officials were involved in focus group discussion.

The municipalities were selected considering geographical, ecological, revenue volume, population size and types of municipality. Trend analysis of revenue and expenditure of all 58 municipalities for 12 years was done using descriptive statistics. Further specific analysis was done for 12 years in the sample municipalities using both primary and secondary information.

It is found that the implementation of Local Self Governance Act (LSGA) 1999 is weak because of inadequate policy coordination, imperfect design of local bodies and ineffective management. The pillars of fiscal decentralization are not properly matched due to overlapping functions between central government and local bodies; duplication of functions among District Development Committee (DDC), Village Development Committee (VDC) and municipalities; unclear functions in LSGA; and unconsolidated task assignment to local bodies. Likewise, vertical and horizontal linkages and complementary and supplementary roles as well as relations among local bodies and the line agencies at the district level are weak. The central budgetary system is not

decentralized to the tune of fiscal needs of the municipalities as it is largely ad hoc and incremental.

It is further found that the municipal taxation and fiscal decentralization are directly linked with municipal service delivery. Similarly, urban governance has adopted limited fiscal decentralization and given tax bases to municipalities are too narrow. The responsible institutions like Ministry of Local Development (MOLD), Decentralization Implementation Monitoring Committee (DIMC) and Local Bodies Fiscal Commission (LBFC) do not have plan for devolution; nor do they have capacity strengthening comprehensive plan at the local level. The accountability mechanism is not functional and revenue plan is not prepared in the sample municipalities due to lack of elected representatives since B.S.2059 (2002 A.D.)

The expenditure assignment between central agencies and local bodies and among the local bodies themselves is highly overlapped. Due to such overlap, the overall service delivery and the accountability of these service providers is weak. There is a big gap between service delivery provisioning and real service delivery in both central agencies and local bodies including municipalities.

Despite various constraints, the efforts made by the municipalities are positive and the revenue collection trend is incremental. The introduction of formula- based grant system is considered as the main achievement which removed arbitrary basis of grant distribution to local bodies.

The overarching conclusion is that the fiscal decentralization is the key to decentralization success and destination of governance reform. It is not properly designed and practiced in Nepal. The level of fiscal autonomy and its optimum utilization for people's welfare and service delivery depends on the level of good governance as well as social capital at the local level. There is no 'one size fits all' system of fiscal decentralization and municipal taxation. The four pillars of fiscal decentralization need to be considered as the basic elements of local government's reform in different layers including municipalities. The further studies on inter-governmental fiscal relations are needed to find out the needs and the gap of overall decentralization.

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LIST OF ABBREVIATIONS

ADB	Asia Development Bank
ADDCN	Association of District Development Committees in Nepal
CA	Constitutional Assembly
CBO	Community Based Organization
CBS	Central Bureau of Statistics
CG	Central Government
DAGs	Disadvantaged Groups
DDA	District Development Advisor
DDC	District Development Committee
DDF	District Development Fund
DMC	Decentralization Implementation and Monitoring Committee
DIP	Decentralization Implementation Plan
DMC	District Management Committee
DPs	Developments Partners
GON	Government of Nepal
HMGN	His Majesty's Government of Nepal
LBFAR	Local Bodies Financial Administration Regulation
LBFC	Local Bodies Fiscal Commission
LBFCS	Local Bodies Fiscal Commission Secretariat
LBs	Local Bodies
LDF	Local Development Fund
LDO	Local Development Officer
LBFAR	Local Body Financial Administration Regulation, 2056 (2000)
LG	Local Governments
LGCDP	Local Governance and Community Development Programme

LGP	Local Governance Programme
LMs	Line Ministries
LSGA	Local Self Governance Act, 2055 (1999)
LSGR	Local Self-Governance Rules and Regulation, 2056 (2000)
MDF	Municipality Development Fund
MoF	Ministry of Finance
MoLD	Ministry of Local Development
MuAN	Municipality Association of Nepal
NAVIN	National Association of VDCs in Nepal
NDF	Nepal Development Forum, 2004
NGO	Non-Governmental Organizations
NPC	National Planning Commission
PAF	Poverty Alleviation Fund
TYAP	Three Year Approach Paper, 2010/11-2012/13
TYIP	Three Year Interim Plan, 2007/08-2009/10
UN	United Nations
UNDP	United Nations Development Programme
VDC	Village Development Committee
VDP	Village Development Programme
WB	World Bank

CHAPTER I

INTRODUCTION

1.1 Background

It was traditionally believed that the responsibility of managing nation-states was solely the job of government. It was an established belief in many countries that the central government can do the job better. However, the responsibility of the state government has been organized differently for about fifty years.

In most of the countries in the third world the common people detached themselves with the institutions of the government. These institutions could hardly respond the varied interests and expectations of the people. There was an obvious, persistent and increasing gap between the government policies and their implication to achieve intended outcomes. The socio-economic distance between the poor/marginalized group of people and the government institutions (particularly the ones which were dominated by the elite group of people) grew larger and broader. The process of social exclusion and marginalization continued uninterruptedly in many countries around the world. On the other hand, the importance of national and trans-national private business interests, globalization that increased civic awareness and consciousness grew rapidly. As a result, the earlier concept and understanding of government has now been changed to the concept of governance.

"Many governments in the Third- World countries had become more centralized during the 1950s and early 1960s. They naturally first turned their attention to nation-building and thus invested heavily in Programme for economic development. Both process seemed to require and legitimize centralized development. But, over the time, the modest and sometimes negative consequences of central planning and administration became apparent¹".

The central government was observed to bear many weaknesses in course of performing its responsibilities to the people and the state. Advocates, therefore, prescribed decentralization in particular two forms namely field agencies and local

¹ Henry Maddick (1963). *Democracy Development and Decentralization*. Bombay : Asia Publishing House, PP. 225-230

government. The decentralized system of exercising the authority was considered to aid²:

- (a) The growth of popular control
- (b) Economic and social development and
- (c) The growth of popular participation and support

Institutions like field agencies, community development organization, local authorities and village and town committee were activated to practice the system of decentralization.

“Despite increasing centralization, a large number of developing countries that are politically, economically and ideologically diverse began decentralizing some development planning and management functions during the 1970s. The dissatisfaction with the result of national planning and administration and changed international development strategies during the 1970s further assisted to enhance the practice of decentralization³.”

Emergence of globalization has also generated the awareness of people which created opportunity and growing demand for peoples’ participation in whole governance processes. Changes in perception of ordinary people and donor agencies in support of participatory governance with the local participation and autonomy have also contributed to promote decentralization as a political reality.

Decentralization has, therefore, been adopted in one or another form in almost all countries around the world irrespective of the system (federal, unitary or centralized) of governance in the country. Decentralization is a long process and manifests itself in various forms and formats. It promotes democratization, equity, people's participation and effective service delivery at local level through transfer of authority, power, responsibilities including fiscal authority and resources to lower level of the government.

² Henry, op.cit.1, p. 2

³ Dennis A. Rondinlli, Jhon R. Neelis, G. Shabbir, Decentralization in Developing Countries, A Review of Recent Experience (1984), Washington D.C. :The world Bank, P.2

Modern Political system is predominantly based on people's participation, local self-governance and decentralization. Decentralization is an integral part of the modern governance at the central, provincial, and at the local level. Now it has become a global phenomenon. In the late 1990's the demand for decentralization received worldwide concerns. Both in the developed and developing countries people are demanding more decentralization for participatory local democracy, effective service delivery and addressing diversities.

"Decentralization entails transfer of power to different levels within political system."⁴ It comprises of the assignment of political, fiscal and administrative responsibilities to the lower levels of government. It is an integral part of overall political system in any mode of governance (unitary or federal). The process of decentralized governance is adopted in each and every country in different ways. The structure, level of autonomy, effectiveness and achievement varies from country to country.

Fiscal decentralization entails the assignment to sub-national or local governments or resources to finance the functions for which they are responsible. Under the local self-governance a large number of competitive jurisdictions including municipalities are created in Nepal. The benefit of population and economic opportunities enhances the tax potentials in the Municipalities. There is a strong link between popular representation and fiscal decentralization especially in Municipalities where direct democracy can be exercised perfectly.

The devolution of political and fiscal power can be fruitful in the context of increased demand of power by the people to address their varied nearest, particularly for the welfare of municipal residents. Political demands for urban service are increasing in the Nepalese municipalities. Fiscal decentralization with more municipal taxation (together with assigning different functions relating to service delivery as well as strengthening municipal democracy) can be the solution for regional equity.

⁴ Manor James, **The Political Economy of Democratic Decentralization** (1999), Washington D.C. : The World Bank, p. 10.

Municipality is governance entity within the municipal area which concerns the ongoing involvement of citizens and accountability mechanism in the municipality. A municipal tax levy is an amount of money that each property owner and earner must pay annually in order to fund the municipal activities. A municipal tax levy is often used to refer to all of the levies that a city has imposed in the form of property. The rate and ways of these funds are levied in various forms depending upon the area of work. But a municipality is not allowed to charge more tax than the citizens are able to pay.

In a fiscally devolved system, municipal taxation is a key element of the fiscal decentralization. There is a close relationship between fiscal decentralization and municipal taxation because the more tax revenues is collected the more chance of service delivery will be in place. By this, consumer preferences for public goods in the municipalities can be materialized. Expenditure assignment, revenue collection and service delivery are interdependent. All the three components are necessary to interlink with the framework and measures of fiscal decentralization.

Currently Nepalese municipalities are facing pressing need of revenue enhancement to meet the funding gap of the increasing service delivery demands in the municipality. One of the appropriate ways of maintaining fiscal order in the municipality is the effective taxation system followed by the expenditure credibility and accountability. Fiscal decentralization deals these matters perfectly. So, there is a strong relationship between fiscal decentralization and municipal taxation.

The initiation for decentralization in Nepal has passed six decades. After the advent of democracy in 1950, the reform process in governance started gradually. A series of administrative reforms and decentralization committees were formed (Annex 1) and reports were submitted accordingly. Decentralization in Nepal was started as a means of development and administrative reform. A separate commission was formed for the first time in the name of decentralization in 1962. The commissions and committees efforts created constitutional and legal (different Panchyat acts and regulation) framework for decentralization. "The efforts on decentralization in Nepal came up through administrative reform, decentralization and local self governance and legal

arrangement for local bodies⁵". The Local Self-Governance Act, (LSGA) 1999 is the act which has provided tasks, responsibilities and fiscal authorities to the District Development Committee, Municipalities and Village Development committee as local bodies. LSGA 1999 can be taken as a consolidated legal framework and the result of popular movement in 1990. It is in operation since last 12 years. The present VDCs (3915), municipalities (58) and DDC (75) are designed and are in operation under the LSGA 2055(1999).

The Interim Constitution 2063 (2007), Periodic National Plans, and government's policies on poverty reduction, local self governance and governance reform efforts are carrying decentralization as an effective tool for good governance and local service delivery.

Decentralization, by placing the government closer to the people, fosters greater responsiveness of political parties and leaders, bureaucrats and policy makers to the needs of the common people and results in a closer congruence between public preferences and policy. This is not only because decision makers in decentralized units are likely to be more knowledgeable about and attuned to the needs of their areas than the centralized government decision makers, but also because decentralization permits these decision makers to be held directly accountable to the local people through periodic local elections. It should be noted here that the decentralized state structures in any country would promote the innovation while centralized state structures promote adoption and domination.

Decentralized governance in Nepal is not perfectly blended the functions, funds and functionaries to produce better results and deepening local democracy. There is mismatch between functions and funds in the local bodies (LBs) including municipalities. "LBs are trying to fulfill underfunded and unfunded mandates by the ad hoc financial resources provided by the central government⁶". There are many problems in local governance system. The major problems in fiscal decentralization and municipal taxation in Nepal are as follows:

⁵ Somlal Subedi, **Bikendrikaran Ra Sthaniya Bittta Bayabstha**(2063B.S.), Kathmandu : Anjana Subedi, p. 8.

⁶ Somlal Subedi, **Federalism in Nepal and Expenditure Assignment**(2065),Kathmandu: Anjana Subedi P.137

- (i) Expenditure assignment is not delineated clearly among the tiers of government. So, there are many overlapping responsibilities between municipalities and central agencies located at the local level.
- (ii) Fiscal decentralization system is not systematically designed and municipalities are heavily dependent on the central fiscal transfers.
- (iii) Municipalities are not able to exploit tax potentials.
- (iv) Municipal institutional capability is not adequately capacitated to discharge the services designated by the Local Self- Governance Act 1999.
- (v) Local accountability is weak due to absence of elected representatives for the last ten years and which has weakened the popular control as well as participation.

1.2 Statement of the Problem

Decentralization in Nepal has been observed since ancient times. “During the Kirat period (700Bc-225 AD), local administration was divided into Thum (district) and Gram (village) administration. In the Lichhavi period (225-899AD), the administrative divisions of the country were called Gram, Gulmak, Pur, Tal, Drang and Kot. Among them, Drang was entirely municipal like municipality. Similarly, in the Malla period (1201-1769 AD), the country was divided into a number of administrative units and so many autonomous villages in them with clear system of power decentralization to the district, sub- districts and autonomous villages.”⁷

After the unification of Nepal, the Shah period (1769-1846 AD), the country was divided into twelve administrative units. Local administration was based upon Panchayats consisting of representatives of people specially to punish the criminals. The land revenue was collected through Chaudari and Jamindars as private collectors. In this period the centralistic attitude in Nepalese governance was very strong. Right from the reign of King Prithivi Narayan Shah the founder to his 11th successive generations the Monarch ruled with the absolute powers. The monarchy was above

⁷ Shashtra Dutta Pant, Aspect of Decentralization in Nepal 2046 (1989), Pulchowk Lalitpur: Sajha Perakashan p.82.

the law enjoyed and executive, legislative and judicial powers. During Rana regime (1846-1950AD) Nepal was divided into 35 districts which were governed by centrally appointed Badahakims. The Badahakims appointed Jimubal, Mukhiya and Thari in hills and Jamindar and Patuwaari in terai and were assigned to collect land taxes. Panchayats adhoc assemblies of communities from the respectable families were empowered to settle disputes or consider any matter involving disagreement among several individuals or groups.

The history of decentralization in Nepal from ancient time to Shah regime was simply driven for the convenience of the ruler to maintain law and order and revenue collection. For the first time, separate Village Panchayat and Municipal Panchyat Acts were issued in BS 2006 to arrange basic services and manage developmental activities by the Panchyat. But they were not implemented as desired. "In accordance to the act there were 171 villages throughout the country in 1950 AD⁸".

After the advent of democracy in 1951 the decentralization based on deconcentration was initiated and practiced. During Interim and party system period (1951- 1960AD) Village Development Scheme based on the community development was launched, the country was divided into 150 Blocks, District Development Officer was appointed for the development of the district in each district. Municipal Act 2009 and Village Panchyat Act 2013 BS were issued and assigned responsibilities to lower tiers of local government. In the Panchyat system period (1960-1990AD) the country was divided into village Panchyat , town Panchyat and District Panchyat(75) and Zonal Panchyat (14) politically. These tiers of Panchyat were designed as political network rather than development as well as autonomous bodies. It was also divided into seventy five districts, fourteen zones and five development regions. Legal provisions for the local Panchyats were made during this period. Village Panchyat Act 2018 B.S, Municipal Act 2019BS and District Panchyat Act 2019 were the separate Acts to devolve power to the Panchyats. A separate Decentralization Act 2039 BS and its regulation 2041 were adopted.

During the advent of democracy in 1951, prior to Local Self- Governance Act 1999, different legal frames were adopted in the name of decentralization. Under the legal

⁸ Ibid p.92

frames and limited practices of decentralization, very limited fiscal power to the Panchayat was given. There was no fiscally developed system. After the restoration of multiparty democracy in 1990, the demand of decentralized governance emerged. Existing Panchayat Acts were converted into Village Development, Municipal and District Development Acts. Considering the need and demand of decentralization, a high level Decentralization Committee was formed. Based on the recommendation of the committee, the Local Self-Governance Act, 1999 was promulgated. This Act is a consolidated Act and the milestone of decentralization including fiscal decentralization in Nepal.

In addition to reorganizing the local government structure, the LSGA 1999 has assigned different responsibilities with fiscal sources (internal revenue and transfers). The participatory planning process has been inbuilt in the LSGA. Affirmative actions, inclusive local democracy with allocation efficiency are envisioned in the acts and more elaborative support system is developed through the different policies, directives and foreign aid Programme. The grant is increasing gradually. The local revenue is being collected. In spite of the legal framework and institutional network the services are not delivered by the local bodies effectively. As a result, the need of reform is felt in many areas of local governance in Nepal.

With the increasing focus on fiscal decentralization the burden of formulating policies and implementing Programme is now much greater at lower level of government than it was in the past. Municipalities are different from village development committees in terms of economies of scale, population, economic opportunities and level of development with multi-sectoral dynamism of overall development. Municipalities have more potential to enjoy the benefit of fiscal decentralization. But, the effort on tax enhancement is not adequately paid attention in Nepalese municipalities. To discharge the duties within the respective jurisdiction, the local bodies have to search resources to sustain their economic and developmental activities.

Local governments vary to the extent in which their citizens are involved in local economic development, planning and implementation. Fiscal decentralization expects more capable and participatory local institutions and behavior. To promote economic growth and to provide public services, local bodies need funds. The fundamental sources of funding to local bodies in Nepal are the means of fiscal decentralization.

The most reliable and sustainable source of revenue is the local taxes.

Globally, managing cities/municipalities have both challenges and opportunities. Urbanization is increasing in all over the world. Similarly, urban growth in Nepal is also rapid. Cities are engine of economy but they need to maintain basic infrastructure and be able to fulfill the raising aspirations of the people.

Urban good governance is a worldwide trend and it is being included as one of the component of the overall country's reform in public sector management. But in the context of Nepal following realities can be observed in relation to urban governance:

- Role delineation and accountability is not clear.
- The transfer system has less predictability and revenue is not adequate.
- Inadequate internalization of fiscal decentralization spirit within central budgeting system.
- There is no scientific formula and data base for grant distribution. Municipalities are more dependent on central government in fiscal resources.
- Weak municipal, institutional arrangement is not supporting for good fiscal behavior.
- Weak accountability in municipal governance system, as well as poor service delivery mechanism.
- There is no priority and enough link between overall reforms and municipal strengthening.
- Expenditure assignment and revenue generation and the transfers are not matched properly.

Based on the above problems and explanation, the key research questions that need to be addressed by this study have been summed up as follows:

- (a) Has the existing legal and fiscal framework been working adequately to deliver the services in municipality?
- (b) Do the fiscal decentralization friendly institutions exist?
- (c) How municipalities' tax efforts are made and how is revenue collected?
- (d) What is the degree of central policy and system conduciveness for fiscal decentralization?

1.3 Rationale of the Study

Decentralization has been practiced in Nepal for the last six decades. Due to centralistic attitude of policy makers and politicians effectiveness in decentralization is still awaited. The past efforts on decentralization demonstrate more focus on political slogan with few fiscal resources. The rising expectations of the people and populist attitude of the politician demands more decentralization of national powers to local level. However, there are many challenges on policies and practices of decentralization. As our country is moving to a federal setup, decentralization has become more important and relevant.

Sooner or later we have to decentralize fiscal resources. Localizing services through decentralization of fiscal resources is one of the critical aspects of overall governance reform in Nepal. The urban growth has taken on national significance on the one hand and the country is moving towards federalism on the other . Globally and in Nepal also there is general concern about the rapid growth of large cities and basic urban infrastructure. There is a pressing need to formulate policies to manage urbanizing activities more effectively. The need to develop an effective policy is also felt to address problems of congestion, pollution, slum settlements and inadequate facilities. The design of federal system and urbanization management in the Nepalese municipalities are greatly demanding both the fiscal decentralization and effective municipal taxation followed by an appropriate and effective service delivery in the municipalities.

Fiscal decentralization is now widespread with many countries embarking on some forms of fiscal decentralization. It is important to study its impact on municipal financial resources management. Since cities are the engine of economy, there is greater potentiality of taxation to increase the municipal revenue and distribute the resources in a sustainable manner.

Currently Nepal is in transition for federalism. Federalism is widely discussed and accepted by most of the political parties. Many politicians, activists and scholars are talking about decentralization and federalism but they are not paying adequate attention on fiscal decentralization. Similarly, Nepalese municipalities are not focusing to exploit the revenue potentialities, levying taxes and linking taxation with the service delivery. So, it is very relevant to study on "Fiscal Decentralization and

Municipal Taxation" in the present changing political context. An important background to this study is the compliance of LSGA, 1999 which has further implication on drawing attention to devolve more authority to the local government with greater fiscal resources followed by an accountable mechanism.

The key actors for effective decentralization are politicians, bureaucrats and citizens. They are equally important and they should have adequate knowledge to perform their respective role. Considering, the importance of LSGA's full implementation both GON (previously HMG/N) and donors commissioned a joint committee and task force was formed. The task forces have produced a policy document on Decentralization of Nepal. "It has recommended three key areas for immediate actions as decentralization implementation plan, local governance finances system and donor coordination⁹". The review has identified one of the key components to suit local government finance system. It has highlighted fiscal decentralization as a prerequisite for effective decentralization and poverty reduction. It has recommended the fiscal decentralization process along with the steps given below:

- Clearly define LG tasks and assess their costs.
- Review the existing situation within LG sources of revenue and finances.
- Increase the share in national budgets.
- Design a national LG budget classification and accounting systems.
- Establish an LG financial database at local and national level.
- Make criteria for grant, budget and assistance provision more transparent.
- Develop a system to improve the level of resources available to poor districts.
- Strengthen LG's financial management, audit and revenue generation capacities.

This study is different in its nature in the field of decentralization. It seeks to provide policy recommendation on fiscal decentralization and municipal taxation which is supposed to contribute to effective municipal governance with adequate fiscal

⁹ **Decentralization in Nepal: Prospects and Challenges, Findings and Recommendations of Joint HMGN- Donor Review**, (March 2001), Kathmandu.P.15-17

resources. The match between municipal expenditure assignment and local revenue in municipality is not designed perfectly. This study aims at digging out the components of fiscal decentralization and the dynamics of municipal taxation.

1.4 Objective of the Study

Decentralization in general has been an old phenomenon. It has six decades long history in Nepal. Fiscal decentralization however remains with relatively short history. Local Self-Governance Act, 1999 has emphasized the need for local self-governance as well as fiscal decentralization.

Various Administrative Reform Committees and Decentralization task forces or Committees have vaguely looked and not given emphasis at the issues of the Fiscal Decentralization, but none has properly assessed the major issues the Fiscal Decentralization especially at the municipal level. Moreover, none of the studies or reports have considered the resources mobilization capacity of the municipalities nor they have considered authority and attitude of center in allocating resources to municipalities and municipality to ensure socio-economic development. Adequate attention is not paid for alternative ways of resource mobilization at municipal level.

Hence, this research aims to widen the understanding of the theoretical and practical issues relating to Fiscal Decentralization at municipal level and capacity of municipalities to mobilize resources provided by the central government as well as their own revenue. The general objective of the study is to examine the relationship between fiscal decentralization and municipal taxation in Nepal. Specific objectives are:

- To review fiscal decentralization practice in Nepal.
- To evaluate government's resources allocation to municipalities.
- To assess the efforts made by the municipalities.
- To analyze revenue potentiality, institutional capacity, management practices and revenue mobilization.
- To propose measure to apply efficient taxation system in municipalities and strong link with effective fiscal decentralization.

1.5 Understanding the Concept of Decentralization

Decentralization is considered as a process of power sharing among the levels of governments leading to participatory and inclusive governance at local level or below the centre. It has a strong linkage and direct bearing on policy, legal, institutional, operational and fiscal frameworks of the different tiers of the government.

Decentralization is sometimes called "decentralization by default"¹⁰. This happens when government institutions become so ineffective that they fail almost entirely to make the influence of central authorities penetrate down to lower level arenas and people at grass root become heartily cynical about government. The term decentralization sometimes refers to downward fiscal transfers, by which higher levels in a system could influence over budgets and financial decisions to lower levels. United Nations Human Settlement Programme (UNHABITAT) recognizes that sustainable development is made possible by "the effective decentralization of responsibilities, policy management, decision making authority and sufficient resources including revenue collection authority, to local authorities closest to, and most representative of their constituencies."¹¹

According to Silverman "Hybrid model decentralization is a kind of decentralization characterized by the co-existence of the elements of the three forms of decentralization namely deconcentration, delegation and devolution, together with other highly centralized functions."¹² Practically it is applicable in Nepal. The all three forms of decentralization prevail in Nepal among different agencies and the LSGA itself.

Based on the general conceptual framework, the decentralization in Nepal is designed and practiced. The decentralization comprises policy and legal framework, fiscal framework, institutional provisions operational framework with political, fiscal and administrative decentralization of powers and authority to the local bodies seems in a holistic manner. A brief explanation of existing frameworks is given below:

¹⁰ Manor, op.cit.4, p.10

¹¹ Mustapha Ben Letaief, Charles Nach Mback Jean, and others, **Decentralization and Democracy in the World**, (2008), Washington DC : The World Bank and United Cities and Local Government, 2008), p. 20.

¹² Tulshi Narayan Shrestha, **The Concepts of Local Government and Decentralization**, (1996), Kathmandu : Ratna Pustak Bhandar, p. 73.

1.5.1 Policy and Legal Frameworks

Decentralization is the means of inclusive local democracy and one of the alternatives of the service delivery. It is one of the ingredients of governance reform in the contemporary world. It can be claimed as a mechanism to bring local people and community organizations into local public management and enhance downward accountability. Due to failure of top- down approach to promote development and reduce poverty, decentralization has been appropriate option for any political system either federal or unitary. It has become the necessity for the better service delivery and compulsion for participatory governance globally.

The Interim Constitution, of Nepal 2007, Local Self-Governance Act, 1999, Different policies and government publications and reports have undertaken decentralized governance and service delivery. The Article 139 (1) of The Interim Constitution of Nepal, 2063 (2007) states that 'the provision of local self-governance related authorities shall be made based on decentralization and devolution of authority in order to promote the participation of people, to the maximum extent possible, in the system of governance of the country by creating such environment as is conducive to the exercise of sovereignty by the people even from the local level, deliver service to the people at the local level and have institutional development of democracy even from the local level." Similarly, the Article 140 (1) has assured the allocation of responsibilities and revenue between the Government of Nepal and Local Self-Governance related authorities as provided by law in order to make the local self-governance related authorities accountable for the identification, formulation and implementation of local level plans¹³."

The Local Self-Governance Act, 1999 has been adopted in the spirit of the then Constitution of Nepal, 1991 which had stated that it shall be the clear responsibility of the state to maintain conditions suitable to the enjoyment of the fruits of democracy through wider participation of the people in the governance of the country and by way of decentralization. Promulgation of LSCA, 1999 was a major achievement for decentralization including fiscal decentralization in Nepal. The major objectives of the LSGA are to make provisions conducive to the enjoyment of the fruits of democracy

¹³ The Interim Constitution of Nepal 2063 (2007), Kathmandu: **The Government of Nepal**, Ministry of Law, Justice and parliamentary Affairs, Law Books Management Board, p. 119.

through the utmost participation of the sovereign people and to institutionalize the process of development and constitute local bodies for the development of the local self-governance system. The LSGA has provided basic policies, expenditure assignment to local bodies legal and regulatory frameworks on decentralization. It has further offered fiscal framework and a number of principles of local governance including devolution of power, responsibilities and means and resources and authority to generate resources.

The Eighth (1991-96), Ninth (1997-2002) and Tenth (2003-2007) plans had incorporated decentralization as policy priority. The main objective of decentralization, according to the Tenth plan or PRSP was to ensure greater participation of the people in the governance process to accelerate the development by implementing fiscal devolution in a phase-wise manner as envisaged in LSGA and creating necessary institutional mechanisms including the formation of local service commission

The Three Year Interim Plan (2007/08-2009/10) has set long term vision for decentralization and Devolution as.¹⁴

"Local bodies restructured according to the concept of inclusion, democracy and federal government system will be capable as the local government to effectively deliver the services."

The objectives of TYIP are as follows:

- To promote good governance at the local level by clearly delineating the political, planning, financial, legal and administrative rights of the central and local level according to the concept of the federal structure and inclusive democracy and policy of full devolution through the establishment and operation of the local government.
- To enhance effectiveness of the local government in local development works and service delivery by developing and adopting the participatory planning system based on people's aspirations and local demand through inclusion and mainstreaming at the local level.

¹⁴ Three year Interim Plan (2007/08-2009/10), (2007), Government of Nepal. Kathmandu : National Planning Commission, p. 462.

In addition to the constitutional, legal and periodic plans there are reform Programme like Governance Reform Programme, Local Governance and Community Development Programme (a donor consortium) and other sectoral Programme are offering decentralization and local service frameworks.

1.5.2 Structural/Institutional Frameworks

The current structure of governments in Nepal can broadly be divided into two levels. At the central level there are- Ministries, Constitutional bodies, different departments, regional directorates, district line agencies and service and sub service centers. Government schools and health posts and sub- health posts are the extended institutions of the central government at the village level. There are some of the important institutions which are working in different capacity for decentralization are MOLD, DIMC, NPC, LDTA and Local Bodies Fiscal Commission. For the central administrative purpose the country is divided into 75 districts, 14 zones and five developmental regions.

At the local level there are 75 DDC working as upper tier of local bodies. In the municipal/urban sector, there are 58 municipalities which include 1 metropolitan city, 4 sub-metropolitan cities and 53 municipalities. There are 606 wards under 58 municipalities as frontline service provider to the urban people. Each municipality is further divided into ward ranging from 9 to 35. For the DDC election and planning purpose 75 DDCs are divided into 927 *Ilakas* ranging from 9 to 17 in each district which include both municipal and rural areas (VDC). All over the country's rural area, there are 3915 VDCs and each VDC has 9 wards with a total of 35235 wards. But there is no permanent institutional mechanism for the ward. VDCs are the only service provider in the rural area.

Legally, all the local bodies (DDC, VDC and Municipality) are equally autonomous. Practically, DDCs are the focal point for service delivery at the district level. All the developmental line agencies are supposed to submit their annual Programme to the concerned district council for approval. NGOs/INGOs are also need to submit their plan/Programme to the area where they are working including municipality.

The political transition for preparing new constitution and logical end of the peace

process has minimized the local governance reform in terms of structural and institutional review. The LSGA based institutional and structural frameworks are in practice. These frameworks are supposed to review under the forthcoming federal constitutional arrangements and state restructuring.

1.5.3 Fiscal Frameworks

Fiscal provision and resource predictability is one of the preconditions for effective decentralized governance. No task can be performed without fiscal resource. So, it is very critical. Functional decentralization needs the perfect blending of political, fiscal and administrative decentralization. The devolved tasks should be followed by the fiscal source. It is one of the bases of autonomy and credibility of the lower level governments. The authority and institutional mechanism need to be arranged to the local governments including municipality to generate local revenue to discharge the assigned services.

In Nepal, local bodies including municipality are assigned responsibilities and given authorities. The main sources of funding of local bodies are grants from the central government which include the foreign aid, locally generated tax and non tax revenues, revenue sharing with central government and local borrowing as provisioned by the LSGA. Institutional discipline, responsiveness, in-built monitoring and evaluation mechanism and auditing provisions are also made in the LSGA to support the fiscal framework.

1.5.4 Operational Frameworks

Good policy, constitution, legal and operational framework do not yield the result unless they are not practiced perfectly. The promulgated laws and developed policies on decentralization and local governance need their timely and effective implementation. In order to discharge the duties by the local bodies to the people implementation issues are very critical and important. Given revenue authorities to LBs including municipality are linked with services to deliver in their respective area. The incentive for revenue generation can be increased by the expenditure credibility. So, real operational institutions are equally important as policy and legal frame is considered. The transparency accountability and people's participation play the critical role to make any local body more functional and result oriented.

1.5.5 Forms of Decentralization

Decentralization is transforming the structure of governance in any country. It can be defined as transfer of power, resources and responsibilities to sub national units of government. The dispersion of power is a global trend. People around the world are demanding greater self-determination and influencing the decisions of their government-a force this report has labeled localization. "Some 95 percent of democracies now have elected sub national government and countries everywhere are devolving political, fiscal and administrative powers to sub national tier of government."¹⁵ Everywhere in the world, different models and approaches are practiced differently. There is no single model, principles and rules that can be adopted in the process and practice of decentralization. It depends largely on the design of governance, objectives, changes in structures of the governments and cooperation by the stakeholders.

"In development literature, vertical decentralization has been dealt with in three ways: decentralization, delegation and devolution."¹⁶ Tulsi Narayan Shrestha (1996) has explained the following five forms of decentralization into the following five kinds:¹⁷

- deconcentration
- delegation
- devolution
- transfer of functions from government to non-governmental institutions and
- privatization

All forms of decentralization could be appearing in different ways and combinations across the countries within countries and even within sectors. In Nepal, we can notice all forms of decentralization in practice. A brief description of each of them is as follows:

¹⁵ Entering the 21st century (2000), World Development Report 1999/2000 published for the World Bank Oxford University Press, p. 105.

¹⁶ Rabindra Khanal, Local Governance in Nepal, (2007), Lalitpur : Smriti Books, p. 10.

¹⁷ Shrestha Tulsi Narayan, op.cit., 11, p. 65.

1.5.5.1 Deconcentration

Deconcentration is traditional form of decentralization, which gives the power of central government's offices located in the field. "Deconcentration can be defined as the transfer of power and function from the central level government organizations to their respective field level agencies enabling to carry out their tasks efficiently and effectively by making timely decisions and enjoying reasonable latitude of flexibility and discretion as per the local needs and conditions¹⁸." "Deconcentration is the process of shifting decision making power within the central government structure from central government officials in the capital to central government officials located outside the capital at the regional or local level. Deconcentration preserves the hierarchical relationship between field staffs and central government.¹⁹

Kirsten says that deconcentration is the process of redistribution of administrative responsibilities within the central government which might be used to consolidate the central government's power through field offices (cited by Khanal). For Maddick, deconcentration is "the delegation of authority adequate for the discharge of specified functions to staff of a central department who is situated at the headquarters.²⁰" Deconcentration, however does not allow the recipient units or the staffs the freedom of decision making. The accountability of the deconcentrated activities is not maintained at the local level.

1.5.5.2 Delegation

Delegation is the process of shifting expenditure responsibilities from the central government to semi-autonomous government bodies that are not wholly controlled by the central government, but that are still accountable to it. Delegation can be defined in two senses. First, delegation refers to the creation of some autonomous organization outside the regular government bureaucratic structure and transferring to them certain functions and powers, second it denotes to a "process whereby a superior

¹⁸ Ibid, p. 66.

¹⁹ World Development Report 1999/2000 (2000), Washington D.C. The World Bank, p. 108, Box 5.1(Decentralization as the Devolution of Powers).

²⁰ Henry Maddick, Democracy, Decentralization and Development, (1963), New Delhi : Asia Publishing House, p. 23.

divides his total work assignment between himself and subordinates operative personnel in order to achieve both operative and management specialization.²¹ It implies transfer of creation of broad authority to plan and implement decisions concerning specific matters – a variety of activities within specific spatial boundaries transferred to an organization that is technically and administratively capable of carrying them out.²² Some authority and decision making power is delegated to local officials but the ultimate power and accountability remains with the central government and the delegated power can be taken back by the center when it feels necessary.

1.5.5.3 Devolution

Devolution is the transfer of authority for decision making, finance and management to quasi-autonomous units of local government with corporate status. Devolution usually transfer of responsibilities for services to municipalities that elect their own mayors and councils, raise their own revenues, and have independent authority to make investment decisions. “In a devolved system, local government has clear and legally recognized geographical boundaries over which they exercise authority and within which they perform public functions. It is this type of administrative decentralization that underlines most political decentralization.”²³

Devolution is the process of transferring power from the central government to a lower level by legal arrangement. It is the most intended form of decentralization. It highlights the legal conferring of powers to discharge specified or residual functions upon formally constituted local authority.

1.5.5.4 Privatization

Privatization has been defined as the act of reducing the role of government or increasing the role of private sector in an activity or in the ownership of assets. As a form of decentralization, privatization implies transfer of certain functions and responsibilities from government to the private sector. It can be transfer by any level

21 Tulsi Narayan, op.cit. 12, p. 67-68.

22 Rabindra, op.cit. 16, p. 11.

23 Jennie Litvack and Jessica Seddon, Decentralization Briefing Notes, Working Paper (1999), Washington D.C.: World Bank Institute, p. 3.

of government. “It encourages the involvement of private sector in state ownership and brings about efficiency and effectiveness in the management of national economy. It gives incentives to popular participation and enhances the overall development process.”²⁴

1.5.6 Types of Decentralization

There is a usual presumption that decentralization is a good thing which goes along with democracy, good governance, a market economy, poverty alleviation, and efficiency in public expenditure. The contexts for decentralization varied and generalization is perilous. The essence of decentralization is that it does not occur in general but rather in a particular country with own history and traditions and its own specific institutional, political and economic context.

Decentralization, the transfer of authority and responsibility for public functions from the central government to subordinate or quasi-independent government organizations or the private sector-covers a broad range of concept. “Each type of decentralization-political, administrative, fiscal and market-has different characteristics, policy implementations and conditions for success.”²⁵ The brief elaboration of the types of decentralization is as follows:

1.5.6.1 Political Decentralization

Political decentralization aims to give citizens or their elected representatives more power in public decision making. It is often associated with pluralistic politics and representative government, but it can also support democratization by giving citizens or their representatives more influence by formulating and implementing policies. Advocates of political decentralization assume that decisions made with greater participation will be better informed and more relevant to diverse interests in society than those made only by national political authorities. The concept implies that the selection of representatives from local electoral jurisdictions allows citizens to know better their political representatives and allows elected officials to know better the needs and desires of their constituents. Political decentralization, as explained by

²⁴ Rabindra, op.cit. 15, p. 12.

²⁵ World Bank Institute ,op.cit 23, p. 2.

Furnish refers “to greater individual citizen participation in the decision making process and / or representative inputs into the decision making structure in an attempt to provide more benefits to the society”²⁶. It is the means of aggregation of people's voices and articulate those through the electoral process and the accountability mechanism built in the governance system. It is the one of the useful tools to empower people and teach the democratic process/system in a wider scale.

Political decentralization shifts decision making powers to lower levels of government, allowing citizens and their elected representatives to participate in decision making processes. “In a fully decentralized structure, lower levels of government formulate and implement policies independently without intervention from higher level of government.”²⁷

1.5.6.2 Fiscal Decentralization

Fiscal decentralization is the mechanism of sharing fiscal resources among the tiers of governments. The assigned responsibilities and fiscal authorities must be matched. The fiscal resources determine the degrees of decentralization. The conflicts and negotiations between the levels of government are more complicated in the fiscal issues. So, fiscal decentralization is considered most important part of decentralization. Fiscal decentralization involves transferring expenditure and revenue responsibilities from the central government to sub-national governments. Fiscal decentralization can take many forms, including:²⁸

- Self-financing or cost recovery through user charges,
- Co-financing or co-production with private sector,
- Expanding local tax and non-tax revenues,
- Inter-governmental transfers, and
- Local borrowing

²⁶ Furniss Norman, the Practical Significance of Decentralization, Journal of Politics, 1974 cited by Tulsi Naarayan Shrestha op.cit. 12 P 71.

²⁷ Salvatore, Schiavo-campo and Pachampt sundaram, To Serve and to Preserve in a Competitive world (2001), Manila Philippines : Asian Development Bank, p. 156.

²⁸ World Bank Institute, op.cit.23, P37

Vito Tanzi defines fiscal decentralization as “an increase in taxing and/or spending responsibilities given to sub national jurisdictions. “In many cases of fiscal decentralization, additional layers such as states provinces and regions area created”.²⁹

The pressure for more fiscal decentralization has originated from different directions as:³⁰

- First, deepening democratization has given more voice and weight to the preferences of specific groups or regions. The view that fiscal decisions made at the local level better reflect the citizens' preferences- than, say, decisions made by politicians or officials in the often distant capital cities has been a common assumption on the part of those pushing more fiscal decentralization.
- Second, globalization is creating market areas that are no longer identical with the national territory. Globalization has relaxed the economic links of regions to other regions of the same country and has increased the links with other countries. This by itself may have increase the desire on the part of some regions to become economically less dependent on the national government.
- Third, in the jargon of economists, decentralization may be similar to a "superior good" which becomes more desirable when incomes increase. As countries become richer, they may demand more of it. If this assumption is correct, decentralization will become even more popular in future years
- Fourth, as incomes and flow of information increase, and as differences in income levels across the regions within countries rise, the richer regions become more aware that through the tax system and through various spending Programme, there is some or at times a lot of income redistribution taking place from the richer to the poorer regions. This realization leads to demands on the part of the richer

²⁹ Ehtisham Ahmad and Vito Tanzi(ed), *Managing fiscal Decentralization* (2002) ,London and New York:Routledge Taylor and Francis Group, p. 17.

³⁰ Ibid, p. 17-18.

regions to reduce the role of the of the national government and to increase that of the sub national governments

1.5.6.3 Administrative Decentralization

Administrative decentralization seeks to redistribute authority, responsibility and financial resources for providing services among different levels of government. It is the transfer of responsibility for the planning, financing and management of certain public functions from the central government and its agencies to field units of government, sub-ordinate units or levels of government, semi-autonomous public authorities or corporations or area-wide, regional or functional authorities.

Asian Development Bank has defined administrative decentralization as “it involves mainly the design of organizational roles, the identification of specific administrative tasks needed to fulfill those roles, and the assigning of actors to perform the tasks. Some generic administrative roles are executive leadership, policy innovation, planning, financial management and regulation and oversight³¹”

1.5.6.4 Economic or Market Decentralization

Economic or market decentralization recognizes the role of market under the decentralized frame of governance. It believes the most complete forms of decentralization from a government's perspective are privatization and deregulation. They shift responsibility for functions from the public to the private sector. “They allow functions that had been primarily or exclusively the responsibility of government to be carried out by businesses, community groups, cooperatives, private voluntary associations, and other non-governmental organizations-privatization and deregulation are usually accompanied by economic liberalization and market development policies.³²”

1.5.6.4.1 Privatization

Privatization can range in scope from the provision of goods and services based entirely on the free operation of the market to public-private partnerships in which

³¹ Salvatore Schiavo-Campo and Pachampt Sundram op.cit 26.P 157

³² World Bank Institute op.cit.23 P 4

government and the private sector cooperate to provide services and infrastructure. Privatization means allowing private enterprises to perform functions that had previously been monopolized by government.

1.5.6.4.2 Deregulation

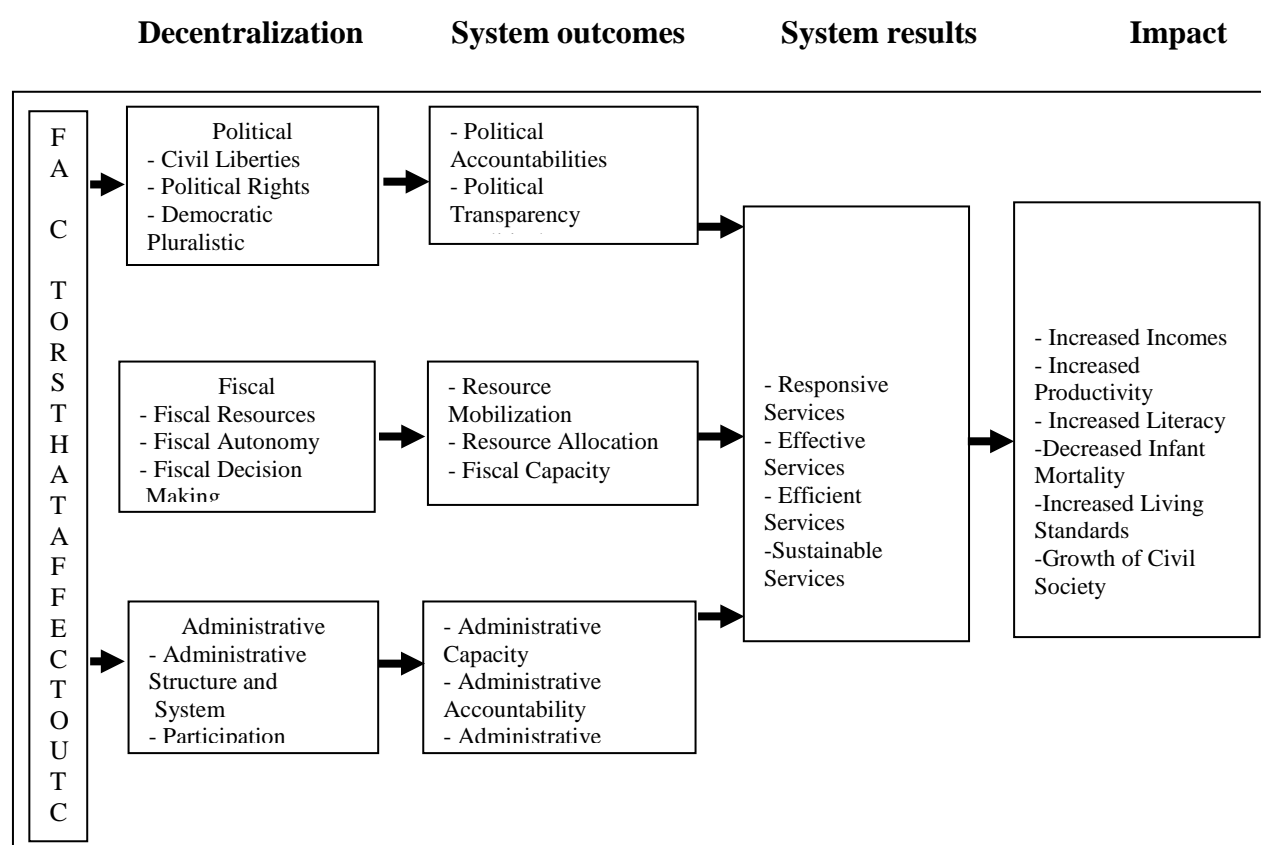
Deregulation reduces the legal constraints on private participation in service provision or allows competition among private suppliers for services previously provided by the government or by monopolies.

Building the frameworks for decentralization is not adequate to localize resources and decentralize the governance. The perfect combination of political, fiscal and administrative decentralization is the best form of decentralization. The given frameworks should be effective and result oriented. Decentralization can help to simplify the complex bureaucratic procedures and it can increase government official's sensitivity to local conditions and needs. Moreover, decentralization can help national government ministries to reach larger numbers of local areas with services, allow greater political representation for diverse political, ethnic, religious and cultural groups in decision making and relieve top managers in central ministries of routine tasks, allowing them to concentrate on policy. Central government's role for exploring global opportunities to the citizens can be supported by the appropriate legal, institutional and fiscal framework for decentralization.

Conceptually, in general decentralization of public policy making power is transfer of legal and political authority for planning projects, making decisions and management of public functions from the central government and its agencies to sub national governments. Power can be transferred on three fronts political, administrative and fiscal. However, each type of decentralization has different characteristics, operating system, outcomes and policy implications. The expected impact on people's levels is positive in general. The following figure developed by Parker Andrew gives the conceptual frame for the decentralization's outcomes and results.

Figure No. 1

Decentralization on Three Fronts

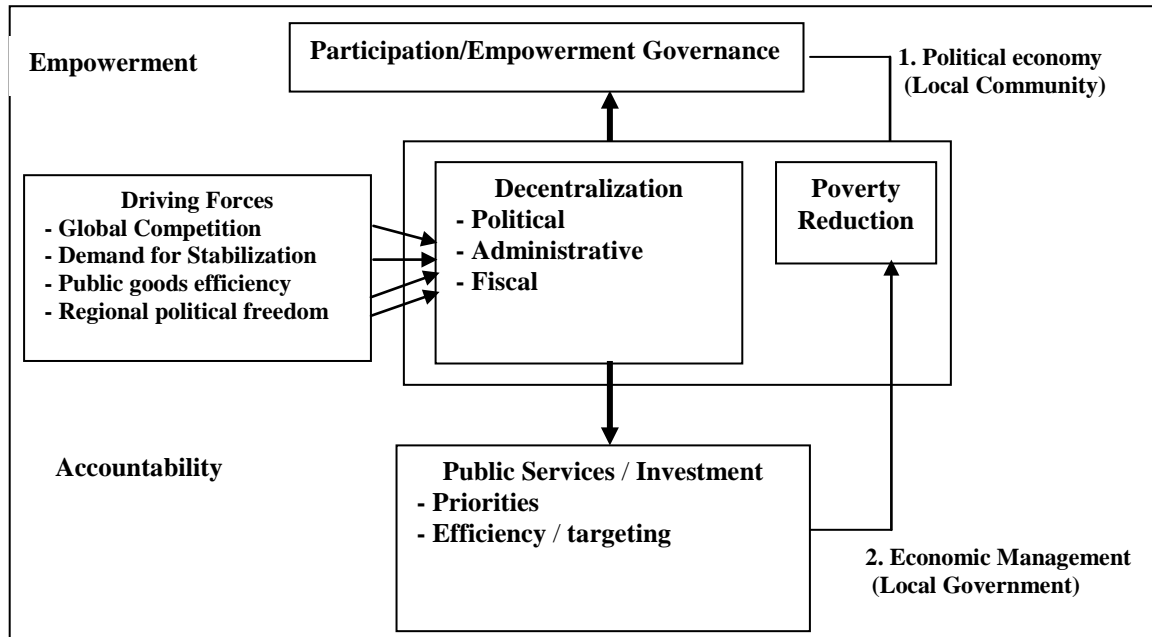


Source: Concept of Fiscal Decentralization and Worldwide Overview by Robert D. Ebel and Serdar Yilmaz, World Bank Institute, 2002 (*Adapted from Parker Andrew N. 1995 "Decentralization The way Forward for Rural Development"; World Bank Institute (2001) concept of Fiscal Decentralization and Worldwide Overview p. 13.)*
<http://www.worldbank.org/wbiep/decentralization/module1/topic01,printer.htm>.
 2001-6-19

Similarly, decentralization has linkage with poverty reduction. By engaging the poor in operating, monitoring and evaluation of delivery of public services at the local level accountability of local government increases leading to more efficiency in the delivery of public goods. The two linkages are explored further below. In order to shed further light on the linkages between decentralization and poverty reduction, Figure 2 asks also whether public services for the poor are fostered by decentralization and by the fiscal decentralization in particular.

Figure No. 2

Conceptual Framework or linkages between Poverty Reduction and Decentralization



Source: Joachim Von Bram and Ulrike Grote, Does Decentralization serve the poor?
Managing Fiscal Decentralization, Edited by Ehtisham Ahmad and vlto Tanu.
Routledge, Jayler Francis Group-2002, p. 73

1.6. Methodology

This section describes how the research is approached. It starts with the general introduction to the research design. It also describes the selection of study site, and the selection of participants that is followed by data generation tools and procedures. Further, it provides a framework for analysis. Finally, I have described the measures for quality standards.

1.6.1 Research Design

The focus of my study is to exploring issues relating to fiscal decentralization and the municipal taxation in Nepal. Thus, the research involved construction of knowledge together with the participants about the organizational functioning at the municipal

level, the role of fiscal decentralization in the process and realities on the municipal taxation. Further, I believed on the existence of multiple realities and subjective knowledge and so there is no intention of the researcher to capture or uncover the objective reality. Rather, the whole research study focused on exploring and analyzing the situations from different perspectives, from perspectives of central level stakeholders to the local level; from political to managerial and institutional perspective; from legal and structural perspectives to the capacity and participation perspective. Hence, the research is qualitative in nature and so the choice of the institutional units for the study and research participants is mainly based on purposive criteria- i. e., the potential for richness of information and diversity of cases to generate knowledge.

1.6.2. Case Study Method

The case study research is described by Yin (2003)³³ as ‘an empirical inquiry that investigates a contemporary phenomenon within its real-life context’ (p. 13). Because of the nature of situatedness of the inquiry it is natural to relying on multiple sources of evidence, with data needing to converge in a triangulating fashion. The process of exploration of something as soft as the governance issue requires in-depth study of the phenomenon and demands interpretation of multiple perspectives of diverse participants. Thus, the case study is purely a methodological choice for the study.

There are three distinct types of case studies to serve the distinct interests and purposes of inquiry: a) intrinsic- where the particularity and ordinariness of the case in itself, draws interests; b) instrumental: where the case is of secondary interests, and facilitates understanding of something else; and c) collective: where there is even less interest in one particular case and a number of cases are studied jointly in order to have better understanding about a still larger collection of cases Stake (2005). With regard to my study, the main interest is to unravel the structure and situation fiscal decentralization, and municipal taxation. Thus, my study fits closely with the third variant of the case-study research as mentioned by Stake (2005)³⁴.

³³ Yin, R. (2003). *Case study research: design and methods* (3rd ed.). California: Sage.

³⁴ Stake, R. E. (2005). Qualitative case studies. In: *The Sage Handbook of Qualitative Research* (3rd ed.), 443-466. Denzin, N. K., & Lincoln, Y. S. (eds.). California: Sage.

The argument from Stake (2005) appears very much relevant regarding the epistemological construction of knowledge. He argues ‘formally designed comparisons as competing with learning about and from the particular case’ and citing Geertz (1973) presents comparative description as opposite of *thick description* (p. 457). However, he highlighted the importance of studying a number of cases in multiple circumstances as exemplars so as to generate ‘valued and trustworthy knowledge’ (p. 458-459). Thus, I designed the study so as to learn about the cases and from the cases rather than focusing on strict comparison.

1.6.3 Sources of Information

This study has used quantitative and qualitative techniques of data collection using both primary and secondary sources of information to come across the study objectives.

The primary data have been collected through the 116 survey questionnaires from the Municipalities, Ministry of Local Development, Local Bodies Fiscal Commissions Secretariat and other corporate institutions. In the municipalities, political parties’ persons were consulted for in-depth interaction on the issues.

As mentioned earlier, the potential richness of information is the main criterion for the selection of research participants. Accordingly, the respondents were selected based on their current and past engagement and experiences as well as understanding on decentralization, fiscal decentralization and municipal management including municipal taxation.

To gain understanding of the different perspective of research participants, separate Focus Group Discussions (FGDs) were organized by their area of representation. In five FGDs in the sample municipalities, total 97 participants participated actively. Furthermore, to make efficient use of the time and to concentrate on the research issues, background information on the study area and major discussion questions were

presented prior to the actual discussion. The details of the discussions were recorded in detail in paper that could be utilized later to draw different themes.

Before the actual field work I reviewed the relevant literature and official documents of the Government of Nepal. Thus, the initial desk study was started as early as 2006 and continued for almost two years. Next, the finalization of research design, development of tools and initial field visits and interaction with the participants was accomplished during 2008. The final field work was carried out during 2008 -2010. The study has adopted both descriptive and analytical approaches in order to portray the information and derive meanings through the analysis.

The Secondary data were collected from sources such as library study, review the available literatures, reports and study during the working period in MOLD and other sources to analyze the macro level data and practices. The review of literature incorporated (presented) in chapter two is wholly based on the information obtained from libraries, books, various study, review and research reports from MOLD, LBFCs, NPCF, MOF and donor agencies and other past studies related to fiscal decentralization and municipal taxation.

The extensive literature survey on concepts and practices of decentralization including fiscal decentralization has immensely contributed this research. By the literature survey on conceptual framework and different models of practices has provided insight both on theories and practices of fiscal decentralization as well as municipal taxation. It has further encouraged digging out Nepalese practices of fiscal decentralization.

1.6.4 Rationale of Selecting Study Areas

In spite of more than five decades practice of decentralization in Nepal, the fiscally devolved decentralized system is still far. The fiscal decentralization and local taxation is in practice all over the country through widely dispersed local bodies. All the 58 municipalities are exercising authorities provided by the LSGA. The revenue collection efforts from the municipal taxation are practiced in different capacity. Thus, despite the common legal framework for fiscal decentralization, there exists a significant variation in terms of the resource generation, allocation and absorptive

capacity and exercise of local autonomy among the municipalities. Moreover, based on the population, level of development, and resource availability the perceptions and perspectives of the stakeholders are also expected to vary. In this regard, Flyvbjerg (2004), argues- ‘cases are selected on the basis of expectations about their information content’ (p. 426). He further suggested to using extreme cases and variations to obtain information on unusual cases and variations. Hence, to meet the purpose of my study the study of selected municipalities was more important than studying a number of randomly selected representative ones. Thus, from the criterion of potential richness of information and diversity five municipalities were selected for the study. The main rationales and considerations for the selection of the municipalities were as follows:

- (a) Geographical diversity: The five municipalities were selected so as to include the geographical diversity and ecological variations: from east to west covering development regions and from hills and tarai (the plain are that are generally heavily populated).
- (b) Size of the population: the municipalities vary significantly in terms of populations and accordingly the selection of the municipalities is based on the considerations on the diversity in terms of the size of the population.
- (c) Revenue generation potential: The municipalities vary significantly also in terms of potential for resource generation. Thus, the five municipalities included for study are based on this important consideration.
- (d) Diversity in terms of nature of city or level of development: Furthermore, the researcher has gathered a long experience at different capacities regarding governance and management at the municipalities in Nepal. I observed closely the uniqueness of management system in the Metro-Politian and Sub-metropolitan cities and the dynamics of municipal governance. Thus, these features were taken into consideration for the selection of municipalities for the study.
- (e) Cultural variations: The governance and management system of the municipalities can have an important bearing on the socio-cultural make up of the concerned municipal area. This variation has also been considered in the selection process.

1.6.5 The Sample, Sample Size and Selection of Municipalities

Ecologically, Nepal is divided into three regions i.e. High hills, Mid hills and Terai. The urbanization process in the high Himalayan region is slow and there is no single municipality. Biratnagar and Nepalgunj municipalities are from the eastern and western Terai with different levels of development. Being the capital city, Kathmandu has greater economic opportunities compared to other municipalities. Pokhara is a renowned touristic place with scenic views whereas Gorkha is the historical place where the unification of Nepal was started.

Sample selection criteria and Considerations: Population, level of development and internal revenue generation capacity (FY 061/62)

Criteria		Biratnagar	Kathmandu	Pokhara	Gorkha	Nepalgunj
Population (33.8%)	Population in five municipalities [1,223,000 out of total municipal popn 3,616,000]	180 (5%)	773 (21.38 %)	181 (5%)	28 (0.77)	61 (1.68%)
Internal revenue (43.29%)	Internal revenue (volume)	110700	61906 5	738 57	39 10	29453
	Share— 836985,000 in 1933537,000	5.72	32.02	3.82	0.20	1.52

Source : Adopted from MLD/Udle (2008) p. xiv and Statistical year book of Nepal, 2002 HMG, Central Bureau of Statistics, cited by Udle, 2008, p. xiii³⁵

³⁵ Detailed Revenue and Expenditure of 58 Municipalities (for the year 2007-08), MOLD/LBF-GTZ/udle, 2009.

Based on the above preliminary facts the sample and sample size of five municipalities was selected for this study.

Both of the above tables depict all the regional representation except Far West Development Region. There is no much difference among Nepaljung, Dhangadhi and Mahendra Nagar municipalities in socio- cultural and geographical aspects. The sample municipalities cover 33.82 percent of total urban population and 43.29 percent of total internal revenue. Thus, the sample municipalities are representative for this research. The research on Nepalese municipalities cannot be generalized to represent equally in terms of potentiality, population and institutional capacity, resources and infrastructure for development. So, considering the potentials, population and geographic areas the above mentioned five municipalities were selected as sample municipalities.

1.6.6 Field Study Processes

Although the study took little bit long period which enhanced more observations, interactions and develop the linkage with the practices and theories. The following steps were the different processes considered for the study.

- Step I: First of all, preparatory visits were made to each municipality selected purposively to collect their profile, annual reports and related information on municipal management as well as tax efforts. The general ideas were developed in the Municipal Management Section MOLD through preliminary discussion about the data collection and FGD.
- Step II: Information available in the MOLD and reports from the selected municipalities were collected.
- Step III: Five Municipalities were selected for detail study. The questions were prepared and distributed in the selected municipalities to the personnel, politicians and selected stakeholders including central level respondents.
- Step IV: A checklist for FGD was designed and the FGDs organized. During FGD, the questionnaires distributed earlier were collected and Municipal data on taxation gathered.

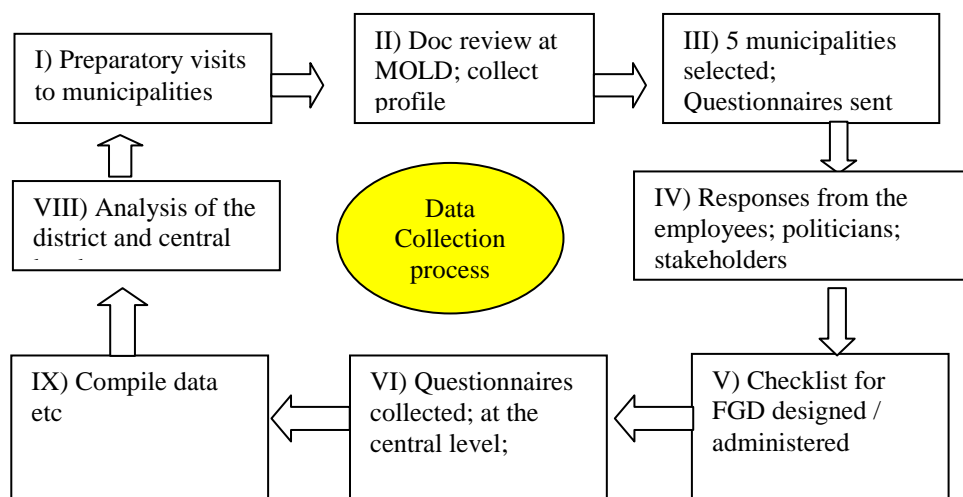
Step V: Central level questionnaires were collected.

Step VI: Compiled municipal level and central level information summarized key finding and proceeded to write up.

Figure No 3:

Field Study Design

The detailed steps of field work are presented in the diagram below:



The whole data obtained from the study field was divided into two stages i.e. field and central level respectively. Some of the supplementary data from the field were also collected from Kathmandu.

1.6.7 Method of Data Collection

Methods like Different questionnaire survey and focus group discussion as well as informal interactions during data collection were used as follows:

- (a) Municipal level questionnaire
- (b) Policy level questionnaire
- (c) Local bodies fiscal commission and ministry of local development and central level questionnaire
- (d) Focus group discussion

1.6.8 Analysis of Data

Fieldworks in the municipalities and in the capital (Kathmandu valley) were undertaken by using above mentioned techniques of survey questionnaires and FGD, to collect the primary data. Both primary and secondary sources were used to collect the data. The collected data were verified, edited, coded, classified and tabulated in appropriate formats and presented in graphs, pie-charts etc. The data collected in the field are basically qualitative in nature and results are interpreted judgmentally.

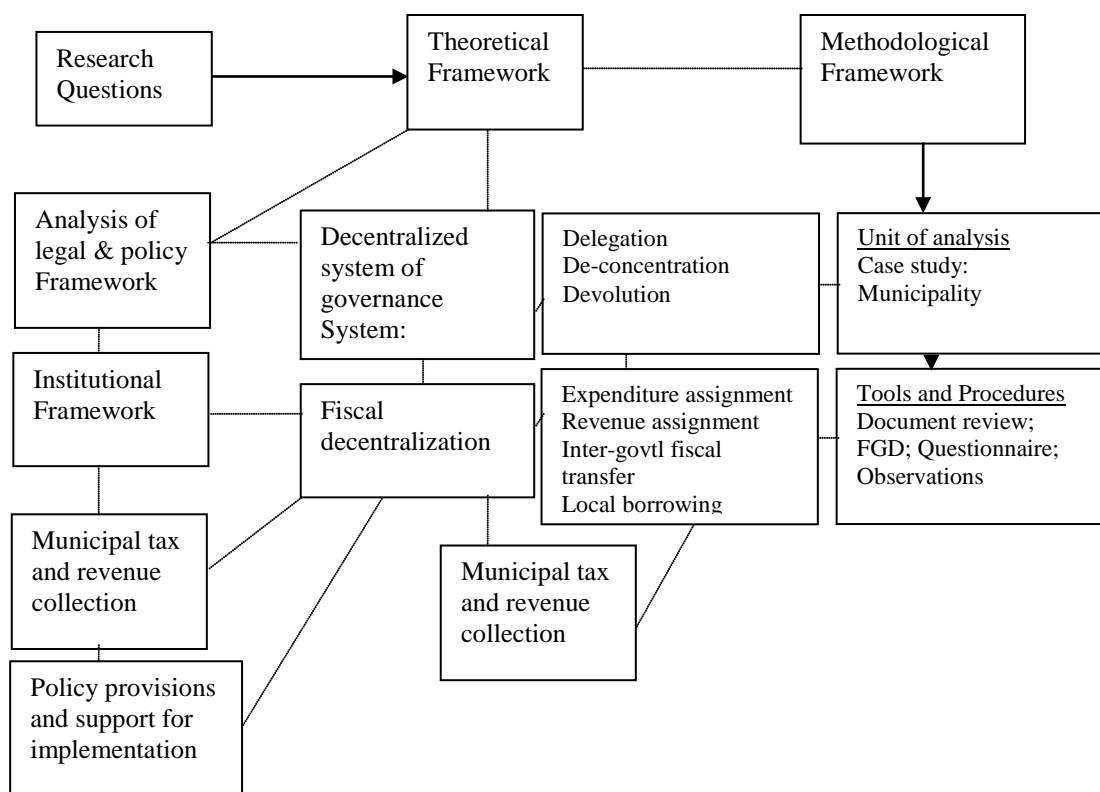
1.6.9 Quality Standards

The strategies offered by Maxwell (2004) have provided insights to guide my study with regard to quality considerations. The author favored ‘modus operandi approach’ (rather than looking for controlling the extraneous variables, deals with them as natural processes), ‘use of discrepant evidence’ (rather than ignoring the data that does not confirm to hypothesis, rigorously examine them), ‘triangulation’ and ‘member checks’ as the strategies for dealing with issues of causal validity. Reflexivity has helped maintain the quality standards.

The research took an evolving process. I visited the municipalities four times. Thus, there was opportunity to observe and interact with the cases in developmental perspective. This is one of the most important advantages of conducting inquiries over a period of two years. I could correct myself, substantiate the information, or interpret the events in different ways after these series of visits. I attended important events and functions and even followed through formal / informal communications. I noticed many changes over time.

The general contradictions that appeared between the informal talks and interview were recorded and reflected upon. Further, the multiple perspectives as provided by the diverse groups of participants were analyzed to generate meaning with regard to the study in question. This triangulation of information helped in enhancing the credibility of the study.

The summary of the general conceptual framework of the study is provided below:



Source : Author's derivation, 2012

1.6.10 Limitation of the Study

Generally, study without limitation is not possible. Accordingly in this study there are some limitations as follows:

- (a) The nature of this study is very complex which needs in depth and comprehensive data from local level to central level. Getting reliable data at local level and linking with central macro level is very difficult task. Similarly, fiscal decentralization is new subject with wider scope. Most of the researches are related with rural areas and very few of them are related with municipalities.
- (b) Municipal taxation is equally complicated as the central taxation use to be. Data base and updating itself is complex in the developing countries like Nepal. The understanding of the respondent is very critical to acquire appropriate data as well as suggestions on municipal

governance. The different situation in different municipalities may vary the facts which make the judgment complicated.

- (c) This study does not cover all the aspects of fiscal decentralization and the localization funds of line ministries as well as conditional grants provided by different agencies of the central government and the non-governmental sector. The efforts to analyze the fiscal decentralization and linkage with municipal taxation are indicative.
- (d) Municipal taxation in Nepal is still in its infant stage. The capacity of the municipalities, level of understanding of general people and limited knowledge of personnel are the constraints of accurate data acquiring and limited understanding on the subject.
- (e) The study has not focused more on the federal context and the required details on this overly loaded subject.
- (f) Being a civil servant, researcher's time, resources and environment limitation could not be underestimated.

1.7 Organization of Chapters

This dissertation has been divided into seven chapters. Chapter one gives a short background, concept of decentralization, fiscal decentralization and municipal taxation. Other components of this chapter contain the rationale, objectives, problem statement, conceptual framework and the methodology of the study which sets different techniques applied to generate the required information and data to fulfill the study objectives.

Chapter two has attempted to review theoretical framework as comprehensive literature related to decentralization, fiscal decentralization, municipal taxation and other related aspects. Moreover, this chapter deals with the theoretical aspects of decentralization, fiscal decentralization, fiscal federalism, local tax, municipal taxation and International experiences of fiscal decentralization from the secondary sources. This chapter attempts to explore the existing knowledge based on the available sources which provides foundations to this research.

Similarly, chapter three is devoted to discuss on policy and legal frameworks of fiscal decentralization and municipal taxation while chapters four and five have analyzed the institutional capacity and fiscal decentralization and municipal taxation.

Chapter six highlights the problems and prospects. The final, i.e., the seventh chapter contains the findings, summary, conclusions and recommendations drawn from the study. In addition to chapters the annexes, appendix, questionnaire, checklist used for the field study and references/bibliography are attached.

CHAPTER II

CONCEPTUAL FRAMEWORK

2.1 Theoretical Framework

2.1.1 Introduction

Fiscal decentralization is a new phenomenon especially in developing countries like Nepal. There is limited literature on fiscal decentralization and municipal taxation in Nepal. Due to limited literature and its availability in Nepalese context this study has also used the literature relating operational research and reports. Such literature has also dealt with many emerging concepts and recent phenomenon in this field. This chapter seeks to make review of literature related to the subject and develop a conceptual framework of this study.

“Since the 19th centuries in most developed countries, and during the second half of the 20th century in the developing countries, many waves of deconcentration have come to serve as a counterweight to these two characteristics of nation-state giving rises to a new distribution of decision making between the central government and its regional and local outposts³⁶.” Decentralization policies are part of vigorous initiatives to support rural development mostly through deconcentration. In the agricultural and rural development during 1960s and 70s, integrated rural development projects launched and contributed to decentralize more powers to local governments. Food and Agricultural Organization (FAO) has identified following three major trends relating to decentralization³⁷:

- The gradual appearing of a new distribution of responsibilities among the national, regional and local levels of government through the process of deconcentration (an initial and limited form of decentralization)
- The disengagement of the state and economic liberalization, which favored a new wave of decentralization through devolution

³⁶ Jean Bonnal A History of deconcentration: [http: ://www. ciesin.org/ decentralization/ English/ history_ fao.htm](http://www.ciesin.org/decentralization/English/history_fao.htm).page 3retrived on 12/19/2011

³⁷ Ibid page2

- Increased involvement of local jurisdiction and civil society in the management of their affairs, with new forms of participation, consultation and partnership.

The failure of centralization and limited decentralization through deconcentration directed to true decentralization.”During the 1980s and more intensely during 1990s, governments have tried to overcome the flaws of deconcentration by transferring decision-making powers, not to local levels of central government organs or the semi-autonomous public agencies, but rather to elected officials of local jurisdictions, and to civil organizations. "Decentralization by devolution therefore, the transfer of functions, resources and decision making to citizen themselves, who would exercise the powers ceded to either local government, or to their representative organizations³⁸”. The practices and experiences of decentralization in both developed and developing countries area creating pressure to devolve more powers to the lower levels of government.

The task of decentralization was administered when the statecraft came into existence. Modern political system is predominately based on people's participation, local self-governance and decentralization. Decentralization is demanded more both by the people of developed and developing countries. Decentralization with effective people's participation is considered to be the prerequisite for democracy. It is also the means of grass root democracy. Power sharing culture can be promoted by decentralization in political arena. Without decentralization the political empowerment process will not fulfill. So it is an integral part of overall political system either in federal or in unitary mode of governance.

Decentralization, the assignment of fiscal, political and administrative responsibilities to lower levels of government is occurring world-wide for different reasons at different paces and through different means. The 'why' of decentralization is as varied as the how of decentralization. The complexity inherent in the decentralization process is further aggravated by its cross cutting impact. The perfect combination of political, fiscal and administrative decentralization is very critical in designing decentralized governance system. The temptation for power at the central level is very

³⁸ Ibid page 4

critical constraint especially in developing countries. Political changes world-wide have given voice to local demands and the need to bring economic and political systems closer to local communities. "In Nepal decentralization efforts in the past are likely tasks without fund or unfunded mandates³⁹". The Local Self-Governance Act 1999 has assigned tasks & responsibilities to Local Bodies (District Development Committee, Municipality and Village Development Committee) and has provided different fiscal authorities. The local taxation especially municipal taxation in Nepal is more potential, reliable pillar of fiscal decentralization.

2.1.2 Rationale of Decentralization

Decentralization is an integral part of governance. It has taken place and motivated by political concerns. A growing body of literature is examining the following economic rationale for decentralization:⁴⁰

1. Economists justify decentralization on the grounds of allocative efficiency.
2. A second economic rationale for decentralization is to improve the competitiveness of governments and enhance innovation-and hence the likelihood that governments will act to satisfy the wishes of citizens.
3. Another potential benefit for decentralization is that people are more willing to pay for services that respond to their priorities, especially if they have been involved in the decision making process for the delivery of these services.
4. In an important economic sense the market is the ultimate form of decentralization in that consumers can acquire a tailored product from a choice of suppliers.

The other aspects of decentralization are more related with governance. Organization theory argues that decentralization improves accountability by clarifying the

³⁹ Somlal Subedi, **Decentralization and Local Fiscal Arrangement** (2063), Kathmandu : Anjana Subedi, , p. 19 .

⁴⁰ World Bank Institute, op.cit 23p. 6-7.

responsibilities of the distinct units of government, reducing the costs of constituent participation and by increasing the likelihood that participation will influence policies”.⁴¹ “Another school of thought relates decentralization close to democracy and the strengthening of democratic process”. It emphasis on people's participation and mass empowerment activates the citizen groups both in the political and developmental functions”.⁴²

Osborne and Gaebier (1992)⁴³ have mentioned the following four advantages of decentralized institutions:

1. They are more flexible than centralized institutions, they can respond quickly to changing circumstances and customers needs
2. Decentralized institutions are more effective than centralized institutions. Decentralized institutions are far more innovative than centralized institutions
3. Decentralized institutions generate higher morale more commitment and greater productivity.

2.1.3 Approaches of Decentralization

The state- led initiatives for decentralization can be analyzed through a number of approaches that are interlinked together. Some of them can be adopted as alternative models for the economic and social development of the country. Rabindra Khanal has explained the following approaches of decentralization.⁴⁴

a. Welfare Approach

The concept of welfare state in modern period is linked not only with the social security provided by the state but also consists in preparing the citizens to enjoy the rights and freedom in democratic manner. As J.S. Mill says that state which rules the

⁴¹ Public Finance in Theory and Practice McGraw Hill, 1984, p. 37.

⁴² Rabindra, op.cit. 16 p. 14.

⁴³ David Osborne and Ted Gaebler, **Reinventing Government**, (1991), India : Practice Hall Pvt.Ltd., , p. 252.

⁴⁴ Ravindra, Op.cit. no. 22, p. 6-8.

least is the best because if people are given choices, they are the best judges on government. A person with full freedom can never go beyond his reasoning. There is no need for him to engage in activities that are harmful to society. A modern state therefore, emphasizes on people's participation in all the decisions that affect their life. Because of the welfare policy's capability with the prevailing development paradigms of modernization, it was continued by quite a few governments of the developing countries on the basis that social welfare institutions should come into play only when the normal structure of supply, family and market breaks down (willensky H. and C, Lebeause 1998 cited by Khanal), Local government institutions in this regard are the outcome of this approach in the society at large and in a particular political systems.

b. Anti- Poverty Approach

Another important approach can be taken to analyse the scheme of decentralization and local governance is the Anti- Poverty Approach. Now it has been widely recognized that modernization theory with its accelerated growth strategies based on maximizing GDP, has failed either to redistributive income or to solve the problems of third world poverty and unemployment. The poverty targeted models implemented in development could not yield the intended results. So, decentralization has recognized as an alternative model of service delivery.

Decentralization of power and authority through local governance will enable the people at grassroots to plan development according to their needs. The participatory planning process adopted by LSGA in Nepal is example to include create an environment for the people to mobilize the local resources on the basis of local knowledge especially in a country like Nepal where modern technology is for beyond the ordinary people's reach. Majority of the people in any locality are poor and when even a little power comes in their hands, they endeavor to do their best. That is why, anti-poverty approach is regarded as one of the best approach in the study of decentralization and local governance.

c. Efficiency Approach

Any governance system depends on its efficiency for sustainability. The globalization is demanding more efficiency and competitiveness in governance. The third world

countries have to survive in this cut-throat competition they need to build up efficiency right from the grassroots. Efficiency and productivity, in fact are the two major objectives of Structural Adjustment Policy (SAP) which is gaining popularity amongst the international aid agencies and national governments in order to bring about efficiency in their respective socioeconomic and political systems. It is well understood that local government can demonstrate the efficiency in local governance if they are properly designed and appropriately operated.

d. Empowerment Approach

Empowerment is an integral part of the sustainable decentralization. It is desperately needed for the third world countries. The purpose of empowerment is to enhance people's participation and develop the accountability mechanism. The interrelationship between local development and decentralized power is important to access the need of empowerment. It further seeks to identify those who are powerless in terms of degree of domination by others over them and also in terms of their capacity to increase self-reliance and internal strength. Defining rights of the people to determine their choices and influence the direction of change through the ability to gain control over the resources empowerment plays a decisive role. It helps to get the desired results. Similarly, decentralization enhances the empowerment of the people. Furthermore, free, fair and regular electoral process, participation and other mechanism of people engagement in local governance is a regular and effective tool for people empowerment. Adequate empowerment of the people and beneficiaries is one of the preconditions for effective local governance.

2.1.4 Main Elements of Decentralization

Decentralization is found to have been practiced differently in different countries. Therefore, it is difficult to view decentralization of a particular country on the basis of specific structure. Never the less, similarities are found in democratic countries in some indispensable elements. These elements have been presented in the following four categories.⁴⁵

1. Legal infrastructure and political commitment
2. Fiscal resources and management

⁴⁵ Local Bodies Fiscal Commission Report (2001), Kathmandu Pulchowk: p. 11.

3. Organizational capability and
4. Public service /satisfaction

These four elements supplement and complement each other. In comprehending them and taking decisions two other aspects- principle of subsidiary and good governance should also be taken into consideration. Subsidiary principle is new concept. It emphasized locally effective decentralization. Subsidiary governance is based upon the following principles: ⁴⁶

- Functions/services that can be carried out by citizens or citizen's institutions should be carried out by them.
- If functions/services can be carried out at a lower level these should be carried out at that level, and
- Essential governance functions should always be carried out as close to the citizen as possible.

2.1.5 Approaches to Designing Sub-national Territories

The efficiency and sustainability of decentralization depends on its design. Functional institution has direct link with designing sub national territories. To perform the assigned roles by decentralized local institution is an integral part of decentralization. ⁴⁷ ADB has presented six approaches to delimiting geographic areas as follows;

- a) Functional Approach: matches area to function
- b) Community Approach: Gives primary consideration to social geography
- c) Efficiency Approach: considers performance
- d) Managerial Approach: Considers management capacity of government organization.
- e) Technical approach: considers the landscape or economy of the country - climate, topography, soil conditions, etc.

⁴⁶ Human Development Report HDR (2001) Kathmandu: National Planning Commission/United Nations Development Programme Nepal

⁴⁷ Salvatore Schiavo-Campo and Pachampt Sundaram op.cit 27, pp. 164-168.

- f) Social Approach: considers the natural formation of inhabitants in geographic areas.

a) Functional Approach

The process of matching area to function involves identifying government functions and the associated necessary institutions and on this basis delimiting the geographic boundaries within which government functions are to be performed. Following Oat's theorem, the hierarchy of geographic communities corresponds to the scale of operations necessary for the optimum performance of the general government.

But there are difficulties, aside from the fact that the different functional criteria may produce overlapping boundaries, it is impossible to objectively restrict the "natural" geographic area of a problem (such as in health, housing, and the environment) to the functional areas that is politically determined by the government. In effect, the determination of functional areas becomes a political judgment as to what the "right" jurisdiction is for a particular function. The functional approach remains the main point of reference, but needs to be complemented by other considerations.

b) Community Approach

The Community approach prescribes that government boundaries should correspond to territories in which the inhabitants manifest common behavior and attitudes. Applying the community approach involves determining two essential elements: (I) the spatial distribution of settlements such as villages, towns, cities and metropolitan area; and (II) the spatial patterns of the activities of inhabitants, indicated by the people's economic transactions, their personal mobility in community to work and shopping, recreation and cultural linkages.

The process mainly involves in identifying geographic centers and hinterlands and their social and economic interdependence as indicated by the number of inhabitants employed in banks, shops, schools, hospitals, newspapers, and so on. This is useful for the design of effective land use plans, traffic management, highways development and public transport.

Complexities in centre hinter-Land relationships make it difficult to demarcate communities and measure the urban status of centers. But the task of making government boundaries coincides with centers in towns or urban areas. However, it would be difficult to "internalize" the service externalities generated by local government functions. Also, it would produce an equitable distribution of government goods and benefits among the community inhabitants. The more homogeneous the community is, the greater the likelihood that government action will be close to the collective preferences of citizens.

c) Efficiency Approach

Geographic areas may be divided to permit the government to deliver goods and services efficiently and make the best use of its resources. This approach suggests large jurisdictions with large populations permitting local government to (i) wider their range of functions to serve more people, (ii) benefit from a large tax, and (iii) optimize their workloads. The efficiency approach is most appropriate for local government services such as urban planning housing, water sewerage and transportation. The efficiency approach to decentralization can be embodied in Oates "decentralization theorem".

Measuring the efficiency of an organization according to its output forms the basis for either enlarging or reducing jurisdiction boundaries. However, unlike services whose output is quantifiable, such as highways, sewerage systems, or water, supply objective criteria for measuring the output of services say teachers, social workers, police men, health workers and the like are extremely difficult to find.

Many Western European countries (notably Denmark, Germany, Sweden and United Kingdom) have reduced the number of their municipality by merging them together . There is, however, no conclusive evidence that operating in large jurisdictions is always more efficient than operating in smaller ones. Scale economies constantly change with changes in technology and government function. Also, exploiting scale economies does not necessarily require on administrative entity of optimum size. Scale economies can also be attained by adopting joint service agreement, and by delegating the execution of a variety of local services to provincial governments.

d) Management Approach

The aim of the management approach is to divide state territory into more manageable parts. It corresponds roughly to the "span of control" criteria for central government organization. It involves drawing boundaries to reflect the perceptions of central decision makers as to how the flow of work can be managed. The number and location of field officer are arrived according to an optimum span of control by the headquarters, or the workload appropriate for a field office. This approach is more appropriate for decentralization and delegation, rather than for political decentralization or for the constitution of local government units.

e) Technical Approach

In dividing the state territory, one may consider the natural properties and physical features of regions that bear significance of administration. The term region may mean different things in geography and public geographical regions, i.e. areas with unifying characteristics or properties.

Administrative boundaries are often drawn on the basis of physical geography, especially when governments attempt to manage natural resources such as water supply land, drainage coastal erosion control, irrigation, soil conservation, forest development, recreation, waste disposal or wildlife conservation. Also, physical geography can offer an appropriate basis for economic and social planning, especially if the lives of the inhabitants are tied closely to the exploitation of natural resources.

f) Social Approach

The territorial structure of government and administration may consider socially distinct regions based on history, ethnicity, language or some combination of these. The approach is especially useful when, during the process of unification some areas forming the constituent parts of a country may continue to experience a sense of identify that cannot be overlooked by the constitutional and administrative system.

Changing the boundaries of the states of a federal country is more difficult than changing regional boundaries within unitary states as states in federal countries are usually protected by constitutional guarantees. However, when state boundaries in a

federation own their origins to the artificial creations of an external power (normally through a colonial experience) restructuring a federation may be easier.

Conceptually, decentralization has been evolved from de-concentration, delegation to devolution. Different theories emerged and practiced differently. Decentralization of governance is widely believed to promise a range of benefits. It is often suggested as a way of reducing the role of the state in general by fragmenting central authority and introducing more Inter-governmental competition and checks and balances. It is viewed as a way to make government more responsive and efficient.

“In a world of rampant ethnic conflicts and separatist movements, decentralization is also regarded as a way of diffusing social and political tensions and ensuring local cultural and political autonomy”⁴⁸

Democratic decentralization is said to contribute 'The breeding of better societies and the establishment of social harmony, community spirit and political stability'.⁴⁹

2.2 Fiscal Decentralization

"Fiscal decentralization has to do with the degree of fiscal autonomy and responsibility given to sub-national governments. It is a subject on the policy agenda in many developing transition and industrial countries. There always has been a cry for more decentralization of government, resulting from a combination of people wanting to get more involved in the process of government and inability of central governments to 'get the job done'.⁵⁰

Maltas, (2008)⁵¹ has analyzed the political determinants of fiscal decentralization. He pointed out the need of a dynamic positive theory of fiscal decentralization. The traditional normative studies of fiscal federalism are insufficient to explain the actual patterns of fiscal decentralization across countries. That's why it is important to

⁴⁸ Hand Book of Fiscal Federalism(2006) Ehtisham Ahmad (ed),UK : Edwaul Elgar Publishing Limited , p. 201.

⁴⁹ Decentralization The Territorial Dimension of the State, Reader in Public Administration (1985), London : University of Bath, p. 23.

⁵⁰ Roy Ball (htm), Worldwide Trends in Fiscal Decentralization. <http://www.worldbank.org/wbiom/dencentralization/bahi>.

⁵¹ A comparative study of fiscal decentralization: an event history analysis (2003),North Carolina U.S.A. : Duke Graduate Students Colloquium, September, p. 15.

incorporate political variables into the analysis and further investigate the incentives and constraints of the main political actors.

"An important pre-condition of fiscal decentralization is political decentralization. Political decentralization aims to decentralize political power by establishing semi-autonomous sub national government bodies that have a corporate charter (they should be able to hold property, generate revenue and incur expenditure) and that are politically accountable to the local electorate."⁵²

Jamie (1998) has defined fiscal decentralization as "Inter-governmental fiscal relations and fiscal decentralization deals with how the government sector is organized and finance. Inter-governmental fiscal relations studies how different levels of government interact with each others on fiscal issues. It is the concept of assigning fiscal decision making powers and management responsibilities to lower levels of government in a devolved system".

"Fiscal decentralization is associated with enhanced quality of governance as measured by citizen participation, political and bureaucratic accountability, social justice, improved economic management and reduced corruption." ⁵³

Considering economic perspective on fiscal federalism Oates⁵⁴ has defined fiscal federalism as 'the division of fiscal functions among levels of government which is more relevant to fiscal decentralization.

Fiscal decentralization is one of the decisive elements of any decentral activity. "Decentralization is pursued to bring the decisions closer to people's needs and capabilities in order to increase responsiveness to people's preferences and create more efficient solutions to comply with them. To achieve this fiscal decentralization may be most influential tools at hand to let it happen. Local finance can if properly designed provide" custom-tailored" public goods to satisfy very different needs in the

⁵² United Nations Capital Development Fund, Principles of Fiscal Decentralization in Introductory of overview of intergovernmental Fiscal Relation, Distance Learning Series(2001), p. 2

⁵³ Handbook of Fiscal Federalism, op.cit.46, P 494

⁵⁴ The Political Economy of Fiscal Federalism, Lexington Books, D.C. Health and company Lexington, Massachusetts, Toronto.

different regions and the feeling to handle one's own public money spurs efficient use of it.⁵⁵

Financial responsibility is a core component of decentralization. If local government and private organizations are to carry out the practices of decentralization effectively, they must have adequate revenues- raised locally or transferred from the central government as well as the authority to make expenditure decisions. Fiscal decentralization can take many forms including.⁵⁶

- Self-financing or cost recovery through user charges
- Co-financing or co-production in which user participates in providing services and infrastructure through monetary or labor contributions.
- Expansion of local revenues through property or sales taxes or indirect charges.
- Inter-governmental transfer of general revenues from taxes collected by the central government to local government for general or specific uses.
- Authorization of municipal borrowing and mobilization of national or local government resources through loan guarantees.

"In a fiscally decentralized system the policies of sub national branches of governments are permitted to differ in order to reflect the preferences of their residents. Furthermore, fiscal decentralization brings government closer to the people and a representative government works best when it is closer to the people."⁵⁷

The theoretical argument for fiscal decentralization is formulated as "each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision". However, much of the established theoretical literature of fiscal federalism has been based on issues that arose within developed countries. Particularly, the USA and Canada and the definition and implementation of fiscal decentralization differ greatly across developing countries due to differences in economic and political structures.

⁵⁵ Strengthening Local Government Finance (2000), Nepal Case Study, (GTZ), .p.7.

⁵⁶ World Bank Institute, op.cit 23, p. 3.

⁵⁷ Intergovernmental Fiscal Relations & Local Financial management Programme, http://worldbank.org/wbiiep/decentralization/module/topic01_printer.htm(retrived 2001/6/19 p.2)

This diversity creates challenges to measures and compares the degree of decentralization across countries and to make generalization about it.⁵⁸

2.2.1 Concept of Fiscal Decentralization in Nepal

In a highly centralized country like Nepal, the efforts of decentralization could not provide adequate fiscal authorities to local bodies to deliver local services. The deconcentrated model has been adopted for more than six decades under the unitary system of governance without matching responsibilities and the funds. So, fiscal decentralization is still a new challenge of decentralization in Nepal. Formally, for the first time to assign fiscal authority to local bodies, the Town Panchyats (municipalities) were given the authority to impose house and land tax in 1963. In the same way, the Town Panchyats were also given the right to impose professional tax, up to 10% on the land tax, up to 20% entertainment tax on the admission fee and vehicle tax not exceeding Rs. 100 on the means of registered in the same town. As the mobilization of tax did not gain momentum, it was reviewed in 1965-66. The household tax, professional tax and vehicle tax were simplified. The additional surcharge on the land tax was collected. There was a provision of trade surcharge @ 0.3% and a new tax – Panchayat Development Land Tax (PDLT) - was implemented. In the fiscal year 1975-76, there was a provision of imposing 0.50% trade tax, but the Panchayat Development Tax was suspended. In the year 1989, the trade tax was suspended and a provision was made to levy taxes at 1.00% as octroi.

After the political change of 1990, the then Panchayat Acts were abolished and the VDC Act, 1992, Municipality Act, 1992 and DDC Act, 1992 were introduced with a view to consolidating the local bodies and making them powerful. In those Acts, there were powers for the local bodies to impose different taxes. The power to collect land revenue was handed over to the VDCs and the municipality from fiscal year 1997-98. Despite all these powers, local bodies could not collect taxes to their full potentials for different reasons. So, making timely improvements in the existing conditions, the Local Self-Governance Act and Regulation were introduced in 1999 with a view to

⁵⁸ Ibid.p.2

granting more autonomy to the local bodies. "From the LSGA, 1999 and its regulation, 1999 several powers are granted to the local bodies."⁵⁹

The LSGA is the milestone of decentralization including fiscal decentralization in Nepal. The LSGA aims to allocate means for the development to achieve the balance and equal distribution of the fruits of development in a participative as well as inclusive way. It has incorporated principles and policies of Local Self-Governance. The clause 3 has provisioned the principles and policies related to fiscal decentralization. The Local Self Governance Act 1999 has provisioned five principles and policies of local self –governance. Out of five principles two are related with fiscal decentralization. They are:⁶⁰

1. Devolution of such powers responsibilities, and means and resources as required making the local bodies capable and efficient in Local Self-Governance.
2. Devolution of powers to collect and mobilize such means and resources as required discharging the functions, duties, responsibility and accountability conferred to local bodies.

Based on the legal and institutional framework defined functions and responsibilities to local bodies by the LSGA, 1999 and the policies adopted by the Government of Nepal (GoN), the fiscal decentralization is being practiced.

Modern political system is predominantly based on people's participation, local self governance and decentralization. Decentralization is an integral part of the modern governance at the central, provincial and at the local level. In 1990s, demand for decentralization received worldwide concerns. Both in the developed and developing countries people are demanding more decentralization for participatory local democracy, effective service delivery and addressing diversities.

Decentralization can entail transfer of power to different levels within political system. It comprises the assignment of political, fiscal and administrative responsibilities to lower levels of governance. It is an integral part of overall political

⁵⁹ Local Authorities Fiscal Commission Report (2000), Kathmandu, Lalitpur, p. 46.

⁶⁰ Local self - Government Act, 1999, Clause 3, p. 4.

system in any mode of governance (unitary or federal). The process of decentralized governance is adopted in each and every country in different ways. The structure, level of autonomy, effectiveness and achievement varies from country to country. The word 'decentralization' in general refers to such a condition where powers and functions of governance are dispersed, delegated, deconcentrated or developed to lower layers of institutions, groups, communities, civil societies and even to private citizens in a geographic units".⁶¹

Fiscal decentralization is the key ingredient of decentralization. Without fiscal decentralization services delivery is not possible. Effective decentralization seeks the perfect blend of political, fiscal and administrative decentralization. "Expenditure assignment, revenue assignment, fiscal transfers and local borrowing are the major components (pillars) of fiscal decentralization (Jami, 2001).⁶²" All the components of fiscal decentralization are equally important in designing Inter-governmental fiscal system. It is a complex mixture of political choice, designing decentralized system of governance, geographical situation, historic reasons and country contextual factors. The size, structure and number of local government play dominant role in devolving fiscal authority.

Decentralization of decision making to the regional and local levels, while providing genuine legal and financial autonomy for local institutions is one of the main components of a comprehensive public sector reform.

In a decentralized system of governance, different tiers of government assigned expenditure responsibilities and revenue authorities. Municipalities are the lowest tiers of governance in the governance system. The urban population in the globe is escalating, along with problem of infrastructure, services and supplies resulting into urbanization of poverty. Financial requirements of the local (municipal) governments to cope with the rapid urbanization, growth in urban population is also escalating. To meet the pressing fiscal need, municipalities are demanding more fiscal authorities and the central governments are gradually devolving more revenue authorities to the cities.

⁶¹ Poverty Reduction and Decentralization A Linkage Assessment (2002), Lalitpur, Nepal: LDTA, p. 17.

⁶² United Nations Capital Development Fund, op.cit.50 p.3.

2.2.2 Fiscal Federalism

In the early years of the 21st century the world appears to be in the midst of a paradigm shift from a world of sovereign nation-states to a world of diminished state sovereignty and increased interstate linkages of a constitutionally federal character. Watts (2008) explained federalism as "federalism is used basically not as a descriptive but as a normative term and refers to the advocacy of multi-tiered government combining elements of shared-rule and regional self-rule. It is based on the presumed value and validity of combining unity and diversity i.e. of accommodating, preserving and promoting distinct identities within a larger political union."⁶³

The economics of federalism or fiscal federalism is an area of study in which the principles of economics are applied to the functioning of the public sector in a federal political system. "Fiscal federalism is concerned with the principles governing the division of taxing and expenditure functions among levels of government in a multilevel public sector organization and evolving mechanisms and policy instruments for resolving fiscal imbalances and achieving socially optimal resource allocation."⁶⁴

The analytical literature on fiscal federalism by Charles Tiebout (1956) has emphasized the gains from fiscal decentralization. Fiscal federalism is considered to be an optimal institutional arrangement for the provision of public services. The key feature of the argument leading to the welfare gains from fiscal federalism has been that it combines the advantages of decentralization with benefits from economies of scale. Inter-jurisdictional competition provides incentives for innovation and increases efficiency in the production of public services.

Much of the literature on fiscal federalism has focused on benefits of federal financial relationship among a group of politically autonomous regions or federating units as the advantage accruing out of 'cooperative federalism' (Scott. 1964, Hicks, 1955, Elazaar 1997, Cited by RAO). Under fiscal federalism viewed as an exercise in

⁶³ Ronald L. Watts Comparing Federal Systems(2008), Third Edition, Published for the school of policy studies, Queen's University By MC Gill-Queens University Press Mart rent & Kingston, London, Ithaca. P.

⁶⁴ Abdulrahim P. Vijapur(ed), Dimensions of Federal Nation Building(1998), Centre for Federal Studies, Delhi: MANAK Publication (p) Limited G-19 Vijay Chowk, Laruni Magar p. 124

cooperation, the economic relationship among the federating units transcends political boundaries. All economic transactions-tax and expenditure assignments, inter-governmental and inter-jurisdictional interaction and inter-governmental transfer systems are determined purely on economic confederations.

Fiscal federalism connotes an ideal joint rationality in the political and economic spheres optimal level of decentralization in the choice of the mix of public services and a suitability centralized political authority which can ensure smooth and efficient sharing of resources combined with a rational elimination of avoidable expenditures.

To quote Shah, "The Fiscal federalism principles are concerned with the design of fiscal constitutions i.e. how taxing, spending and regulation functions are allocated among governments and how inter-governmental transfers are structured as these are of fundamental importance to the efficient and equitable provision of public services".⁶⁵

Regarding the structure "A federal form of government is known for a multi-order structure each all order of government has "some independent as well as shared decision making responsibilities" (Shah, Rezende, Rajaram and Rao, et.al. p. 134). Linking with the system "Fiscal Federalism is the system or approach used to apply the principles of federalism in Inter-governmental relations in which governments interact with each other by cooperation, coordination, and competition to maximize the welfare of citizen"⁵¹.Srivastab further explains fiscal federalism as "the system or approach used to apply the principles of federalism in Inter-governmental relations in which governments interact with each other by cooperation, coordination and competition to maximize the welfare of citizens."⁶⁶

2.2.2.1 Genesis of Fiscal Federalism

Several accepted theories provide strong rational for decentralized fiscal constitutions (Civic republics as termed by Kincaid, 1967) on the grounds of efficiency, accountability manageability and autonomy (Shah, Rezende, Rajaram and Rao, et.al. 139).

⁶⁵ Shah, Rezende, Rajaram and Rao, 4th International Conference as federalism 5-7 November, 2007, (New Delhi : Chattupadhyay Rupak, 2007), p. 133.

⁶⁶ D.K. Srivastav, Key Elements of a New Federal Regime in Federal Nepal(2011),Ottawa, Ontario(Canada) : Forum of Federations P.67.

The Home Rule by George Stigler (1957) identifies two principles of jurisdictional design:

- A representative government works best the closer it is to the people.
- People should have the right to vote for the kind and amount of public services they want.

These principles suggest that decision making should occur at the lowest level of government consistent with the goals of allocation efficiency. This optimal size jurisdiction would vary with specific instance of economies of scale and benefit- Cost Spill over.

2.2.2.2 Principle of Fiscal Equivalency

A related idea on the design of jurisdiction has emerged from the public choice literature. Oison (1569) argues that “if a political jurisdiction and benefit area overlap the free-rider problem is overcome and the marginal benefit equals the marginal cost of production thereby ensuring optimal provision of public services. Equating the political jurisdiction with the benefit area is called ‘Principle of Fiscal equivalency’ and requires a separate jurisdiction for each public sector⁶⁷.” A related idea the so-called ‘correspondence Principle’ is proposed by Oates (1972). “According to this principle the jurisdiction determining the level provision of each public good should include precisely the set of individuals that consume it. This generally requires a large number of overlapping and competing jurisdictions. They argue that jurisdictions can be organized along functional links while overlapping geographically and that individuals and communities could be free to choose among competing jurisdictions. Revenues are raised from members in return for delivery of services to them.”⁶⁸

2.2.2.3 Decentralization Theorem

According to the "decentralization theorem" advanced by Oates "each public service should be provided by the jurisdiction having control over the minimum geographic

⁶⁷ Shah, Rezende. Rajaram and Rao, op.cit 61.p.140

⁶⁸ Ibid 140

area that would internalize benefits and costs of such provision" (Oates 1972). Practical implications of this theorem require a large number of overlapping jurisdictions.

2.2.2.4 Subsidiary Principle

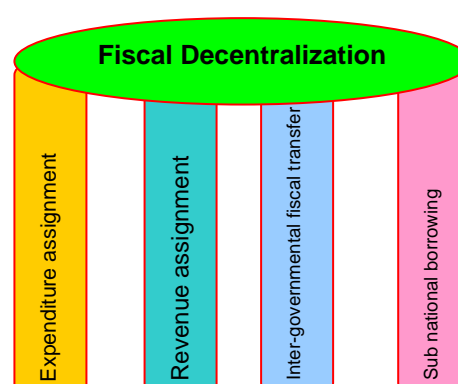
According to the subsidiary principle advanced by the European Union, taxing, spending and regulating functions should be exercised by the lowest order of government (the government closest to the people) unless a convincing case can be made for assigning these to higher orders of government.

2.2.3 Components / Pillars of Fiscal Decentralization

Fiscal decentralization is the key for functional and effective decentralization. Without fiscal authorities decentralized responsibilities cannot be carried out. Fiscal responsibilities and resources are integral parts of decentralized system of governance. The dimension of decentralization is closely linked with fiscal decentralization.

Experts consider that inter-governmental fiscal relations or fiscal decentralization reforms can be divided into several interrelated dimensions. In sequence, the building blocks or pillars of fiscal decentralization are (Boex Jamie 2001) ⁶⁹:

- (a) Expenditure assignments
- (b) Revenue assignments
- (c) Inter-governmental fiscal transfer
- (d) Sub national borrowing



Source : Author's derivation, 2012

⁶⁹ Georgia State University, Andrew young school of policy studies Georgia state school of policy studies (2001), An Introductory Overview of Intergovernmental Fiscal Relations International Studies Programme , Atlanta, Georgia 30303, United States of America, p. 3.

The design of a decentralized system requires sorting out of Public sector responsibilities among different tiers of government and the process of sorting out entails transfer of some decision making powers from central to sub national government. The challenge is to design an Inter-governmental system that can best achieve not only the general objectives of fiscal decentralization (efficiency, transparency and accountability) but also maintain national integrity and political stability and equitable to different people and places. Such a design is based on four pillars: expenditure assignment, revenue assignment, Inter-governmental transfers/grants, and sub-national debt/ borrowing."⁷⁰

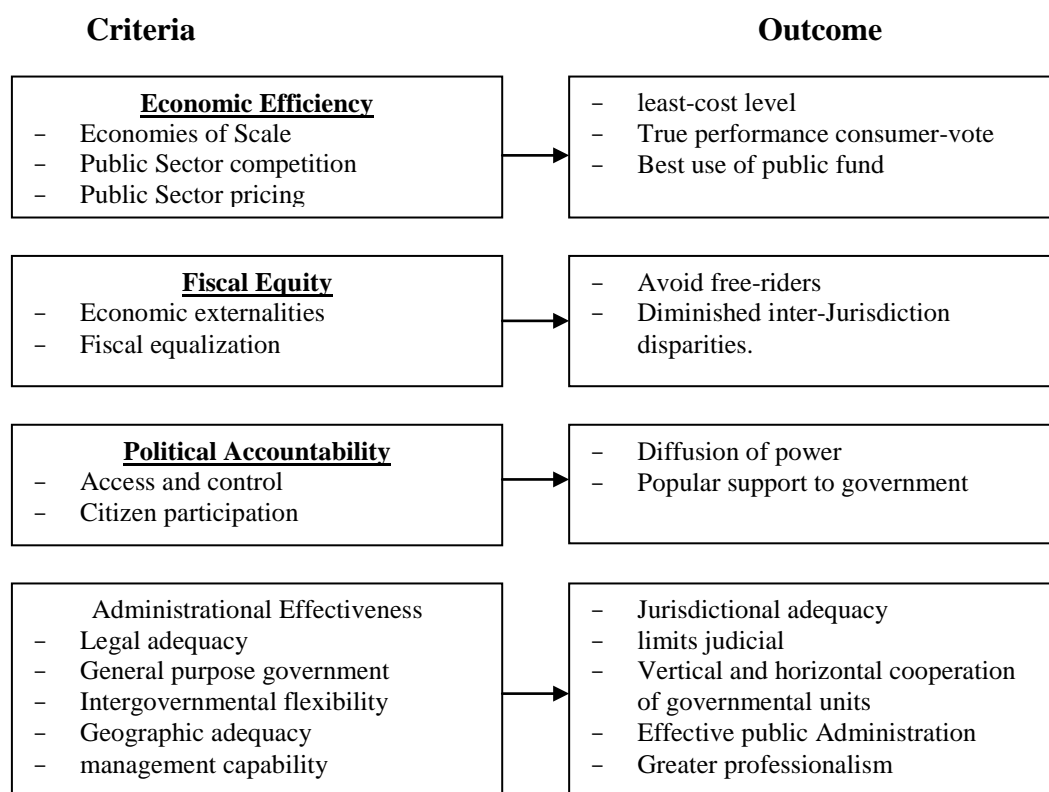
a) Expenditure Assignment

Expenditure assignment is the first step in designing an Inter-governmental fiscal system. Designing revenue and transfer components of a decentralized Inter-governmental fiscal system without concert expenditure responsibilities would weaken decentralization process. The lack of clarity in the definition of sub national responsibilities has a negative impact on three aspects. First, if the responsibilities are imprecise the necessary corresponding revenues will poorly define. Second, without clear responsibilities, sub national government officials might prefer to invest in populist projects which benefit them in the short run rather than in projects with long term impact on regions economy (Such as infrastructure education, etc). Third, there will be confusion whether sub national expenditures represent local priorities or centrally determined Programme.

The Key to success of a decentralized system is matching expenditure responsibilities with the objectives of service assignment. A report prepared by the Us Advisory Commission on Inter-governmental Relations (ACIR) on Governmental functions and Process (1974) lists four criteria in assigning services as economic efficiency, fiscal equity, political accountability and administrative effectiveness (the following figure)

⁷⁰ World Bank Institute, Intergovernmental Fiscal Relations & Local financial Management Programme , http://www.worldbank.org/wbieys/decentralization/module/topic01_printer.htm, p.15, retrieved, 2001/6/19

Expenditure Assignment



Source: Adapted from ACIR (1974) Governmental Functions and process local and Inter-governmental Relation A- 45 Washington, D.C. cited by Richard Bird.

These characteristics suggests that expenditure assignments should be made to government units that can

1. supply a service at the lowest possible cost
2. finance a function with the greatest possible fiscal equalization
3. provide a service with adequate popular political control
4. Administer a function in an authoritative technically proficient and cooperative fashion.

The Characteristics of expenditure assignment provide a framework to determine whether each function could be best performed by central government or any other level of governmental unit. In more specific terms they relate economic, political and administrative considerations to the size variable (WBI).

1. **Economic Efficiency**

Functions should be assigned to jurisdictions:

- a. that are large enough to realize economies of scale and small enough but to incur diseconomies of scale (economies of scale)
- b. that are willing to provide alternative service offering to their citizens and specific services within a price range and level of effectiveness acceptable to local citizenry; (public Sector Competition)
- c. that adopt pricing policies for their functions whenever possible (public sector pricing)

2. **Fiscal Equity**

Appropriate functions should be assigned to jurisdictions :

- a. That are large enough to encompass the cost and benefits of a function or that are willing to compensate other jurisdictions for the service costs imposed or for benefits received by them (economic externalities)
- b. That have adequate fiscal capacity to finance their public service responsibilities and that are willing to implement measures that insure inter-personal inter-jurisdictional fiscal equity in the performance of a function (fiscal equalization)

3. **Political Accountability**

Functions should be assigned to jurisdictions:

- a. That are controllable by accessible to and accountable to their residents in the performance of their public service responsibilities; (access and control)

- b. That minimize the conditions and opportunities for active and productive citizen participation in the performance of a function (citizen participation)

4. **Administrative Effectiveness**

Functions should be assigned to jurisdictions:

- a. That are responsible for a wide variety of functions that can balance competing functional interests (general-purpose character)
- b. That encompass a geographic area adequate for effective performance of a function (geographic adequacy)
- c. That explicitly determine the goals of and means of discharging public service responsibilities and that periodically reassess Programme goals in light of performance standards; (management capability)
- d. That are willing to pursue Inter-governmental policies for promoting inter-local functional cooperation and reducing inter-local functional conflict: (Inter-governmental flexibility) and
- e. That have adequate legal authority to perform a function and rely on it in administering the function (legal adequacy)

Especially, the type of functions assigned to the regional level is important. Generally the type of local government functions can be divided in⁷¹

- 1. Agency functions where the local authorities perform tasks and services without own influence (or little influence) on the level and

⁷¹ Retrieved from
<http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPUBLICSECTORANDGOVERNANCE/EXTPUBLICFINANCE/EXTTPA/0,,contentMDK:20234456~menuPK:390373~pagePK:148956~piPK:216618~theSitePK:390367,00.html>

quality of the services they carry out the functions on behalf of the central government as agent (e.g. Some types of pensions)

2. Partly agency functions and functions partly influenced by the local governments.
3. Functions where the local governments have a strong control over the services and the amount and quality of these services themselves, e.g. administration, certain health care functions and parts of the roads.

Principles of Expenditure Assignments

One way to examine the adequacy of expenditure assignments is to analyze how well the actual assignment of responsibilities fits the fundamental rules for the ideal assignment of responsibilities in a decentralized system of government.

I. No single Best Assignment

There is not any absolute best way for deciding which level of government should be responsible for particular public services. The adequacy of any assignment has to be judged in terms of how well it achieves the goals or objectives set up by the government in its decentralization strategy. "The application of these rules largely facilitates the assignment of expenditure responsibilities to different levels of the government. However the rules do not always yield an unequivocal answer. The best assignment is likely to change over time with changes in costs and technological constraints, as well as changes in preferences.⁷²" Expenditure assignment needs to be the first and fundamental step in the design of a decentralized system of Inter-governmental finances.

II. Commonly accepted objectives for fiscal decentralization include those of and efficient allocation of resources via a responsive and accountable government and equitable provision of services to citizens

⁷² Jorge Martinez-Vazquez, Intergovernmental Fiscal Relations and Assignment of Expenditure Responsibilities(2001),International Studies Programme , Andrew young school of policy studies, Georgia State University, p. 5.

in different jurisdictions and preservations of macroeconomic stability and promotion of economic growth.

III. The critical role of the efficiency criterion: The efficient provision of government services requires that government satisfy the needs and preferences of taxpayers as well as possible. This is best achieved by the "subsidiary principle". Responsibility for the provision of services should be at the lowest level of government compatible with the size of "benefit area" associated with those services. The benefit area for sanitation services is clearly the local community, but for air traffic control the benefit area is the entire national territory. Leaving the supply of public services with wider benefit areas to smaller units of government is likely to result in the inefficient under provision of services e.g. a tertiary hospital providing regional services is solely financed by single municipality. Efficiency in the provision of public services is enhanced if consumption benefits are linked to costs of provision via fees, service charges or local taxes. Public services would be provided efficiently if it is provided "by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision."⁷³ This is because;

- a) Local provision allows governments to cater better to the tastes and needs of local residents whereas central provision often results in more uniform provision.
- b) Decision making is closer to the people for whom the services are intended. This induces greater responsiveness to local concerns as well as more fiscal responsibility/accountability and efficiency at provision, especially where financing of services is decentralized as well;
- c) multiple layers of jurisdiction are eliminated and
- d) Inter-jurisdictional competition and innovation in the provision of public services are enhanced.

⁷³ Shah and Zia, **Intergovernmental fiscal Relations in Indonesia**, (2002) World Bank Discussion Paper Issues and Reform options, Washington D.C: p. 28.

- IV. The objectives of redistribution and stability best pursued by the central government. It is generally thought that expenditure Programme under taken by governments to enhance equity or for income equalization reasons such as social welfare, low income, and housing or poverty reduction Programme should be the domain of the central government. Local or regional governments will not be able to sustain Programme of this nature at the sub-national level without financial support from the central level because these Programmes will attract needy residents from other areas while they will disproportionately tax potentially mobile non-poor residents more heavily. This would result in wealthier residents feeling local governments that engage in redistributive policies.

While funding for social Programme should be a central government responsibility implementation of social policies can very well be left to local governments which may have informational and other comparative advantages. Expenditures undertaken for the stabilization of the economy such as massive investment or unemployment compensation are by their scale also naturally ascribed to the central government.

- V. Co-Sharing of Responsibilities: The actual assignment of functional responsibilities is often quite different from what it appears to be in the formal assignment established by law of practice. Take the case of education. Even though in terms of actual expenditures going through the budget, education would appear to be for the most part a local (or regional) activity, many key decisions in educational policies are carried out at the central level in many countries. More in particular the Ministry of Education may be responsible for the construction of school buildings, curriculum design, teacher training and design and production of textbooks. Activities that are preserved at the local level may be the recruitment and hiring teachers. At times the local government may be given the authority for appointing principals, school inspectors and checking specialists. However, even in these

cases local authority is limited because of the dual subordination of School officials to both the Ministry of Education and to the sub national government. In many countries in transition even the head of the regional administration is ultimately a central government appointee. Similar issues to those in the education sector rise in other sectors such as health.

- VI. Importance of a clear and Stable Assignment: The lack of clear assignment of expenditure responsibilities may be less burdensome in practical terms in centralized systems. As fiscal systems become more decentralized, the failure to establish by law a clear assignment of expenditure responsibilities for each government level can become a source of conflict between the central and sub national governments and can lead to an inefficient provision of public services. In situations where government budgets are tight which is almost always the lack of clear assignment may lead to the under provision of key public services (Shah and Zia, 2002).
- VII. Recognizing the multi-dimensional nature of expenditures: It is important to recognize that the assignment actually has a multi-dimensional component; expenditure responsibilities for (1) actually producing a good or delivering a service, (2) providing or administering the services, (3) financing a service and (4) setting standards regulations or policies guiding the provision of government services (Shah and Zia, 2002).

The assignment of local public service provision to local or area-wide governments can be based on a number of considerations. These includes economies of scale, benefits/ cost spillovers, political proximity (proximity of local administration to local residents) consumer sovereignty (voter preferences determine the level, mix and quality of public services), and economic evaluation of sectoral allocation choices. The following table presents representative assignment of major public services among different tiers of government.⁷⁴

⁷⁴ Anwar Shah, **The Practice of Fiscal Federalism , Comparative Perspectives** (2007), Forum of Federations and iacfs, London : McGill, Queen's University, pp. 14-15.

Table 1
Representative Assignment of Expenditure Responsibilities

Function	Policy, standards, and oversight	Provision and administration	Production and distribution	Comments
Interregional and international conflicts resolution	U	U	F,P	Benefits and costs international in scope
Protection of Fundamental Rights	U,N	N	N,P	Has national and global dimensions
External trade	U	U,N,S	P	Benefits and costs international in scope
Telecommunication	U,N	P	P	Has national and global dimension
Financial transactions	U,N	P	P	Has national and global dimensions
Environment	U,N,S,L	U,N,S,L	N,S,L,P	Externalities of global, national
Foreign direct investment	N,L	L	P	Local infrastructure critical
Defense	N	N	N,P	Benefits and costs national in scope
Foreign affairs	N	N	N,P	Benefits and costs national in scope
Monetary Policy, Currency, and Banking	U,ICB	ICB	ICB,P	Independence from all levels essential: some international role for common discipline
Interstate commerce	Constitution, N	N	N	Constitutional safeguards important for factors and goods mobility
Immigration	U,N	N	N	U because of forced exit
Transfer payments	N	N	N	Redistribution
Criminal and civil law	N	N	N	Rule of law, a national concern
Industrial policy	N	N	P	Intended to prevent "beggar the neighbor" policies
Regulation	N	N,S,L	N,S,L,P	Internal common market
Fiscal Policy	N	F,S,L	F,S,L,P	Coordination possible
Natural resources	F	N,S,L	N,S,L,P	Promotes regional equity and internal common market
Educational, health and social welfare	N,S,L	S ,L	S,L,P	Transfers in kind
Highways	N,S,L	N,S,L	S,L,P	Benefits and costs vary in scope
Parks and recreation	N,S,L	N,S,L	N,S,L,P	Benefits and costs vary in scope
Police	S,L	S,L	S,L	Primarily local benefits
Water, Sewer, refuse, and fire protection	L	L	L,P	Primarily local benefits

Source: Anwar Shah, Forum of Federations (2007): The Practice of Fiscal Federalism, Comparative Perspective, p. 14-15.

Note: U = Supra national responsibility, ICB = Independent Central Bank, N = national government, S = state or provincial government, L = Local government, P = Private/nongovernmental sectors or civil society.

The above table shows that a significant number of services would be suitable for two or more tiers of government. For those services, it is important to specify as clearly and precisely as possible the roles of various orders of government to avoid duplication and confusion. Such specification is usually critical for infrastructure and social services in most developing countries.

b) Revenue Assignment

Once the assignment of expenditure responsibility has been determined the second key question as: Who gets what resources? Obviously, an important determinant of the assignment of revenue sources to sub national governments is the assignment of expenditure responsibilities, giving rise to the adage; finance should follow function. "The revenue assignment acquisition as tax policy is known in the context of Inter-governmental fiscal a relation is often considered the second main pillar or building block of fiscal decentralization policy".⁷⁵

The traditional theory of fiscal federalism prescribes a very limited tax base for sub-national governments. The only "good" local taxes are said to be those (1) that are easy to administer locally (2) that are imposed solely (or mainly) on local residents and (3) that do not raise problems of "harmonization" or "competition" between sub national governments or between sub-national and national governments (Bird, 2003).

"In western democracies governments drive their revenues one of three legal powers: sharing, proprietary or regulatory. These powers are most typically granted in constitutions or charters but may also come from statutory authority or infrequently through courts orders Governments levy taxes on any of three bases-income, consumption, and wealth (or property)- to pay for the cost of their operations."⁷⁶

The generally accepted principles for the optimal assignment of revenue sources are: (World Bank, webpage)".⁷⁷

⁷⁵ Richard Bird, Sub national Revenues, Realistic and prospects (2001), International Studies Programme Andrew Young School of Policy Studies Georgia State University Atlanta, Georgia United States of America.

⁷⁶ Bland Robert, A Revenue Guide for Local Government (2005), Second Edition, International City/Country Management Association (ICMA), p. 4.

⁷⁷ Revenue Assignment principles,
<http://www.worldbank.org/publicsector/decentralization/revenue.htm> (04-01-2000)

1. Local governments' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law, i.e. adequacy of resources to cover the minimum mandatory tasks. When competencies are transferred there should be a corresponding fiscal transfer.
2. Local governments should be entitled within the national economy policy to adequate financial resources of their own. The local governments should be able to dispose these resources freely within the framework of their powers.
3. At least a share of the financial resources of local governments shall derive from local taxes and charges of which within the limits of statute, they have the power to determine the rate and or the tax base.
4. The financial systems on which resources available to local government are based shall be of a sufficiently diversified and buoyant nature to enable them to keep pace as far as practically possible with the real evolution of the costs of carrying out their task.
5. The protection of financially weaker. Local authorities call for the institution of financial equalization procedures or equivalent measures which are designed to correct the effects of the unequal distribution of potential sources of finance and of the financial burden they must support. Such procedures of measures shall not diminish the discretion local governments may exercise within their own sphere of responsibility.
6. Local authorities shall be consulted in an appropriate manner on the way in which redistributed resources are to be allocated to them.
7. As far as possible, central government grants to local governments shall not be earmarked for the financing of specific projects. The provision of grants shall not remove the basic freedom of local governments to exercise policy discretion within their own jurisdiction.

8. Revenue needs expand more rapidly than tax revenue at the local level for many taxes. Therefore it is important to identify local taxes which can follow pace with the development in the economy and expenditure needs.

Above Principles are supported by most international experts on local government finance⁷⁸ and should also be the guiding principles whenever new local government reforms and revenue sharing formulae are designed and implemented. Real decentralization of functions assumes decentralization of the revenues as well.

Therefore, an appropriate link between the structure the responsibility for the functions and their finance should be the guiding principle (standing on one leg is hard in the long term).

No universal model for local government and revenue assignment is applicable for all countries around the world and the best model depends on many other factors on:⁷⁹

- The type of local government
- The size of local government
- The type of functions they are going to perform
- The cultural context of the country historical experiences etc.
- The administrative capacity at the local level etc.

In assigning the revenue authorities the above factors needed to be considered. The type, size, functional capacity, and cultural context are important in mobilizing local revenue.

Principles of Tax Assignment

The division of revenue sources among federal and sub-national governments constitutes the tax assignment problems. Once expenditure and regulatory

⁷⁸ See e.g. in Public Finance , Theory and Practice in central European Transition, Edited by Juray and Glen Wright, 1997.

⁷⁹ Jesper Steffensen and Mikael Holm, Paper on the principles for the Finance of the Future Regions in connection with the Administrative territorial Reform in Lativa(2000), National Association of Local Authorities Denmark (NALAD)

assignments have been agreed on tax assignment and the design of transfers become critical elements in matching expenditure needs with revenue means at various orders of government. Although tax assignment can be undertaken independently of expenditure assignment a common practice in developing countries the advantage of a centralized tax administration and a decentralized provision of public services become apparent when tax assignment reflects anticipated spending. Where theoretical guidance on tax assignment is unclear, expenditure assignment can provide a powerful argument for assigning responsibility to government with the greatest need for more money. Efficiency and equity arguments have to be tempered by administrative considerations and the exact assignment depends on informed judgment. We can, however outline the economic principles that come into play in deciding which taxes to assign to what order of government.

According to Shah four general principles require consideration assigning taxing powers to various governments (Shah, 2007).⁸⁰

- First, the economic efficiency criterion dictates that taxes on mobile factors and tradable goods that have a bearing on the efficiency of the internal common market should be assigned to the national government. Sub-national assignment of taxes on mobile factors may facilitate the use of socially wasteful beggar- they- neighbor policies to attract resources to own areas by regional and local governments. In a globalize world, even the national assignment of taxes on mobile capital may not be very effective in the presence of foreign tax havens and the difficulty of tracing and attributing incomes from virtual transactions to various physical spaces.
- Second, national equity considerations warrant that progressive redistributive taxes should be assigned to the national government. This assignment limits the possibility of regional and local governments 'following perverse redistribution policies using both taxes and transfers to attract high income people and to repel low income ones. Doing so, however leaves open the possibility of supplementary flat-rate, local charges on residence-based national income taxes.

⁸⁰ Shah, op.cit. no.71, pp. 19-20.

- Third, the administrative feasibility criterion (lowering compliance and administration costs) suggests that tax should be assigned to the jurisdiction with the best ability to monitor relevant assessments. This criterion minimizes administrative costs as well as the potential for tax evasion. For example, property, land and betterment taxes are good candidates for local assignment because local governments are in a good position to assess the market values of such assets.
- Forth, the fiscal need or revenue adequacy criteria suggests that to ensure accountability revenue means (the ability to raise revenues from own sources) should be matched as closely as possible to expenditure needs. The literature also argues that long lived assets should primarily be financed by raising debt so as to ensure equitable burden sharing across generations. Furthermore, such large and lumpy investments typically cannot be financed by current revenues and reserves alone.

General Principles of Revenue Assignment

The essence of decentralization is that sub-national governments have the authority and responsibility to own finance local service at the margin. Complete fiscal autonomy over revenues requires that in principle local governments can change tax rates and set tax bases. The general principles of revenue assignment to different levels of government are listed in fiscal federalism and local government finance literatures as (Bird 2000)⁸¹:

1. The tax base assigned to sub-national governments should be immobile, in order to allow local authorities some freedom to vary rates without the base vanishing. Inter-jurisdictional mobility of tax base makes taxation of mobile factors difficult to sub-national governments.
2. Redistributive taxes should be assigned to the central government. Taxes imposed on mobile factors for redistribution purposes might result in inefficient jurisdictional allocation of the factors of

⁸¹ World Bank Institute, Intergovernmental Fiscal Relations and Local Financial Management Programme (2000) http://www.worldbank.org/whiep/decentralization/module/topic01_printer.htm. (2001/6/19)

production. Uniform redistributive taxes minimize locational distortions of economic activities.

3. Service provided by sub-national governments should to the extent possible be financed through user charges and other local fees and taxes that are related to benefit. Efficient allocation of resources requires sub national government recover their expenses from the beneficiaries of their services. Examples of benefit related revenues include taxes levied on motor vehicles and fuels and construction fees.
4. Taxes that are subject to important economies of scale in collection efforts should be centralized.
5. Taxes subject to cyclical fluctuations need to be protected by a system of counter cyclical rate adjustments in order to avoid sub-national government's exploitation of fiscal power.
6. Taxes levied on tax bases that are unevenly distributed should be centralized. Uneven distribution of tax bases among sub-national governments forces the residents of one sub-national area bear the economic burden of taxes imposed by another jurisdiction. Taxation of natural resources is the best example of this type of taxation practice.
7. The revenue yield should be stable and predictable over time.
8. The revenue system should be easy to administer efficiently and effectively.
9. Sub-national taxes should be visible to encourage sub-national government liability.

Tax assignment depends on the tiers of government, revenue potentiality, administrative capability and allocation efficiency. There are different models of tax assignment in the world. Horizontal and vertical fiscal balance is important and critical in assigning taxing power. Table 2 gives general idea about taxing powers among different tiers of government.

Table 2
A representative assignment of taxing power⁸²

Types of Tax	Determination of base	Determination of rare	Collection and administration	Comments
Customs	F	F	F	International trade taxes
Corporate income tax	F,U	F,U	F,U	Mobile factors, stabilization tool
Resource taxes				
Resource rent (Profits and income) tax	F	F	F	High, unequally distributed tax bases
Royalties, fees, charges, severance taxes, and production, output and property taxes	S, L	S, L	S, L	Benefit taxes and charges for state-local services
Conservation charges	F	S,L	S,L	Intended to preserve local environment
Personal income tax	F	F,S,L	F	Redistributive, mobile factors, stabilization tool
Wealth taxes (Taxes on capital, wealth, wealth transfers, inheritance and bequest)	F	F,S	F	Redistributive
Payroll tax	F,S	F,S	F,S	Benefit charge, such as social security coverage
Multistage sales taxes (value added tax)	F	F	F	Border tax adjustments possible under federal assignment, potential stabilization tool
Single stage taxes (manufacturer, wholesale, and retail)				
Option A	S	S,L	S,L	Higher compliance cost
Option B	F	S	L	Harmonized, lower compliance cost
"Sin" Taxes				

⁸² Shah., op.cit. no. 71, p. 22-23.

Excises on alcohol and tobacco	F,S	F,S	F,S	Health care a shared responsibility
Betting and gambling taxes	S,L	S,L	S,L	State and local responsibility
Lotteries	S,L	S,L	S,L	State and local responsibility
Racetrack taxes	S,L	S,L	S,L	State and local responsibility
Taxation of "bads"				
Carbon tax	F	F	F	Intended to combat global or national pollution

Energy taxes	F,S,L	F,S,L	F,S,L	Pollution impact may be national, regional or local
Motor fuel tolls	F,S,L	F,S,L	F,S,L	Tolls on federal, provincial and local roads
Effluent charges	F,S,L	F,S,L	F,S,L	Intended to deal with interstate, intermunicipal or local pollution issues
Congestion tolls	F,S,L	F,S,L	F,S,L	Tolls on federal, provincial and local roads
Parking fees	L	L	L	Intended to control local congestion
Motor Vehicles				
Registration, transfer taxes, and annual fees	S	S	S	State responsibility
Driver's License and fees	S	S	S	State responsibility
Business tax	S	S	S	Benefit tax
Excises	S, L	S, L	S, L	Residence based taxes
Property tax	S	L	L	Completely immobile factor, benefit tax
Land tax	S	L	L	Completely immobile factor, benefit tax
Frontage and betterment taxes	S,L	L	L	Cost recovery
Poll tax	F,S,L	F,S,L	F,S,L	Payment for local services
User Charges	FSL	FSL	FSL	Payment of services received

Source: Anwar Shah (2007): The Practice of Fiscal Federalism.

Note: U=Supranational agency, F=federal, S= State or province, L=Municipal or local government

c) **Inter-governmental Fiscal Transfer**

Since revenue assignment often does not provide regional and local governments with sufficient revenues to fund their expenditure functions, inter-governmental transfers are often necessary to assure revenue adequacy. Transfers are grants from one level of government to another (often from higher to lower) for the purpose of funding government activities. The term 'Transfer' is often used interchangeably with the term 'grant'. In some countries transfers may also be known under different names, such as "subventions" or "subsidies".

After the objectives are set the next step in designing a system of inter-governmental transfers is to structure the horizontal and vertical dimensions of the transfer. In fact, every inter-governmental transfer has two dimensions: the first is the vertical dimension, the distribution of revenues between the central and local government. The second is the horizontal dimension, the allocation of transfers among the recipient units (WBI, 2003).⁸³

Inter-governmental transfers are the dominants, sources of revenues for sub-national governments in most developing countries. Central transfers finance 85 percent of sub-national expenditures in South Africa, 72 percent of provincial and 85 percent of local expenditures in Indonesia, 67 to 95 percent of state local expenditures in Nigeria and 70 to 90 percent of expenditures in less prosperous states in Mexico. The design of these transfers is of critical importance for efficiency and equity of local public services provision and the fiscal health of sub-national governments (Shah, 1994).⁸⁴

Kim and Paul, (2005) highlights the Inter-governmental fiscal transfers and emphasizes that it is an important tool of public sector finance in both industrialized and developing countries for three principal reasons. First, central governments have advantages over sub national governments in raising revenue from many types

⁸³ Intergovernmental Fiscal Relations & Local Financial Management Programme
<http://www1.worldbank.org/whiep/decentralization/topic08.3.htm>, 2001-06-19.

⁸⁴ Anwar Shah, The reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economics, Policy and Research series, 1994, p. 24.

particularly productive sources, while sub national governments have advantages in providing many types of public services. This reality invariably results in a mismatch between the costs of expenditures that sub national governments are expected to undertake and the resources locally available to them.

Second, there are often substantial disparities in revenue-raising capacity across decentralized levels of government. If sub national governments were left to rely exclusively on their own resources, wealthier jurisdictions would be able to spend more on public services than lower-income jurisdictions. Such a situation has not only equity implications but efficiency implications as well. If decentralized governments are responsible for infrastructure and services that are essential production inputs, areas with lower resource levels may be unable to support local economic development.

Third, resources from the central level can be used to ensure that basic national priorities will be met in all sub national jurisdictions. Typical priority sectors include health and education, but often extend to roads, water, and other services. Providing these services may promote both efficiency (if externalities are involved) and equity, and also support poverty reduction efforts.

Taxonomy of Grants

For the purpose of economic analysis grants can be broadly classified as non-matching and matching. Non-matching transfers may be either conditional (selective) offer a set amount of funds without local fund matching, provided the funds are spent for an established purpose. Such transfers ensure that the recipient government spending on the specified category will be at least equal to the amount of the grant. If the recipient is already spending an amount equal to the grant funds, some or all of the grant funds may be diverted to other uses. In theory, the fungibility of funds, increase in expenditures difference between the grant and the prior local expenditures. In practice, because of the lumpiness investments in areas such as infrastructure as well as other factors, expenditures often do exceed the amount of grants.

General or unconditional non matching grants attach no constraints on how the grants are spent and unlike the case with conditional grants; no minimum expenditure in any area is expected. Because the grant can be spent on any combination of public goods

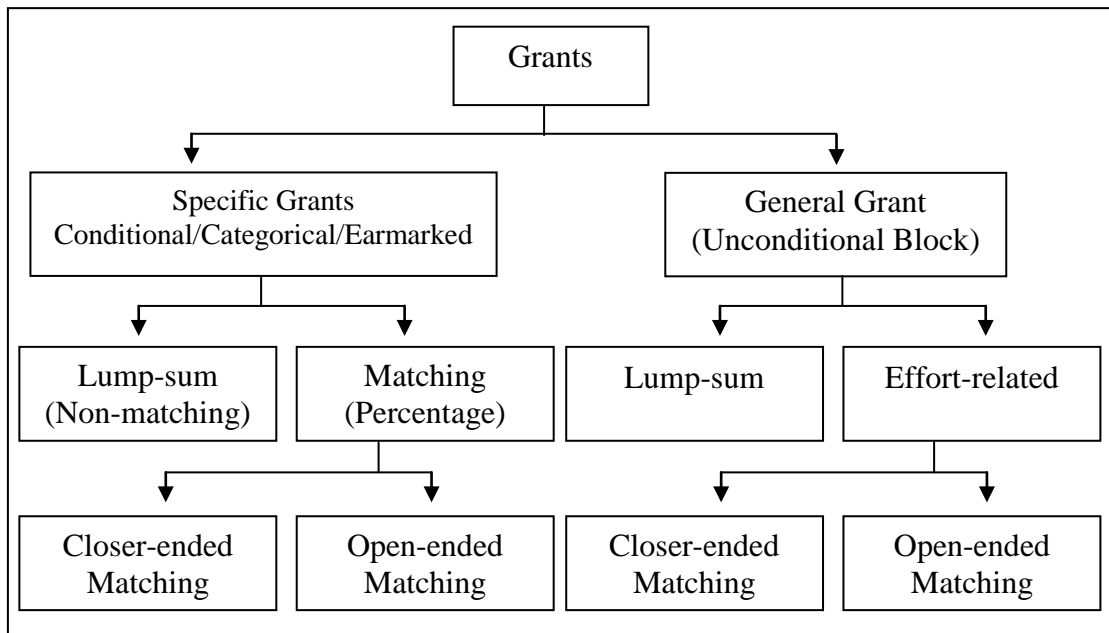
or services or to provide tax relief to residents general non-matching assistance does not modify relative prices and is the least stimulate of local spending. Matching grants or cost-sharing Programmes are conditional transfers that require funds be spent for specific purposes and that the recipient match the funds to some degree. Such transfers have two effects: an income effect; as the subsidy give the community more resources, some of which may go to acquire more of the assisted services and a price or substitution effect as the subsidy reduces the relative price of the assisted service, allowing the community to acquire more for a given budget. Both effects stimulate expenditures on the assisted category. Such transfers can be open-ended (no limit on matching funds) or closed-ended. Matching transfers may distort local priorities and be considered inequitable in that richer jurisdictions can raise matching funds more easily. But the second effect can be offset, if desired by adjusting matching rates to jurisdictional wealth. The first effect-distorting local priorities may be the desired outcome when the transfer is intended to internalize spillovers or achieve overriding national policy objectives (for example family planning Programme).

A Typology of Inter-governmental Grants

In Typology of grants given below; it is assumed that the grants are paid by central government (the grantor) to local government (the grantee) in order to stimulate the provision of services. Hence the term 'grants-in-aid' is used.⁸⁵

⁸⁵ Stephen J. Bailey, **Local Government Economics**, Principles and Practice (1999) Basingstoke and London: Macmillan Press Ltd. , pp. 180-181.

Inter-governmental Grant



A Typology of Inter-governmental Grants

Specific grants are paid in respect of specific services and can only be spent on that service. They are, therefore, also referred to as conditional categorical or earmarked grants. They may be used to finance services which local authorities provide on behalf of central government to encourage provision of services with sustainable spillover effects or to finance a minimum standard of service requested by central government.

General grants can be used to finance the broad range of services provided by local authorities as long as their activities are not ultra virus. They are, therefore, also referred to as unconditional or block grants. They are often used to achieve horizontal and vertical equity through financial equalization schemes.

Both general and specific grants are sometimes paid to local governments for example where a specific grant is paid in respect of municipal housing and social services leisure and recreation and so on. Specific grants can be lump-sum (that is of fixed amount) or matching (where the grant forms a given percentage of the local governments spending for example 35 percent). There may however be an upper limit on the amount of grant that can be levered by the local government in which case it is a close ended grant. If there is no such limit it is open-ended. Similarly, general grants

may be lump-sum or effort related. Which a matching specific grant matches expenditure on the specific grant-aided service, the effort of the local authority. Revenue effort is usually measured in terms of tax effort; the greater the revenue raised from local taxes, the more grant the local authority receives. Again grant may be open-ended or closed ended according to whether or not central government wishes to avoid too stimulatory an impact on local government expenditure.

Economic Rationale for Transfers

There are five broad economic arguments for central-state transfer, each based on efficiency or equity and each applying in varying degrees in different countries.⁸⁶

1. The Fiscal gap: An imbalance between the revenue raising ability of sub-national governments and their expenditure responsibilities (the vertical imbalance) might arise for two reasons. First, there may be an (often inappropriate) assignment of taxing and spending responsibilities that put the expenditure needs of sub-national governments above their revenue means. Second many taxes are more efficiently collected at the central level, to avoid tax competition and interstate tax distortions, so transfers are necessary to enable local levels to carry out their expenditure responsibilities.
2. Fiscal Inequity. A country that values horizontal equity (the equal treatment of all citizens nationwide) will need to correct the fiscal inequity that naturally arises in a decentralized system. Sub-national governments with their own expenditure and taxation responsibilities will be able to provide different levels of services to their residents for the same fiscal effort owing to their differing fiscal capacities. If desired, these differences may be reduced or eliminated by tying the transfers to each jurisdiction to relative tax capacity and to the relative need for and cost of providing public services.
3. Fiscal inefficiency. The argument for such transfers is reinforced by the fact that the same differentials that give rise to fiscal inequality also

⁸⁶ Jennie Litvack and Jessica Seddon , op.cit.23 p. 28-29.

cause fiscal inefficiency. The regional differentials in levels of service received for a given fiscal effort can influence business and investment decisions, possibly leading to a less inefficient allocation of resources.

4. Interstate Spillovers. Normally, sub-national governments will not have the proper incentive to provide the correct services that yield spillovers across jurisdictions. In theory, a system of matching grants based on expenditures that give rise to spillovers will provide the incentive to increase expenditures. In practices, the extent of the spillovers will be difficult to measure so the matching rate selected will be somewhat arbitrary.
5. Fiscal harmonization. To the extent the redistribution is a goal of the central government there is a national interest in the redistribution that occur as a result of the provision of public services by sub-national governments. Expenditure harmonization can be accomplished by the use of (non-matching) conditional grants; provided that the conditions reflect national efficiency and equity concerns and that a financial penalty is associated with failure to comply. In choosing such policies there will always be a tradeoff between uniformity which may encourage the free flow of goods and factors, and decentralization, which may encourage innovation, efficiency, and accountability.

Criteria for the design of inter-governmental fiscal arrangements⁸⁷

1. Autonomy: Sub-national governments should have complete independence and flexibility in setting priorities and should not be constrained by the categorical structure of Programme and uncertainty associated with decision making at the centre. Tax base sharing-allowing sub-national governments to introduce own tax rates on central bases, formula-based revenue sharing or block grants-is consistent with this objective.

⁸⁷ Shan Anwar, **Intergovernmental Fiscal Relations in Developing and Emerging market Economics (1994), Policy and Research**, No. 23, Washington D.C. : The World Bank., p. 30.

2. Revenue adequacy: Sub-national governments should have adequate revenues to discharge designated responsibilities.
3. Equity: Allocated funds should vary directly with fiscal need, factors and inversely with the taxable capacity of each province.
4. Predictability: The grant mechanism should ensure predictability of sub-national governments shares by publishing five-year projections of funding availability.
5. Efficiency: The grant design should be neutral with respect to sub-national government choices of resource allocation to different sectors or different types of activity.
6. Simplicity: The sub-national government's allocation should be based on objective factors over which individual units have little control. The formula should be easy to comprehend so that "grants man ship" is not rewarded as appears to occur with plan assistance in India and Pakistan.
7. Incentive: The proposed design should provide incentives for sound fiscal management and discourage inefficient practices. There should be no specific transfers to finance the deficits of sub-national governments.
8. Safeguard of granters objectives: The grant design should ensure that certain well-defined objectives of the grantor are properly adhered to by the grant recipients. This is accomplished by proper monitoring, joint Programme reviews and providing technical assistance, or by designing a selective matching transfer Programme.

The various criteria specified above could be in conflict with each other and therefore a grantor may have to assign priorities to various factors in comparing policy alternatives.

Guidelines for Grant Design

The design of fiscal transfers is critical to ensuring the efficiency and equity of local service, provision and the fiscal health of sub-national governments. A few simple considerations can be helpful in designing these transfers:⁸⁸

1. Clarity in grant objectives: Grant objectives should be specified clearly and precisely.
2. Autonomy: Sub-national governments should have complete independence and flexibility in setting priorities.
3. Revenue adequacy: Sub-national governments should have adequate revenues to discharge designated responsibilities.
4. Responsiveness: The grant Programme should be flexible enough to accommodate unforeseen changes in fiscal situation of the recipients.
5. Equity (fairness): Allocated funds should vary directly with fiscal-need factors and inversely with the tax capacity of each jurisdiction.
6. Predictability: The grant mechanism should ensure predictability of sub-national government's shares by publishing five-year projections of funding availability. The grant formula should specify ceiling and floors for yearly fluctuations. Any major changes in the formula should be accompanied by hold harmless or grandfathering provisions.
7. Transparency: Both the formula and the allocations should be disseminated widely in order to achieve as broad a consensus as possible on the objectives and operation of the Programme.
8. Efficiency: The grant design should be neutral with respect to sub-national government's choices of resource allocation to different sectors or types of activity.

⁸⁸ Shah., op.cit. no. 71, p. 26-27.

9. Simplicity: Grant allocation should be based on objective function over which individual units have little control. The formula should be easy to understand so as not to reward grantmanship.
10. Incentive: The design should provide incentives for sound fiscal management and should discourage inefficient practices. Specific transfers should not be made to finance sub-national government deficits.
11. Reach: All grant financed Programme create winners and loser. Consideration must be given to identifying beneficiaries and those who will be adversely affected in order to determine the overall usefulness and sustainability of the Programme.
12. Safeguarding the grant's objectives: The grantor's objectives are best safeguarded by having grant conditions specify the results to be achieved (output-based grants) and by giving the recipient flexibility in the use of funds.
13. Affordability: The grant Programme must recognize donor's budget constraints. This suggests that matching Programme should be closed ended.
14. Singular focus: Each grant Programme should focus on a single objective.
15. Accountability for results: The granter must be accountable for the design and operation of the Programme. The recipient must be accountable to the grantor and its citizen's voice and exit options in grant design can help advance bottom-up accountability objectives.

Objectives for National Fiscal Transfers

Six broad objectives for national transfer can be identified.⁸⁹ Each of these objectives may apply to varying degrees in different countries, and calls for a specific design of fiscal transfer. Lack of attention in these designs to specific objectives leads to negative perceptions of the grants.

1. Bridging vertical fiscal gaps: The terms vertical fiscal gap and vertical fiscal imbalance have been mistakenly used interchangeably in recent literature on fiscal decentralization. A vertical gap is defined as the revenue deficiency arising from a mismatch between revenue means and expenditure needs, typically of state and local orders of government. A national government may have more revenues than warranted by its direct and indirect spending responsibilities while regional and local governments may have less revenue than their expenditure responsibilities.

A vertical fiscal imbalance occurs when the vertical fiscal gap is not adequately addressed by the reassignment of responsibilities or by fiscal transfers and other means. Broadway argues that vertical fiscal imbalance incorporates an ideal or optimum view of expenditures by different orders of government and is therefore difficult to measure.

A vertical fiscal gap may arise due to (a) inappropriate assignment of responsibilities (b) centralization of taxing powers (c) pursuit of beggar-thy-neighbor tax policies (wasteful tax competition) by sub-national governments, or (d) Lack of tax room at the sub-national orders due to nearer tax burdens imposed by the national government.

2. Bridging the fiscal divide through fiscal equalization transfers: Fiscal equalization transfers are advocated to deal with regional fiscal equity concerns. These transfers are justified on political and economic considerations. Decentralized decision making results in differential net fiscal benefits (imputed benefits from public spending minus tax

⁸⁹ Ibid, pp. 28-31.

burden) for citizens depending on the fiscal capacities of their place of residence. Fiscal equalization Programme equalizes fiscal capacity (the ability to raise revenues from own basis using national average tax rate) to a national average standard and it provides compensation for differential expenditure needs and costs due to inherent cost disabilities rather than differences that reflect different policies.

3. Setting national minimum standards: Setting national minimum standards for regional and local services may be important for two reasons. First there is an advantage to the nation as a whole from such standards which contribute to the free flow of goods, services, labor and capital; reduce wasteful inter-jurisdictional expenditure competition; and improve the gains from trade from the internal common market. Second, these standards serve national equity objectives. Many public services provided by the sub-national governments such as education, health, and social welfare are redistributive in their intent providing in-kind redistribution to residents. In a federal system state and or local provision of such services-while desirable for efficiency preference matching and accountability-creates difficulty fulfilling federal equity objectives.
4. Compensating for benefit spillovers: Compensating for benefit spillovers is the traditional argument for providing matching conditional grants. Regional and local governments will not face the proper incentives to provide the correct levels of services that yield spillover benefits to residents of other Jurisdictions. A system of open-ended matching grants based on expenditures giving rise to spillovers will provide the incentive to increase expenditures. Because the extent of the spillover is usually difficult to measure the matching rate will be somewhat arbitrary.
5. Influencing local priorities: In a federation there is always some degree of conflict among priorities established by various orders of government. One way to induce state and local government is for the

national or state government to use its spending power by providing matching transfers. The national or state government can provide open-ended matching transfers with a matching rate that varies inversely with the recipient's fiscal capacity. The use of ad hoc grants or open-ended matching transfer is inadvisable. Ad hoc grants are likely to result in behavioral responses that are not consistent with the grantor's objectives. Open-ended grants may create budgetary difficulties for the granter.

6. Dealing with infrastructure deficiencies and creating macroeconomic stability in depressed regions: Fiscal transfers can be used to serve national government objectives in regional stabilization. Capital grants are appropriate for this purpose, provided funds for future upkeep of facilities are available. Capital grants are also justified to deal with infrastructure deficiencies in poorer jurisdictions in order to strengthen the common economic union.

Capital grants are typically determined on a project-by-project basis. Indonesia took a planning view of such grants in setting a national minimum standard of access to primary school (within walking distance of the community served) for the nation as a whole. The national government provided capital grant for school construction, while local governments provided land for the schools. Experience with capital grants shows that they often create facilities that are not maintained by sub-national governments which either remain unconvinced of their utility or lack the means to provide regular upkeep.

Inter governmental transfer as a share of Local Government revenues varies in Developing and OECD countries. Following tables illustrate this well.

Table 3**Inter-governmental Transfer as share of Local Government Resources in Developing Countries"⁹⁰**

Transfers as a percentage of total local revenues	Countries
10-20	South Africa
20-30	Kazakhstan, Chile
30-40	India
40-50	Argentina
60-70	Indonesia, Brazil, China
70-80	Poland, Uganda

There is no single acceptable criterion. The following table shows the share in OECD countries⁹¹

Table 4**Inter-governmental Transfer as a share of Local Government Revenues in OECD countries in 2000**

Transfer as a % of total local revenues	Countries (listed in ascending order of the share of transfers)
10-20	Finland, Sweden, New Zealand
20-30	Canada, Austria
30-40	France, Japan, Australia, USA
40-50	Ireland, Norway, Belgium, Germany
50-60	Spain
60-70	Greece, Portugal,
70-80	Italy, UK, Netherlands

⁹⁰ Shah Anwar (etd.), **Local Governance in Developing Countries**, (2006), Washington D.C.: The World Bank, p. 47.

⁹¹ Ibid.

d) Local Borrowing

Financial decentralization allowing sub-national governments to access capital markets directly is an important complement to the devolution of fiscal powers to regional and local authorities. "If properly designed decentralization of borrowing powers can add to the gains in efficiency and governance expected from fiscal decentralization, implementing financial decentralization therefore should receive equal priority in the design of Inter-governmental fiscal relations."⁹²

Local government's fiscal balance can be defined as the difference between its expenditure responsibilities on one hand and its own source and transfers on the other hand. If for any local government expenditure needs are not properly balanced with the resources available to it this could result in sub national deficits and the incurrence of debt, of course, just like central government debt, the incurrence of sub national debts by sub-national governments would have the potential of driving up interest rates and crowding out private sector investments. Since this would have important ramifications for macroeconomic conditions and the ability of the central government to rely on fiscal policy as a tool to manage macroeconomic conditions, central government often require sub-national governments to balance their budgets or tightly regulate their ability to hold debt.

Access to Financial markets Important?

There are three primary reasons why access to financial markets is considered important for sub-national governments.⁹³

- i. Financing capital expenditure - Sub-national governments often have responsibility for public investments that are lumpy in nature. Financing such capital investment increases in current taxes would be insufficient. In addition because the benefits of such public investments often last over several decades, equity considerations would suggest future generations participate in the financing. Capital markets provide this inter-temporal link.

⁹² Jennie Litvack and Jessica Seddon, op.cit 23. P 37

⁹³ Ibid P 32.

- ii. Matching expenditure and tax flows- Within a particular fiscal year, expenditures incurred and tax intake may not be fully synchronized. Access to financial markets offers an opportunity to smooth out these mismatches.
- iii. Fostering political accountability- The pricing of capital by markets may provide an independent mechanism to foster political accountability. Markets may signal the poor performance of sub-national governments through increases in interest rates or simply by blocking access.

There are at least four channels through which sub-national governments can access capital markets.⁹⁴

- i. Direct borrowing by central government and on-lending to sub-national tiers.
- ii. Through a public intermediary such as financial parastatal.
- iii. Direct borrowing from capital markets.
- iv. Through market decentralization of public services where possible.

In ascertaining the merits of one channel over the other, policy makers need to consider several factors. The channel selected should minimize or eliminate the inefficient political allocation of credit. Any implicit liability by an upper-tiers government should be explicitly recognized and reduced or eliminated. Finally, selection should be made with a view toward strengthening capital markets.

The real challenge for inter-governmental fiscal reformer is to develop an appropriate spectrum of options to finance capital investment from grants and subsidized loans for poorer sub-national governments and non self-financing projects to various types of loans and bonds for fiscally sound sub national governments and self financing projects. As with grants, the approach that a central government takes towards enhancing sub-national government access to loans depends on the fiscal context as

⁹⁴ Ibid, p. 33.

dose the extent to which these efforts pose a danger to macroeconomic stability (ADB 2002).⁹⁵

Debt Ceilings:

Debt ceilings are limitations that are put on the total borrowing of a sub-national government and are usually expressed in one of two ways:⁹⁶

- A maximum amount of outstanding debt as some multiple of the annual revenues of the local government; or
- A maximum amount of annual debt service keyed to one of several indications of local governments revenue collections. This is the most common form of debt ceiling and four different ways of fixing the annual debt service ceiling;
 - (a) A percentage of total local revenues (including central government transfers)
 - (b) A percentage of locally collected revenues;
 - (c) A percentage of local tax based (or of the local property tax base);
 - (d) A percentage of a central government transfer (usually a shared tax)

2.2.4 Implementing rules of Fiscal Decentralization

Fiscal decentralization is a precondition for effective decentralization as well as for services delivery by the sub-national government. Being inter-governmental fiscal relations fiscal decentralization requires clear, implementable and transparent rules to be followed by the all tiers of governments.

⁹⁵ Paul Smoke (edt.), *Intergovernmental Fiscal Transfers in Asia, Current Practice and Challenges for the Future* (2002), Manila Philippines: Asian Development Bank , pp. 51-52.

⁹⁶ Ibid, p. 53.

There are many analyses of fiscal decentralization as a policy strategy. Most focus on evaluating the decentralization experience around the world, and looking for the much between theory and practice. There has been much less attention given to implementation strategies. Suggested twelve implementation rules of fiscal decentralization as follows:⁹⁷

1. Fiscal decentralization should be viewed as a comprehensive system.
2. Finance follows function
3. There must be a strong central ability to monitor and evaluate decentralization
4. One Inter-governmental system does not fit the urban and rural sector
5. Fiscal decentralization requires significant local government taxing powers
6. Central governments must keep the fiscal decentralization rules that they make
7. Keep it simple
8. The design of the Inter-governmental transfer system should match the objectives of the decentralization reform
9. Fiscal decentralization should consider all the levels of government
10. Impose a hard budget constraint.
11. Recognize that Inter-governmental systems are always in transition and plan for this.
12. There must be a champion of fiscal decentralization.

⁹⁷ Roy Bahl ,Fiscal Decentralization: Twelve Implementation Rules (2001),Georgia: Georgia State university, PP 2-12.

Roy (2002)⁹⁸ has categorized the conditions for a system of fiscal decentralization as:

Necessary conditions:	Desirable conditions:
Elected local council	Freedom from excessive central expenditure mandates
Locally appointed chief officers	Unconditional
Significant local Government expenditure responsibilities	Transfers from Higher-level government
A hard budget constraint	Borrowing powers.
Significant local Government discretion to raise revenue	
Budget autonomy	
Transparency	

2.2.5 International Experiences in Fiscal Decentralization

Fiscal Decentralization covers the financial autonomy and authority in its four components explains in section 2.2.3 of this study. In this section, tax system as well as revenue generation part, expenditure authority and fiscal transfer system is reviewed and discussed.

Decentralization has been practiced differently in different countries of the world. There is no "one size fits all" model for decentralization. Fiscal decentralization can view as the fuel of decentralization. There are layers of government both in the federal and unitary countries. Fiscal decentralization is the Inter-governmental fiscal relations between the tiers of the government. Expenditure assignment, revenue assignment, Inter-governmental fiscal transfer and local borrowing are the main components of the fiscal decentralization. Based on the assigned tasks to the lower levels of governments fiscal resources are needed to perform the given tasks. Transferring fiscal revenues in order to ensure that sufficient revenues are available for the equal provision of public services is the most critical arrangement under fiscal decentralization. The vertical and horizontal fiscal balance is the precondition in designing the decentralized governance.

⁹⁸ Ibid, p. 3.

The constitutional provision, legal mandates and the efficiency in services at local level are basis of fiscal decentralization in any country. Both the federal and the unitary countries have been adopted fiscally developed system of governance in different ways. The degree of devolved fiscal resources is varied country to country. We cannot generalize country context, capacity and the level of services delivery by the lower levels of government. For the general introduction of fiscal decentralization the practice of fiscal decentralization in some selected countries will be highlighted here.

2.2.5.1 Fiscal Decentralization in African Countries

In this section, fiscal decentralization of some African countries (centre, north, south, east and west) are discussed and reviewed.

The view of decentralization in African governments seems to fluctuate between regarding it as a technique of administrative organization and –more rarely– as a genuine long-term policy. If decentralization is a policy, it can help to change the operation of existing political systems. In practice, decentralization in Africa has most often been conceived and implemented as an administrative technique. Indeed, when colonial powers controlled most of Africa, they often sought to disrupt traditional ties in order to consolidate their centralized power. Local government finance comes from two main sources-local taxes and state grants. In some places, local governments share local tax revenues with the central government. The state also makes financial transfers to local governments in the form of conditional or unconditional grants, and other types of state financial contributions. The specific method of funding local development varies from country to country. The capacity to mobilize "own revenues" is one of the fundamental principles of decentralization.⁹⁹

Legislation allows African local governments to raise panoply of resources in their own territory from direct or indirect local tax revenues, service tax, fees collected from the operation of services, economic activities or municipal assets management. Unfortunately, the law does not always list the necessary local government taxing

⁹⁹ Mustapha Ben Letaief, Charles Nach Mback, Jean-Pierre Elong Mbassi and Briam Owens Ndiaye, *Decentralization and local democracy in the world* (2008), USA : A Co-publication of the World Bank and United Cities and Local Governments, p. 28.36.

powers to alter the volume of their revenues; which means that municipal incomes generally regarded as "own resources" are in fact controlled by central government.¹⁰⁰

Local governments in Anglophone countries generally enjoy broader taxing powers and greater freedom to set rates and other indirect local tariffs; such as real estate's tax in Ghana, South Africa, Tanzania, Zambia and Zimbabwe, and service fees in the afore-mentioned countries and Nigeria. Nonetheless, local taxation in some countries is negligible (e.g. Nigeria and Uganda, where tax revenue as a percentage of total revenue dropped from 30% to 11% in five years after the removal of more productive "graduated tax"). Local government powers to create indirect duties or tariffs on local activities are also exceptional (e.g. in Zambia and Mozambique). It is however, necessary to relativist the importance of these local taxing powers, bearing in mind the decisive control of central governments over revenue mobilization (such as the prior approval required for rates and tariffs in Zambia), the low level of own source revenues (see the case of Ghana in figure 1) and the percentage of own revenues making up a small share of the whole budget (30% on average, except in Zambia - 77%- and South Africa -90%).¹⁰¹

The level of government responsible for collecting the revenues also varies between countries: In some locations the municipalities ensure the collection of taxes, while in others the state collects the taxes and later distributes the revenues among local governments. African francophone tax revenue systems are generally centralized, although some duties may be collected locally (e.g. Mail, Morocco, Senegal) and some countries may present certain exceptions to this rule (as is the case in Tunisia for the collection of certain taxes). However, regardless of the system in place the tax collection rates remain low in all the countries: approximately 50% in Kenya; lower still in Nigeria; 20% of real estate taxes in Tunisia (collected at the local level); and between 45-50% on average in Cote d'Ivoire or Niger (where the state ensures the collection of revenues).¹⁰²

In recent years, most Sub-Saharan African countries have been improved in

¹⁰⁰ Mustapha Ben Letaief, Charles Nach Mback, Jean-Pierre Elong Mbassi and Briam Owens Ndiaye, *Decentralization and local democracy in the world* (2008), USA : A Co-publication of the World Bank and United Cities and Local Governments, p. 28.36. p. 38.

¹⁰¹ Ibid.

¹⁰² Ibid.

comprehensive reforms of their public administrative systems, focusing on decentralization as major tools to improve efficiency in public service delivery and strengthen involvement of citizens in decision-making processes. Uganda has made fundamental changes in the organization of the public sector and the system of service delivery by embarking on radical decentralization.¹⁰³

Local government in Uganda is a multitier system with the district, city council and municipalities as units under which are lower local government structures and administrative units. Local governments are responsible for primary education, medical and health services, water services, road services, sanitary services, agricultural ancillary field services, setting service delivery standard, planning and cities management etc.¹⁰⁴

The revenue of local government comprises graduated tax (approximated income and wealth tax), property tax, user fees and charges, licenses and other revenue in Uganda.

Fiscal transfers are by far the most important local government revenue source. According to article 193 of the constitution, grants are typically classified as unconditional, conditional and equalization grants. In 2004/05 budget the composition of the grants was as follows:¹⁰⁵

Grant type	Amount in US billion
Unconditional Grants	87.5
Conditional Recurrent Grants	527.0
Conditional Development Grants	187.4
Equalization Grants	3.5
Total	805.4

According to article 155 of the 1995 constitution subject to the provisions of this constitution and with the approval of the government, a local government may, for the

¹⁰³ Jesper Steffenson, *Local Government Organization and Finance : Uganda, Local Governance in Developing Countries* (2006), Edited by Anwar Shah, Washington D.C.: The World Bank, 2006), p. 93.

¹⁰⁴ Ibid, p 95.

¹⁰⁵ Ibid, p. 98.

carry out of its functions and services borrow money or accept and use any grants or assistance as parliament shall prescribe (cited by Steffensen).

The constitution assumes, implies and requires generally a cooperative relationship between spheres in South Africa. The constitution institutionalizes the role of organized local government. Local government functions are provisional in the constitution (cited by Heymans, 2006).

In South Africa, local government expenditure accounts almost one fifth of government expenditure. The basis for local expenditure assignments is the constitution which assigns functions to be shared between spheres of government. Schedules 4B and 3B set out a wide range of functions to be shared between spheres. Function not listed in these schedules is the sole responsibility of the national government.¹⁰⁶

Local governments in South Africa are exclusively empowered to impose property rates and surcharges on fees for services provided by or on behalf of the municipality. They are, however, prohibited from imposing income, value added or general sales tax or customs duties. In addition, national legislation could enable specific categories of local government to impose other taxes, levies and duties.

In aggregate, 10 to 16 % of municipal expenditure is financed through Inter-governmental transfers, but this range disguises significant variance between larger urban municipalities and other. The national direct transfers to local government in 2004/05 and 2005/06 are 16.9 and 16.3 billion respectively (Heymans, 2006).¹⁰⁷ The constitution allows municipalities to borrow, within a regulatory environment provided by the national government.

Grants are organized in many ways, and also vary from country to country. Similarly, the process of transferring grant funds varies. In general, transfers can be unconditional (local governments are given free use of revenues), or conditional, in which case central government transfers are either based on pre-established objective criteria or have a certain margin of direction (for local spending). The principles of

¹⁰⁶ Ibid, op.cit. no. 57, p. 39-40.

¹⁰⁷ Ibid, p. 39-40.

Inter-governmental transfers are sometimes listed in the Constitution. Apart from practical difficulties, this system has increased the financial dependency of local governments on central government. The 1999 Constitution in Nigeria provides that at least 13% of the country's revenue accruing to the Federation Account derived from natural resources should be distributed among the states, based on a sharing formula that takes the principle of origin into account (in relation to the volume of production of each state). Sometimes the law provides a formula for grant allocation. One of the best examples is that of South Africa governed by articles 213 and 214 of the Constitution. All money received by national government is paid into the National Revenue Fund (art. 213).

Global transfers offer local governments more freedom over spending, though the allocation criteria are usually vague, as in the case of Algeria, Tunisia, Gabon, Guinea, Cote d'Ivoire, Senegal and also in Kenya (where the global transfers are combined with a sectoral grant for road works). In Algeria, the allocation of the solidarity fund grant (95% of the resources from this fund) is managed with clear eligibility criteria: for communities where wealth indices are lower than the national average. Finally, there are countries that do not have organized system transfers: in Niger and Togo, Inter-governmental transfers are intermittent and dependent on the political situation. Similarly, particularly in UEMOA (West Africa Economic and Monetary Union) and CEMAC (Economic and Monetary Community of Central Africa) countries, governments are often resistant to decentralizing the financial resources in keeping with the sectoral policies that absorb, even so, large flows of aid and public investment.¹⁰⁸

Two indicators usefully measure the financial significance of local government: the share of the nation's Gross Domestic Product (GDP) allotted for local authorities, and the actual amount of money that comes under the control of local governments. A World Bank study on the experience of decentralization in 30 African countries revealed that expenditure controlled by local governments is around 10% in South Africa, between 5 and 10% in Nigeria, Uganda and Zimbabwe and between 3 and 5% in Kenya, Ghana, Senegal, Mozambique and Zambia. Generally speaking, the average ratio between local expenditure and national budget resources excluding donations is

¹⁰⁸ Ibid, p. 41.

below 5% and the ratio between local expenditure and gross domestic product (GDP) less than 1%. In addition, with the exception of South Africa and North Africa, local governments resort to borrowing in other countries is at a very early stage.¹⁰⁹

2.2.5.2 Fiscal Decentralization in Asia-Pacific Countries

In this section fiscal decentralization of Asia Pacific countries are reviewed where Australia (HDI rank – 3) and Pakistan (HDI rank – 134) are also included.

The Asia-Pacific region comprises an enormous variety in the size of nation states. This ranges from the two demographic giants of the world, China and India, which together account for one-third of global population, to the many island states of the Pacific that have less than 100,000 inhabitants. The region also displays a great variety in living standards, ranging from the high-income OECD countries of Australia, Japan, Republic of Korea and New Zealand to a number of the least-developed countries of the world, including Bangladesh and Nepal.¹¹⁰

In China, the different tiers of local government play a major role in service provision and local economic development. Local government manages some 80% of state-owned enterprises. As a result, they account for 81% of public expenditure and 22% of GDP. In Japan, local governments have wide functional responsibilities and account for over half of the total public expenditure and 10% of GDP. In Indonesia, as a result of the recent 'big bang' decentralization, local governments now account for one-third of total public expenditure. By contrast, despite their long-established traditions, local governments in Australia and NEW Zealand have quite limited responsibilities and account for less than 10% of public expenditure and around 2-4% of GDP. The size of local government in Vietnam has risen rapidly in recent years – more than doubling in absolute size and increasing from 40% to 48% as a share of total public expenditure from 1997-2002. Nevertheless, until it implemented the 2004 State Budget Law, Vietnam was formally one of the least decentralized countries in

¹⁰⁹ Ibid, p. 41.

¹¹⁰ Andrew Nickson, Nick Devas, Alex B. Brillantes, Willelmina L. Cabo and Alice Celestino. *Decentralization and local democracy in the world*(2008), USA : A Co-publication of the Bank and United Cities and Local Governments, 2008, p. 83.

the world, with local governments essentially carrying out deconcentrated functions at the behest of the central government.¹¹¹

In India, expenditure assignment to union, state and local government has been defined by the constitution. The Union List, State List, Concurrent List and Powers, Authorities and Responsibilities of Panchayat and Municipalities have been spelled out by the constitution of India. The powers, authorities and responsibilities of Panchayat and Municipalities is mentioned in detail in Annex 2.¹¹²

The constitution does not lay down the revenue base for municipalities. The power to determine the revenue base be it the tax authority, tax base, tax rate setting, local tax autonomy, or even the grants in aid and other forms of transfers – rests with state governments. Within this framework, state governments have specified the taxes that municipalities can levy and collect. "Most state governments lay down local tax policies, including policies relating to the choice of tax rates or the determination of who can be included or excluded from payment of taxes" (Mathur, 2006). In year 2001/02 Municipalities own source revenue was IRS 127481 million, which is 3.07% of the total revenue in India.¹¹³

For the rural area, a variety of taxes have been devolved to different level of PRIS. The relative importance of these taxes varies from state to state. The intermediate and district Panchayats are endowed with power to collect very few taxes, whereas Village Panchayats are given substantial taxing powers. In a number of cases, under the tax rental arrangement, the village panchayats collect taxes and pass them to the higher level of Panchayats. Property tax, land revenue, surcharge on additional stamp duty tolls, tax on professions, tax on advertisements, non motor vehicle tax, octroi, user charges and the like contribute the maximum to the small Kitty of own-source revenue which contributed 6.8% of the total expenditure of PRIS in the year 2002/03.

Inter-governmental fiscal transfers are received by local governments in India on the recommendations of State Finance Commissions and the National Finance

¹¹¹ Ibid, p. 69.

¹¹² P M Bakshi, The Constitution of India., Seventh Edition, Delhi: Universal Law Publishing Co. Pvt. Ltd. Schedule 11 & 12, Pp 290-291.

¹¹³ PM. Bakshi, op.cit. 110, pp. 290-291.

Commissions. There are several types of grants in practice.

Municipal government borrowing is regulated by the Local Authorities Loans Act, 1914. This act specifies purposes for which local bodies may contract a loan, limits on the amount of the loan, duration of loans, security of collateral and repayment procedures. State government borrowing is regulated by the article 293 (3) of the constitution. All state government of India, which are empowered to impose such conditions are considered necessary (cited by Mathur).

Property taxation is by far the major source of local taxation; in Japan it accounts for 46.2% of own tax revenues (before the "trinity Reform"); in Australia this accounts for 100% of own-revenue and in New Zealand for 91% of own-revenue. In both countries, as well as in China, local governments also have discretion over the rate of property taxation whereas elsewhere this tends to be determined by central or state government. In China, Indonesia and Vietnam, the proceeds of some locally collected taxes are shared with higher tiers of government. In China, revenue from personal income tax, product tax, business tax and joint enterprise tax are all shared between central and local government. In Vietnam, local governments have no taxing powers at all. Instead, they share with central government the proceeds from VAT, cooperate income tax, income tax on high-income earners, special consumption tax on domestic goods and services, and gasoline and oil tax. Other tax revenues are exclusively assigned to them, namely land and housing taxes, natural resources taxes (excluding petroleum), license tax and land use rights transfer tax. In Indonesia, local governments share the proceeds of taxes on land and property, and on motorized vehicles and fuel with provincial government. Many municipalities also levy user fees and charges that comprise a minor part, typically less than 10%, of their total own-source revenues.¹¹⁴

While local governments have their own tax sources, the degree of fiscal autonomy also varies considerably between countries. The more developed countries, such as New Zealand and Australia generate a substantial share of their revenues locally and are hence less reliant on Inter-governmental fiscal transfers. The share of grants in total local government revenue has fallen in both Australia and New Zealand in recent

¹¹⁴ Ibid, op.cit.no. 107, p. 69-70.

years – from 23% in the 1980s to 16% in the late 1990s in Australia and from 18% to 10% over the same period in New Zealand. In Japan the local finance reform ("Trinity Reform") 2005-2007 replaces targeted subsidies by tax revenues (transfer from the national personal income tax upon the individual inhabitant tax, however for a lower expected yield) and the global tax grant, until now a major equalizing transfer from central budget, is being reduced-drastically. By contrast, in lower-income countries of the region such as India, Indonesia, Pakistan and Thailand, local governments (outside the major urban centers) generate a much smaller share of their total revenues from local tax sources (typically 10-30%) and hence are heavily reliant on central transfers and grants. In Thailand, according to 1999 Decentralization Plan and Procedures Act, local governments were to be allocated at least 20% of the national government budget by fiscal year 2001 and at least 35% by fiscal year 2006.¹¹⁵

Borrowing is another source of local government funding. In the past, central governments in most countries of the region had limited the access by local government to capital markets because of the inherent risk that over-borrowing may lead to macro-economic instability. In Korea the size of local government outstanding debts from bond issues hardly changed during 2000-2006 because of the strong control exercised over local borrowing by central government. In China, the central government placed strict limits on the power of local governments to borrow, but the latter often found ways to avoid these controls by obtaining loans through their municipally owned enterprises. In Japan, loans are no longer subject to authorization, but only an understanding with central government, since April 2006. In India, several of the larger cities have issued municipal bonds and in the state of Tamil Nadu arrangements have been made for smaller municipalities to join together to issue bonds.¹¹⁶

Borrowing from commercial banks has been minimal because of the lack of collateral guarantees. Loans from government financial institutions (GFIs) have been far more common because these GFIs serve as the depository banks for the local governments

¹¹⁵ Ibid, p. 70-71.

¹¹⁶ Ibid, p. 71.

for their Inter-governmental transfers. Hence GFIs can always withhold these central transfers in the event of default on loan repayment by the local governments.¹¹⁷

2.2.5.3 Fiscal Decentralization in Eurasia

This chapter analyzes the fiscal decentralization trend of local government in the states of the Eurasian region that were formerly member states of the Soviet Union: Azerbaijan, Armenia, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

The most acute problem of local government is the shortage of financial resources. This lack of funds inevitably impedes the execution local-government functions. The Constitution of Belarus (article 121) and annual laws on the republic's budget enumerate local taxes and duties that may be established by local councils of deputies. The share of local taxes and duties in state revenues is above 2.1%. In Ukraine, the equalization grant for some 700 main local budgets is calculated by the difference between spending needs established from a formula devised by the central government, and the revenues from tax sharing. In Russia, more discretion is left to the subjects of the Federation than is permitted for Ukrainian regions in the matter of resource allocation to the local budgets.¹¹⁸

The Russian Federation has only two taxes: the land tax and the tax on physics personal property. Representative bodies of local self-government define, within the framework provided by the Tax Code of the Russian Federation, tax rates and the procedure and terms for paying taxes. Other elements of local taxation are prescribed by the Tax Code. According to preliminary data for 2005, local taxes comprise only 4.29% of revenues of local budgets. Local self-governments in the Russian Federation have been constantly losing their local, own sources of revenues. The Law of December 21, 1991 "On Fundamentals of the Tax System" provided for 23 kinds of

¹¹⁷ Ibid, p. 72.

¹¹⁸ T.Y. Khabrieva, L.V. Andrichenko, V.A. Vasiliey. Decentralization and local democracy in the world (2008), USA : A Co-publication of the World Bank and United Cities and Local Governments, p. 108.

local taxes and duties. Even so, in 1998 they yielded on average 12% of total municipal revenues.¹¹⁹

In Ukraine, bodies of local self-government may establish, in accordance with law, local taxes and duties, which are allocated to appropriate budgets. Meetings of citizens may produce local duties on the principles of voluntary self-taxation. In 2005, local taxes and duties comprised 2.4% of the general revenues of local budgets. Local bodies in the states of Central Asia are not permitted independence in the tax and budget spheres. They are not able to define tax rates or other elements of local taxation. Tax rates and other elements of taxation are prescribed by central bodies for all taxes, including local levels. In Uzbekistan, the Cabinet of Ministers establishes local taxes and their rates. In Kyrgyz Republic, local taxes and duties may be introduced only by the Parliament. On the whole, local taxes account for an insignificant share in the revenues of local budgets. In all countries of the region, tax shares accrued to local government on the revenue from national taxes are the main source of revenue for local budgets. This is generally a share of the local yield of the national taxes. In Kazakhstan, law does not provide for a division of taxes between the republic and local governments. Local budgets receive 50% of the income tax on corporate entities, and 50% of the excises levied on certain specified goods. Income tax on personal property, social, land and transport taxes, and payments for the use of water and forest resources are wholly directed to local budgets.¹²⁰

Reinforcement of the revenue base of local budgets is exercised by increasing the share of taxes left to local budgets at the expense of state taxes; such is the case in Uzbekistan and state Kazakhstan, for instance. In Belarus, the share of state taxes and duties makes up more than 14% of local budget revenue. In Ukraine, since the adaptations of a new budget code in 2001, the personal income tax is fully devoted to local budgets of the respective levels (province, district, and municipality) in proportions fixed by the law.¹²¹

To provide subsidies for shared financing of investment programme and development of the public infrastructure of municipal units, the subject of the Russian Federation

¹¹⁹ Ibid, p. 106-107.

¹²⁰ Ibid, p. 107.

¹²¹ Ibid.

may establish funds for municipal development. Funds for mutual financing of high priority social expenditures may also be included in subject budgets. Municipal units may receive other forms of financial aid from the federal budget and from budgets of the subjects. The main requirement is the transparency of distribution of financial resources.¹²²

Since Russia is a federal country, the bulk of local budgets depend on the budget and the policy choices of the subjects of the Federation, within the framework designed by the Budget Code. The tax base of the subjects of the Federation has been strengthened in 2004 and 2005 with the transfer of the transportation tax and of the tax on assets of legal persons. Part of the current revenues of the subject has to be reallocated to local budgets. Laws of the subjects of the Federation grant additional assignments of tax revenues from regional budgets. As a rule, such assignments are to be made at uniform rates, except that differential assignments may be established in cases provided by law for the period from 2006 to 2008. In 2005, assignments of taxes comprised 36.7% of local budget revenues. The share of local budget revenues of the total budgetary funds of the Russian Federation (including regional and local) comprises 10%.¹²³

Grants are paid by the subjects of the Federation through district funds for the support of municipalities, and through regional funds for the support of municipal districts and city districts. There is also a regional support fund for municipalities receiving contributions from the district funds.¹²⁴

Municipal units may receive other forms of financial aid from the federal budget and from budgets of the subjects. Transfers are an important part of local budgets. For instance, in Belarus the share of transfers in the general volume of revenues reaches 58%, depending on the kind of territorial units and the relationships between state local government and local self-government. In Uzbekistan, where law proclaims the principle of balanced local budgets, grants are used to cover deficits. In Kazakhstan, the share of grants is high and has a tendency to grow: in 2004 by 19.81%, in 2005 by 25.28% and in 2006 by 37.1%. A similar tendency can be observed in several

¹²² Ibid, p. 108.

¹²³ Ibid, p. 107.

¹²⁴ Ibid, p. 108.

countries, such as Ukraine and Georgia. This reflects the low buoyancy of tax shares compared to expenditure needs that are growing faster.¹²⁵

2.2.5.4 Fiscal Decentralization in Europe

Financial autonomy is the basis of local self-government, as stated in Article 9 of the European Charter of Local Self-Government, and it has three dimensions: resources must be in line with the costs associated with the duties conferred upon local authorities by law; the authorities must be able to dispose freely of the resources allocated to them; and they must have certain powers to determine the level of their own resources. However, despite the abundance of national and international sources, carrying out an international comparison of local government financial systems presents real difficulties of methodology and interpretation, even in Europe.¹²⁶

The term local public expenditure refers to the expenditure of local public authorities; that is, international authorities with the exception of federal entities and regional autonomies. Note that although Spain is treated as a federal state, Italy is not, despite high levels of powers and responsibilities for public spending, as well as legislation devolved to the Italian regions. The same applies to the United Kingdom with respect to Scotland and Northern Ireland. However, the amount of expenditure alone is not enough to characterize financial autonomy. Functional independence also depends on how much discretion a local authority has to allocate and commit its expenditures, and to manage its resources.¹²⁷

The European Charter of Local Self-Government have "adequate financial resources of their own, of which they may dispose freely within the framework of their powers," and that the financial resources of local authorities must be "commensurate with the responsibilities provided for by the constitution and the law" (art. 9, Para 1 and 2). The first provision is a condition for local freedom; the second is guarantee for local authorities that they should be given the necessary resources to finance the tasks devolved to them by law. However, financial autonomy depends on the resources of

¹²⁵ Ibid, p. 108-109.

¹²⁶ Gerard Marcou and Hellmut Wollman, *Decentralization and local democracy in the world*(2008), USA : A Co-publication of the World Bank and United Cities and Local Governments, p. 141-142.

¹²⁷ Ibid, p. 142

local authorities consist for the most part of shared taxes, for which the central authorities hold the tax-setting powers.¹²⁸

2.2.5.5 Fiscal Decentralization in Latin America

The progress in financing sub national governments may be seen as a whole in Table 3, though the figures used-based on data from the IMF and World Bank, national accounts and others-are not always homogeneous and must be considered with caution. Nevertheless, the positive impact which decentralization has had on all of the countries is obvious. The simple average decentralized expenditure in Latin America went up from 11.6% of total governmental spending around 1980, to 18.8% between 2002 and 2005.¹²⁹

Drawing from the information for aggregated expenditure in the table below, the following classification can be made:

- The first group of countries with sub-national public expenditure greater than 20% includes federal countries – Argentina, Brazil and Mexico – and the unitary countries, Colombia, Peru, Bolivia and Ecuador. However, in federal countries, the states and provinces take up the largest share of expenditure, while local government expenditure is lower than 20% in Brazil and less than 10% in Argentina and Mexico.
- A second group of nations – with an intermediate degree of centralization – with sub-national public spending between 10% and 20% includes Republica Bolivariana de Venezuela, Chile, Uruguay and Guatemala.

A third group of countries has only incipient decentralization, with public expenditure less than 10%. These are Costa Rica, the Dominican Republic, Nicaragua, Panama, Paraguay and EI Salvador.¹³⁰

¹²⁸ Ibid, p. 145.

¹²⁹ Ibid, p. 182.

¹³⁰ Mario Rosales and Saldor Valencia Carmona, Decentralization and local democracy in the world, USA : A Co-publication of the World Bank and United Cities and Local Governments, 2008, p. 182.

Some scenario of fiscal transfer in Latin American countries is presented in the following table 5. The table indicates the percentage of centre government budget distribution to the different level of government.

Table 5

Expenditure by National, Intermediate and Local Governments in Latin America

Countries	Evolution of expenditure by sub-national governments (% expenditure of central government)	Distribution of total governmental expenditure between national government, intermediate government, and local governments, 2002-2005			
		Local government	Intermediate government	National government	General government
Argentina	41.6	7.8	33.0	59.1	100.0
Bolivia	29.5	8.5	21.0	70.5	100.0
Brazil	42.1	16.6	25.5	57.8	100.0
Chile	15.0	13.2	1.8	85.0	100.0
Colombia	29.8	17.0	12.8	70.2	100.0
Costa Rica	6.0	6.0	-	94.0	100.0
Dominican Rep.	7.0	7.0	-	93.0	100.0
Ecuador	22.1	17.2	4.9	77.8	100.0
El Salvador	8.7	8.7	-	91.3	100.0
Guatemala	13.0	13.0	-	87.0	100.0
Honduras	5.6	5.6	-	94.4	100.0
Mexico	31.9	4.3	27.5	68.1	100.0
Nicaragua	3.8	3.8	-	96.2	100.0
Panama	3.8	3.8	-	96.2	100.0
Paraguay	7.0	5.2	1.8	93.0	100.0
Peru	26.8	8.5	18.3	73.2	100.0
Uruguay	13.2	13.2	-	86.8	100.0

Source: This table is adapted from Mario Rosales and Valencia Carmona, Decentralization and Local Democracy in the World, a co-publication of the World bank and United Cities and Local governments, 2008, table no 3, page no 183.

In essence, the political autonomy of any sub-national government depends largely on its financial strength. Self-administered revenue comes primarily from local taxes, over which autonomous local governments exercise direct control. But in Latin America, restrictions on local taxation powers are one of the main limitations of decentralization processes. In most countries, the municipalities do not have the power to impose duties and local taxes. Rather they have a high level of dependence on central funds transfers, and although the degree of dependence varies from one country to another, the overall trend appears to be moving toward increasing dependency.¹³¹

Transfers from central governments or in the federal countries- to local governments have increased in recent years. In Latin America, different transfer systems are used – over fiscal income or the national budget – with varying fixed or variable percentages, distribution criteria by levels of government and other conditions. Distribution criteria for transfers involve different factors – population, levels of poverty, access to services, economic potential, and efficiency in management – but they have limited regional gaps. Some transfer systems are mentioned here:¹³²

In Argentina, the Regime of Federal Co-participation with the provinces contributes 57% of the collection of taxes on income, wealth and sales. The provinces transfer part of these funds to the municipalities, to which they add two transfers: a) maintenance of schools, hospitals and specific projects, and b) discretionary resources. Together it adds up to more than 50% of municipal revenue.

In Brazil, the two main sources are the Municipalities Participation Fund (FPM) and the States and Federal District Participation Fund (FPE); both are fed by national taxes. Furthermore, the municipalities receive transfers from the states (25% tax on the circulation of goods and services, 50% tax on vehicles and the exportation of goods). Some municipalities receive royalties for the exploitation of natural resources. Transfers over the municipal budget have increased in the past decade, reaching 90% of the budget for the smallest municipalities.

¹³¹ Ibid, p. 184.

¹³² Ibid, p. 187-188.

In Venezuela, R.B., Municipal dependency on transfers rose from 35% in 1986 to 48% in 1998. It is based on the Treasury Fund (20% of tax income) and extraordinary contributions (inter governmental Decentralization Fund, with resources from VAT and the Law of Special Economic Assignations, with oil resources).

In Colombia, the General Participations System (articles 356 and 357, of the Constitution) provides the resources transferred by the state to territorial entities (departments, municipalities and districts and indigenous reserves) to finance the services that are their responsibility. The resources are divided into: sector allocations for education (58%), health (24.5%), drinking water and basic sanitation (17%), and special allocations (4%). The distribution of resources is based on population, attended population, population to be attended, equity, fiscal efficiency administrative efficiency and relative poverty.

In Bolivia, tax co-participation transfers to the municipalities' amount to 20% of the national taxes, less the Special Hydrocarbon Tax. To this are added resources from debt cancellation (HIPC I y II) for education, health and investment in infrastructure and the Fund for Productive and Social Investment (FPS). The transfers contribute two thirds of the municipal budgets; 85% is used for investment.

In Ecuador, the transfer derives from the Section Development Fund (FODESEC) and the distribution of 15% of current income from the central government budget. Both sources allocate 80% and 70% respectively of their funds to the municipalities and 20% and 30% to the provincial councils. The transfers represent between 47% and 74% of the municipal budgets (1998-2000), and are generally conditional – they are usually earmarked for public investment, not for current expenditure.

In Chile, the Common Municipal Fund redistributes 30% of municipal taxes (zoning tax, commercial patents, vehicle tax) with the role of addressing imbalances between rich and poor municipalities. The ministries of Health and Education allocate transfers to finance the corresponding responsibilities. The National Fund for Regional Development, FNDR, and the National Fund for Social Investment, FOSIS, deliver resources to projects for social investment and to reduce poverty. Various other sectorial funds exist. The transfers constitute half of the total municipal resources.

In Peru, free availability transfers more than doubled between 2003 and 2006 and the municipalities were the main beneficiaries. Of these transfers, 36% come from the Municipal Compensation Fund based on the national taxes collected, 16% of the Canon (levy) and royalties for exploiting natural resources, and 2% for participation on Customs Duty. The regional governments receive 2% from FONCOR, 4% from the Canon and 1% from Customs Duty. In addition there are transfers of funds from sectorial Programme and projects (FONCODES, PRONAA, PROVIAS, etc.)

In Uruguay, transfers account for between 33% and 16% of departmental budgets, and in **Paraguay**, limited transfers derive from royalties from bi-national hydroelectric companies.

In Central America, the legislation allocates a growing percentage of the national budgets to the municipalities: 10% in Guatemala, 7% in EI Salvador, 6% in Nicaragua (it will reach 10% 2010), 5% IN Honduras, although the government failed to meet the targets. In Costa Rica the constitutional mandate (2001), which allocated 10% of the national budget to the municipalities, has not yet been implemented. In Panama there is no norm for transfer to the municipalities.

In Dominican Republic, although Law 166 (2003) raise transfers to the municipalities from 6% to 10% of the national budget, only 8% had been transferred (2005). Even so, resources have more than doubled in two years. The Dominican Municipal League, in charge of the transfers, fulfils a controlling and inspecting role over the town councils. Transfers represent 90% of the local budget in most municipalities.

2.2.5.6 Fiscal Decentralization in Middle East and Western Asia

In Turkey, local expenditure amounts to 4% of the Gross Domestic Product (GDP), 75% of this share goes to the municipalities and 25% to the SPAs. This is the highest share of GDP in the region, except Jordan (which is 6% according to UN-POGAR). The Constitution and the laws require the national government to contribute to the financing of local functions. State funding covers little more than 50% of municipal budgets; 55% of these state funds represent a 6% share of national taxes, redistributed to the municipalities in proportion to their population. Moreover, the metropolitan

municipalities receive a share of 4.1% of the taxes collected in the region, revenues which in turn are redistributed to the metropolitan municipality itself (55%) and to the municipalities (35%). A further 10% is allocated to water and sanitation. In addition, 15% of the municipal budget is paid as subsidies from the various ministries. National government subsidies and transfers assure a more balanced distribution of financial resources among local governments throughout the country.¹³³

In the West Bank and Gaza, there was a slight improvement in 2002, since the mayors then obtained the right to collect directly taxes on fuels and road traffic, in addition to an education tax the only tax they were allowed to collect directly until then. The Palestinian Authority is supposed to pay back to the municipalities 90% of these local taxes, but it does not do so Result: the municipalities are becoming increasingly poor. Furthermore, Palestinian cities are not able to collect taxes in the surrounding areas. Realistically, tax revenues can be collected only in villages, to which many people who now live abroad send money, or towns with longstanding strong commercial activities. Until recently, 90% of local investment expenditure was funded by the Palestinian Authority, thanks to funding from outside organizations, such as the World Bank, the European Union for the urban areas, and the UNDP for the rural areas, as well as bilateral technical aid from the GB countries. However, unhappy about the recent takeover by Hamas, most sources of outside funding have stopped all aid, and there is now a movement toward a fragmentation of services.¹³⁴

2.2.5.7 Fiscal Decentralization in North America

In terms of its place in public expenditures, public finance and functions, local government in Canada and the U.S. occupies an average place within the spectrum of developed countries. In the United States, the role of local government has generally been more pronounced, but in Canada that role still exceeds local government powers in other countries with similar British colonial legacies, including Australia and New Zealand. The relative discretion that North American local governments exercise over their own finances and the modest supervision by higher government officials also set

¹³³ Mustapha Adib, *Decentralization and local democracy in the world*, (2008) USA : A Co-publication of the World Bank and United Cities and Local Governments, p. 217.

¹³⁴ Ibid, p. 218-219.

local government in both countries apart from most of their counterparts worldwide, including in Europe and East Asia.¹³⁵

Table 6

Financial Management scenario of some countries

	Australia	Canada	New Zealand	United States
Total Public Expenditure (% of GDP)	37%	42%	42%	35%
(per capita) (Euros)	€1,486.56	€3,717.90	€9,692.57	€14,507.04
Local Public Expenditure (% of GDP)	2.4%	7.5%	3.9%	9.6%
(per capita) (Euros)	€275.68	€1,311.16	€380.50	€1,386.30
Local/Total Public Expenditure (%)	6.6%	17.8%	9.4%	27.4%
Local/Total Public Investment (%)	6%	NA	16%	8%
Local Revenues:				
Local Taxes (% of local revenues)	38%	41%	58%	38%
Property Tax (% of local taxes)	100%	92%	91%	72%
Local tax autonomy (0 (high) -2(low))	0.34	0.12	0.43	0.82
Grants (% of local revenues)	16%	40%	10%	38%

Source: This table is adapted from table no 2, page no 241 from book “Decentralization and local democracy in the world” a co-publication of the World Bank and United Cities and Local Governments, 2008, written by of Mustapha Adib.

Overall, the proportion of Gross Domestic Product (GDP) devoted to governmental expenditure in Canada and the U.S., remains somewhere lower than the average for the OECD. The local government portion of this expenditure, though it varies considerably, also remains below levels reported for Northern Europe. In Canada and the United States, 18% and 27%, respectively, of public expenditure was distributed

¹³⁵ Ibid, p. 241-242.

to local governments. The bulk of these distributions is spent on education. Education consumes 57% of all local expenditure in the United States, and 40% in Canada.¹³⁶

Locally raised revenue pays for most educational and security expenditures. As in other former British colonies, such as Australia and New Zealand, the property tax remains by far the most important source of local government revenue. In Canada, it has generated 80% to 90% of all local tax revenues.¹³⁷

2.2.6 Fiscal Decentralization in Nepal

The initiation for decentralization in Nepal has passed six decades. After the advent of democracy in 1950, the reform process in governance started gradually. A series of administrative reform and decentralization committees were formed (Annex 2)¹³⁶ and submitted reports accordingly. Decentralization in Nepal was started as a means of development as well as administrative reform. A separate commission was formed for the first time in the name of decentralization in 1962. Some of its recommendations are still applicable even today. The commission and committee efforts created constitutional and legal (different panchayat acts and regulations) framework in decentralization. The Local Self-Governance Act (LSGA), 1999 is the act which has provided tasks, responsibilities and fiscal authorities to the District Development Committees (high level local bodies) and Municipalities and Village Development Committees as local bodies. We can say that achievement of past efforts is LSGA. The scope of functions and responsibilities of the local bodies in Nepal (defined by the LSGA 1999)¹³⁸ is presented in the following table:

¹³⁶ Ibid, p. 242.

¹³⁷ Ibid.

¹³⁸ Local Self-Governance Act 1999 (2044 B.S.) His Majesty's Government, Ministry of Law, Justice and Parliamentary Affairs, Law Book Management Board Kathmandu, p. 28, 78, 142.

Table 7**Powers, Functions and Responsibilities of Local Bodies in Nepal**

Village Development Committee	Municipalities	District Development Committee
a. Agriculture	a. Finance	a. Agriculture
b. Rural water supply	b. Physical development	b. Rural water supply and settlement
c. Works and transport	c. Water resources	c. Hydro power
d. Education and sports	d. Education and sports	d. Works and transport
e. Irrigation, soil erosion and river control	e. Culture	e. Land reform and management
f. Physical development	f. Works and transport	f. Women's development and handicapped
g. Health services	g. Health services	g. Forest and environment
h. Forest and environment	h. Social welfare	h. Education and sports
i. Language and Culture	i. Industry and tourism	i. Labor wage
j. Tourism and cottage industry	j. Approval of building design	j. Irrigation, soil erosion and river control
k. Miscellaneous	k. Miscellaneous	k. Information and communication
	L. Optional functions	l. Language and Culture
		m. Cottage industry
		n. Health services
		o. Tourism
		p. Miscellaneous

Source: Derived from LSGA, 1999

The LSGA, 1999 has been made provision for tax fees and revenue sources for the DDC, VDC and Municipality. Tax, Service charge in services provided by the local bodies themselves, fees and Sales are sources of revenue. The Local Self-Governance Regulation has fixed the rates of sources of revenue of the local bodies. In the regulation, there are sources for tax rated with minimum and maximum limits. Regarding the loan from the bank or other institutions with or without collateral with

approval from the Government of Nepal (GON) has been provisioned by the LSGA, 1999.

Fiscal decentralization in Nepal is recent phenomena. Its milestone is Local Self-Governance Act 1999. The act has included some policy directions regarding the fiscal decentralization which are as follows;¹³⁹

- (i) Devolution of such powers, responsibility and means and resources as are required to make the local bodies capable and efficient in local self governance.
- (ii) Devolution of powers to collect and mobilize such means and resources as are required to discharge the functions.

Regarding the grant to local bodies the clause 236 of the act has spelled out the government of Nepal shall have to provide the local body each year with minimum grant prescribed and also with additional grants on such basis as population, level of development, possibility and capability of mobilizing revenues, necessity of financial resources, regular record keeping of income and expenditure, situation of auditing and financial discipline of the concerned local body.

Currently, Nepal is in the cross-road of the political transition and state restructuring. The new constitution drafting is under process. The Interim Constitution of Nepal, 2063 (2001) has provisioned local self-governance more clearly than the past constitutions. The Article 139 has spelled out the following provisions on local self-governance.¹⁴⁰ “The provision of local self-governance related authorities shall be made based on decentralization and devolution of authority in order to promote the participation of the people, to the maximum extent possible, in the system of governance of the country by creating such environment as is conducive to the exercise of sovereignty by the people even from the local level, deliver services to the people at the local level and have institutional development of democracy even from the local level”.

¹³⁹ LSGA, 1999, Clause 3 p. 4, 5.

¹⁴⁰ The Interim Constitution of Nepal 2063 (2007 B.S.), Government of Nepal, Ministry of Law, Justice and Parliamentary Affairs, Law Book Management Board, 2007, p. 118-119.

The organizational structure, framework territoriality and value of formation of the local self-governance related authorities shall be as provided by law.

The decentralized governance with fiscal resources followed by accountability is curial for democratization, inclusive participation, equity and ensuring services deliver at the nearest points of the people i.e. by the local governments including municipality. In the statecraft history of Nepal decentralization seems to have been motivated more by the controlling people, wish fulfillment of the rulers and simplifying administration rather than providing services to the people.

After the advent of democracy which overthrew the one hundred and four years old Rana autocracy in 1951, Nepal entered the modern world reforms in governance began. Systematic efforts for decentralized governance in Nepal began in 1960s with the establishment of separate district, municipality and village panchayats. These panchayats were elected local bodies and had the authority to formulate policy, undertake the Programme and levy taxes. The constitution of Nepal, 2019 (1962) regarded decentralization as one of the foundation of governance. The village, town and district panchyats were given powers through Panchyats Acts in the panchyat regime (1960-1990). A separate Act i.e. Decentralization Act, 2039 (1982) and Decentralization Regulation, 2041 (1984) were promulgated in the panchyat regime. But the fiscal powers to the than panchyats were limited. After the successful popular movement of 2046(1990), democracy was restored. For the organization and mobilization of local bodies VDC act, 2048(1992), Municipality Act, 2048(1992) and DDC Act, 2048(1992) were adopted. A High Level Decentralization Coordination Committee was formed in 2053(1997). On the basis of the recommendations of the committee and provision made in the constitution of 1991, the Local Self-Governance Act, 2055(1999) has been formulated and under this Act 3915 VDCs, 75 DDCs and 58 Municipalities are in operation now.¹⁴¹

¹⁴¹ Local Authorities Fiscal Commission's Report (2000), Lalitpur: Local Authorities Fiscal Commission Shree Mahan, Pulchowk, p. 23.

2.3 Local Taxation

2.3.1 Principle of Local Tax

The principal indicator of financial power of local self-government is the right to impose taxes. "In most countries of the region, the share of local taxes in the total revenue of the local government is extremely low."¹⁴²

a) Principles of Local Taxation

The standard principles of taxation are as applicable at the local government level as the central level, even if their application differs somewhat. However, there are also a number of other principles which apply at the local level (Bailey 1999).¹⁴³

- 1) Equity: The usual notion of horizontal and vertical equity apply i.e. that within the local authority taxpayers in similar financial situations should pay similar amounts of tax and taxes should not take higher proportions of income from low income groups than from high-income groups.
- 2) Efficiency: Local taxes should promote allocative efficiency. This requires local voters to pay local taxes so that use of service reflects willingness to pay.
- 3) Visibility: The accountability of service provides to taxpayers depends on voters knowing exactly how much they are paying in taxes. Local accountability is therefore enhance by highly visible local taxes
- 4) Local autonomy: If the allocative efficiency gains of Oates' decentralization theorem are to be achieved, it is essential that local governments and their voters are free to determine the rates at which local taxes are set. Central control of local tax rates would be tantamount to imposition on local government of a nationally uniform standard of services.

¹⁴² Ibid, p. 106.

¹⁴³ Stephen J. Bailey, Local Government Economics, Principles and Practice(1999), Basingstoke and London: Macmilin, Press Ltd. 1999, p. 154-155.

- 5) Economy: From the local authority's point of view local taxes should not be so closely to collect that much of the revenue raised is lost on administration is lost as administration of the tax system. From society's point of view the local tax should not create such high levels of default that expensive legal processes must be incurred to enforce payment or punish those who will not pay. From the taxpayers point of view the tax should be simple to understand and easy to comply with.
- 6) Revenue Sufficiency: The tax yield should be sufficient to finance the levels of services for which local people vote. The local tax should therefore have an easily adjustable tax rate and /or an elastic tax base, the latter being buoyant over time, expanding as fast as expenditures in order to avoid severe fiscal stress.
- 7) Revenue Stability: It would be difficult to find a affect by adverse long-term economic trends, but it should be possible to find one which does not experience short-term instability in tax revenues. Such instability would create discontinuities in the availability of local government services, especially as many central governments do not allow local authorities to borrow to finance current expenditure. This may be regarded as undesirable if those services are crucial components of the welfare state. In that case the most suitable local tax is one whose revenue yield is largely unaffected by cyclical variations in the local economy.
- 8) Immobile tax base: Relatively high rates of local taxation in one authority should not lead to erosion of the local tax base, otherwise the revenue sufficiency and stability rules will be breached. Hence, local taxes should not levy upon highly mobile tax bases because tax-base migration could result.

These eight principles make clear that local tax should not allow 'tax exporting' where by the economic incidence of the tax falls out with the jurisdiction of the authority which levies the tax. These principles of local taxation can be used to determine which taxes are appropriate for local government. These principles further

provide a solution to the tax-assignment problem, namely determining which level of government should control the major taxes.

The composition of revenue is also important for the functioning of the system of local government finance. The following main types of local government revenues exist in most countries.¹⁴⁴

- Taxes
- Fees and charges
- Different types of grants
- Loans
- Other revenue example: donor coordination and sales of assets.

The exact composition of these types of revenues will depend on the above mentioned factors but a balance system of finance on the variety of revenue sources, which ensures predictability, stable revenue sources, high yield, and balanced sources across the local authorities, few negative side effects should be pursued.

2.3.2 Characteristics of a Good Local Tax

If municipal governments are to play an active and expanding role in the provision of public services, they must have access to adequate revenue sources, and they must be both permitted and encouraged to use them efficiently. In judging any tax that might be proposed for imposition at the local level, the following characteristics should be considered.¹⁴⁵

Local political accountability

Any local tax should be visible to local voters and large enough to impose a noticeable burden. The more voters feel the “pain” of financing municipal expenditures, the more likely they will be to hold elected officials accountable for the quality of services delivered.

¹⁴⁴ <http://www1.worldbank.org/publicsector/decentralization/revenue.htm> (o4.09.2000)

¹⁴⁵ World Bank Institute: Intergovernmental Fiscal Relations and Local Financial Management Programme, Revenue Assignment http://www1.worldbank.org/wbiep/decentralization/topic06_intro.htm. (o4.09.2000)

Tax base immobility

The tax base should be relatively immobile, so as to allow local authorities some way in varying rates without losing most of their tax base. Thus, despite their other problems, local property taxes are effective revenue-raisers for many municipalities throughout the world.

Revenue adequacy

The tax yield should be adequate to meet local needs. Its revenues should be responsive (“buoyant”) enough to expand as fast as local expenditure obligations (including inflation).

Revenue stability, predictability, and sustainability

Tax revenue should be predictable, stable, and sustainable – especially if municipalities are to help finance essential services such as education or health care. Reliance on shared income taxes, despite their buoyancy, thus might cut municipal revenues during economic downturns. Also, municipal tax sources should not be diminished without adequate replacement funding.

Undesirability of tax exporting to nonresidents

Municipalities should not seek to export the burden of locally imposed taxes to nonresidents of the jurisdiction who have no “voice” in local taxing and spending decisions. Otherwise, this lack of accountability will encourage the taxing jurisdiction to overspend, local residents will not relate tax burdens to expenditure benefits, and local officials will be less accountable to their constituents for their use of all tax funds actually collected.

Visibility of the tax base

As with tax exporting, visibility of the local tax base helps ensure accountability. Local taxes such as the

Characteristics of good local tax

- The base should be relatively immobile so that government can carry the tax taxes without losing a significant portion of the tax base.
- The tax yield should be adequate to meet local needs, increase over time as expenditures increase and be relatively stable and predictable.
- The tax should not be one that is easy to export to non-residents.
- The tax base should be visible to be reasonably fair.
- The tax should be relatively easy to administer.

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- Source: R.M. Bird (2001)
 - UNHABITAT, Guide to Municipal Finance (2009)
 - Nairobi, Box 2, p.22

property tax are generally direct taxes. Because taxpayers know the base and certainly the amount of such taxes, they look more carefully to what local benefits they receive from such tax payments. Such taxpayer fiscal awareness fosters local accountability. Indeed, fiscal decentralization might even make taxes more visible if it were to shift the overall tax burden from an indirect national value-added tax toward direct local property taxes, income-tax surcharges, or other truly local sources of revenue.

Perceived fairness of a tax

Local taxpayers must perceive a tax to be fair. Otherwise, tax compliance will be a problem – either via tax avoidance by individual taxpayers, or even outright rejection of the tax by organized groups of taxpayers. Narrowly-targeted local business taxes can thus be overdone.

Ease of administration

Local taxes should be easy and economical to administer. Central administration of some local taxes on behalf of municipalities can be more efficient than local administration. Central government tax offices, however, would rarely pursue such collection activities with the self-interested vigor of municipal governments. Simplification of local taxes and fees

- Especially scheduler fees on business activities
- Can cut administration costs without hurting revenues.

CHAPTER III

POLICY AND LEGAL FRAMEWORK

3.1 Existing Policies

Constitutional, legal and policy frameworks are the foundation of decentralized governance. Without constitutional, legal and policy mandates no decentralization can exist. Decentralization friendly policies and conducive environment are the preconditions for functional decentralization as well as effective local taxation. It is further considered instrumental in reducing poverty and achieving overall development goals and targets in the coherent of geo-political and socio-economic diversity of Nepal. There are many legal and policy frameworks for decentralization in Nepal. The major policy frameworks can be explained as follows:

(a) Constitution

The Interim Constitution of Nepal, 2063 (2007) has recognized the "Sovereign Nepalese People having the state authority". The background and basic objectives of the constitution are:¹⁴⁶

- Respecting the people's mandate expressed in favor of democracy, peace and progression through the historical struggles and people's movements launched by the Nepalese people at various times from 2007 (1951) ante till now.
- Pledging to accomplish the progressive restructuring of the state in order to solve the class related, ethnic, and regional and gender problems existing in the country.
- Expressing the full commitment to competitive multiparty democratic system of governance, civil liberties, fundamental rights, human rights, adult franchise, periodic election, and freedom of press, independent

¹⁴⁶ The Interim Constitution of Nepal 2063 (2007), Kathmandu: Government of Nepal, Ministry of Law Justice and Parliamentary Affairs, Law Books Management Board, 2007, p. 1.

judiciary and the concept of rule of law, as well as universally accepted democratic values and norms.

- Putting democracy, peace, prosperity, progressive socio-economic transformation and sovereignty, integrity, independence and prestige of the country in the center.

The article 34 has provisioned Directive Principles of the State. Some of the principles are directly or indirectly related with decentralization and local governance which are as follows:¹⁴⁷

- The objective of the state shall be to maintain conditions suitable to the enjoyment of the fruits of democracy through wider participation of the people in the governance by way of self-governance, and to promote public interest, by protecting and promoting human rights and by maintaining peace and order in the society.
- The fundamental economic objective of the state shall be to transform the national economy into an independent, self-reliant and progressive system by preventing the economic resources and means available in the country from being concentrated within limited section of the society, by making arrangements for the equitable distribution of economic gains on the basis of social justice, by making such provisions as to prevent economic exploitation of any race, sex, class origin or individual and by giving priority and encouragement to national enterprises both private and public while at the same time eliminating economic inequalities.
- The state shall pursue a policy of according priority to the local communities while mobilizing the natural resources and heritages of the country in such a manner as to be useful and beneficial to the interest of the nation.

In the part 17 of the Interim Constitution structure of state and local self-governance has been mentioned in details. It has focused on progressive restructuring of the state with inclusive, democratic federal system of governance. But the constitution is silent about restructuring of local bodies.

¹⁴⁷ Ibid, p. 23.

However, the constitution has made the following provisions with regard to on local self-governance:¹⁴⁸

- The provision of local self-governance related authorities shall be made based on decentralization and devolution of authority in order to promote the participation of people, to the maximum extent possible, in the system of governance of the country by creating such environment as is conducive to the exercise of sovereignty by the people even from the local level, deliver services to the people at the local level and have institutional development of democracy even from the local level.
- The organizational structure, framework, territoriality and mode of formation of the local self-governance related authorities shall be as provided by law.
- There shall be mobilization and allocation of responsibilities and revenue between the Government of Nepal and local self-governance related authorities as provided by law in order to make the local self-governance related authorities accountable for the identification, formulation and maintaining equality in the mobilization, appropriation of means and resources and in the balanced and equitable distribution of the fruits of development with a view to strengthening the local self-governance related authorities for local development.
- While mobilization and allocating the revenue, special attention shall be accorded to the overall upliftment of those classes and communities who are backward socially and economically in such a manner as to have a balanced and equal development of the country.

The different provisions made in the Interim Constitutional show the future statecraft of Nepal will be based on decentralization and local governance. The allocation of resources followed by responsibilities will be adopted under the federal Nepal. It further visualize that fiscally devolved tiers of government will be designed in the forth coming state restructuring. However, the exact shape of federal structure will be decided by the new constitution which is yet to be adopted.

¹⁴⁸ Ibid, p. 118-120.

(b) Local Self-Governance Act, 2055(1999)

Despite the long history since ancient time, the decentralization had its weak legal framework with fewer authorities to local bodies. After the advent of democracy in 1950, the authoritarian regime was over and the avenue for decentralization was also opened. In its five decades efforts in the interim period and Party less Panchayat regime many acts were promulgated in an incremental ways. But they were deconcentration focused. Many Panchayat acts as mentioned earlier came into existence and implemented in different ways. Due to weak legal frame and nominal political commitment, devolution was not effective during the regime. After the reestablishment of democratic system by the popular movement in 1990 the need of devolution was realized and process was expedited. Consequently, the Local Self-Governance Act(LSGA), 1999 was adopted to devolve more authorities including fiscal power to local bodies in Nepal.

The LGSA is the first integrated act which made detail provisions of DDC, VDC and Municipalities design and assigned more responsibilities to them. It is one of the ambitious act which aims good local governance adopting participatory mechanism in different steps of local governance. The constitution of the Kingdom of Nepal 2047(1990) which had replaced by the Interim constitution 2063 aimed to provide social, economic and political justice to all citizen of Nepal through equitable distribution of resources. It had included decentralization as one of the guiding principles and policies of the state. In article 25(4) which stated, " It shall be the chief responsibility of the state to maintain conditions suitable to the enjoyment of the fruits of democracy through wider participation of the people in the governance of the country and by way of decentralization and to promote general welfare by making provisions for the protection and promotion of human rights by maintaining tranquility and order in society."¹⁴⁹

His Majesty's Government of Nepal promulgated the Local Self-Governance Act 1999, which has set an policy shift by legally endorsing the concept of self governance and devolution of authorities to LBs.

¹⁴⁹ The Constitution of the Kingdom of Nepal 2047 (1990), His Majesty's Government, Ministry of Law Justice and Parliamentary Affairs, Law Book Management Board, Fifth Edition, 2004, p. 15.

The preamble of the act mentions the following objectives from the local governance in Nepal ¹⁵⁰:

- Make provisions conducive to the enjoyment of the fruits of democracy through the utmost participation of the sovereign people in the process of governance by way of decentralization.
- Institutionalize the process of development by enhancing the participation of all the people including the ethnic communities, indigenous people and down-trodden as well as socially and economically backward groups in bringing out social equality in mobilizing and allocating means for the development of their own region and in the balanced and equal distribution of fruits of development.
- Have institutional development of local bodies capable of bearing responsibility by providing such responsibility and power at the local level as is necessary to formulate and carry out plans, and
- Constitute local bodies for the development of the local self-governance system in a manner that they are able to make decisions on the matters affecting the day to day needs and lives of the people, by developing local leadership.

The LSGA and its Regulation (1999) have provided legal basis for local bodies. The Act has mentioned the principles and policies to be adopted by the state for developing a system of local self-governance. These principles and policies are as follows:¹⁵¹

- (i) Devolution of necessary power, responsibility and resources to make local bodies capable and efficient;
- (ii) Development of institutional mechanism and functional structure for bearing of responsibility;
- (iii) Directing the local bodies to adopt democratic process, transparent working methods, creation civil society based on public accountability and popular participation;
- (iv) Encouragement for the involvement of private sector;

¹⁵⁰ LSGA 1999,P 1

¹⁵¹ LSGA,1999, p. 4.

- (v) Devolution of authority to mobilize revenue;
- (vi) Development of local leadership

According to these policies, the Act and Regulation have made the following provisions regarding the local bodies:

- Creation and operation of local bodies;
- Composition, work responsibility, duties and rights;
- Tax, revenue and other resources to be mobilized by the local bodies;
- Local bodies to work in cooperation with NGO, Community organization, user group and the private sector;
- The work of other sectors should also be brought under one umbrella of local bodies; and
- Relation between the central and local bodies.

The LSGA has assigned functions and responsibilities as mentioned earlier and enlisted in the annex. Similarly, they have authorized to levy taxes, fees and user charge with authority to borrow. As per the act they have to follow the participatory planning process.

The clause 241 of LSGA has provisioned a high-level Decentralization Implementation and Monitoring Committee (DIMC) to monitor whether or not the acts have been done in accordance with the objectives, policies and provisions of the Act and to get the acts done in harmony with the norms relating to local self-governance. The composition of the committee is as follows:¹⁵²

- | | | |
|----|---|-----------------|
| 1. | Prime Minister | – Chairman |
| 2. | Minister for Local Development | – Vice-Chairman |
| 3. | Leader of Opposition party in the House of Representative | – Member |
| 4. | Ministers of GON | – Member |
| 5. | Chairman of the concerned committee of the House of Representatives | – Member |

¹⁵² Ibid, p. 177.

- | | | |
|-----|--|--------------------|
| 6. | Vice Chairman, NPC | – Member |
| 7. | Chief Secretary, GON | – Member |
| 8. | Secretaries of GON | – Member |
| 9. | One representative of each political party
representing in the House of Representatives | – Member |
| 10. | Chairman of the Associations, Federations
relating to Local Body | – Member |
| 11. | Secretary MOLD | – Member Secretary |

(c) Three Year Interim Plan (TYIP) (2007/08-2009/10)

The TYIP had accepted decentralization as "a main means of enhancing good governance", a process of administrative, political, social, and economic and development works, and a strategy for promoting people's participation and people's empowerment. It has set long term vision decentralization and devolution as "local bodies restructured according to the concept of inclusion democracy and federal government system will be capable as the local government to effectively deliver the services."¹⁵³

The objectives relating to decentralization and devolution of TYIP are as follows:¹⁵⁴

- (1) To promote good governance at the local level by clearly delineating the political, planning, financial, legal and administrative rights of the central and local level according to the concept of the federal structure and inclusive democracy and policy of full devolution through the establishment and operation of local government.
- (2) To enhance effectiveness of the local government in local development works and services delivery by developing and adopting the Participatory Planning System based on people's aspirations and local demand through inclusion and main streaming at the local level.

¹⁵³ Three Year Interim Plan (2007/08-2009/10) Government of Nepal, National Planning Commission, December, 2007, p. 462.

¹⁵⁴ TYIP, p. 462.

There were strategies many policies and working policies of TYIP. The major Programme of this TYIP were as follows:¹⁵⁵

- Formulation of Interim Local Bodies
- Local bodies restructuring
- Development of local government borrowing mechanism
- Strengthening local bodies grant (transfer) mechanism
- Fiscal decentralization strengthening
- Local Statistics Strengthening

Fiscal consolidation will be made through the expansion of the bases and rate of tax and non-tax and grants to be made available to the local bodies according to the fiscal decentralization policy, was the major Programme for fiscal decentralization.

(d) Three Year Plan Approach Paper (TYPAP) (2010/11-2012/13) (pp. 102-105)

The Government of Nepal has published Three Year Plan Approach Paper (2010/11-2012/13) in August, 2010. As most of the national periodic plans specially after the peoples movement in 1990 have prioritized decentralization the TYPAP has also focused on decentralization.

Objectives of TYPAP¹⁵⁶

To lay down the foundation for the overall development of the country by increasing accessibility of the local people to available resources and opportunities by providing the basic services and facilities to the people in an effective manner and utilizing resources, skills and technologies under the direct involvement of the local bodies and the local people.

Strategy¹⁵⁷

1. Establish and operate autonomous, responsive and accountable local body by carrying out devolution of political and administrative rights

¹⁵⁵ TYIP, p. 463-466.

¹⁵⁶ Three Year Plan Approach Paper (2010/11-2012/13) Government of Nepal, National Planning Commission, August, 2010, p. 102.

¹⁵⁷ TYPAP (2010), p. 103.

to local bodies on the basis of federal structure and in accordance with the principle of inclusive democracy.

2. Increase the accountability of socially, economically and geographically deprived class, region and community to the available resources by empowering them through the principles of equity and inclusion.
3. Improve the living standard of the people by creating job opportunity at local level utilizing local resources, labor-centered technology and environment friendly participatory approach in infrastructure development.
4. Strengthen local governance by creating an environment of autonomy by devolution of authority and by increasing capability of local bodies through devolution of work plan prepared by sectoral ministries.
5. Manage to implement Programme clarifying the roles of governmental, non-governmental, and social organizations, user's committees, and stakeholders who launch Programme at local level and make them accountable to local bodies.

Working Policy¹⁵⁸

- 1.1 Local bodies will be given resources and hierarchical responsibilities on the basis of rights, revenue sources, administrative privileges, uniformity and performance.
- 1.2 To strengthen Local Self-Governance, devolution action plans, prepared by sectoral ministries in coordination with NPC and the Ministry of Local Development will be effectively implemented.
- 1.3 Following the concept of devolution of authority, projects which are conducted by different bodies will be coordinated and facilitated and sharing of information will be effectively implemented.

¹⁵⁸ TYPAP (2010), p. 103.

- 1.4 To make effective services and facilities available from the local bodies, their existing administrative organizations will be re-evaluated and strengthen according to workload.
- 1.5 To prepare suitable legal base for the local bodies, rules and regulations will be modified as required.
- 1.6 Revisions will be made in the guidelines to declare municipalities.
- 2.1 Special Programme will be carried out to uplift Karnali, its border areas including remote and disadvantaged regions and classes.
- 2.2 Programme targeting poverty reduction will be carried out by developing and mainstreaming marginalized class which have been left behind socially and economically.
- 2.3 For the overall development Programme in the rural areas, the existing economic resources will be utilized effectively by formulating development strategy and preparing Programme accordingly.
- 3.1 To provide reliable access of social services and economic opportunities to local people, rural roads will be upgraded to run round the year, roads and bridges will be constructed in a planned way.
- 3.2 Skills, capability and other talents of local ethnic groups and their public heritage will be documented, recognized and registered.
- 3.3 Incomplete projects will be completed and other projects will be prioritized in such a way that available resources will be integrated and utilized better.
- 3.4 In order to lunch, development projects which are under the demand and necessity of local people, resources will be utilized through basket funding.
- 3.5 Maximum use of natural resources and means will be made considering sustainability; special Programme for environmental

conservation will be undertaken and the local resources will be consumed in an eco-friendly way.

- 3.6 Private and community sector will be involved and given ownership in the waste management and cleanliness of the urban and rural areas.
- 3.7 Rural infrastructure policy and strategic planning will be effectively implemented.
- 4.1 In order to create competent manpower to increase capabilities of local bodies, Local Development Training Academy and other eligible organizations will conduct training in collaboration and networking with domestic and foreign organizations.
- 4.2 The capability of local bodies will be strengthen through the management of means and resources generated from local revenue mobilization and Inter-governmental fiscal transfer so that allocation and financial potential and service provision will be effective.
- 4.3 Registration, documentation and verification of incidents will be carried out effectively by establishing local bodies as the initial and legitimate sources of the information.
- 4.4 The capability building Programme of district information center will be enhanced and it will act as an information bank. So that, information required during local Programme can be referred to form it.
- 4.5 Participatory monitoring, social audit, public audit, management audit, quality check, transparent and accountable working procedure and e-governance will be strengthened at local bodies.
- 4.6 By strengthening and extending the role of local bodies in implementing Programme related to social security a mechanism for providing social security allowances from financial institutions will be established.

- 5.1 The duplication of Programme implemented by local bodies and NGOs will be removed such Programme will be organized in a unified and collaborative manner.
- 5.2 In order to effectively implement service flow and development works carried out by local bodies, authorized sector, stakeholders, NGOs and social organizations will be made accountable to local bodies.
- 5.3 A unified modality of working procedure will be created and put into effect in order to make plan information, implementation and management effective in terms of cost, benefit, initiative and responsibility; and by establishing participation, involvement and ownership of the users groups.
- 5.4 Partnership and joint efforts with the representative associations/organizations of local bodies will be strengthened in the activities like decentralization, self-governance and local development.
- 5.5 In the utilization and conservation of public land, lake, natural and cultural heritage, role of local bodies will be established and made them responsible.
- 5.6 Keeping the possibility of duplication of work that the municipality and town development committees working in the same region, in view working modality and regarding the formation of town development committee will be reevaluated and suitable replacement will be in place.

(e) Nepal Development Forum, 2004¹⁵⁹

Donors' supports and intervention in the development endeavor including decentralization are playing vital roles in Nepal. New policy adoption, governance reform, services delivery, poverty reduction, infrastructure development and support on decentralization are source of the major areas where donors assistance has been utilizing since last more than five decades. In line with aid effectiveness and

¹⁵⁹ Chairman's Summary of the Proceedings Nepal Development Forum, 2004 Ministry of Finance, p. 82.

coordination joint meetings with development partners and the Government of Nepal were organized time to time. Nepal Development Forum was organized in May 4-6, 2004. In the forum different representatives from donor community presented written statements suggesting Nepal's ways forward for development. The general remarks on behalf of Switzerland which has been working in Nepal for more than 40 years has highlighted on democracy and decentralization. In the statement the following importance on democracy and decentralization was highlighted (NDF, 2004 p. 82):

"Democracy is a prerequisite for sustainable development. Development cooperation can only be effective with democratically legitimized and elected authorities at all levels.

Decentralization of resources and devolution of decision making power to local authorities is crucial for empowerment and accountability.

The forum has agreed Basic Operating Guidelines for all development. Some of the points of the guidelines related decentralization are as follows (P.95):

1. We are in Nepal to contribute to improvements in the quality of life of the people. Our assistance focuses on reducing poverty, meeting basic needs and enabling communities to self-sufficient.
2. We work through the freely expressed wishes of local communities and we respect the dignity of people, their culture religion and customs.
3. We provide assistance to the poor and marginalized people of Nepal, regardless of where they live and who they are priorities for assistance are based on need alone and not on any political, ethnic or religious agenda.
4. We ensure that our assistance is transparent and we are accountable to those whom we seek to assist and to those providing the resources.
5. We seek to ensure that our assistance tackles discrimination and social exclusion most notably based on gender, ethnicity, cost and religion.

3.2 Policy and Legal Issues

The continued efforts for decentralized governance and localizing services in Nepal have completed more than half a century. Although, significant achievements have been made in a number of areas, the raising aspirations of the people and expected progress could not be realized. There are many legal, policies and practical issues in decentralization including fiscal decentralization. Some of the issues and challenges will be explained below:

(a) Local Authorities Fiscal Commission (LBFC) Report, 2000¹⁶⁰

The LAFC report is the first fiscal decentralization focused report in Nepal. It has analyzed the dynamics of decentralization. Some problems and challenges on fiscal powers and status of local bodies highlighted by the report are as follows (LAFCP 2000)

- Many tax and revenue powers have been given to local bodies. Yet only some main taxes are important from the view of local resources – (adequacy, buoyancy, potentiality) – like property based tax, professional tax, entertainment tax, export tax and natural resource utilization tax. Even among them, for the sake of most of the VDCs in the hills, the property based tax is the most important one. Talking of the property based tax, in many hilly and mountainous VDCs, the administrative cost of collecting the tax and workload will be much higher than the revenue collected. Similarly, in the case of other sources of tax as well as the capability of local bodies to determine fixed tax rate is very low. Keeping in view the facilities/services provided, their tax policies and the fiscal and environmental factors. Thus, even after getting fiscal powers, there has been no special improvement in their previous economic condition due to the lack of organizational capability and the shrinkage of autonomy.
- Even through the fiscal resources of local bodies are scarce, delivery of public services can be done through other alternative means like the mobilization of the private sector and NGOs. But in practice, there is

¹⁶⁰ Local Authorities Fiscal Commission Report, His Majesty's Government of Nepal, Local Authorities Fiscal Commission, Shree Mahual Puichowk, 2000, p. 62-63.

very low involvement of the private sector and the NGOs in the government functions of service delivery. In the case of the local bodies, the real condition reflects lack of mutual contact and attitude among the local bodies, the private sector and the NGOs. Sometimes the mutual attitude appears to be that of competitors. Because of this, there is lack of coordination and cooperation and the assumption has not been established that they are complementary to each other.

- There is no capable and effective organization to invest loan to local bodies. Through there is a Town Development Fund for the sake of the municipalities, it is not in a position to fulfill the needs and demands of all the municipalities. For the sake of the DDCs and VDCs, there is no such body. It has been necessary that the government mobilizes fiscal resources for long term investment. The TDF should be made capable to fulfill the needs of the municipalities.
- It did not become evident that by giving the power to mobilize fiscal resources, the revenue would be collected. Land revenue and the household tax can be cited as its example, and the situation still persists that much more efforts should be made to collect house and land tax to the previous scale.
- The central government had collected Rs 610 million as land revenue in Fy 1994-95 while the local bodies could collect only RS 29.6 million including arrears in Fy 1998-99. This collection has challenged the assumption that the local bodies can mobilize greater revenue. The local bodies DDC and Municipalities, had collected Rs 299.32 and 4042.50 million respectively as revenue (including octroi, miscellaneous taxes and fees) which form 0.79% and 2.76%. (respectively) of the total revenue of HMG. Even in the tax actually collected the ratio of indirect tax is predominant. As the representatives prefer the indirect tax, it has been a challenge to attract the local bodies toward direct taxes.
- All the local bodies have tried to collect taxes on the export of the products. In giving such power to each local body there will be not only implemented in the free flow of goods by the frequent road barriers in short distance, but will also harass the business people. If local bodies

are prevented from taking taxes on local products, there is no better alternative in the present circumstances. There is no provision for the government to impose tax on agricultural products at present and if the local bodies also do not impose tax on it (mainly cash crop and the cereals with mass production), the potentials for local taxation will be just left out. So, a simple but effective alternative way should be explored to systematize it.

- The councils have the power to determine the taxes of local bodies. The council makes the tax decision without consulting the tax payers. This practice has resulted in vast differences between the estimation and actual collection. Paying attention to the fact that involvement of the tax payers in determining taxes results in better revenue yield, effectiveness in revenue mobilization should be brought by making institutional arrangement for involving tax payers and concerned organizations in the process of tax determination.
- The LSGA, 1999 has given the local bodies the responsibility of protecting and utilizing the land not owned by HMG or anyone else. But it has not transferred the ownership. It cannot be believed that responsibility without ownership can guarantee protection and best utilization of such property.
- In Nepal, there are various physical and natural heritages. There is a great revenue potentiality in them. But such a work needs management capability and investment as well.

(b) Decentralization in Nepal: Prospects and Challenges

Considering the importance of LSGA's effective implementation both GON (HMG) and donors commissioned a joint review of decentralization efforts in Nepal. The findings and recommendations are very important policy document for decentralization for Nepal. The review has concluded in different components of decentralization. The following two important components are concluded by the review.¹⁶¹

¹⁶¹ Review on Decentralization in Nepal, Draft Final Report, Joint HMG/N-Donor, Review on Decentralization in Nepal, February-August, 2000, p. 159-160.

(i) Central Government Policy and Strategic Framework

After the restoration of democracy the decentralization process has matured as a result of pluralist environment and increasing assertive role of stakeholders, particularly the LGs themselves. The government has demonstrated willingness to become responsive to the changing context and demands of the LGs. The enactment of LSGA in line with the 9th Plan objective has been achieved which now provides the base for further promotion of the decentralization framework in the country. However, LSGA and Regulations are only in the first steps of actual implementation and unless sufficient financial support can be provided and political and administrative support in the central bureaucracy mustered by GoN, LSGA runs the risk of not being effectively implemented.

(ii) Local Government Finances

Fiscal decentralization is the least focused area in Nepal's decentralization experiences and processes, and it distinctly lacks a sufficient policy and programme framework. Decentralization without adequate financial resources devolved to LGs is not functional. The share of LGs total budgets in the national budget is less than 5%, LGs share of the development budgets less than 10% and what amounts to approx. 13% of the total VDC budgets are channeled to local communities through MPS on an individual basis and without any involvement of VDCs. The financial situations in districts vary greatly, creating disparity for the poorest districts. As well LGs presently do not have sufficient skills and knowledge within financial management. The review has recommended three key areas for immediate action¹⁶²

Key area 1: Decentralization Implementation Plan (DIP)

A sequential implementation plan is urgently needed to target the effort and measure the progressive success of decentralization reform in Nepal. Such plan should describe, law to amend duplication, overlapping and interferences in LSGA devolved functions; review LG structure: develop a decentralized LG fiscal system; establish synergetic relationship with GON bodies; design a

¹⁶² Joint HMG/N - Donor Review, Exertive Summary, March, 2001, p. 1.

sound decentralization supervision and monitoring system; build cooperation and partnerships with sectoral ministries; workout mechanism for regular dialogue between GON and LGs, implement local civil service provision made in the act; build up governance capacity of LG leadership and include LG association as a partner and stakeholder in decision relating to decentralization.

Key area 2: LG Finance System

Fiscal decentralization is a prerequisite for effective decentralization and poverty reduction. It is recommended that fiscal decentralization process progress by taking following steps:

- Clearly defined LG tasks and assess their costs.
- Review LG's own sources of revenue and finance
- Increase LG's share in national budget
- Design a reformed national LG's budget classification and accounting system
- Establish a LG financial database
- Make criteria for grant budget and assistance provision objective and transparent
- Develop a system to improve level of resources to poor districts and
- Strengthen LG's financial management, audit and revenue generation capacities.

Key area 3: Donor Coordination

Effective decentralization needs fully coordinated donor support which can be achieved where is an implementation plan. Also a national institution should be assigned to take lead in establishing a forum where HMGN, donors and other stakeholders can discuss key issues relating to their support programme and identify area for peer review to assess each other contribution. Indicator based decentralization monitoring model be developed for all stakeholders to clearly monitor status, needs and achievements of the decentralization reform

process. It would also facilitate better communication among each other in designing future plans.

(c) Contradicting Acts with LSGA

LSGA assigns responsibilities to local bodies with fiscal authorities. There are many sectoral acts and regulations existed earlier than LSGA. There is a general tendency that LBs are taken extended arms of MOLD as the field offices of line ministries are considered. The LSGA is wider and provisioned LBs as local governments with many autonomous functions. LBs are the front line service providers and nearest government of the people. But political and administrative leaders want hold powers at the center and hesitant to devolve power. Most of the people think that contradicting acts are barrier for LSGA effective implementation. But this is the attitudinal problem. If any central institution is interested to devolve power to local bodies, there are delegation, deconcentration and devolution that they can choose anyone. Due to reluctance in devolving powers the question of contradicting acts is preoccupied in the mind set of policy makers. By this kind of attitude and environment, the compliance of LSGA is not in place as required. There are many acts and regulations contradicting with LSGA which were promulgated during the highly centralized regime with centralistic and controlling values. The major contradicting acts with LSGA are as follows:¹⁶³

¹⁶³ LAFC Report (2000) OP.cit.165, Annex 5, p. 39.

Table 8
List of Contradicting Acts with LSGA

S.N.	Sectoral Acts	Related Clause
1.	Animal Health and Services Act, 2055 (1998)	4, 16, 17 and 19
2.	Animal Slaughter House and Meat Quality Examination Act, 2055	5 and 8
3.	Birth, Death and Other Personal Events Registration Act, 2033 (1976)	2, 3 and 5
4.	Consumers Protection Act, 2054 (1997)	15
5.	Construction Enterprise Act, 2055 (1998)	4 and 5
6.	Cinema (Protection, Show and Distribution) Act, 2026 (1969)	4
7.	Education Act, 2028 (1971)	3, 11 and 12
8.	Electricity Act, 2049 (1992)	3 and 12
9.	Environment Conservation Act, 2053 (1996)	7
10.	Forest Act, 2049 (1992)	2, 17, 23 and 48
11.	Judicial Administration Act, 2048 (1991)	7
12.	Local Administration Act, 2028 (1971)	5, 9 and 10 ka
13.	Local Governance (Election procedure) Acts, 2048 (1991)	16
14.	Land Revenue Act, 2034 (1977)	32
15.	Mines and Minerals Acts, 2042 (1985)	5
16.	Natural Calamity Act, 2039 (1982)	7
17.	Public Roads Act, 2031 (1974)	21
18.	Statistics Act, 2015 (1958)	7
19.	Soil and Watershed Conservation Act, 2039 (1982)	4 and 6
20.	Sports Development Act, 2048 (1991)	12
21.	Vehicles and Transport Management Act, 2049 (1992)	78 and 121
22.	Water Resources Act, 2049 (1992)	4
23.	Solid Waste Management and Resource Mobilization Act, 2044 (1987)	To be annulled fully

Source: LAFC, 2000

Local Authorities Fiscal Commission (2000) has analyzed the contradiction between LSGA and His Majesty's Government's Business Allocation Rule, 2057 (2001).

Table 9

Contradiction between Business Allocation Rule and LSGA

Work Area	No. of Work Area	No. of Work Area Tallying with the Local Bodies	
		Fully Tally	Partial Tally
Total Work Areas of Development Work Ministries	254	31	65
Total Work of Other Ministries/Secretariats	138	-	-
Total	392	31	65

Source: Adopted from LAFC, 2000 (p. 84)

From the view of number, among a total of 392 work areas, the local bodies have been working fully in 31 areas and partially in 65 areas. The fund allocation, capacity and downward accountability demand more resources to be allocated for local bodies. This contradiction shows the imperfect devolution even after the adoption of LSGA, which situation still exists.

(d) Three Year Interim Plan (2007/08-2009/10)

TYIP under its chapter 37, decentralization and devolution has identified major problems and challenges:¹⁶⁴

(i) Problems

- Lack of clear strategy and framework of subject-wise devolution in the decentralized and devolution sector.
- Difference in the vision of the central level institutions towards devolution.

¹⁶⁴ TYIP, 2007/08 - 2009/10, p. 460-461.

- Existence of dual responsibility situation of the bureaucracy towards the central and local bodies related to devolved functions.
- The co-ordination and facilitation done by DDCs for devolution have not been effective at the local level.
- Initiated devolution could not be pushed forward as desired due to absence of political representatives in local bodies.
- Problems in the implementation of the devolved sector due to inability to make the resource available and working mechanism on the basis of work responsibility in a package.
- The lack of capacity enhancement in the devolved sectors and lack of clarity in the operating process after devolution.
- Lack of Skilled Civil Servants in the local bodies due to lack of Acts related to the local services.
- Devolved functions could be moved forward as expected due to various experiment made in the operation of local bodies with the start of the devolution.
- Different situation in plan formulation and implementation (need to play a dual role DDC and Central level plan formulation and implementation by line agencies).

(ii) Challenges

The challenges are managing and operating the local self-governance bodies in line with inclusive, democratic and federal structure while the state is restructured according to the Interim Constitution of Nepal, 2007 and to reorient the required resources, means and resource allocation balanced, proportional and for the overall upliftment of socially and economically backward groups and communities while fulfilling the responsibilities given to these bodies. Other challenges are:

- Full compliance LSGA and its Regulation.
- Transform the local bodies to local government.

- Manage the civil servants at the local level by promulgating Local Service Act.
- Transform into local bodies into a viable structure by restructuring them.
- Deliver the function performing service delivery by the local level with accountability and functions like the mobilization of local bodies for the overall poverty reduction.

In Nepal, decentralization, urban management and rural development Programme are implemented and managed by different central agencies. Coordination in policies and cooperation in implementation at grassroots are always problems. Municipal and urban management is one of the challenges of developing countries for the 21st century. In this context, there is no serious consideration paid for comprehensive policies in urban management as well as rural services delivery.

In TYPAP (2010/11-2012/13) housing and urban development policies are spelled out separately. Generally, objectives and policies are infrastructure oriented and the governance as well as revenue potentiality is not adequately prioritized. There are 58 municipalities and 132 small towns which are bearing the urbanization pressures day by day.¹⁶⁵ Policies can be hardly found on rural urban linkages and development. The central apex body for decentralization is MOLD and for urban management Ministry of Physical Planning and Works is responsible. Based on the experience of the researchers since last one decade it is noticed that in both ministries urban development and municipal taxation and revenue generation are not under top priority.

3.3 Federal Context of Nepal

Currently, Nepal is in Transition towards state restructuring and federalism. Federalism is directly linked and depended on fiscal federalism. In the context of federal Nepal fiscal decentralization is very important. Without fiscal resources and its link with expenditure assignment federal units and local governments cannot work effectively. Effective fiscal federalism only can create the social equalization and

¹⁶⁵ For details, see Housing and Urban Development Policies of TYAP, pp. 154-155.

enhance balance development in the country. Considering fiscal resources allocation and deepening democracy in each tiers of government, Nepal is fully engaged in drafting a new constitution, restructuring the state and designing federal system.

The Interim Constitution, 2063(2007) has stated that "There shall be made progressive restructuring of the state with inclusive, democratic federal system of governance. By doing away with the centralized and unitary structure of the state so as to end discriminations based on class, ethnicity, language, gender, culture, religion and region."¹⁶⁶ Currently, country is in transition in terms of politics, administrative reforms and state restructuring. The Constituent Assembly's Committees on different thematic areas have prepared draft reports in their respective areas. The new constitution making process is under way. Fiscal decentralization and municipal taxation in the future will be based on the state restructuring provisions in the new constitution on expenditure and revenue assignment.

The Constituent Assembly, restructuring of the State and Distribution of power committee on its report on concept paper and preliminary draft, 2066 (2009) has proposed the list of local level as follows (CARSDC, 2009a).¹⁶⁷

- Town police, community police
- Cooperative
- FM operation
- Local tax (property, house, rent, automobile tax etc), service charge, fee, tourism charge, advertisement tax, land tax
- Royalty from natural resources
- Management of local service
- Collection of local statistics and documentation
- Local level development projects
- Primary and secondary education
- Basic health and sanitation

¹⁶⁶ Interim Constitution of Nepal 2063 (2007) article 1.138 (1).

¹⁶⁷ Constituent Assembly Restarting of the State and Distribution of state power, committee Report on concept paper and parliamentary, Draft, 2066, p. 40-41

- Local bazar management
- Local highway/rural road/auricular road
- Local court, mediation and arbitration
- Citizenship, passport and documentation management
- Distribution of land and housing ownership certificate
- Management of elderly, disabled, women, single women and helpers
- Data collection of unemployed
- Management, operation and control of agriculture
- Registration of vital events like birth, death etc.

The CA Committee has presented federal, province, local level, concurrent list and list of rights of autonomous regions. Compared to existing LSGA's provisions critics opine that the local level list is regressive than LSGA. In this connection following points need to be taken consideration while reviewing the lists¹⁶⁸

Proposed lists of assignment of Village Government in the federal structure:

a) Services related to Agriculture and Veterinary:

Plan formulation and implementation of agriculture. extension, agriculture inputs/products production, commercialization, cooperative farming, herbs cultivation, marketing, cattle rearing (animal husbandry), animal feeds, fisheries, bee keeping, horticulture, grazing, treatment of veterinary diseases and control services.

b) Services related to Rural drinking water:

Drinking water supply plan formulation, implementation, operation and maintenance, conservation of water source, well, ponds, etc construction and maintenance.

c) Services related to construction and transportation:

¹⁶⁸ Som Lal Subedi, Federalism, Local Government and Transitional Arrangement in Nepal,(2067) Kathmandu : Anjana Subedi, p. 172-192.

Plan formulation, implementation, maintenance and operation of rural roads, agricultural roads, track and trail, maintenance of different physical infrastructures handed over by different organizations.

d) Services related to education and sports:

All education up to the secondary level, vocational education, supervision, monitoring and evaluation of school, establishing and operating, libraries, sports and distribution of scholarship as per the approved policy.

e) Services related to irrigation, soil erosion and river training :

Plan formulation and implementation of irrigation, dams, river, training, canal, water grinding mill and distribution of electricity

f) Services related to physical development :

Plan formulation and implementation of land use and physical development plan prepare standards/ indicators on house, building, drainage and other physical infrastructures and /or implementation as per the existing indicators as well as on land procurement and compensation.

g) Service related to health services:

Operation and regularization of health institutions provide basic health services such as Health Centre, Health Post, Sub-health post, Ayurvedic dispensaries for provision of preventive and curative treatment and emergency services as well as formulation and implementation of Programme on basic health education, sanitation and management of solid waste. Implement Programme on safe motherhood, inoculation, child health, family planning and maternal child health Programme. Impose restriction /ban on sales of consumable goods that adversely affect public health, restrict on transportation and use of goods considered injurious to public health.

h) Services related to forest and environment:

Programme formulation and implementation on conservation of public land, forestation, conservation of forest, promotion and regularization of community forest, vegetation, bio-diversity, soil and environment conservation. Formulation and implementation of Programme alternative energy and support to wild life conservation.

i) Services related to language and culture:

As per the approved national standard/indicator, preserve language and cultural heritage, sites/places of archaeological and religious importance and promotion and preservation of infrastructures.

j) Services related to tourism and industry:

Preservation, development and expansion of touristic importance sites, operation of cottage and small scale industries and facilitation on micro- enterprise development

k) Disaster Management and support to rehabilitation and risk minimization/mitigation.

l) Local economic development, employment generation, income generation, public private partnership and promotion of consumer's welfare.

m) Authority on Revenue:

Taxes on house and land, land revenue and land tax, Hat bazaar/shop tax, vehicular taxation, entertainment tax, advertisement tax, occupational tax, service charges, levy and distribution of revenue generated through use of natural resources and registration fees.

n) Miscellaneous:

Community police, vital registration, relational certificates, data documentation, old aged, physically handicapped, orphan, women and child preservation, support and management, determining, wages, eradication of child labor and emancipation, distribution of social security amount and drug control.

o) Coordination on development:

Maintain coordination among Village government Programme and Programme of the upper government implemented at the village level and monitor Programme implemented by other organizations.

p) Development Plan at the local level:

The above mentioned work including local level plan and Programme formulation and implementation.

q) Local court, reconciliation and mediation:

r) Citizenship, Passport, house and land certificate, distribution and management of documents.

s) Information and communication:

Management of information and communication, FM operation, Computer Centre and arrangement of Tele-centers

t) Arrangement / organization of local services.

u) Market inspection and monitoring and support to price control.

v) Preservation of public property in the respective locality.

w) Relating to Cooperatives and non-governmental organizations.

Proposed lists of assignments of City / Municipal government in the federal structure:

Cities are considered as the symbol of modern civilization. In the transitional society, movement from rural to urban areas/city is viewed as an opportunity and prestige.

Currently, urban management and urban governance is a major challenges of the developing countries including Nepal. Management of public services and resource distribution itself is a major challenge in Nepal due to rapid urbanization, compulsion to enter cities for opportunities, concentration of economic opportunities and facilities in the cities/urban areas.

Owing to the constraints on easy access to basic services and lack of its proper management in the cities, Nepal has been witnessing numerous problems. In addition, adequate attention and focus on Programme related with urban poverty minimization have not been given which in turn is going to be a big threat /danger in the future. Therefore, there is a need of a high level, effective and accountable Municipal/City government in the federal Nepal for proper management of basic services, municipal governance, poverty reduction and economic development.

In this context, job responsibilities of the Municipal/City Government in the federal structure could be presented below.

a) Jobs related to physical development:

To Plan formulation and implementation on land use, directed land development, housing, drinking water and drainage, sewage, quality of drinking water and transportation.

To formulate plan and implementation on Programme implementation, maintenance, development of garden and entertainment sites/places, management of public toilets, approval of building and infrastructure, community building, rest houses/guest houses and other physical development.

To control haphazard settlement pattern, formulate standards on building construction , land acquisition and compensation related packages.

b) Jobs related to Hydro power, environment and sanitation:

Preservation and use of the water sources within the municipal area ,irrigation plan and its implementation; river cutting , flood and soil erosion control, pollution control and preservation of environment, preservation of forest, vegetation and other natural resources, sanitation and solid waste management and distribution of electricity.

c) Jobs relating to education and sports:

All education up to the secondary level, vocational education, supervision, monitoring and control of schools, distribution of scholarship as per the approved policy, libraries colloquiums, sports development, Computer Centre and Tele centre arrangement and operation of FM.

d) Culture- related jobs:

Preservation, promotion and maintenance of sites of cultural heritage and religious importance, preservation and promotion of archaeological objects, language, religion art and culture use and induce to use it.

e) Jobs related to construction and transportation :

Formulation of plans, implementation and maintenance of roads (both black topped and fair weather), bridge, Sub-way, and culverts. Arrangement for parking and transport and registration of means of transportation use in the Municipal area such as Thela, Riksha, Tanga etc.

f) Jobs related to health services:

Operation and regularization of health institutions provide basic health services such as Hospital, Ayurvedic dispensaries and Health Centre, for the provision of preventive, curative, promotional treatment and emergency services. Formulate and implement family planning, child health, safe motherhood, inoculation, maternal child welfare, population education, public health and HIV Programmes. Arrangement to be made for the control of epidemic and infectious diseases within the municipal area along with ban on public use and transportation of goods/commodities considered injurious for health and impose restriction on sale and utilization of consumable goods that adversely affect public health along with control of drugs.

g) Jobs related to social welfare:

Provision of services and distribution of the amount under social security, formulate and implement welfare Programme on women and child, disabled, destitute, children without parents and orphans as well as cremation of the unknown deceased, control on illicit trade, arrangement for the aged and the orphanage and city residential code.

h) Jobs related to industry and tourism:

Promotion of cottage and medium scale industries, promotion preservation, extension and usage of natural, cultural and touristic importance heritage and establishment of tourist information Centre

i) Proper arrangement for street lamp, greenery and urban beauty, slaughter house arrangement , proper management of mortuary, arrangement for transportation vehicles for the deceased and preservation of open space and public property and control of electricity leakages/ theft.

- j) Data/ information:
Updating Population, House, land, block number of houses, relational certificate, civil registration along with basic information in the municipal area.
- k) Cooperatives and cooperative organizations.
- l) Entertainment sites, Sport spot, Sangrahalaya/Museums, Zoo, parks etc management.
- m) City Police and public security.
- n) Management of disaster:
Preventive and rescue works, fire brigade, Ambulance service, Animal rescue services.
- o) Economic development
Income generation, employment generation, industrial Development and vocational training centers', management of markets
- p) Public Private Partnership and service flow.
- q) Revenue authority:
Land revenue, tax on land and house, house rent tax, Occupational tax, vehicular taxation, property tax, Entertainment tax,, Advertisement tax, service fees and charges, distribution of revenue raised through natural resource and house land registration as per the approved criteria.
- r) Local court, Reconciliation and mediation.
- s) Distribution of house, land ownership certificate, Citizenship certificates, Passport distribution and documentation.
- t) Arrangement/organization for local services.
- u) Minimization of urban poverty and arrangement/organization for basic services.

- v) Preservation of Users welfare and treatment against suffering, market monitoring and support to price control.
- w) Control on sale of liquor, drugs and gambling.
- x) Wage and animal related
- y) Cooperative and Non-governmental organization. Agencies related.

Proposed lists of assignments of Metropolitan and Sub-Metropolitan cities in the federal structure:

Management of the metropolitan city is a difficult task in the modern governance system. The metropolitan city remains as centre of economic opportunities along with challenges of urbanization. It seeks specialized management which is different from ordinary governance system and service delivery. The metropolitan city expects most modernized dimensions on governance, use of technologies, risks minimization, etc. For this to materialize, it is necessary for preparing specialized bases on job assignment/responsibilities, resources and the institutional arrangement. Since the metropolitan city needs to adopt and implement skilled, effective and accountable procedures in the federal structure, it should, at least, be provided with a status equal to a province and special authority necessary for vertical growth. In addition to the above mentioned proposed authority of the municipal authority, the following additional responsibilities of the metropolitan and sub-metropolitan cities have been proposed in the federal structure.

- a) Responsibility related to economic and physical development:
 - Promotion of investment in enterprise and business.
 - Facilitation in local economic development.
 - Renewal, reconstruction and structural reforms.
 - Special type of construction standard, condition and regulation in certain sector.
 - Additional metropolitan infrastructure such as City hall, Stadium bus-park, etc.

- Identification and development of geological sources.
 - Preservation and management of open spaces.
 - Management of community buildings and potable drinking water.
 - Purchase of electricity and telephone on whole sale rate and distribution.
 - Management of the physical facilities as per demand and the development status.
 - Service management of Public Private Partnership.
- b) Responsibility related to managing environment and sanitation
- Determination of sanitation standard and its implementation.
 - Pollution emission of transportation means and control of industrial pollution.
 - Testing of water quality.
- c) Responsibility related to health services:
- Management of hospital and special services.
 - Approval for and regulation of opening private hospital, Nursing home, Health Centre, Health laboratories.
- d) Responsibility related to education and sport:
- Approval for and regulation of opening private school
 - Management of higher education after approval
- e) Responsibility related to entertainment spot:

- Establishment, development and management of Park, Garden, sport site, swimming pool, picnic spot, Museum. Approval for opening film halls.
- f) Inspection of the quality of public transportation means and improvement.
- g) Development of information technology.
- h) Responsibility related to good management of the metropolis.
- Control of illicit trade and business and crime minimization.
 - Fixation on Condition on purchase, sale and services of liquor and its adherence.
 - Facilitate free and unrestricted movement in Road, lane and footpath.
- i) Regulation on standards of Hotel and restaurant and their services and food and beverages quality and management.
- j) Ownership of public land.
- k) Control on black marketing, profiteering, adulteration and social ills.

Preparing a list of assignments as per the above toward entrusting authority to the Village and the city government is the first Task/work. It is not certain that providing assignments alone do guarantee ability to render services to the public. Therefore, local government formed after restructuring should be accessed and evaluated on their capacities to deliver services and capacity development/enhancement plan should be formulated. Along with increased capacity development, it would be useful to devolve additional authorities from the Province/Centre to the local government in asymmetric basis.

Federal Capital City

In the layer wise lists of assignments proposed by the Constituent Assembly Restructuring of the state and distribution of state power committee, the assignment

list of the federal capital city has been left. Where to build the federal capital city? What it should be? Will it be Kathmandu or search elsewhere has not been specified. The Constituent Assembly which has got additional one two as bonus for the formulation of the Constitution must decide on federal capital. Generally, the authorities enjoyed by the Metropolitan city should be given to the federal capital. In addition, the federal capital should have the status equivalent to a province along with responsibilities and other system/arrangement. The capital city of many nations has shifted. The federal capital city has obtained status equivalent to a province and in our context also the capital city responsibilities, area, source, resources and alternatives needs to be analyzed in depth.

Another CA Committee on Natural Resources, Economic Rights and Revenue Allocation on its Report of the Preliminary Draft of the Constitution has prescribed allocation of revenue among different level of governments. The proposed allocation of revenue among different level of governments is given below:¹⁶⁹

¹⁶⁹ Constituent Assembly, Committee on Natural Resources, Economic Right and Revenue Allocation Report of the Parliamentary Draft of the Constitution (with concept paper, 2009b), www.can.gov.np, pp 40-42.

Allocation of Revenue among the different level of governments

Source of Revenue	Federal	Province	Local	The reason why the provision, or interpretative comment
Custom Duty	✓			It is the fare in order to regulate the international market. The international market is regulated by means of custom and such power is exercised by the federal government. Custom is related with the production, import-export, and revenues of the country, and it does impact the competitive capacity of the country. Therefore, the federal government has to regulate the international market through trade tax.
Value Added Tax	✓			Such tax is imposed on the various stages of transactions of goods and services- from the production stage to retail sale-where the value is added. The tax imposed in the first stage is deducted in the subsequent stages. Therefore, the person who consumes at the last pays this tax. Giving this power to federal government means it does not discounted the chain of tax deduction and get rid of the problem of boarder tax adjustment.
Excise Duty	✓	✓		The excise duty is imposed against the creation of the traditional social cost (such as impact on public health) in the production and consumption of goods, and in order to manage the cost on the same basis. At present, the area of the tax is extended, therefore this tax is imposed on the production and consumption of goods except the goods of basic needs. Since the responsibility to manage the social and environmental obligation created by the production and consumption of good lies on the federal and provincial government together, it would be appropriate to provide certain portion of the royalty as determined by law to the provinces.
Entertainment Tax		✓	✓	Generally the entertainment services lies in particular place and it is difficult to transfer such entertainment to another place only due to tax.

Land Tax (Land Revenue)			✓	There is not possibility of transfer of base of tax due to the reason of tax. It would be more appropriate to collect from the local level.
Institutional Income Tax	✓			<p>An institution (such as a company) may be transferred from one place to another place due to the variation of tax rate, collected in a limited geographical areas, one company can have multiple transactions and consequently there might be unnecessary competition between the lower political units. By means of this tax, overall financial stability should be maintained addressing the fluctuation in economy, and it is the duty of the federal government. In addition, through this tax, it will be re-distributed income and this would be more effective and efficient if the federal government carries this task out.</p> <p>Under this tax, the income from a profession, investment, rent (such as machinery, land, house etc.), interest, contingency income, and etc. are considered the major sources.</p>
Individual Income Tax	✓			<p>Through this tax there will be re-distribution of income, and this would be more effective if the federal government carries this task out. Individual income tax influences the entire economic stability and it is the duty of the federal government to make overall financial management stable. In addition, if this tax is levied by the federal government, there would not unnecessary competition among the different political wings.</p> <p>Under this tax, the income of a profession, investment, rent (such as machinery, land, house etc.), interest, contingency income, and etc. are considered the major sources. The federal government collects the remuneration tax from the employees of the provincial and local governments and sent back to the respective governments.</p>
Property Tax			✓	The tax base is not moveable, the value of the property would increase from the development

				activities performed by the local government, and the benefits of it should also go to same government. It would be more effective and appropriate if the local government performs this task because the local government better knows its taxpayers. House and land tax is also included in this tax.
Business Tax			✓	It would be more appropriate if the local government charges fees or levies other taxes according to law, while giving permission to establish a business at the local area.
Vehicle Tax		✓		There is less chance to be transfer tax base due to the rate of tax, the province levies taxes over the ownership of a vehicles. However, the federal government levies taxes on the income of the rent of vehicles.
Registration Charge of land and house		✓		This tax is related with the land administration, and the provinces have rights to collect this tax. The provinces have to allocate some portion of such tax to the local governments.
Casino	✓			Casino is run in a regulated way in order to attract tourists, and it is located at a particular place. Therefore, it is appropriate to collect by the federal government and distribute among others.
Service Charge	✓	✓	✓	The government that provides services can only impose the services charge on its service. The services which are only provided by the federal government such as passport, visa, and post office charges etc. go to the federal government. Similarly, the charges collected by the provincial and local governments upon their services are the income of such governments. The provincial government will collect the taxes for the services to be given to the provincial and local level such as vehicle tax, house and land tax etc. The taxes which are considered to be more effective to collect at the local level such as rent tax, house construction permission tax, advertisement, local bazaar (hat bazaar) recommendation etc. are collected by the same government that provides services at local

				level. However, for the services to be provided at different level (such as irrigation, drinking water and permission for tourism), the respective government that provides services will impose service charges.
Carbon Service	✓			Since this issue has international dynamics, the federal government has to settle the amount to be received by Nepal having necessary dialogue with the concerns. Such amount should be provided to the provincial and local government on certain basis.
Royalty and other income to be generated from natural resources	✓	✓	✓	According to the nature and expansion of the natural resources and as per the allocation of such sources among the different level of governments, the charges and royalties to be received from such sources is included under the jurisdiction of such governments. The federal and the provincial government have to allocate the revenue generated by the utilization of natural resources under their jurisdiction to the subordinate governments. The respective government shall have to make arrangement to distribute certain portion of such revenue to the affected local communities in equitable manner. The federal and provincial governments shall have to make arrangement to distribute certain portion of royalty (cash/goods/services) to the subsequent governments on the basis of revenue sharing.
Punishment and Fine	✓	✓	✓	The fine or penalties awarded by local government shall be the revenue of the same level of government.

CHAPTER IV

INSTITUTIONAL CAPABILITIES

4.1 Concept

Capacity is the ability of individuals, institutions and societies to perform tasks solve problems and set and achieve objectives in a sustainable manner. It is widely understood to mean "the ability of people, organizations and society as a whole to manage their affairs successfully and is a key to overall development performance. Thus, capacity is the emergent combination of attributes capabilities and relationships that enable a system to exist adopt and perform."

Legal framework and given authority will not be functional unless it is not supported by the effective institutional mechanism for fiscal decentralization. There are two tiers institutional in Nepal. Basically they are central level Ministry of Finance (MOF) has dominant role, Ministry of Local Development (MOLD) has facilitative role and National Planning Commission plays an advisory role to enhance fiscal decentralization. These are part and parasol of executive mechanism and the parliament has the key role for legislation.

The Municipal institutional capacity including other local bodies (DDC/VDC) is the milestone to collect local revenues as well as expenditure. The LSGA provides substantial authority, responsibility and resources including strengthening institutional capacity. The current institutional characteristics in municipalities and central level organizations can be mentioned as follows:

Central level organizations

- Highly centralized attitude
- Believe in incremental decentralization
- Inadequate coordination
- Lack of professionals for fiscal decentralization.
- No consultation with Local Bodies
- Rarely analyses the policy

- MOF itself is highly centralized and it has determinant role in fiscal policy including local finance.
- Generalized approach is in practice
- Formula based grant distribution is applied only for Local Bodies block grant.

Municipal Capacity

- Faulty design (without adequate facilities defined by LSGA)
- Non viable and smaller in size
- Dependency culture rather than revenue collections and self-sufficiency
- No conducive environment to levy taxes and strengthen the system
- No human resource development plan that focused taxation
- Narrow tax base and low revenue yielding which is not convenient for developing professionals as taxation
- Low economic development and most of the municipalities are not feasible for revenue planning and collecting sufficient revenue to meet the expenditure need.

Institutional variables and linkages

Institutional variables and linkages are fundamentals for capacity and utilization. Institutional capacity depends on institutional variables and linkages.

Like the human body, organizations have many parts that are interrelated and integrated. Internally an organization has certain goals, manpower and procedures. Each organization interacts with the environment in which it works. The change in environment changes the situation in organization and vice versa.

Changes are generally introduced through organizations. Organizations make modern life easy due to specialization of tasks and exchange of goods and services. The

organizations that induce change protect change and formal became institutions and they are valued by societies as meaningful entity (Blase).¹⁷⁰

Esman (1986) identifies and describes five institutional variables: leadership, doctrine, Programme, resources and structure. He describes a leader as a person who controls the institutions internal operations and manager relations with the external environment. Doctrine consists of purpose, objectives and methods of operation of the institution. Programme is related to the activity of the institution that produces and delivers goods and services. Resources are physical, financial, personnel, and infrastructural inputs necessary for the operation of the institution. Internal structure includes the dispersal of authority, division of job and line of interaction within and institution to make decisions and guide actions (Blase, 1980).

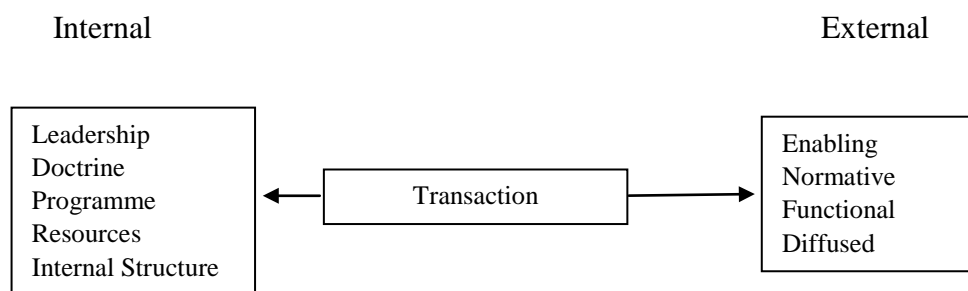
For an organization to function, it should establish relationships with other organizations through linkage. Linkages are the mechanisms that hold the elements together. Thus, linkage in a relationship an organization has with other organizations as which the organization depends on resources authority, and support (UN, 1982).¹⁷¹

The enabling linkage is established between unequal organizations. It is a lower level organizations relation with higher level organization, which controls the resource and exercises authority. The functional linkage is the relation with other organizations dealing with supply and marketing. Functions here are complementary. The normative function is related to interest in Social purposes. The diffused linkage is the relation with individuals or groups not linked to any other organization. These linkage variables and the organizational variables discussed above explain institutional behavior. The institutional behavior is very critical for municipal finance including taxation. For fiscal decentralization many central and local institutions have importance to maintain and balance Inter-governmental fiscal relations. The relationship between the two types of variables is shown in the following figure:

¹⁷⁰ Ojha Ganapati, Partnership between government and non government organization in agricultural extension in Eastern Chitwan, Nepal : Unpublished Ph.D. Thesis : LosBanos: University of Philippines, 1999, p. 25.

¹⁷¹ Ibid, p. 24.

Institutional variables Linkage variables



The institution-building universe

Source: Blasé, 1986 (P.69 cited in Ojha (1999) p. 26.

4.2 Local Self-Governance System

Nepal has a two-tier local governance structure with district development committees- DDC (75) on the top tier and municipalities (58) and village development committees- VDC (3913) in the grass-roots tier. As the electoral constituencies the DDC is further divided into 9 to 17 Ilakas and VDC has 9 wards each, while wards in municipality vary from 9 onwards to a maximum which depends on population, geographical coverage, level of development, income and need for services.

The political system has provided a premise for LBs where they can freely exchange their views and ideas. Accordingly three associations of LBs - Association of District Development Committees in Nepal (ADDCN), Municipal Association of Nepal (MuAN) and National Association of Villages in Nepal (NAVIN) - came in early 1990s, and are active in policy advocacy and lobbying for decentralization.

DDC has become the focal institution of decentralized planning and coordination at the district level. These local self-government bodies have become prominent in implementation aspect of local development efforts where the people's representatives are involved in policy making planning and prioritization of development needs.

At the grassroot level the Municipality and Village Development Committees are formed on the basis of popular voting. The DDC chair, vice chair and members are elected by the electoral college of all elected members of the VDCs, and

municipalities of the district. The respective councils are entitled to nominate the representative of the disadvantaged groups and women in the councils. All LBs have councils to approve budget and Programme; hence they function as legislative bodies. The DDC officials, chairs and vice chairs of VDC and mayors and deputy mayors of Municipality constitute the electoral college for the election of 15 members in the upper house of parliament from the respective development regions. (3 from each region)

Decentralized governance in Nepal has been an outcome of a close collaboration between government agencies, development partners, local bodies and civil society. The major development partners, such as UNDP, DANIDA are involved in the area of decentralized policy and governance whereas the World Bank, ADB, SDC, UNCDF, DFID, WFP are involved in rural infrastructure development. Similarly, IFAD, UNDP, NORAD, UMN, UNICEF, SNV GTZ, CIDA are involved in the sector of social mobilization and capacity development. Moreover, LBs, line agencies (LAs), Non-Governmental Organizations (NGOs), Community-Based Organizations (CBOs), and private sector are working together to enhance better service delivery through decentralized governance at local level.

A decentralized one window financing framework (DDF), as envisaged in the Act, has been institutionalized and operationalized for managing funds at district level. It will regularize fund flow system and enhance financial transparency at local level.

The four pillars are: broad based economic growth, social and rural infrastructure, targeted Programme, and good governance.

LBFC is created to support and strengthen the fiscal decentralization system through establishing fiscal framework (expenditure and revenue assignment, Inter-governmental transfers, and borrowing) to meet the fiscal gaps of LBs. This arrangement, in the long-term, will enhance the institutionalization of the funding criteria, fiscal sustainability and autonomy in local decision making.

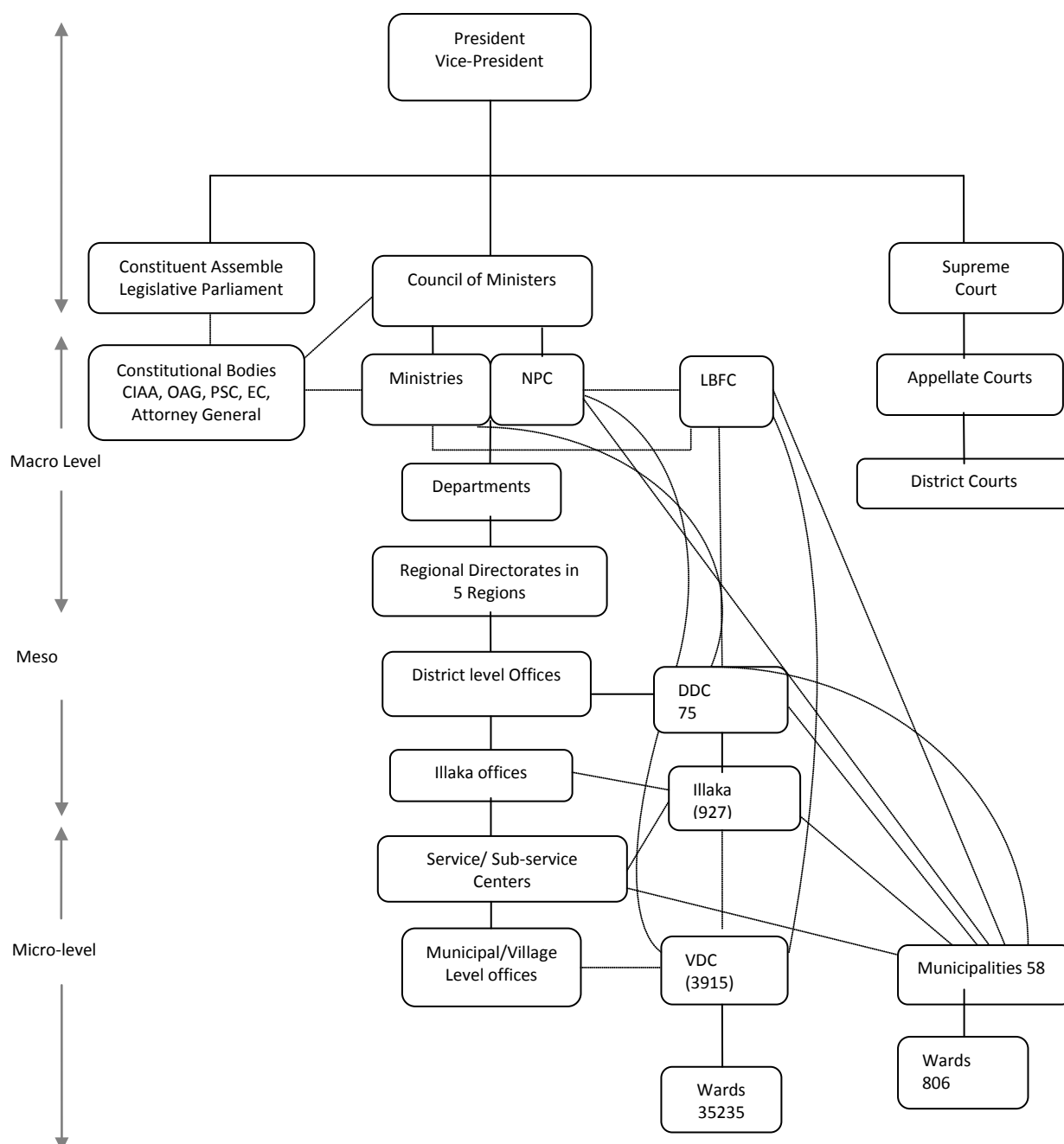
4.3 Governance Structure

Legal framework itself is not advanced unless it is supported by the effective institutional mechanism for fiscal decentralization. Although the country is in transition toward federalism the unitary institutional structure is in practice in Nepal. There are institutional structures of central government and local government at the local level which are working as service providers at grass roots level. The major part for service delivery still vested at the central level institutions and front line offices are extended arm of central institutions which are centrally driven rather than local autonomy and accountable to the clients.

Principally, at the state institutions are created for people. They are for people's benefit and welfare. State institutions are entitled to exercise fiscal powers including officers. Directly or indirectly, all the institutions are related with fiscal decentralization as well as required accountability. By legal framework most of the institutions are responsible to the people in their respective area/sector. To provide an overview of the present whole structural framework of the institutional aspect of Nepal, there are different levels and units of the state structure ranging from micro to meso to macro level as follows:

Figure No: 4

Overall State Structural Framework of Nepal



Source: Developed based on the Interim Constitution, 2007 GON Business Allocation Rule, 2008 and LSGA.

Note: Autonomous LBS are created by the LSGA

- LMS are channelizing their fiscal resources through their own field offices.
- NPC/LMS can provide fund directly to LBS
- Resources funneling channel started from centre and trickle down to micro level.

4.4 Central Institutions on Fiscal Decentralization

Basically there are three institutions Ministry of Finance, National Planning Commission and Ministry of Local Development – Local Bodies Fiscal Commissions playing fundamental role for fiscal decentralization in Nepal. These three institutions are the key institutions at the central level. The other ministries focus more on their own field offices to deliver services to the people as well as on expenditure arrangement. The LSGA clause 243 (2) has provisioned that the concerned ministries shall have to send the Local Body the estimate of the grant to be provided for the Programme of the forthcoming year of the Local Body within the month of Kartik.¹⁷² This provision has not been implemented as it has taken the spirit of plans and Programme integration as well as fiscal transfers. Most of the line ministries are practicing ad hoc mechanism rather than systematic fiscal transfer.

The Central level organizations should be committed for fiscal decentralization. Without their positive attitude and adequate capacity fiscal decentralization cannot be sustained. In Nepal, there are many issues related to fiscal decentralization within the responsible central institutions. Based on the observation and experiences of the researcher the general institutional characteristics of the central level are as follows:

- Central institutions are preoccupied with highly centralized attitude and interested in discretionary power.
- Central institutions are not pro-active to expedite fiscal decentralization with localizing capacity Political and administrative elites generally do not generate decentralized reforms to lose power unless circumstances compel them to do so.
- Similar with administrative reforms decentral reform is also coming through incremental process rather than big bang approach.
- Due to pervasive overlapping of sectoral acts and regulations with LSGA, coordination in decentralization including fiscal decentralization and utilizing human resources coordination itself is a challenge.

¹⁷² LSGA (1999), p. 180.

- Both at the central and local level lack of professionals on fiscal decentralization is very critical.
- Considering the capacity of local body and the respective communities the spatial differences even in laws is necessary. But there is a generalized provision and tendency in most of the laws. There is no holistic analysis of policies formulation implementation and monitoring from the local bodies perspective by the central institutions.
- Except the GON's block grants to local bodies administered by MOLD, there is no formula based allocation system in line ministries. This situation clears that most of the budget in Nepal is distributed either ad hoc or incremental modality. These modalities are the constraints for fiscal decentralization in Nepal.

As mentioned above the MOF, NPC and MOLD-LBFC are major institutions playing vital role at the central level. The brief explanation of those institutions has been given below:

a) Ministry of Finance

MOF is the main actor of public expenditure and revenue management. As in practice in other countries MOF in Nepal is super institution on fiscal matter. The GON's Business Allocation Rules has given power and authorities to the MOF. Traditionally, MOF itself is centralized institution and has been adopted deconcentrated model for revenue collection. The intervention by the annual policies, Programme and budget is more effective with compliance for which MOF is the key. So far the effective fiscal decentralization the commitment of MOF can be considered as precondition. If we analyze the responsibilities of MOF provided by GON's Business Allocation Rules 2008 and the work description of Budget Division of the Ministry we cannot find any word about decentralization and other provisions of fiscal decentralization. The efforts made on fiscal decentralization (FD) area basically on the way to incremental and the pressures generated by MOLD, NPC and even Development Partners (DPS). The Practices and past efforts show that Fiscal Decentralization is not under priority of MOF.

Similarly, municipal taxation is also not adequately supported by MOF. In the organization of the MOF out of nine divisions three divisions (Revenue Advisory Committee, Revenue Administration Division and Budget and Programme Division) are more related with revenue and expenditure.¹⁷³ In those divisions the following policies and activities can be related with fiscal decentralization:

- Broaden the tax base especially in the areas of income tax and value added tax
- Harmonize different tax instruments
- Suggest the amount of revenue to collect or loose on proposed policy
- Introduce performance- based allocation; introduce multiyear funding system so that core project does not go under funded.

The above policies and activities of the MOF are for central budget and revenue. In the overall structure of MOF no decentralization focused division is found. Since the economic aspect is fully controlled by the ministry without any specific division on fiscal decentralization in the ministry no one can expect the pro-active role on fiscal decentralization from the ministry. The experience of the researcher since last twenty one years, very few initiations from the MOF on fiscal decentralization and municipal taxation has been noticed. The role of MOF and practices on fiscal decentralization in Nepal is not priority under the central institutions that should be more responsible for it. The LAFC 2000¹⁷⁴ has suggested the participation from Local Bodies Association in Central Revenue Advisory Committee to discuss the policy implication of the central government on the revenue sharing and allocation of funds (grants) to local bodies which is not materialized to date. It shows that MOF is not serious on the fiscal decentralization. One of the imperfect devolution can be sighted here is "In 2000 the then urban house and land tax named property tax by LSGA 1999 was devolved to the concerned municipalities. But the personnel working in the same job in the respective tax offices were not devolved and internalized in the municipalities. Only the files and documents were handed over. It shows that the combination of functions, fund and functionaries is not followed by the policy and behavior in Nepal.

¹⁷³ <http://mof.gov.np/revenue/index.htm> (2-2-2011)

¹⁷⁴ LAFC Report, Summary and Recommendation, 2000, p. ix.

b) National Planning Commission

National Planning Commission in Nepal is an apex body for plan development and financial resources allocation to the development ministries as well as development Programme. It can enhance the fiscal decentralization process in the country if it is really committed. The Formation and Operational code (Adesh) for the National Planning Commission 2010 (2067) has identified 19 work, duties and authorities of the commission. Out of 19 some of the major work, duties and authorities relating to fiscal decentralization are as follows:¹⁷⁵

- Review and mobilize the resources required for economic development.
- Formulate policies and strategies for balance development at regional and local level.
- Determine the budget ceiling development Programme in coordination with MOF.
- Make policy and plan for efficient and sustainable management of natural resources.

In the organization structure of NPC has the similar issue with MOF about the specific division for fiscal decentralization. Only a section on local development headed by undersecretary exists in the NPC organization (NPC organogram). Without responsible division and professional member of the commission no one can hope to expedite the process and campaign on fiscal decentralization.

The LSGA clause 195(2) has assigned responsibility of the commission that "On the basis of annual and periodic plans formulated by the DDCs the commission and GON have to provide grant and necessary policies and guidelines to the DDC within the month of Kartik."¹⁷⁶ The Commission has been providing the annual budget ceiling followed guidelines and policy directions to the DDCs. But this work is ritual and the volume of the budget is incremental. There is no any specific road map with the planning commission and ministry of finance for fiscal decentralization as well as municipal taxation.

¹⁷⁵ The Formation and operation order of National Planning Commission 2067 (2010), Nepal Rejpatra, 2067-3-14, No. 11, p. 4-6.

¹⁷⁶ LSGA (1999), p. 156.

c) Ministry of Local Development and Local Bodies Fiscal Commission

Ministry of Local Development is facilitating coordinating and advocating central institution for decentralization including fiscal decentralization in Nepal. It is also responsible for monitoring local bodies especially for the conditional grants to local bodies for local development and local service delivery. As per the LSGA clause 240, in making contact with GON the local body shall do so through the Ministry of Local Development. But, LBs can direct contract with other Ministries in respect of the budget and Programme.¹⁷⁷

As per the Nepal Government Business Allocation Rule, 2008, Ministry of local development is entrusted to expedite local development activities through decentralized system. Ministry of Local Development key achievements of 2007 have spelled out the objectives of the Ministry as follows:¹⁷⁸

- Contribute in the poverty reduction by mobilizing local means and resources utilizing skill and technology to the optimum level and creating employment.
- Enhance access of socially and economically disadvantaged groups, region and community to the service and facility delivered
- Capacity building of local government through the local self-governance and contribute to promote local good governance.
- Empowerment of women dalit, indigenous Madheshi, Muslim disable and ultra poor people through social mobilization and their mainstreaming into the wave of development.
- Ensure inclusive development by enhancing peoples participation in decision making and planning process.

Similarly, the roles and responsibilities of MLD are as follows (MLD 2008):¹⁷⁹

- Formulation of policies, plans and Programme related to local self governance, local development, remote area development, rural and

¹⁷⁷ LSGA (1999), p. 177.

¹⁷⁸ Ministry of Local Development (2008), Key Achievements of 2007, p. 4.

¹⁷⁹ Government of Nepal Business Allocation Rules, 2008, p. 15.

community development, and water supply drainage and sanitation at local level and their implementation monitoring and implementation.

- Training, research and investigation related local self governance, local development rural and remote area development and water supply and sanitation at local level.
- Demarcation and mapping of village Development committee, municipality district, zone and development region.
- Coordination of local development, local human resource and Programme
- Mobilization of local human resource and people's participation
- Necessary arrangement for local development related interaction conference and relations
- Management of local level fair and market
- Coordinate and develop cordial relation among local bodies
- Local infrastructure and agriculture road construction and maintenance.
- Activities related to the development of indigenous, dalits and janajatis.
- Administration of vital registration
- Coordination with regional and international organizations for rural and local development etc.

Fiscal decentralization efforts by MOLD expedite jointly with Local Bodies Fiscal Commission. Currently, the commission is convened by the Minister for Local Development. LBFC has not independent working authority MOLD itself is responsible for fiscal decentralization and municipal taxation.

The organizational structure (organogram) of MOLD is also traditional and centralistic itself similar with MOF and NPC. The establishment of LBFC is like additional institutional part of MOLD rather than professionally autonomous. The spirit of FD is not fully internalized in MOLD expect the formula based grant distribution to LBs. The organization of MOLD has not been fundamentally changed after the promulgation of LSGA. Although the Department of Local Infrastructure Development and Agriculture Roads (DOLIDAR) has been enriched with both human resource and financial resources but it is more centralistic instead of capacitating LBs technical institutions responsible for technical work in the field.

The observation and experience of MOLD's general characteristics regarding fiscal decentralization and municipal taxation can be mentioned as follows:

- 1) Political instability and less vision on the fiscally devolved local government management in both the political and administrative leadership.
- 2) Frequent transfer of MOLD secretaries and no criteria is found for MOLD secretary expect political blessing. This tendency is making MOLD's capacity weak to expedite decentralization and devolution process as well as increasing professional capacity of the ministry and bureaucracy under the ministry.
- 3) Central intervention at local level from the political power and leadership is not reducing and bureaucracy is not professional as required for fiscal decentralization.
- 4) Municipal tax expert's area rarely found in the ministry and even in the municipalities.
- 5) At the central level MOLD is not capacitated adequately to enhance fiscal decentralization and lobbying for more power devolution to LBs and capacitating LBs to exercise the fiscal power.
- 6) Traditional targeted Programme and centrally implemented foreign aided Programme are hindering the fiscal decentralization in Nepal. Most of the time of the MOLD and DOLIDAR bureaucrats is occupied in dealing with Development Partners (DPs). So institutional capacity and sustainability is not getting adequate priority.
- 7) MOLD's roles and responsibilities given by the GON (GBR 2008) is not modified as required for the effective fiscal decentralization.
- 8) The decision making tradition and other modus operandi of MLD is toward sectoral ministry rather than apex body facilitating and coordination the stake holders of local governance system in the country.

Local Bodies Fiscal Commission

Institutional provision is the backbone of any system. Institutional arrangement is also basic requirement to implement the system efficiently. Regarding the institutional provision on transfer mechanism; a debate exists in selecting the options of establishment of Central Government Agency (CGA), Inter-governmental Forum (IGF) or Independent Grant Commission (IGC). Italy, China, Zambia, Switzerland and Ghana have central government agency model. Brazil adopted national legislature model. India has two models in practice: for capital grants central government agency works and rest of transfer arrangement is done under the recommendations of Finance Commission that works as a Constitutional Body. Countries including Uganda, South Africa and Australia various types of grant commissions are working. Central agency model is more familiar in both developing and industrial countries. These work under the president or prime minister's office with sole or shared responsibilities for policy making and implementation of transfers and equalization.

Under national legislature model the national legislature must enact legislation to provide a legal basis for vertical transfers. In Brazil, the constitution specifies the pool and revenue sharing criteria and the senate works as primary decision maker and a body for establishing formula and monitoring compliance. Inter-governmental forums, familiar in federal countries, facilitate consultations among different level of governments, strike a balance among competitive interest and mediate conflicts. South Africa and Australia have forum with strong role with the power of review and decision on independent agency recommendations. Canada, Germany, Indonesia, Nigeria and Pakistan rely solely on the forums for decisions on fiscal transfer. In some countries independent grant commissions are created by the National Governments. The duties of these commissions are to report either to the executive of legislature on permanent or periodic basis. By experience IGF restricts political bargaining; conflicting interests' area represented and these areas successful in defining an explicit political compact acceptable to all parties with high premium of simplicity. Comparatively the model of IGC/FC is highly independent, professional,

less political and desired to deal with more desired complex tasks (ADB/MOLD 2009).¹⁸⁰

About past one decade LBFC established itself and in supporting fiscal decentralization for the GON. The Major two achievements of the commission are recommending formula based grant system and administering minimum conditions and performance measures.

The LSGA clause 237 has provisioned the following powers and modality to form LBFC in Nepal.¹⁸¹

"GON may form a fiscal commission comprising the representatives of the concerned federation of the local bodies to study and investigate as to the taxes to be imposed by the local bodies and the revenue to be allocated between GON and the LGs and to make suggestions on the policy to be adopted to make tax system and accounting method timely.

The current composition of LBFC is given below:¹⁸²

- | | | |
|----|---|-------------------|
| 1. | Minister for Local Development | – Convener |
| 2. | Vice-Chairperson, National Planning Commission | – Deputy Convener |
| 3. | Chief Secretary GON | – Member |
| 4. | Secretary MOLD | – Member |
| 5. | Secretary MOF | – Member |
| 6. | Representative National Association of District Development Committee Nepal | – Member |
| 7. | Representative National Association of village Development Committee | – Member |
| 8. | Representative municipal Association of Nepal | – Member |

¹⁸⁰ Asian Development Bank/Ministry of Local Development Nepal, Nepal's Choice in Fiscal Federalism, (2009) Appendix IV, p. 26-27.

¹⁸¹ LSGA, 1999, p. 175.

¹⁸² LBFC Secretariat, MOLD, 2010.

- | | | |
|-----|--|--------------------|
| 9. | Representative Federation of Nepalese Chamber of Commerce and Industries | – Member |
| 10. | MOLD Joint Secretary designated by the MLD Minister | – Member Secretary |

In addition to above mentioned powers of LBFC the GON has mandated to the commission the following scope of work:¹⁸³

- 1) To coordinate LAFC 2000 recommendations and Decentralization Implementation Plan 2001 implementation.
- 2) To develop grant policy and distribution criteria to LBs.
- 3) Prepare the revenue sharing policy and the basis of its distribution.
- 4) Develop and administer MCs/PMs indicators and standard and determine the amount of grant to LBs.
- 5) Organize the capacity strengthening Programme to LBs for LBs revenue enhancement. For MCs/PMs implementation and capacity strengthen 0.5 percent from the LBs grant and revenue sharing to be allocated to LBFC.
- 6) To identify the problems on fiscal decentralization and submit recommendations to resolve the problems to GON.
- 7) Coordinate between GON and LBS for fiscal decentralization
- 8) Study on revenue potentiality and identify and recommend new possible revenue base to LBs.
- 9) Reform LBs revenue and accounting system.
- 10) Monitoring and reviewing fiscal decentralization.
- 11) Inter-ministerial/agency coordination and secretarial work for revenue sharing to LBs.

¹⁸³ LBFC Secretariat, 2010.

- 12) Prepare LBs borrowing policy and basis.
- 13) Provide support and recommendation to LBs for resolving fiscal problems.
- 14) Other subjects relating to fiscal decentralization.
- 15) In addition to the above jurisdiction LBFC can add other functional areas if needed.

LBFC in Nepal is very weak. In practice MOF, NPC and MOLD are engaged in fiscal transfers. The strong institution for fiscal transfers as well as fiscal decentralization is needed to devolve resources to the lower levels of governments. In the federal context strong and effective institutional arrangement for Inter-governmental transfer will be a precondition for fiscal balance. The characteristics of the current LBFC experienced and noticed by the researcher in the last one decade can be pointed out as follows:

1. LSGA itself is a weak law. Line ministries are advocating and executing the sectoral laws contradicting with LSGA. So LBFC is automatically becoming very weak institution without enforcing power.
2. Commission is comprised of ex-office members whose prime responsibility is not LBFC's tasks and responsibilities.
3. Convening by the minister for local Development is not creditworthy for its neutrality and professional integrity as well as autonomy in a country like Nepal.
4. The secretariat of the commission with two full timers under secretaries and other staffs is very weak. The changes of personnel including member secretary in the past one decade shows that it is not attractive institutions for the personnel and priority reform area for MOLD. Only one member secretary had worked for more than five years in the secretariat in its one decade period. Currently there is no institutional memory and no permanent professional staffs are motivated. Thus LBFCs itself is ad hoc institution.

5. MCs/PMs and its linkage with block grants to LBs are the thin thread to retain LBFC. It has no recognition in the overall budget of the country. It is exercising over the ad hoc divisible pool provided by MOF.
6. As per the necessity of fiscal decentralization LBFC is not functioning adequately. It is cosmetic rather than functional as mentioned above the independent grant commission, forum and centrally effective institutions for fiscal transfer, which can influence country's overall budget.

4.5 Municipal Capacity

Measuring local capacity can be difficult and the debate over quantifying it has often been motivated by political concerns as well as technical considerations about the local government's ability to provide services. "It is useful to out some of the relevant issues in objectively measuring local capacity. There are four general skill areas: identifying and analyzing local problems in order to plan appropriate responses, mobilizing and managing resources communicating and coordinating policy implementation, and resolving local conflicts."¹⁸⁴

There are several issues to consider in measuring capacity:¹⁸⁵

- (a) Outputs or outcomes – output measures can be defined as the number of services delivered (for example, school attendance, vaccination coverage, kilometers of road build or vehicle traffic)
- (b) Variable ability – one of the most important tasks in planning decentralization is to identify and account for the differing skill levels of local governments. Variations in the ability to plan and execute projects for example, can lead to differing implementation rates and ability to use revenue, which in turn can exacerbate inequalities.
- (c) People or institution – Does local capacity consist of individuals who may or may not continue to play a role in the government or are there

¹⁸⁴ Graham Kerry, *Local Technical Capacity and Managerial Capacity* : World Bank Institute, , (1999), Edited by Jennie Litvack and Jessica Seddon, p. 46.

¹⁸⁵ Ibid, p. 46-47.

institutionalized mechanism (such as competitive pay, prestige, contracting arrangements, or training procedures) for assuring a continuous supply of technical and managerial expertise ? Important factors to look at in assessing the community's capacity are depth and history of civil society organizations, number of private contractors, and concentration of skills.

- (d) Bureaucratic and technical infrastructure –
The process by which information is received, processed and stored underlines most local governance functions.
- (e) The role of civil society – Nongovernmental organizations can often be a source of trained, experienced personnel, and local construction, accounting, and squire firms can provide services on a case-by-case basis.

Most of the municipalities in Nepal are the outcome of incremental urbanization rather than planned settlement and development. The mode of decentralization adopted in the country since last five decades is not localizing resources and capacity from the center. Similarly municipal institutional capacity is also increasing gradually. The assigned responsibility to the municipalities by the LSGA is not fulfilled by them due to lack of institutional capacity as well as financial resources.

The efforts by the municipalities themselves and few donors were made for municipal capacity enhancement. The Municipal Organization and Development Administration (MODA) and Financial Management (FIMA) initiatives under the support of UNDP were taken in the past. In 21 municipalities urban poverty reduction and monitoring strategy papers were prepared in 2007. Similarly, periodic plans preparation initiation is under way. But these efforts are not institutionalized and not able to focus on municipal taxation. Nepalese municipalities are focusing more on expenditure than revenue. There is no municipal revenue plan in Nepalese municipalities including in the sample municipalities.

Recently, under the support of Local Governance and Community Development Programme (LGCDP), all the 58 municipalities have prepared the Capacity

Development plan for three years. Although these plans are LGCDP focused but we can understand the general capacity gaps in the municipalities in Nepal. The common and specific issues of municipal capacity development and specified CD activities except Kathmandu Metropolitan City of sample municipalities are given below:¹⁸⁶

a. Common Issues

Areas	Common Issues
Policy & systems	<ul style="list-style-type: none"> • Lack of comprehensive urban policy of GON • Absence of strategic/periodic plan of municipalities complemented by or backed by sectoral plan • Poor Urban and Physical Planning • Poor Urban financing • Weak Civil Society Participation • Unavailability of disintegrated database • Lack of integrated solid waste management approach and mobilization of private and CSOs • Inadequate study on internal resource mobilization and mobilization of private and CSOs • Absence of procurement plan and service outsourcing policy • Poor interventions in social mobilization and accountability related works
HR/D	<ul style="list-style-type: none"> • Lack of specific technical and managerial skills • Poor Private Sector Mobilization • Inadequate knowledge, skill and experiences on public procurement • Absence of procurement units in the municipalities • Poor functioning of revenue advisory committees and limited interactions among stakeholders on revenue mobilizations
Resources & Facilities	<ul style="list-style-type: none"> • Inadequate office and field equipments • Poor infrastructures and services • Lack and impoverished performance of environment and sanitation section of municipalities

b. Specific Issues

¹⁸⁶ Source: LGCDP (2010): Considering the capacity gap in municipalities in Nepal, LGCDP had provisioned grant for capacity Development Plan Preparation to all the municipalities. The common issues and specific CD activities are derived from the CD plan of the respective municipalities from the PCU of LGCDP/MOLD

Municipality	CD Areas	Specific CD Issues
1. Gorkha	Policy & Procedures	<ul style="list-style-type: none"> • Lack of practical user committee mobilization, consumer rights protection framework • Difficulty in inventory management due to lack of computer software on inventory • Difficulty in monitoring, evaluation and reporting of project and Programme due to lack of municipal monitoring and evaluation system, planning and progress monitoring software • Difficult and delay in project implementation due to lack of procurement plan and delivery of goods and services • Lack of clear TOR to respective committees, sections, units & portfolios • Insufficient interventions; and practices on downward accountability • Non-compliance of LSGA/R, Grant Guideline, performance based funding and/MCPMs
	Resources & Facilities	<ul style="list-style-type: none"> • Insufficient basic office and/or field equipments • Insufficient office facilities and supplies
	HR/D	<ul style="list-style-type: none"> • Inadequate knowledge and insufficient orientation on periodic planning to stakeholders • Low level of knowledge, skills and experiences on decision makers, staffs and other stakeholders on monitoring and reporting • Poor operation of hardware projects due to poor intervention on repair, maintenance and sustainability of projects • Poor engagement of citizens especially vulnerable & marginalized communities • Poor implementation and not-compliance of national building code • Poor knowledge and information on earthquake resistant building construction • Poor coordination and partnership between municipalities, private sectors and CSO/CBOs • Poor capacity of office on procurement, inventory management
2. Pokhara	Policy & Procedure	<ul style="list-style-type: none"> • Lack of disintegrated municipal data base by ward, gender, class and social strata
	Resources & Facilities	<ul style="list-style-type: none"> • Insufficient information & communication facilities in municipality and ward offices • Difficulty in service delivery from ward offices

Municipality	CD Areas	Specific CD Issues
	HR/D	<ul style="list-style-type: none"> • Low morale, motivation and productivity among municipal staffs • Insufficient knowledge and information on social security and safety nets • Poor coordination among municipal stakeholders on planning especially LAs, CSOs and municipality • Poor engagement of citizen and CSOs in planning, monitoring • Insufficient interventions and practices on GESI planning, transparency and downward accountability • Poor Low ?coverage of social mobilization and ritual practices • Poor interaction and communication between municipality and PSOs and CSOs • Poor mobilization of cooperatives and other CBOs in local economic development activities • Gradual increment on volume of advance and beruju(arrears) • Building code properly not followed and poor information and communication on earthquake resistance building construction and national building code • Poor management and technical capacity of TLO, CSO, WCF representatives
3. Nepalgunj	Policy & Procedure	<ul style="list-style-type: none"> • Lack of strategic plan of lead and priority sectors like transport, tourism, drinking water and sewerage • Lack of GESI policy of municipality and gender budget audit • poor monitoring, lack of evaluation and poor and irregular and delay reporting • Poor communication among urban development and governance stakeholders • Poor performance in internal revenue mobilization • Unhealthy competition and poor tendering process • No mechanism for complain and grievance handling • Lack of updated information, record and comparative areas of advantage of CSOs and other service providers
	Resources & Facilities	<ul style="list-style-type: none"> • Unavailability of resource map • GIS not used as intended • Difficulty and survey for infrastructure projects due lack of equipments and software

Municipality	CD Areas	Specific CD Issues
	HR/D	<ul style="list-style-type: none"> • TLO/CBOs and representatives of all party mechanisms not properly oriented on planning and project implementation • Poor performance of UC and TLO in project implementation and quality monitoring and its operation • Stakeholders not properly get acquainted knowledge on GESI and cultural heritage protection and environment management • Lack of sectoral strategic plan of lead sectors and periodic plan of the municipality • Pressure from communities on repair and maintenance of urban infrastructure & cultural heritage • Inadequate knowledge and information of CBOs about heritage conservation and use to CBOs • Poorly managed solid waste despite high investment • Poor performance of record, documentation and reporting • Very low attention on internal revenue study and mobilization • Lack of spatial analysis and integrated urban database • Lack of dissemination and knowledge on RTI among stakeholders, citizen and marginalized communities • Very poor intervention at community, TLO and CBOs in solid waste management • Lack of Programme me and interventions for greenery development and park management • Inadequate knowledge on proposal development/writing?
4. Biratnagar	Policy & Procedure	<ul style="list-style-type: none"> • Very weak work performance of environment section • No strategies for solid waste management and sanitation • Very ritual planning and budgeting and with any consideration of GESI in planning • High investment of municipality in repairing, maintenance and operation of municipal property and lack of system of repair, maintenance and operation of urban public goods • No updated records of heritage and conservation plan
	Resources & Facilities	<ul style="list-style-type: none"> • Lack of computerized software Programme and training on it

Municipality	CD Areas	Specific CD Issues
	HR/D	<ul style="list-style-type: none"> Stakeholders and staffs not properly and adequately oriented on current, recent policies, by-laws, procedures and guidelines Role of TLSs and its coordination committees are realized but not formalized Poor participation in planning and budgeting and poor knowledge on results based monitoring Poor capacity and minimum interventions for environment and solid waste management

Planned activities with respect to common and specific issues

Common CD Activities

Supply Driven CD Activities

Areas	Common CD Activities
1. Policy, system and procedure	<ul style="list-style-type: none"> Development of CD Strategy/manual for municipalities and support for CD Plan preparation Development of various policy framework and systems as Block Grant Guideline for municipality Gender & Social Inclusion Policy and Procedure Environment and Social Safeguard Framework Social Mobilization Guideline Information Education & Communication Strategies and Guideline Local Governance Accountability Facility Operational Manual Annual Municipal Development Planning Framework Monthly, Trimester and Annual Reporting Format Accrual accounting system
2. Resources & Facilities	<ul style="list-style-type: none"> Equipments and logistic (Laptop, motorcycle, camera, etc) Computerized software Programme mes (Planning, Procurement, Logistic Inventory, Vital Registration etc.)

Areas	Common CD Activities
3. HRD (Training/ Orientation)	<ul style="list-style-type: none"> • Public Procurement Act & Procurement Plan Preparation • Capacity Development • Minimum Conditions and Performance Measures • Gender and Social Inclusion Budget Audit • IEC Strategies • Environment and Social Safeguard Framework, Disaster Management • Social Mobilization • Revenue Mobilization • Accounting/auditing • Block grant guideline and others
Policy and systems	

Demand-Driven CD Activities

Areas	Common CD Activities
Policy and systems	<ul style="list-style-type: none"> • Formation of integrated planning committee at municipality & ward level • Contracting out consultants for city profile preparation • Impact study of infrastructure projects in the municipalities • Organize public hearing, social and public audits & other accountability and voice mechanisms • Ward citizen and learning centers formation and its operation • TLO networking and operation guideline • Website design and update • Develop and procure software like account, inventory, vital registration, planning etc.) • Publication and broadcasting of activities, services and public grievances through from print and electronic media • Annual and multi-year procurement plan preparation • Establish NGO/CBO desk and organize quarterly interaction • Contracting out for regular publication of municipal activity bulletin

Areas	Common CD Activities
HR/D	<ul style="list-style-type: none"> • Project implementation and maintenance training to UCs and TLOs • Institutional development, networking & operation training to TLOs • Orientation on urban policy, guideline and manual related to municipal development and governance • Interaction on conservation and tourism promotion • Interaction on MCPMs & social accountability mechanisms and tools • Study tour and exposure visits • Study/update Organizational Development of municipalities • Training on Appreciative Inquiry • Team building training cum workshop • Monitoring and evaluation training • Proposal development and report writing training • Orientation on LSGA/R and urban policy and planning • Orientation on public procurement act, regulation, process and practices to officials, staffs, representatives of UC and political mechanism • Interaction with CCI officials, entrepreneurs and representatives of all party mechanism of municipality on business tax collection and mobilization • Practical training on result-based monitoring
Resources & Facilities	<ul style="list-style-type: none"> • ICT facilities and basic engineering equipments

Specific CD Activities

The specific CD activities by cross-cutting areas with respect to specific issues of the study municipalities are presented below:¹⁸⁷

Municipality	CD Areas	Planned CD Activities
1. Gorkha	Policy and Procedure	<ul style="list-style-type: none"> • Development of policies, software Programme, & carrying out studies as; • Consumer Rights Protection Guideline • Traffic, Sanitation & Public Health Management Guideline • Procure Inventory Management Software • Municipal monitoring and evaluation guideline • House mapping software • Consumer awareness guideline

¹⁸⁷ According to PCU/LGCDP, Kathmandu metropolitan city did not prepare CD Plan even the grant from the Programme me had provided to it.

Municipality	CD Areas	Planned CD Activities
		<ul style="list-style-type: none"> • Consumer satisfaction/exit poll survey • Preparation of annual & multiyear procurement guideline (MLD will provide?) • Study on quality standard and effectiveness on urban service delivery • ToR development of committee, sub-committee section, unit and portfolios
	Resources & Facilities	<ul style="list-style-type: none"> • Procure a Computer and Digital Camera • Procure Computer Software • Filing rack, cabinet and system
	HR/D	<ul style="list-style-type: none"> • Training/orientation on; • UC and TLO Mobilization • Municipal Periodic Plan Preparation • Organization of Exposure Visit • MCPM Manual and LSGA/R • Urban Governance and Social Accountability • Project Repairing and Maintenance • Procurement and inventory management training • National building code • Filing system • Interaction on Earthquake Resistant Building Construction with Stakeholders • Interaction on GESI Planning and Gender Budget Audit • Coordination and partnership development workshop
2. Pokhara	Policy and Procedure	<ul style="list-style-type: none"> • Resource and poverty mapping by wards • Strengthen the internal resource mobilization and audit section

Municipality	CD Areas	Planned CD Activities
	Resources & Facilities	<ul style="list-style-type: none"> • Procurement computer and networking with different sections & wards • Purchase survey, lab equipment and computer software
	HR/D	<ul style="list-style-type: none"> • Attitude and behavior change training to municipal staffs • Social Security and safety nets training to ward secretaries • Orientation on inclusive, participatory municipal development planning & coordination between LAs & municipalities and NGOs • Project implementation to UC, TLOs and NGOs • Training on urban governance and accountability tools • Social mobilization training to ward secretaries • Solid waste management and safety measures to municipal staffs of concerned sections • Security management training to municipal police in coordination with security agencies • Interaction workshop between municipality and CCI for partnership development • Interaction workshop between municipality and cooperatives operating in the municipality • Orientation to construction entrepreneurs on earthquake resistant building construction • Human Rights Based Approach (HRBA) training • Training on inclusive development • Orientation on advance and beruju reduction • Technical training on AutoCAD, GIS, Road and Sewerage design to technical staffs • Office management training ward secretaries • Urban planning and development control training to municipal respective municipal staffs • Orientation on monitoring and its tools to monitoring and supervision committees • Training on proposal writing, project management to TLOs, CSOs and WCF representatives

Municipality	CD Areas	Planned CD Activities
3. Nepalgunj	Policy and Procedure	<ul style="list-style-type: none"> • Preparation of municipal transport master plan • Preparation of GESI Policy of municipality • Preparation of a framework for annual municipal development action plan • Preparation of a framework for results based monitoring and evaluation • Organization of trimester review meeting among stakeholders • Preparation of a guideline on municipal revenue mobilization • E-tendering and e-bidding system development • Preparation of Public grievance handling guideline • Mapping of CSO/CBOs and service providers • Mapping, short listing and capacity assessment of potential investors, service providers and CSOs for PPP
	Resources & Facilities	<ul style="list-style-type: none"> • GIS installment, GPS procurement and operation in place. • Establish and strength the building code and environment section
	HR/D	<ul style="list-style-type: none"> • Orientation on planning, implementation to TLO and political representatives at ward and tole level • Project implementation training to UC and TLOs • Orientation to municipal stakeholders on GESI • Orientation to stakeholder on cultural heritage protection • Exposure visit to share best cases on project implementation • Orientation on sectoral and periodic planning • Training on repairing and maintenance of infrastructures • Training on result based monitoring • Orientation to TLO, WCF, CBOs and women groups on the conservation of cultural heritage • Public awareness campaign on solid waste management and heritage conservation • Training on documentation and report writing • Study on revenue potentiality of municipality and its mobilization • Training on GIS/GPS and spatial analysis
		<ul style="list-style-type: none"> • Orientation on right to information • Training/sensitization to TLOS, CBOs, CSOs and community on solid waste segregation and composting • Interaction on greenery development and park management • Training on urban planning and proposal development
4. Biratnagar	Policy and Procedure	<ul style="list-style-type: none"> • Strengthening environment section • Develop solid waste management and sanitation guideline • Gender budget auditing • Develop guideline on repairing, maintenance & operation of public goods • Prepare inventory of heritage site and the conservation plan • Develop sector plan of priority sectors public infrastructure development, local economic development, environment management, disaster management and CD

Municipality	CD Areas	Planned CD Activities
	Resources & Facilities	<ul style="list-style-type: none"> Develop or procure planning, monitoring and evaluation software
	HR/D	<ul style="list-style-type: none"> Orientation to stakeholders on current policies, bylaws, procedures and guidelines Training on participatory planning ,and on project implementation to TLO coordination committees Training to all party mechanism, staffs and CSOs participatory and result based monitoring Training on environment conservation and solid waste management Orientation on GESI planning

4.6 Issues on Institutional Capacity

Legal framework, structure, functions and accountability of any institutions are determinant factors to achieve the intended results. For fiscal decentralization all the institutions from center to grass-root level must be capacitated adequately and need to be accommodative the required changes including social behavior. The responsive institution can be supported by the people through participation and tax compliance for revenue collection and expenditure to discharge the services.

In the context of fiscal decentralization and municipal taxation in Nepal municipal level to central level institutions are equally important of fulfill the given roles and responsibilities. Currently, the situation and the experiences indicate the following issues on institutional capacity:

- The governance structure and legal framework in Nepal are predominantly centralistic. The fiscal resources trickle down from top to bottom. So central institutions are exercising more powers.
- Fiscally devolved system needs functional local institutional and supportive central institutions. But in Nepal both level institutions are not pro-active adequately.
- The expenditure assignment is the main basis of channeling resources and determining institutional responsibilities. The pervasive overlapping in expenditure is the constraint for fair institutional arrangement for fiscal

decentralization. So there are many institutions with different responsibilities for fiscal decentralization which are relatively weak in overall perspective.

- There is no single influential and responsible leading institution for fiscal decentralization. The Contradicting roles and overlapping responsibilities among different institutions like MOF, NPC, MOLD and LBFC at the central level is the main issue to create single strong institution for fiscal decentralization.
- The legal provision is not consolidated for effective institution.
- There is no road map for fiscal decentralization which breeds the institutional requirements and capacity.
- FD itself is not under priority under government reform which is stand still due to political transition.
- Due to weak accountable mechanism, Municipalities are not accountable to people in delivering services as designated by LSGA. They are highly depended on fiscal transfers from the center. They are not facing fiscal deficit for investment because they do not have comprehensive investment plan. They are engaged in expenditure whatever money they have.
- There is no revenue plan to exploit revenue potentiality in the municipality which is the key for municipal capacity strengthening.
- Fiscal decentralization is political imperative without political vision and commitment on fiscal decentralization the strong legal base and competent institutions is not easy.

The general issues, specified issues and proposed CD activities of the four municipalities mentioned above show that the basic requirement and the level of knowledge is not adequate to utilize given revenue authorities to enhance revenues as well as expanding public services in the municipalities. .

CHAPTER V

ANALYSIS OF FISCAL DECENTRALIZATION AND MUNICIPAL TAXATION

5.1 Introduction

Decentralized governance cannot go beyond the overall governance in the country. Nepal is one of the highly centralized countries where both fiscal decentralization and municipal taxation are in preliminary stage. Although, legal provisions in a narrow scope was given from the very beginning of decentralization but the tax yielding capacity and overall fiscal decentralization could not produce intended results. In previous chapters different perspectives are elaborated. In this chapter, the primary data and secondary data have been analyzed. Based on study the analysis of fiscal decentralization, municipal taxation and capacity are presented below:

5.2 The Pillars of Fiscal Decentralization

(a) Expenditure Assignment

Expenditure assignment is the milestone of fiscal decentralization which opens the other aspects of fiscal decentralization. In Nepal, GON's Business Allocation Rules, 2008 and LSGA, 1999 are the major legal bases of expenditure assignment. Based on the LSGA, Local Bodies Fiscal Commission organized a study on expenditure assignment in 2004. The study has identified key issues related to legislative framework on expenditure assignment. Some of the issues related to expenditure assignment are given below:¹⁸⁸

(i) Overlap Functions between Central Government and Local Bodies

The type of functions that are carried out by central government and local bodies are similar in the sense of nature of tasks, planning, Programme ming and implementation. In most cases, plans and Programme of the central government and the DDC are often duplicated with the lower level bodies (VDC/Municipality) due to their involvement in service delivery functions at local level. Neither the GON Business Allocation Rule nor practice confines

¹⁸⁸ Report on "Expenditure Assignment Study"(2004),Kathmandu: Local Body Fiscal Commission Secretariat/Decentralization Advisory Support Unit (DASU/DANIDA) p. 37-39

the role of central agencies beyond the domain of local bodies. As a result, the central government is involved in services at local level that could be carried out even by the local bodies. The rule is also silent about the role of sectoral ministries on the functions allocation to local bodies.

(ii) Duplication in functions between DDC and VDC/Municipality

In accordance with provisions made by the LSGA, similar types of functions are carried out by the DDC and Municipality/VDC; The LSGA has not adequately defined the services and functions for DDC and VDC/Municipalities, and since the DDC does not have a territory of its own the duplication is prevailing.

(iii) Unclear functions in the LSGA

Some of the functions stated in the LSGA are yet to be sufficiently clarified between DDC and Municipality/VDC. Some of the unclear functions as it is provisioned in the LSGA are education, health, taxation, sale, monitoring and supervision.

(iv) Unconsolidated task assignment of LBs

The LSGA has stated that the LBs should carry out the functions assigned by prevailing other laws, besides the functions assigned by the LSGA. Functions mandated by other Acts to LBs are more of agency-functions such as making recommendation, be witnessed or be in presence or to certify for judicial and quasi-judicial activities. Most of these provisions have not devolved the authority and responsibility.

A detailed comparison on overlapping of activities between GON and LBs has been presented by LAFC, 2000. The report has identified very few single activities among the tiers of government in Nepal. The report has further indicated that "because of several overlaps in relation to other agencies, the functions of mobilizing fiscal resources for the local bodies are being greatly hampered. It has not been possible to make effective utilization of scarce resources because of lack of uniformity in work responsibility, discharge of responsibility, formulation of long term plan, budget management etc. There can be efficiency in mobilizing fiscal resources and it can be assumed that the expenditure will be put to good use only if overlaps are removed and

clarity is made in the scope of work of the central, regional, district, municipal and village level bodies" (LBFC, 2000).¹⁸⁹

Under the study, questionnaire on fiscal decentralization and municipal taxation were distributed to the policy and central level, MLD/LBFC senior personnel and experts, municipal level and focus group discussions in the sample municipalities. Different respondents responded differently. The major finding analysis based on the respondents on expenditure assignment is given below:

(i) Policy and Central Level

The questionnaire on the subject relating to policy and central level were distributed among 30 persons who have knowledge and experience on fiscal decentralization in Nepal. Twenty six respondents responded out of thirty. The response on expenditure assignment (EA) is given below:

- Mind set of centralization has weakened expenditure assignment.
- Expenditure assignment itself is a major challenge of fiscal decentralization in Nepal
- Expenditure assignment is not matched with the fund. So, LBs in Nepal are working with unfunded and underfunded mandates.
- Expenditure assignment between central agencies and LBs is under the problems of duplication, overlapping and ambiguity and prevailing contradicting acts with LSGA is making role delineation unclear.
- Political commitment is very weak and there is no consensus among central level authorities on decentralization and low level of trust over local leadership.
- Fiscal decentralization in real practice is less priority in agenda which is not paying attention for clear Expenditure assignment.
- Duplication between central government and municipalities.

¹⁸⁹ Local Authorities Fiscal Commission Report, 2000. His Majesty's Government Local Authorities Fiscal Commission, Shree Mahal, Pulchowk, p. 33.

- Constitutional guarantee of fiscal decentralization is needed for creating conducive environment for effective fiscal decentralization and municipal taxation.
- Need to remove overlapping, ambiguity and duplication in Expenditure assignment.
- There is need for devolving funds, functions, and functionaries and should be clear in the context of state restructuring.
- No clarity of Expenditure assignment in drafting new constitution.

(ii) MLD/LBFC Senior Personnel and Experts

The questionnaires to thirty senior MLD/LBFC personnel and experts were provided to respond only 19 respondents responded. The questionnaire is broadly related with fiscal decentralization and not directly related with expenditure assignment. It is more specific on municipal taxation, revenue and both LBFC and municipal capacity. The findings of this questionnaire will be presented in relevant headings and fiscal decentralization.

(iii) Focus Group Discussion

Focus Group Discussion (FGD) were organized in sample municipalities. Although the themes of the discussion were municipal taxation focused, but the themes are linked with fiscal decentralization and obviously with expenditure assignment. Major findings on expenditure assignment on FGD are as follows:

- Municipalities have been using the fiscal authorities partially as provisioned by LSGA and its regulation. They are facing coordination problem with government agencies.
- The expenditure assigned to municipalities is not fulfilled due to inadequate political commitment, funding gap, lack of capable human resources and weak institutional capacity. The major services provided by the municipalities are street light, waste management, drainage, vital registration, approval on building

construction, physical infrastructures like roads, schools, buildings etc.

- The major services that are borne by the municipal tax revenues are waste management, sanitation, education, health and road related infrastructure services. In Pokhara, tourism development is enhanced by the tax revenues.
- No answer was found by any municipality about increase in services in terms of increased revenue.
- Both taxes and services can be increased by devolving more authorities to LBs, enhancing staff capacity and coordinating line agencies.
- Overlap/ambiguity in expenditure assignment within LBs themselves and line agencies and house land and rent tax, vehicle tax, professional tax etc.
- The basis for prioritizing projects is mainly community demand. The criteria set by the existing acts/regulations and guidelines are followed.
- Because of lack of political will ad-hoc decision- making practices prevail with regards to all aspects of devolution including expenditure assignment.

(b) Revenue Assignment

Revenue assignment is a basic component of fiscal decentralization. Revenue assignment should be based on the principle that "Finance should follow the functions". This means revenue should be matched with the assigned responsibility. Managing macroeconomic stability, achieving redistribution function and allocating resources and efficiency through rendering goods and services as well as allocating revenue and expenditure responsibilities to different level of governments as per the political system of the country, the constitutional provisions and level of autonomy to be given to different levels of government and the capacity are the basics of fiscal federalism.

There are four types of mechanism of revenue assignment in practice (ADB/MOLD, 2009).¹⁹⁰ Independently local taxation (local choice of base and rate, local control in administration), centrally assisted local taxation (choice of base/rate are defined by center and administration is done by local) with some degree of enforcement assistance by center. This mechanism is experienced being helpful to reduce administrative and compliance cost. Third one is local fees and charges that are levied and collected by local bodies. The revenue/tax sharing mechanism, under which tax is collected by any unit of the government and taxes to be shared that is in favor of uniform tax base and unified tax administration. However, there are two approaches of tax sharing; one is base sharing and another one is rate sharing. So any appropriate option can be chosen while designing such mechanisms. The last one is transfer that is usually known as grant providing mechanism is also familiar mechanism to sub-national governments to meet their fiscal gaps. It is also known as an equalization option. In Nepal, the second and third mechanisms are adopted by LSGA and they are in practice.

Municipalities in Nepal are authorized to levy different types of taxes and collect non-tax revenues. Municipalities are entitled to collect 12 types of taxes defined by LSGA. The act has defined the bases of taxes. The rates are defined by its regulation. But the low tax base and potentials are the main constraints for increasing local revenues and institutional capacity is major problem for collection efficiency. In this research different methods of data and information collection are adopted. Based on the questionnaires and focus group discussion the major findings relating to revenue assignment are given below:

(i) Policy and Central Level

- Urban governance needs to be given wider authority so as to make it full autonomous. Provision for tax needs to be broadened in the comparison to the current provision.
- Local taxation capacity of municipalities is seemed very weak compliance of local tax percentage is low and, law is very weak.

¹⁹⁰ Asian Development Bank/Ministry of Local Development, Revenue Assignment in Nepal's Choices in Fiscal Federalism (2009), p. 5.

- There is need of devolving functions, funds and functionaries at the same time. It is critically important to launch Programme aimed at enhancing institutional capacity of municipalities.
- Enactment of statutory law blended with capacity to be devolved.
- Nepal is in junction of federalism. Until the federal structure is determined by the upcoming constitution we have to rely on existing LSGA. Therefore, the municipalities should impose the taxes which are permitted by the Act.
- Devolving more authority to the local bodies including municipality, the potentiality to be considered to generate more local revenue.
- Enough authority should be devolved to the municipalities in order to make them self-dependence in addressing various complex issues.
- Functional responsibilities and revenue assignment (tax and revenue) base to be delineated clearly.

(ii) MLD/LBFC Senior Personnel and Experts

- LSGA's full implementation and more power to municipalities on tax bases is necessary for effective municipal taxation.
- Municipal tax base is not adequate in many smaller and new municipalities. So, they are not able to manage current expenditure by own source revenue.
- Expenditure and tax assignment to be matched with accountability.
- Reform in revenue assignment is needed.
- LBFC has not focused adequately in municipal taxation due to resource constraint.
- LBFC could not focus on study to improve and revise the LBs revenue situation. No specific suggestions were given for

improvement of LBs tax system due to inadequate human and financial resources in LBFC.

- Lack of clear- cut and sufficient legal, policy and procedural framework and central government support on Municipal taxation.
- The role of LBFC is supportive to enhance municipal tax mobilization to some extent but it has to pay more proactive role to meet the objective
- Tying up revenue assignment with functions and responsibilities can play effective role for effective fiscal decentralization and municipal taxation.

(iii) Focus Group Discussion

Focus group discussions in the sample municipalities with municipal level political leader, members of the political mechanism and the municipal staffs have identified the following issues suggestions and findings related to revenue assignments:

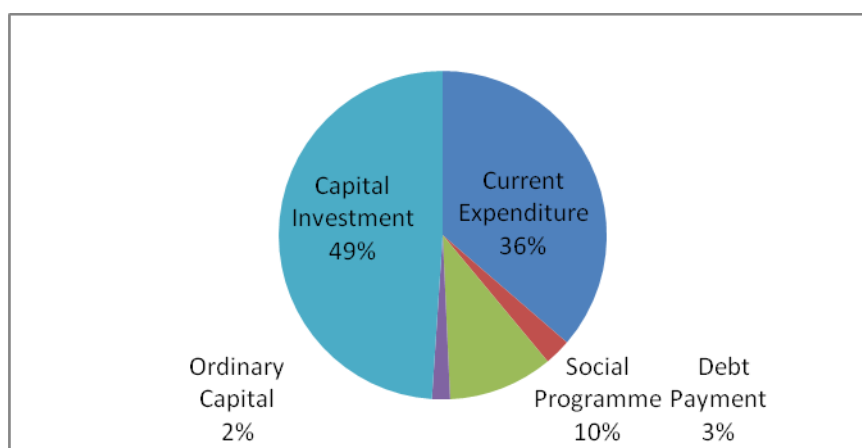
- The rate and base given to municipality by LSGA is low and revenue collection needs support from central government's agencies which is lengthy as well as not municipal friendly.
- Expenditures are relatively higher than revenues as well as specific responsibilities with minimum revenue. To meet the expenditure need viable sources of revenue to be devolved to municipalities.
- The political environment is towards increasing the expenditure rather than broadening the tax and revenue. Some radical changes are required in taxation and revenue generation system.
- The policies on municipal tax system are fine and have given some authority but the approach is more centralized.

The Expenditure and Revenue Collection Trend

a) The Expenditure Trend in Municipalities

The overall expenditure pattern of all 58 municipalities from the fiscal year 2054/55 to 2065/66 (average of 12 years) indicates that 49 and 36 percent of total expenditure goes to the heading of capital expenditure and current expenditure whereas social Programme , ordinary capital and debt payment takes the rest of the total expenditure. The detail analysis of expenditure and revenue pattern for the last 12 years is included in annex 4.1 and the average summary of expenditure is decorated in the following chart.

Chart 1: Total Expenditure of Municipalities



Source: MLD/LBFC/UDLE 2066

b) Comparison with National Expenditure, Municipalities and Sample Municipalities

The total expenditure of all Municipalities in different five categories and sample municipalities is elucidated in the following table. As highlighted above, this data set is the average of 12 fiscal years. The table shows that the recurrent expenditure of Nepalgunj and Pokhara municipalities are quite higher and smaller while comparing with national average for all Municipalities. Likewise, the capital expenditure of same Municipalities are respectively smaller and higher to the national average. The Gorkha Municipality is doing well in social related expenditure Programme such as education, health, cultural, disaster etc. The expenditure pattern in ordinary capitals

such as furniture, machinery equipments, vehicles, etc. seems negligible. The national expenditure in these areas is just around the 2 percent. The expenditure in these sectors of three Municipalities is less than one percent and two municipalities have just above the two percent. The same trend is seen in the debt payment as well.

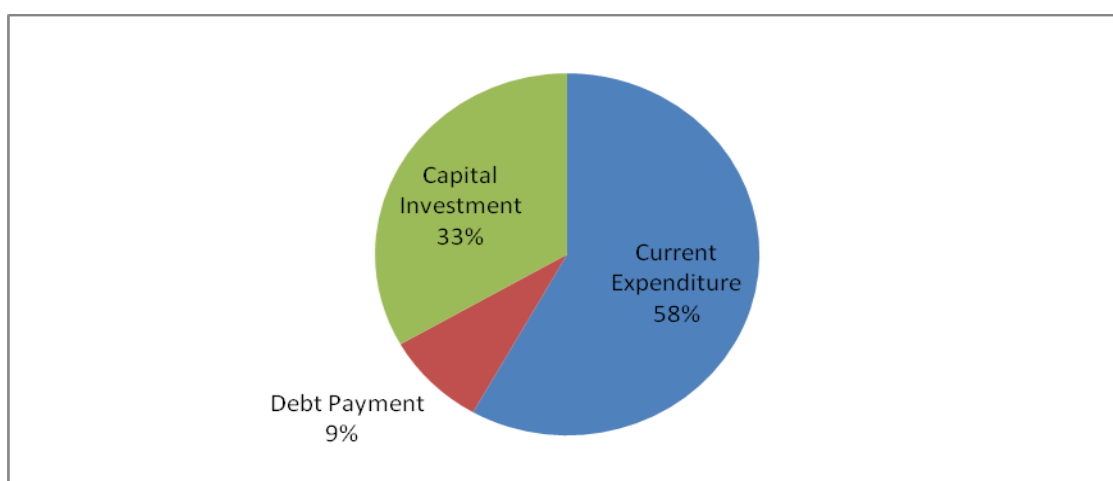
The total expenditure of all Municipalities is comparatively better than the total expenditure of the Government. The recurrent expenditure of Government is higher by 22 percent. The total revenue and expenditure pattern of sample municipalities is analyzed in annex 4.2.

Table 10
Average Expenditure Pattern of Government and the Municipalities
(Rs,000 and %)

S.N	Expenditure headings	Total GON* Expenditure	All Municipalities**	Biratnagar***	Kathmandu***	Gorkha***	Pokhara***	Nepalgunj***
1.	Current Expenditure	127738941 (58.15)	888322(36.33)	41480(35.73)	239662(41.89)	4737(34.56)	33825(28.07)	18011(50.20)
2.	Debt Payment	18834113 (8.58)	64178(2.62)	3805(3.28)	24047(4.20)	113(0.83)	19(0.02)	1454(4.05)
3.	Social Programme	NA	252491(10.33)	12789(11.02)	47674(8.33)	1917(13.99)	13221(10.97)	3040(8.47)
4.	Ordinary Capital	NA	43585(1.78)	995(0.86)	12551(2.19)	344(2.51)	807(0.67)	279(0.78)
5.	Capital Investment	73088864 (33.27)	1196685(48.94)	57021(49.12)	248245(43.39)	6594(48.10)	72626(60.27)	13096(36.50)
	Total Expenditure	219661918 (100)	2445260(100)	116091(100)	572182(100)	13709(100)	120501(100)	35883(100)

Data sources: * Budget speech FY 2067/68, MOF, ** MLD/LBFC/UDLE and *** Field Survey 2066, The data set in parenthesis are in percentage

Chart 2: Total Government Expenditure for the fiscal year 2065-66



Source: Budget Speech, 2067-68, MOF

c) **The Revenue Trend of Municipalities**

The average revenue of all municipalities and the sample municipalities is included in the following table. The table shows that all municipalities (except Gorkha Municipality) are doing well in local taxes which include Octroi tax latter substituted by Local Development Fees (LDF)¹⁹¹ which is now completely abolished (from fiscal year 2066/67) and is being provided by the government as per the compensation to the Municipalities. The other local taxes includes, the vehicle tax, professional tax, house rent tax, contract tax, sales tax, etc. The total own source revenue including LDF is around 61 percent, while excluding LDF it remains only 27 percent. The share of local taxes to the total revenue is decaling every year and actual collection of taxes (excluding LDF) is almost constant to the same consecutive years.

The dependency of Municipalities to the LDF is higher. This is not the good symbol for the existence of the Municipalities. It is now prime obligation of Municipal authorities to explore the new avenues of Municipal finance for the alternative of LDF. Excluding LDF from Municipal revenue structure, it is simply enough to cover their day to day administrative expenditure from their internal sources.

Out of five Municipalities, the revenue collection part of Gorkha Municipality seems relatively poorer. On the other hand, the overall weightage of the tax revenue for all municipalities with comparing to the national tax revenue is quite lesser. The total revenue of the sample municipalities is included in annex 4.2.

¹⁹¹ The LDF was levied by the center at custom point at the rate of 1.5 percent on the value of imports. This fee repealed Octroi, which was being collected by the municipalities previously on the goods and materials, which entered into the municipal territory for consumption. There is a debate on LDF whether it is a part of OSR or grant. MLD distributes the LDF based on the revenue figures of municipalities from octroi before it was abolished. In view of the fact that, the collection of LDF was discontinued with the country's accession to WTO from the beginning of 2011.

Table 11**Average total revenue of all and the sample Municipalities (In Rs, 000 and %)**

S.N.	Revenue Sources	All Municipalities*	Biratnagar*	Kathmandu*	Gorkha**	Pokhara**	Nepalgunj*
			*	*			*
1.	Local Taxes	1409350 (49.77)	91952 (65.64)	393273(57.12)	3496 (21.19)	61971(48.17)	27801(65.72)
2.	Fees and Fines	311232 (10.99)	8547 (6.10)	107357(15.59)	759(4.60)	14935(11.61)	2003(4.74)
3.	Property Rental	77637 (2.74)	3205 (2.29)	17070(2.48)	266 (1.61)	3868(3.01)	1559(3.69)
4.	Other Revenues	59351 (2.10)	3009 (2.15)	9623 (1.40)	284 (1.72)	703(0.55)	338(0.80)
5.	Misc. Revenue	71947 (2.54)	3855 (2.75)	23190(3.37)	82 (0.50)	3784(2.94)	318(0.75)
6.	Grants	590466(20.85)	10256 (7.32)	65502(9.51)	9529 (57.74)	37078 (28.82)	6776(16.02)
7.	Loans	39281 (1.39)	1740 (1.24)	9930(1.44)	191 (1.16)	69(0.05)	1508(3.57)
8.	Balance forward	272332 (9.62)	17515 (12.50)	62535(9.08)	1894 (11.48)	6238(4.85)	1993(4.71)
	Total Revenue	2831483 (100)	140079 (100)	688483(100)	16502 (100)	128650(100)	42300(100)

Data sources: * MLD/LBFC/UDLE and ** Field Survey 2066, The data set in parenthesis are in percentage

Table 12

Average Own Source Revenue of Municipalities
(including and excluding Octroi tax/LDF),
In Rs,000 and %

S. N.	Revenue Sources	All Municipalities*	Biratnagar**	Kathmandu**	Gorkha**	Pokhara**	Nepalgunj**
1	OSR including octroi tax/LDF	1857557 (65.60)	106712(76.18)	527324(76.59)	4805(29.12)	81478(63.33)	31702(74.95)
2	OSR excluding octroi tax/LDF	261921 (26.91)	33237(23.73)	239454(34.78)	1776(10.77)	32432(25.21)	7350(17.38)

Data sources: * MLD/LBFC/UDLE and ** Field Survey 2066, The data set in parenthesis are in percentage

Chart 3: Share of Local Taxes to the Total Revenue (including and excluding LDF) of all Municipalities for the Last 12 Years.

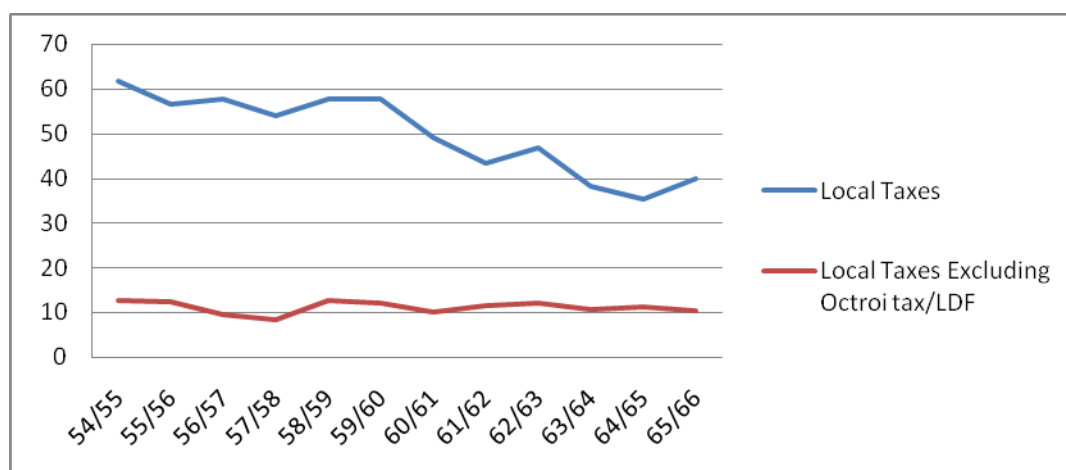
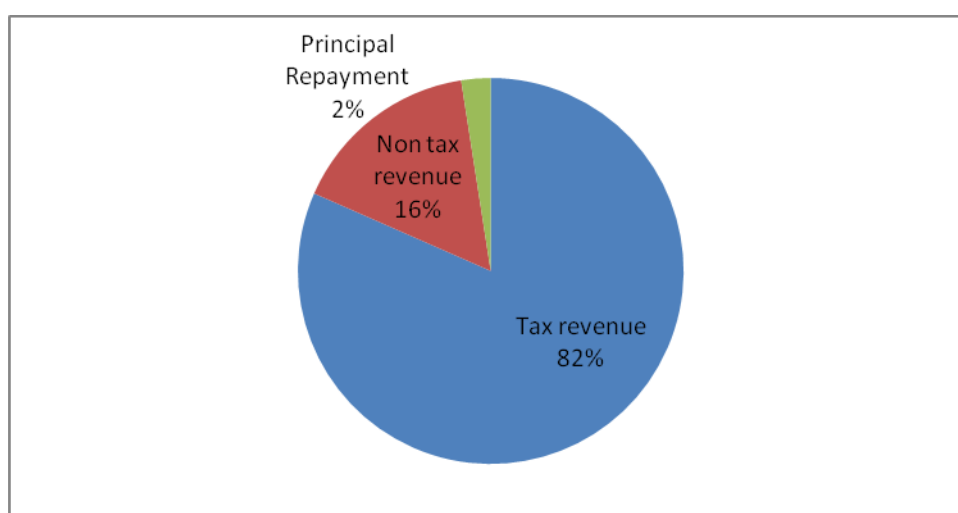


Chart 4: Total Government Revenue for the fiscal year 2065-66



Source: Budget Speech, 2067-68, MOF

(C) Inter-governmental Fiscal Transfers

A sound and rationale inter-governmental fiscal transfer system is precondition in designing fiscal decentralization system in any country either federal or unitary. The main objective of inter-governmental fiscal transfers is to make fiscal balance between expenditure needs and revenue of local governments/bodies. It is a tool for vertical and horizontal fiscal balance among the tiers of governments. Due to macroeconomic and equity consideration, efficiency in tax administration, variance

revenue in potentials and variance in expenditure needs fiscal imbalance occurs. Inter-governmental transfers are used to ensure revenues matching the expenditure needs of various levels of governments as well as to achieve national, regional and local area objectives such as balanced development, fairness and equity. It is concerned to preserving local autonomy and creating an enabling environment for responsible, equitable and accountable public governance (shah 2004 Cited by the study team, ADB/MLD, 2009)¹⁹²

There is no single model of fiscal transfers that can be generally adopted in every country. The models and approaches to be getting in practice basically depend on the numbers, levels or tiers, size (population/geography) of governments and political system adopted by the constitution of a particular country.

In Nepal inter-governmental fiscal transfers is not scientific. The ad-hoc divisible pool allocated by the MOF is being distributed to LBs based on formula but the major chunk of the national budget has not formula for allocation in different level of governments like district, municipality and the village. LBs in Nepal are heavily depended on the fiscal transfers provided by the central government. Due to unevenly distributed tax and revenue potentials and variance in capacity fiscal transfers need to be more scientific for allocative efficiency and equality in services. In the study different questionnaires were distributed and collected. Based on the questionnaire and response by the respondents and focus group discussions the major finding on inter-governmental fiscal transfers is given below:

i. Policy and central Level

- LBs are receiving unconditional (formula based) and conditional grants. They are collecting local revenue within their own jurisdiction as authorized by the LSGS.
- Although, there is formula based distribution in the fund allocated by the MOF Without formula which is not adequate to meet the expenditure needs. So LBs are performing unfunded and underfunded mandates. Comparing LBs total expenditure dependency on the grant from the central government is high.

¹⁹² Asian Development Bank/Ministry of Local Development Nepal's Choices in Fiscal Federalism. (August 2009) Kathmandu:, p. 4.

- Absorbing capacity in many LBs including municipality is weak.
 - Due to centralistic mind set and concentrated model practiced since more than last five decades the fiscal transfer is not integrated and coordination itself is problems .Related central agencies are transferring fund to the line agencies without scientific criteria.
- ii. MLD/LBFC Senior Personnel and Experts
- According to LSGA, DDC has to allocate grant to VDC and municipality, but it is not practiced effectively.
 - Municipalities are highly depended on indirect tax sources and central transfers. The LDF is the major financial source of municipalities which is centrally collected and administered.
 - Fiscal accountability is one of the major challenges of fiscal decentralization especially in municipalities in Nepal.
 - Devolution of fiscal power is started in Nepal but it is not matched with the functions to be done by the municipalities.
 - For the functional fiscal decentralization and effective municipal taxation in Nepal transparency of expenditure to the local people is essential.
 - Sectoral responsibilities need to be tie-up with fiscal resources.
 - Enhancing transparency and Clarifying accountability is necessary.
- iii. Focus Groups Discussions
- Normally, municipality is using fiscal authorities. It has been implemented partially and partly.
 - Fiscal transfer is root only required for addressing the genuine needs but also to reduce the public expenditure.
 - The alternative source of LDF could be more government unconditional grant to municipalities.

iv. Trend of Inter-governmental Transfers in Nepal.

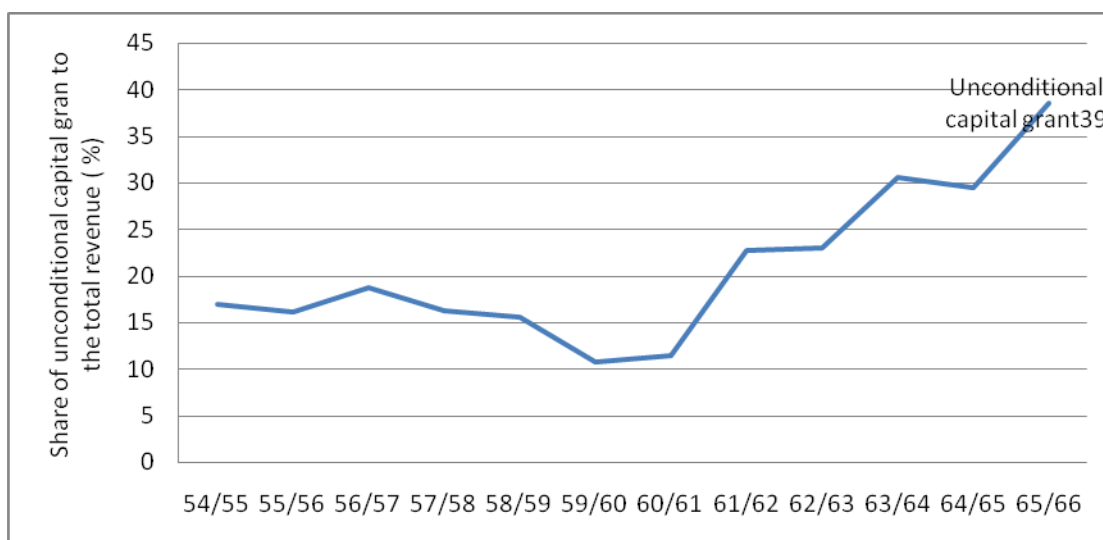
The trend of inter-governmental transfers not only to municipalities but also to all LGs is presented in the following table. In addition to the inter-governmental transfers, the status of fiscal decentralization is also highlighted. The municipalities in Nepal are heavily dependent on the central grant. The actual own source revenue of Municipalities is only 27%. The LDF is itself a grant. The contribution of LDF to the total revenue is near about 40%, whereas the proportion of unconditional capital grant is 21%. The percentage of unconditional capital grant to the total revenue for the last 12 years is included in the chart 5. The curve shows that the dependency of municipalities on grant is going up every year. Out of five municipalities, the dependency of Gorkha Municipality to the grant is too much higher. The dependency rate of Biratnagar and Kathmandu is relatively lower than the other municipalities.

Table 13**Status of Inter-governmental transfers**

S.N.	Benchmark	Status
1.	% of LBs grant to GDP	1
2.	% of LBs grant to GON budget	4
3.	% of Municipalities grant to GON budget	1
4.	% of Municipalities grant to GDP	0.24
5.	% of grant to the total revenue of all Municipalities	20.85
6.	% of grant to the total revenue of Biratnagar	7.32
7.	% of grant to the total revenue of Kathmandu	9.51
8.	% of grant to the total revenue of Gorkha	57.74
9.	% of grant to the total revenue of Pokhara	28.82
10.	% of grant to the total revenue of Nepalgunj	16.02

Source : MOF/MLD and field study 2066

Chart 5: The proportion of unconditional capital grant to the total revenue for all Municipalities



Source : MOLD, 2066

(D) Local Borrowing

Local borrowing is practiced in different ways. The standard limitation and investment menu for the loans have no single model that can be used in a general way. The eligibility criteria for loans to local government can be defined by the legal and policy framework. It is understood that unlimited loan to the local government is not possible to maintain fiscal balance and macroeconomic stability. As mentioned earlier, local borrowing in Nepal by the local bodies is preliminary stage. The TDF is the only institution which is providing loan to Municipalities. But its coverage and marketing skills are not encouraging. LBs are not credible to the financial institutions and there is no any specific financial institution in Nepal which provides loan to DDC and VDC.

In the study local borrowing has limited scope and not focused adequately. Being a pillar of fiscal decentralization it has relevancy and linkage with study and some of the respondents have mentioned about the borrowing. Some of the major findings in the study specially based on the questionnaires are given below:

- i. Policy and Central Level
 - a. Under the funding system of municipality in Nepal only TDF is the institution that has direct approach to municipalities to get loan in addition to grants and own source revenues.
 - b. The provision on local borrowing in LSGA is not adequate.
- ii. MOLD/LBFC Senior Personnel and Experts
 - a. Inadequate commitment of local bodies for increasing local resources and taking decisions on the basis of increase/decrease voters.
 - b. One of the challenges of fiscal decentralization in Nepal is to utilize local government borrowing in productive areas.
- iii. Focus Groups Discussion
 - a. There is very few practice of borrowing
 - b. There is a tendency that municipality would opt to borrow only for the economically feasible projects/Programme.
 - c. some of the criteria's for municipal borrowing in Nepal are:
 - i) Use of capital in productive areas
 - ii) Show sustainable income source
 - iii) Timely repayment of capital and interest.
 - iv) Based on the above criteria, there is no limitation of municipal borrowing.
 - c. Policy should be formulated to taken loan/borrowing in specific project.
 - d. Programmes are operational as per the conditional provision of installment wise interest.

5.3 Fiscal Decentralization

Fiscal decentralization is concerned with the design of constitutions and legal framework when decision making is among various orders of governments. The design of fiscally decentralized system entails the division of power for taxing, spending and regulatory functions as well as fiscal arrangements that accompany such arrangements. There are many issues of fiscal decentralization in its designing and

implementing. The following are the emerging issues in fiscal federalism which are the same for fiscal decentralization in both federal and unitary system of governance.

- a) The assignment problem or the allocation of expenditure and tax functions to various levels of government is the most fundamental issue. The principles efficient provision of public services, fiscal efficiency, regional equity and redistributive role of the public sector, provision of quasi-private goods and preservation of internal common market are equally applicable for both federal and unitary states.
- b) Four general principles require consideration in assigning taxing powers to various governments. They are the efficiency criterion, national equity, administrative feasibility and the fiscal need or revenue adequacy.
- c) Vertical fiscal gaps i.e. mismatch in revenue means and expenditure needs and revenue autonomy at sub national orders remains an area of concern. The reform of conditional transfer and equalization transfers invite controversy due either to the complexity of the formulae or the lack of consensus on the standard of equalization.
- d) Fiscal conflicts among the tiers of governments arise from (i) conflict interests in the division of fiscal resources especially with a concentration of natural resources in few regions: (b) lack of clarity and coordination of roles in fields of shared rule, (c) fiscal transfers that appear to pass the buck and buttress citizens negative perceptions that they simply represent the magical art of passing money from one government to another and saying it vanish in thin air, (d) "beggar thy neighbor policies" under decentralized decision making, and (e) a sense of alienation in lagging regions. (Shah, Rajaraman and Rezende 2008)¹⁹³

In Nepal fiscal decentralization is not designed scientifically. Decentralization itself is coming up in an incremental way. The political transition and centralistic attitude of the policy makers are the main constraints of fiscal

¹⁹³ Ronald L.Watts,Rupak Chattopadhyaya(ed.)Unity in Diversity Learning from Each other (2010),Volume 2, Emerging Issues in Fiscal Federalism, Delhi: Forum of Federations, Viva Books, reprinted 2010, p. 28.

decentralization in the country. The major findings on the four pillars of fiscal decentralization have narrated above. The general findings on fiscal decentralization are given below.

i. Policy and central Level

- Legal and policy frame-work for fiscal decentralization is one of the fundamentals to design and its implementation. As mentioned earlier under the pillars of fiscal decentralization that there are contradiction between laws and policies as well no comprehensive policy exists to the local bodies. In the study question was asked about the adequacy of the legal and policy the response from 26 respondents is as follows.

No. of respondents	yes it is Adequate	No	Partially Adequate
26	1	7	18
%	4	27	69

Similarly, 16% respondents have mentioned that using the fiscal authorities to municipalities is inadequate, 42% has expressed that existing authorities and 42% said that municipalities are not paying attention to exploited revenue potentiality.

- The response on the questionnaires relating to fiscal policies and municipal taxation, accountability and fiscal commissions mandate is found as follows;

Asked Question	Responded area	Percent
Relationship between fiscal policies and municipal taxation	• Mismatch between tasks and fiscal resources	8
	• imbalance on fiscal frame and taxation	0
	• less contribution on expenditure by the tax revenue	15
	• above all	77
Municipal accountability to clients in delivering services	• Highly accountable	4
	• moderately accountable	65
	• not accountable	31
Legal mandate to the fiscal commission	• statutory	38
	• constitutional	58
	• ad-hoc	4

Source : Developed from the response of respondents.

- All the four pillars of fiscal decentralization expenditure assignment revenue assignment Inter-governmental transfer and local borrowing remain weak with regards to their implementation. In general the devolution in Nepal can be seen either as "unfunded mandates" or as "underfunded mandates".
- Major challenges of fiscal decentralization pointed out by the respondents is given below;
 - a. lack of political and bureaucratic will
 - b. Political vacuum (absence of elected representations) in local bodies.
 - c. Mindset of centralization
 - d. Lack of common understanding among stakeholders.
 - e. Poor organizational capacity of municipalities.
 - f. Lack of political commitment for devolution of power
 - g. Fiscal transfers are based more on ad-hoc decisions.
 - h. Transparency and accountability
 - i. Fiscal decentralization is an area of less priority.
 - j. Role delineation is not clear between LBs and LAS.
 - k. No consensus on central level about decentralization.
 - l. Sometime lack of trust between central government and LBs.
 - m. Mismatch between revenue and expenditure needs of the municipalities.
 - n. Weak regulatory framework
 - o. Democratization and accountability
 - p. Determining LBs mandatory tasks, determining service levels and cost of service delivery fiscal gap analysis and Inter-governmental coordination.
 - q. Weak institutional capacity including human resource.
 - r. To make a shift from central to local in terms of fund, function and functionaries is a difficult task it needs joint efforts.
 - s. Dependency syndrome in municipalities on government grant.

ii. MLD/LBFC senior Personnel and Experts

It was expected that this group of respondent should be more professional on the subject matter. The major findings from this group are as follows;

- Out of 19 respondents 2 have accepted the legal and policy framework is adequate. Similarly 2 have expressed the inadequate legal and policy framework and 15 have mentioned that it is partially adequate.
- 10.53 percent responded as inadequate fiscal authorities to municipalities, 10.53 percent said that existing authorities are not used adequately and 78.94 percent blamed that municipalities are not paying attention to exploit revenue potentiality.
- Rereading the relationship between fiscal policies and municipal taxation 5.26 percent said that there is mismatch between taxes and fiscal policies, 5.26 percent said that there is imbalance between fiscal framework and taxation, 10.53 percent mentioned that the contribution of tax revenue on expenditure is less and 78.95 percent respondents expressed that all the three situations are prevailed.
- Relating to municipality's accountability to the clients 94.74 percent said they are moderately accountable and 5.26 percent said that they are highly accountable.
- The following challenges of fiscal decentralization are expressed by the respondents in addition to the policy level respondents:
 - a. Unclear and conflicting mandate to LBs and mismatch between expenditure and revenue assignment.
 - b. Insufficient understanding on the role of municipalities.
 - c. To utilize local government borrowing in productive areas.
 - d. Laws are universal, whereas there is a vast difference in capacity among municipalities.

- e. Downward and upward accountability of municipality.
 - f. Less transparent and accountable municipalities.
 - g. Lack of constitutional guarantee
 - h. Rapid urbanization trend in third world countries.
 - i. Weak institutional base with low capacity and traditional Mindset.
- iii. Prospects of Fiscal Decentralization

Both policy and professional respondents have mentioned the following prospects of fiscal decentralization.

- State restructuring issues have come up which will open up a number of areas of reform for fiscal decentralization and municipal taxation.
- Worldwide acceptance for the local autonomy
- State restructuring and constitution making process in Nepal convinced about powerful local bodies.
- Increase awareness of citizen
- Growing realization by the politicians, academicians and bureaucrats for the need of fiscal decentralization.
- More decentralization will demand more fiscal decentralization.
- Global wave on more democracy and decentralization.
- Cities could generate huge resources as cities being concentration of opportunity of production, consumption and employment.
- Provision of Interim constitution 2063, LBFC arrangement, commitment of all political parties and long experience of decentralization are strength.
- Towards federation and grater public awareness and political consensus as fiscal decentralization.
- Urban centers are becoming the hub of socio-politico-economic-technical-cultural activities.

- Municipalities have initiated integrated property rights which have shown the good impact as increment of local revenue.
- Government policies, legal and constitutional framework on decentralization.

iv. Focus groups Discussion

- lack of political commitment
- There is an essence of structural strengthening and power delegating for effective implementation of fiscal decentralization.
- Municipalities have been using fiscal authorities partially or partly as provisioned by LSSA.
- Municipalities have not adequate capacity to utilize the current authorities.

v. Municipal level questionnaire.

- Municipal taxation in Nepal has high potentiality if we can exploit the existing potentials. As mentioned earlier cities are the center of economic activities, which are increasing local tax yielding capacity together with rapid urbanization. As per the potentials, Nepalese municipalities are not able to utilize it to generate local revenue and prudent expenditure for services delivery. Nepalese municipalities are not able to enhance municipal tax revenue and are unable to link tax and services as mutually inclusive. The study has focused on municipal taxation. The major findings on municipal taxation are as follows.

i. Policy and central level

- For effective fiscal decentralization and municipal taxation we need committed and knowledgeable political leaders at local level.

- To create conducive environment for effective municipal taxation enhancing the capacity of municipalities for local level revenue planning and management is needed.
- To increase municipal taxes increasing tax base and coverage is necessary. It needs to link municipal taxation to central taxation and should develop effective and practical system and procedures for smooth operation of municipal taxation.
- Enhancing people participation in decision making process can help to create conducive environment for municipal taxation.
- There should be good environment along with elected representatives.
- Local taxation should be guaranteed by constitutions.
- Support from development partners to strengthen municipal capacity focusing taxation will be more supportive to enhance revenue in municipalities.
- Dispute between government line agencies and LBS to coordinate development works and utilize the resources.
- It is more or less on attitudinal problem the politicians have phobia about taxation. The administrators are without commitment.
- Ensure fiscal decentralization and municipal taxation vis-a-vis state restructuring.
- More taxing authorities need to be given municipalities.
- Urban local governance needs to be given wider authority so as to make it full autonomous body. Taxes bases too needs to be broadly based than current provisions.

- For wider bases to municipality in Nepal, improving efficiencies in service delivery, managing more transparent and accountable in overall activities are necessary.
- Clear institutional, legal and operational frameworks should be written in legal documents as well as in the constitution.
- Long-term plan for tax system improvement will enhance tax revenue in municipalities.

ii. MOLD/LBFC Senior Personnel and Experts.

- In addition to policy and central level's response the MLD/LBF senior officials and experts of the study areas have responded relating to municipal taxation is given below.
- The role of LBFC defined is supportive but the role actually played in practice has proven far from being actually helpful to enhance municipal tax
- The role of LBFC could be more proactive to enhance municipal tax revenue mobilization by analyzing the tax potential in general and specific to cities.
- Improvement of financial management system with ensuring transparency and accountability will be more supportive to enhance municipal tax.
- Policy environment is not conducive for municipal revenue mobilization.
- Tax are the same to all municipalities If municipality specific tax system could be developed the municipalities could collect more taxes form potential bases

- Municipal tax revenue is very insignificant except in the Kathmandu and few other big municipalities in terms of population and economic activities.
- According to LSGA there are several areas of taxation to cover under the tax net in the municipalities, which are not covered properly.
- Authorize more power and responsibilities to the municipalities for more power and responsibilities to the municipalities for more tax revenue collection will be fruitful.

iii. Focus Groups Discussion

- people are not aware about tax compliance and payment.
- Lack of understanding in own role and responsibilities.
- Lack of coordination with line agencies and skilled staffs.
- House and land tax/ integrated property tax and professional tax are the highest potential tax base with higher contribution in tax revenue.
- Most of the municipalities have no any revenue enhancement plan. However, they have their own strategy such as awareness Programme , guidelines, record system etc to increase the revenue. They should prepare and implement the revenue enhancement plan including tax revenue.
- Both taxes and services can increase if more authorities to LBS devolved, empowered and enhanced the capacity of the staffs and line agencies are coordinated.
- The strengths of municipal tax system are fine polices and given autonomy to municipalities.

- No proper record of tax payers, no skilled manpower, lack of reward and sanction provision (weak), inadequate services and transparency and accountability are some weaknesses.
- The potential taxes not provisioned by LSGA for municipalities are education, reuse of commodity (kawadi) lottery and tax on casino.
- Entertainment, vehicle and advisement house and land and rent taxes are some taxes which are not tapped by the municipalities comparing their potentiality.
- For the effective collection of municipal taxes municipality should implement awareness raising Programme , create tax friendly environment within the organization, focus to prepare revenue improvement plan, develop skilled human resource and utilize the tax potentiality.

5.4 Institutional capacity

Administrative effectiveness is one of the critical elements of fiscal decentralization and municipal taxation. The institutional capacity from municipal level to central level is the key for effective fiscal decentralization. After the legal framework institutional design and operation is necessary. For the better performance better capacity of the institution is required. Fiscal decentralization is multi layer business among the different tiers of government. It is also inter governmental fiscal relation. Naturally, in a fiscally devolved system many institutions involved to make it efficient and effective.

The defined roles and responsibilities of different institution need to be fulfilled in given time in a professional way. So, institutional capability is one of the pre-condition for functional decentralization.

As mentioned earlier, there are many institutions involved in the process of fiscal decentralization and they have direct/ indirect relationship with municipal taxation. In the study institutional aspect of those institutions responsible for fiscal decentralization including sample municipalities is tried to analyze. The major findings in this regard are presented below.

(a) Central Institutions

(i) Central policy institution.

- For the overall fiscal framework, Ministry of Finance, and national planning commission are the leading institutions for fiscal decentralization in Nepal. The policy level respondents were asked about the central institutional proactive role for fiscal decentralization. Out of 26 respondents 15 said that they are not proactive, 8 said that they are playing proactive role and 3 did not response.
- Ownership and accountability of MLD and LBFC is not adequate to implement LSGA's provisions and devolving more fiscal power to municipality. So the ownership and accountability should be shared by the both MLD and LBFC.
- Political instability and other political agendas have overshadowed the decentralization.
- Central institutions are paying more attention to the rural areas through DDC and VDC.
- MLD is not serious on capacity development of LBFCs.
- Power up me syndrome prevailing in the central institution. So they are not proactive in devolving fiscal power to LBS.

- Central institutions are playing role according to time and different perception of different political parties. Sometime they are very slow and sometime they push new agenda.
- Out of 19 MLD/ LBFC Senior official and experts 12 (63.15%) respondents said that central institutions including LBFC is not playing active role to implement LSGA's provisions as well as devolving more power to the municipality.

(ii) Local Bodies Fiscal Commission

Local Bodies Fiscal Commission (LBFC) is the only special institution responsible to support fiscal decentralization in Nepal. Although, LSGA has given limited role to the commission but GON has widened its role to some extent. Since last one decade it has been working in an incremental approach. There are many issues relating to LBFC. The major findings of the study in this regard are as follows:

- LBFC is in low profile
- LBFC has done appreciable job in enhancing fiscal decentralization and municipal taxation initially. However, there are more challenges and issues coming up and present framework may not be sufficient enough in near future to address the issues
- MLD/ LBFC capacity strengthening is needed
- Regarding the functional level of LBFC as expected by LSGA, 89.47 percent respondents could not accept. Only 10.53 percent accepted that LBFC is functional as expected by LSGA.
- The objective of LBFC is very pertinent to make fiscal decentralization more effective in Nepal. However, the role expected to play has not been effective due to constraints

related to institutional weakness, political uncertainty and lack of conducive working climate.

- Various studies done by LBFC have contributed to enhance fiscal decentralization and municipal taxation. Implementation of MCs/PMs under the leading initiation of LBFC has contributed to enhance the municipal taxation indirectly.
- LBFC is contributing for fiscal decentralization but municipal taxation is getting low priority and it has to work a lot in the area of municipal taxation.
- LBFC has not been able to obtain the status of independent agency.
- All the respondents disagreed that LBFC is focusing adequately in municipal taxation.
- Regarding the legal status of fiscal commission 63.16 percent respondents suggested that it should be constitutional and 36.84 percent respondents expressed their view about statutory provision.
- LBFC should be constitutional in which LB associations should be involved actively to play favorable role for local governments.

(b) Municipality

Municipal capacity to utilize the fiscal authorities including taxation is the milestone for municipal management. Devolving power will not be fruitful unless it is not back up by the institutional capacity including skilled human resources. In the study, municipal capacity has focused in questionnaires and focus group discussions. Major findings in this respect are given below:

- Regarding the accountability of municipalities to the clients in delivering assigned services respondents are opined that 65 percent moderately and 4 percent highly accountable and 31 percent are not accountable.
- Institutional weakness of municipalities in enhancing tax revenues are as follows:
 - (i) Lack of political will and instability in both politically and administratively.
 - (ii) Inadequate legal provision, weak organization capability and lack of competent human resource and motivation.
 - (iii) Weakness in administering tax including data base, logistics and compliance.
 - (iv) Inadequate vertical and horizontal coordination.
 - (v) Many municipalities were formed based on political agenda rather than economic and social criteria. So, there is no tax paying and distribution culture followed by the transparency and accountability.
 - (vi) Guided decentralization legally and weak implementation capacity.
 - (vii) Municipalities are not paying attention to exploit the tax potentiality. Similarly, local leaders are not willing to impose and increase local taxes mainly for the fear of being unpopular in election.
 - (viii) Expecting more funds from the center rather than widening the scope of revenue collection internally.
 - (ix) Taxation is not directly linked with service provisions and delivery efficiency of municipal administration. So, there is no pressure for strengthening taxation capacity.
 - (x) Municipality's institutional capacity can be strengthened to mobilize tax revenue by human resources development, political participation, private sector involvement, and potentiality analysis, proper data base management, community

engagement and enhancing capacity of all the stakeholders. Preparing municipal revenue plan and its effective implementation will be critical for revenue enhancement.

- (xi) Fair policy, clear and understandable legislation, simple procedures and competent staffs are the key for municipal revenue enhancement.
- (xii) Municipalities have not adequate capacity to utilize the current authorities. Therefore, the following initiatives should be taken:

- Prepare capacity development plan of each municipality.
- Appropriate placement of the personnel.
- Taxation system to be developed based on transparency and using ICT.
- Link evaluation of staff with performance.
- Link services with taxation.
- Develop monitoring & evaluation system.
- The political behavior is not supportive to revenue enhancement. So convince the local lenders.
- The organization structure and municipal staff's knowledge, skilled and to some extend attitude also not supportive for tax revenue. Make them positive and active.
- Unnecessary interference from center like MOLD should be stopped.
- Political leaders do not want to introduce any new tax base and rate and not actively supportive even in tax collection. Bring them on board for revenue enhancement.

- Inadequate advocacy, promotion and awareness among municipal tax payers.
- No institutional reward/punishment mechanism, incentives and motivation in system place to boost local revenue.
- Lack of required commitment at the local political level to support LSGA implementation for local resource enhancement.
- There is no clear and uniform institutional structure for municipality considering the specific knowledge and skills for taxation.
- Low level of transparency and low quality of services discourage to the tax payer.

Municipal Level Findings

The findings represent the grassroots opinion, feeling and observation of the people. The people's satisfaction is the ultimate goal of any governance system. Considering the importance of the beneficiaries' value judgmental altogether more than hundred questionnaires were distributed in the five sample municipalities. Total 68 respondents provided the filled questionnaire. The feelings opinions and experiences expressed though questionnaires are personal independent thought which are real and the voice from the grassroots. The major findings from the municipal level are given below.

(a) Fiscal Decentralization

- Out of total respondents 45 respondents said that the existing policy and provision of fiscal decentralization is not adequate whereas 23 expressed their views as partially adequate.
- Regarding the internal revenue's contribution in municipal total expenditure the following response is found:

Municipality	Share of internal revenue
Pokhara	More than 20
Gorkha	Less than 10
Kathmandu	More than 20
Nepalgunj	Less than 15
Biratnagar	More than 20

- Out of 71 respondents from five municipalities 48 said that municipalities are not able to fully utilize the given authorities on municipal taxation.
- Majority of the respondents said that the given authorities on taxation are not adequate and the fiscal authorities are not matched with the given responsibilities to discharge the services.
- In the sample municipalities the following are the main tasks carried out by the municipalities out of designated responsibilities:
 - (i) Waste management and sanitation
 - (ii) Infrastructure development
 - (iii) Social development
 - (iv) Annual budget preparation and implementation including revenue collection
 - (v) Approval on building construction.

(b) Municipal Taxation

- Out of the 71 respondents 40 said that property tax is the most potential sources of tax in the municipalities whereas, the 9 respondents from Kathmandu metro–Politian city expressed their view as advertisement tax is the most potential.

- Majority of the respondents selected service charge as the most potential non tax revenue source in the municipalities.
- The following are the main reasons for not fully utilization tax authorities mentioned by the most of the respondents from all the municipalities.
 - (i) Lack of Political understanding commitment and support.
 - (ii) Lack of skilled human resources.
 - (iii) Frustration in both political and bureaucratic front.
 - (iv) Inconsistency between responsibilities and taxation authorities.
- The Following are the major suggestions given by the most of the respondents to increase municipal tax revenue:
 - (i) Political understanding and Commitment
 - (ii) Proactive and capable Local Tax Advisory Committee
 - (iii) Human resources development and honesty among the staff.
 - (iv) Increase people's awareness and tie up taxation with service delivery.
 - (v) Devolve additional potential; tax bases to the municipality.
- Due to absent of elected representatives in the municipalities the following impacts have been noticed by the most of the respondents:
 - (i) No long term policy is available
 - (ii) Tax payers awareness has not been increase
 - (iii) Tax compliance could not increase
- The following suggestions have been given by the most of the respondents to provide more services by the municipality to the people through increasing revenue.
 - (i) Provide training to the staffs with responsibility.
 - (ii) Good service delivery through infrastructure development.

- (iii) Increase awareness.
 - (iv) Transparency and accountability.
 - (v) Organizational development.
 - (vi) Promote cooperation from the government agencies
 - (vii) Establish proper and complete database system.
- The following are the major weaknesses of the municipal tax systems pointed out by the respondents:
 - (i) Lack of political commitment.
 - (ii) Lack of clear tax Policy including revenue plan.
 - (iii) Inadequate skilled and experienced human resources.
 - (iv) Inadequate awareness of tax payers.
 - (v) Central intervention in defining tax base and fixing tax rates.
 - (vi) Demotivated staffs.
 - (vii) Incomplete database.
 - (viii) No full cooperation from the government agencies.
 - (ix) No effective service delivery in practice and no link between tax and services.
 - (x) Weak legal base and tax administration.

(c) Institutional Status

- Regarding the institutional Capacity majority of the respondents are found incremental i.e. they said that after adequate improvement in the municipal institutional capacity the tax authorities' provisional by the LSGA will be used whereas, 11 respondents believed that it needs big efforts.
- Majority of the respondents said that municipal staffs are not adequately active and coordination between the sections in municipality is weak.
- Only seven respondents expressed that the politicians are supportive.

- Most of the respondents collectively said that the following measures in the organization structure and working culture of municipality will increase tax revenues:
 - (i) Strengthen existing tax section
 - (ii) Establish tax section at ward level.
 - (iii) More involvement of the politicians.
 - (iv) Partnership with the private sector.
 - (v) Reward and punishment must be based on performance.
 - (vi) Knowledge based and accountable institution.
- The main aspect of reform in the system to make tax collection suggested by the most of the respondents are as follows:
 - (i) Performance based reward and punishment system.
 - (ii) Credibility in expenditure and expand the services.
 - (iii) Collect tax in minimum cost.
 - (iv) Political coordination and improvement in tax policy.
 - (v) Citizen awareness and organizational development in the municipality.
- Other suggestions given by the respondents collectively and individually are as follows:
 - (i) Widen the tax bases
 - (ii) Keep update information and maintain proper documentation.
 - (iii) Motivate staffs and create conducive working environment.
 - (iv) Motivate tax payers to pay taxes.
 - (v) Increase cooperation from the political parties and their leaders to collect more tax.
 - (vi) Prepare long term revenue plan including separate plan for taxes.
 - (vii) Promote transparency and accountability.
 - (viii) Avoid political interference so that more tax could be collected.

CHAPTER VI

PROBLEMS AND PROSPECTS OF FISCAL DECENTRALIZATION AND MUNICIPAL TAXATION IN NEPAL

6.1 Problems of Fiscal Decentralization in Nepal

Decentralization is a longer-term gradual process that involves, within an appropriate legal framework, various components, such as political decentralization, administrative decentralization and fiscal decentralization¹⁹⁴ and all three components need to be present. However, the mix of the components may vary and consequently the prevailing situation may have a bias towards de-concentration or devolution.

The literature on decentralization describe the assumed benefits of decentralization as: “(i) the principle of subsidiary, (ii) improved governance, accountability, democratization and citizen participation, and (iii) Increased efficiency with regard to service delivery.

Fiscal decentralization generally refers to the devolution of taxing and spending powers from the control of central government authorities to government authorities at sub-national levels (regional, provincial, municipal, etc)”¹⁹⁵. In a decentralized system, local governments have considerable power to mobilize resources, through taxing authorities accompanied by strong tax bases.

Generally, the devolution of functions and expenditure responsibilities goes along with (or is followed by) the de-concentration of public services and local elections. Though there is no one agreed model available for the implementation of decentralization, most countries on the way to fiscal decentralization have started to

¹⁹⁴ Boschmann, Nina (2009), Local Governments and Decentralization, Fiscal Decentralization and Options for Donor Harmonization, Berlin, Page 6

¹⁹⁵ *ibid*, Page 6

develop a (more or less complex) set of legal reforms including a tax code, a new budget law and a treasury law.

As in most of the developing countries, the fiscal decentralization in Nepal is incrementally aligned with the pace of the decentralization. Thus, it appears that fiscal decentralization is concomitant to the decentralization in general in the governance system and it complements to the general purposes of decentralized governance model.

There are a few studies on the overall aspect of fiscal decentralization. The LAFC (2000) has identified the problems of fiscal decentralization in Nepal are as follows:

- There has not yet been clarity in and implementation of such issues as what are the public services to be provided by the government, who is responsible for them, if the people have to uphold their rights, how can they do it, etc. Similarly, due to overlap in the jurisdictions of HMG and the Local Bodies, the respective responsibilities and accountabilities have not been clearly specified. People have not been getting all the services mentioned in the legal form. Fiscal management is very weak. Audit reports are pointing to the fact of progressive irregularities in expenditure, and the increase in amounts of questionable utility.
- The powers given by the Local Self-Governance Act to the local bodies are in conflict with several other powers granted to HMG or other agencies by earlier laws and regulations. One study¹⁹⁶ has shown several points of conflict contained in 23 laws and indicated that only if there are amendments in those laws can the local bodies be more active. All central agencies are not active in transferring the powers that they have been given earlier, to the local bodies. The local bodies are also exercising authorities beyond their legal limits on the claim of having used them in the past. Thus it is not possible to specify sources/resources and identify the truly responsible agency for services. This has retarded the dynamism not only of local bodies but the very process of decentralization.

¹⁹⁶ Study Report on the Improvements to be made in the prevailing Laws for the Effective Implementation of the Local Self-Governance Act, 2055; DANIDA/DASU, January 2000

- All structures, mechanisms and concepts have not yet been completely implemented in accordance with the principle of decentralization and as provided for in the law (Act). The Monitoring Committee that makes policy monitoring has just begun its functions. The agencies that monitor, supervise and assist the local bodies have not been active and effective. Although local bodies have powers to monitor locally based government agencies and NGOs, they are not complete because these powers are not mandatory. The agency responsible for the consolidation of local bodies is not clear by identified and the roles of the Associations of local bodies are also not clear. Government agencies have not assimilated the process of decentralization as being the decentralization of all the works of the government. Thus, the implementation aspect of decentralization is very weak (the clarity in policy notwithstanding).
- A trend is on the rise that the people's representatives of the local bodies take amenities/facilities. It is natural that the larger the number of representatives, the higher in the overhead expenditure. Such an expenditure is on the rise, but the existing facilities are not adequate for whole time involvement of capable representatives who can provide effective leadership. Thus, on the one hand, there is inadequate facility leading to decrease in motivation for efficiency, on the other the expenditure on allowances and facilities for the representatives is increasing because of the excessive number of representatives. The minimum annual amount of the regular legal expenditure on the executive boards of the local bodies alone has reached Rs. 22,53,28,000. This amount is equivalent to 8% of all the grants from the Ministry of Local Development to all the local bodies. As this is the minimum amount and it covers only the executives, the actual total expenditure is much more than this. Because of involvement of many persons in the decision making process, on many occasions, the decision has been impeded or suppressed. There are no two opinions on the fact that, if local bodies are given necessary facilities and incentives, they can surely be more efficient and effective. Likewise, in some countries, the number of local bodies has been reduced and the area and size increased with the objective of making the local bodies more effective from management point of view and financially viable and self-supporting. For example, in Denmark, there used to be, before 1970, 25 counties, 88 urban local bodies and 1300 rural local bodies, but now

they have maintained only 14 counties, and 275 municipalities. Therefore, in Nepal as well, it is felt the time has come to review the number of local bodies and the number of personnel.

- In the context of planned development, some DDCs and Municipalities have started to formulate periodic (5-7 years) plans in the participatory process. If election for the local bodies takes place before such periodic plans are completed, the successive elected body should do the follow-up. Along with this, it is difficult to make an exact projection of capital investment as many plans remained incomplete because of faulty planning process; as the provision, that local priority projects should also get national priority, has not been fully implemented; and the process has not yet started that local services provided by sectoral ministries should be brought under the umbrella of the DDC.
- Because of the weakness of recruitment process in the past, qualified and skilled personnel were not attracted to the local bodies. It has not been possible to train old staff, who have been stuck to their present post for a monotonously long period. Personnel who were recruited over 20 years ago without intense competition have now been promoted to higher levels (up to non-gazetted class I), although their skills and qualifications were not enhanced. These personnel are not controlled under the administrative chain of command but are psychologically attached to the individuals who appointed them. There are examples admitted by office bearers of several DDCs and municipalities that, even if they wish, 60% of the personnel are not capable to assist the local bodies in discharging the present responsibilities properly. Therefore, all these factors must be considered while upgrading the capability of the existing personnel or recruiting new ones.

This study was not municipal- focused. Considering the municipal context the problems of fiscal decentralization can be mentioned as follows:

- Lack of willingness of the centre to relinquish power has been a major impediment to decentralization in many countries including Nepal and is possibly more constraining than the creation of an appropriate legal framework. Therefore, the fundamental challenge for good governance in

municipalities and other local bodies is to strengthen the political will in support of decentralization.

- Nepalese local bodies are not viable in terms of economies of scale and natural resources endowment. The design of LBs including Municipalities in Nepal is ad hoc and they are not service delivery friendly.
- There exists political vacuum at local level (no elected representatives)
- Domination of elites in planning and budgeting (the voice of minorities and marginalized are not adequately captured) Expenditure Assignments (Overlapping and duplication)
- Revenue Assignments (Least use of revenue Potentials)
- Revenue sharing is not systematized
- Weak transparency and accountability with high fiduciary risk
- Weak capacity to exercise the given authorities and discharge the services assigned to the LBs
- The principle that finance follows functions, is not in practiced fully
- Inadequate resources to cover the expenditure needs has resulted in local bodies being unable to deliver the services
- Mismatch between local expectation (voice, services, fiscal) and management has weakened accountability
- Tax revenues enhancement plan is not prepared and implemented by the municipalities.

6.2 Prospect of Fiscal Decentralization

Decentralization is the major area of governance reform in Nepal. The gap in the provision and distribution of the services to the general people demands more decentralization with adequate capacity. The past efforts of governance reform and decentralization could not devolve adequate fiscal resource to local bodies in Nepal. Currently Nepal is in political transition. People are demanding more power to exercise themselves. So decentralizing power and localizing services are the key reform agenda. In many respects, the core of local political autonomy depends upon fiscal self –sufficiency. This can be met only by the effective fiscal decentralization. In this context, the prospects of fiscal decentralization are given as follows:

- a. It enables sub-national governments to take account of local differences in culture, environment, endowment of natural resources, and economic and social institutions.
- b. Information on local preferences and needs can be extracted more cheaply and accurately by local governments, which are closer the people and hence more identified with local causes.
- c. Bringing expenditure assignments closer to revenue sources can enhance accountability and transparency in government actions.
- d. It can help to promote streamlining public sector activities and the development of local democratic traditions.
- e. By promoting allocative efficiency, it can influence macroeconomic governance, promote local growth and poverty alleviation directly as well as through spillovers (De Mello (2000))¹⁹⁷

Considering Nepalese context, the prospects of fiscal decentralization can be added as follows:

- It enhances local economic development
- The current debate on state restructuring is based on the resource allocation. By the allocative efficiency of the resources the equitable society can be created by the effective and functional fiscal decentralization
- It supports to enhance local autonomy and creativity
- The finance follows the function will clarify the role delineation among the tiers of governments.
- Compared to Village Development committees, municipalities are more capable of utilizing the fiscal authorities and they can fulfill the fiscal needs created by rapid urbanization in Nepal.
- Downward accountability will be strengthened.

¹⁹⁷ De Mello, Luiz(2000). "Fiscal decentralization and intergovernmental fiscal relations: A cross-country analysis", *World Development*. Vol. 28, No. 2, pp.365-380.

6.3 Municipal Taxation in Nepal

Globally, local revenue sources are a combination of tax and non-tax charges that are internally generated and transferred from the higher levels of government. “Tax revenues include personal and corporate income tax, property tax and tax on goods and services. Non-tax revenues comprise fees, fines, user, chargers and sales income”¹⁹⁸. Cities/Municipalities are the engine of economy and are the centers of economic developments; there is a high degree of tax potentiality. In this context, municipalities are levying different taxes differently.

The traditional theory of federalism prescribes a very limited tax base for sub-national government. The only "good" local taxes are said to be those:¹⁹⁹

- 1) that are easy to administer locally
- 2) that are imposed solely (or mainly) on local residents, and
- 3) that do not raise problems of harmonization or competition between sub-national governments or between sub-national and national government.

Local taxes are emerging sources of municipal finance. Especially in developed countries, municipal taxes are synonyms of local taxes and in developing countries more potentials local taxes are based in municipality.

Where local authority determines the tax revenue by setting the tax rate and/or defining the tax base and retains the resulting proceeds of the tax for its own purposes.

6.3.1 Concept of Municipal Taxation

Municipal expenditure is financed through various sources via taxes, non tax sources, grants and loans. The municipal taxation is one of the most important sources of finance in municipalities. In a democratic society it is desirable to establish a clear

¹⁹⁸ Pritha Venkatachalam, “Crisis States Working Paper” Series No. 2, Crisis States Research Centre LCE, July 2007.

¹⁹⁹ Pichard M. Bird, "Sub national Revenues : Realities and Prospects" World Bank Institute, Intergovernmental Fiscal Relations and Local Finance Programme , http://www1.worldbank.org/wbliep/decentralization/topic_of_printer.htm 2001-6-21.

link between those concerned with spending public funds and those responsible for the raising revenue.²⁰⁰

Tax is a compulsory contribution to the support of government levied on persons, property, income, commodities etc. A municipality or the supply of public services in municipality will not sustain without taxes to finance them. So, municipalities should be authorized to generate their own revenue in order to respond to the wishes of their constituents through the development of projects serving their needs. municipal taxation can be defined as "the taxes levied by the municipality (Council/elected representatives) on persons, property, income and commodities etc. within the municipal areas.

In Nepal, municipal tax bases are defined by Local Self Governance Act (LSGA), 1999 and rates are defined by Local Self Governance Regulation (LSGR), 2000. House and land tax, land revenue and tax, integrated property tax, vehicle tax, entertainment tax, house rent, advertisement tax, means of professional tax are the major taxes assigned to the municipalities.

Types of taxes

Countries around the world have used the following main local government taxes

- Income tax
- Property tax and land tax
- Corporate income tax/company tax
- VAT and various forms of sales taxes
- National resources taxes
- Other smaller taxes

In the decision about the composition of these revenues the following considerations have (at least) to be included:²⁰¹

²⁰⁰ Rup Khadka, Municipal Finance in Nepal (2002) Kathmandu: Centre for Study and Research on Good Governance, P 6

²⁰¹ <http://www1.worldbank.org/publicsector/decentralization/revenueorg.htm> (04-09-2000).

- The tax should be delivered a high yield to the local government.
- The tax should be fairly distributed across the local government or supported by stony equalization scheme.
- The tax should provide a predictable amount of revenue to finance the supply of public goods and services.
- The tax administration should be related to low administrative costs and compliance costs.
- The tax should have low distortions, e.g. not create a non-balanced development of the country.
- The tax should ensure a close relationship between the costs of the service provision and the finance there of and promote efficient and sufficient spending levels.
- The tax should avoid tax competition across the units and spillover effects.
- The tax should have small revenue fluctuations during business cycles and follow pace with the development of the economy and the expenditure needs.
- The tax should be visible to the citizens.

Advantages and disadvantages of various types of taxes are mentioned in the annex 1.

Defining Municipal Taxes

The theme of fiscal equivalence stated that "There is a need for a separate government institution for every collective good with unique boundaries, so that there can be a match between those who receive the benefits of a collective good and those who pay for it Khadka" (2002). Tax is a compulsory contribution to the support of government levied on persons, property, income, commodities etc. A government for the supply of public services will not exist without taxes to finance them.

Municipal taxes are those which are levied by the municipality within its jurisdiction. "Municipal taxation is also justified to improve the voluntary compliance of the taxpayers." To enhance voluntary compliance, taxpayers must be convinced that a

significant portion of their taxes will be retained locally and that these revenues will be used for projects and services which they value. The important canons are resource allocation, accountability, autonomy, non-mobile tax base, non-exportability of interests, responsiveness to local economic growth and revenue stability.

There are some general criteria as revenue productivity, simplicity, efficiency, and equity, which are used to evaluate taxes levied by any level of government, including municipalities.

Municipal taxes can be levied in bases in different ways, for example, some taxes can be levied as independent taxes and some taxes can be levied as piggy backing while the revenue generated from taxes can be shared with the higher level of government. It is also possible to share administration of some taxes with the higher level of government.

6.3.2 Municipal Taxation in Nepal

Municipalities constitute the local government in the urban areas of Nepal. Municipalities have high potential tax base due to the concentration of economic activities in the urban centers. The specification of municipal area spelled out by Local Self Governance Act is "having a population of at least twenty thousand and with electricity, roads, and drinking water and communications facilities". Similarly, the act has classified municipality into municipal corporation, sub-municipal corporation and municipality based on population, sources of income and other urban facilities.

a) Background

"Information is not available about the municipal tax system that existed, if any prior to the enactment of the Nagar Panchayat Act 1962." In 1962, municipalities were authorized to levy a house roof and rent tax at the rate of two percent of the amount of rent in the case of a rented house and land. In the case of an owner-occupied house and land, this tax was levied at one percent of the income which was defined as the

sum of 4 percent of the estimated construction cost (at the prevailing rate) of the house and current land value Municipalities were also allowed to levy.

- A business and professional tax not exceeding 5 percent of the annual profit of the specified business and professions,
- A surcharge not exceeding 10 percent of land revenue,
- An entertainment tax not exceeding 20 percent of entrance fees,
- A benefit tax not exceeding 50 percent of house roof and rent tax from town dwellers who benefit from the construction, extension, improvement or upgrading of streets, sidewalks, drainage, sewage and its maintenance, supervision and operation, street lighting and the maintenance and cleaning of street, sewage and drainage and for solid waste management undertaken by municipalities,
- A surcharge not exceeding 25 percent of the house roof and rent tax for constructing school buildings, for improving facilities in educational institutions, for providing facilities to students, and for making primary education free and compulsory in the municipal areas; and
- A vehicle tax not exceeding Rs. 100 per annum per vehicle registered in the area of jurisdiction of municipality. In 1963, vehicles were classified into different groups and separate ceilings were fixed for each type. Higher rates were set for rented vehicles than for owner-operated vehicles.

Municipal taxation in Nepal has not been developed systematically. The pace of decentralization itself is slow and fiscal decentralization including municipal taxation is further unsystematic. An incremental approach with narrow tax base was adopted from the very beginning. "The municipal tax system was revised in 1965 when house roof and rent tax, business and professional tax and vehicle taxes were simplified, entertainment tax and surcharge on land revenue were abolished and municipalities were allowed to levy new broad-based taxes, viz Octroi and Panchayat Development and Land Tax (PDLT). Municipalities were authorized to levy Octroi at a rate not exceeding 0.30 percent of the value of goods extending the municipal area. The rate was raised to 0.50 percent in 1977."

The municipal tax system was rationalized considerably in 1988. In the area of property tax, municipalities were classified into 3 groups for the purpose of fixing tax rates. A lower limit of Rs. 3 was fixed for all municipalities, while the upper limit varied for different groups of municipalities, i.e. rates of Rs. 3000, Rs. 1500 and Rs.500 were fixed for municipalities falling into groups A, B, and C, respectively. The rate of Octroi was raised from 0.50 to 1 percent. Similarly house rent tax, business tax and profession tax, were elaborated and made clearer than before. The house rent tax was levied with rate not exceeding 2 percent of the rent of house and land. The business and professional tax was levied as business and profession on an annual basis and rate were fixed on the basis of the type and size of the business and profession.

b) Current Municipal Taxes

Local Self-Governance act, 2055 (1999) is the milestone of decentralization in Nepal. It has assigned different responsibilities to local bodies (District Development Committee, Village Development Committee and Municipality), to deliver basic services at local level. Although decentralization in Nepal was initiated in different ways, Deconcentration through administrative reform, localizing development by creating development agencies and devolving authorities to local bodies by laws are some examples that can be mentioned. The Local Self-Governance Act 1999 is a consolidated form of past efforts on decentralization and the changing will and requirement of the democratic participative local governance. As it has provided authorities to local bodies in their respective jurisdictions, the act has spelled out the fiscal authorities to them.

One of the principles adopted by the Act is "devolution of powers to collect and mobilize such means and resources as are required to discharge the function, duties, responsibility and accountability conferred to the Local Bodies."

As per the Local Self-Governance Act 1999 municipalities are authorized to levy taxes impose fees, service charges and taxes. The following areas of taxation are assigned to the municipalities by the Act.

- (a) Land Revenue and House and Land Tax: The municipality may levy house and land tax, as prescribed on each house and land within its jurisdiction on the basis of the size, type, design, construction and structure of the house and compound and area covered by the house, as approved by the Municipal council. The municipality may impose land tax as prescribed on the land within the municipal area.
- (b) Rent Tax: The municipality may collect rent tax, as prescribed on the amount of rent in cases where any house, shop, garage, go down, stall, shed, factory, land or pond within its jurisdiction is rented wholly or partly.
- (c) Enterprise Tax: The municipality may levy and collect enterprise tax, as prescribed, as trade, profession or occupations within its jurisdiction on the basis of capital investment and financial transactions.
- (d) Vehicle Tax: The municipality may levy vehicle registration and annual vehicle tax on the prescribed vehicles within its jurisdiction and occasional vehicle tax, as prescribed, as all kinds of vehicles entering into its area.
- (e) Property Tax: The municipality may levy an integrated property tax, within its jurisdiction at the prescribed rate.
- (f) Entertainment Tax: The municipality may levy entertainment tax, as prescribed, as the means of entertainment such as cinema halls, video-halls, cultural-show halls.
- (g) Commercial videos Tax: The municipality may levy tax as prescribed as the video, projector, cable etc. used by any person or organization for commercial purpose.
- (h) Advertisement Tax: The municipality may levy tax as signboards, globe mats, stalls, etc. permitted to be placed as roads, jurisdictions, and public places in its area for advertisement, publicity etc.

6.4 Municipal revenue and tax collection

The tax collected by the municipalities is not adequate to discharge the assigned responsibilities to them. Legally, narrow tax based is given to theme as the land and

tax potentiality is largely unused, on the other. The following tables show the position of municipal taxes collection and total expenditure.

Table 14
Tax collection and expenditure of municipalities

FY	Total Revenue in NRs. 000	Total Internal Revenue NRs. 000	Total Expenditure in NRs.
060/61 (03/04)	2519561	1765491	2160153
061/62 (04/05)	3105538	1933536	2726127
062/63 (05/06)	2849478	1867894	2405291
063/64 (06/07)	3597724	1944632	3130921
064/65 (07/08)	4076204	2107424	3547552

Includes Local Development, Fee Source, MoLD/GTZ, 2008, 202

Tax Revenue

The municipalities are heavily depended in Local Development Fee (LDF) in revenue structure. It was substitution of Octroi. If we excludes Octroi from municipal tax revenue the size of tax revenue decrease substantially, LDF collected by the central government up to FY 2008/09. Since FY 09/010 LDF is abolished. The equivalent amount of LDF is included as municipal grant from the central government. The structure of municipal tax revenue is as in the following table.

²⁰² Detailed Revenue and Expenditure Breakdown with Budget and key Financial Indicators of 58 Municipalities (For the year 2007-2008), (2009), Kathmandu: Ministry of Local Development, Local Bodies Fiscal Commission and Urban Development Through Local Efforts, p. All 1-2.

Table 15

The structure of Tax Revenue (NRs in 000)

S.N.	Tax Head	FY 060/061 (FY 03/04)	FY 061/0612 (FY 04/05)	FY 062/063 (FY 05/06)	FY 063/064 (FY 06/07)	FY 064/065 (FY 07/08)
1	Vehicle Tax	34368	31579	31421	28247	39541
2	Professional Tax	47586	63385	57294	58085	76081
3	House and Land Tax	142045	233996	229608	266736	297883
4	House Rent	5586	3875	7193	11853	17798
5	Contract Tax	283	248	645	312	377
6	Local Market Tax	10012	10128	9854	10237	9665
7	Sales Tax Cattle/Fish	5278	4153	4246	3756	5256
8	Unclaimed Land Tax	2794	2425	2800	4004	4290
9	Tax Arrears	3332	7083	1457	1985	2051
10	Other Taxes	54	8	19	35	0
Total		251338	356880	344537	385250	452942
	Local Development Fee	986099	990470	986640	986376	986376
	Total Tax Revenue	1237437	1347350	1331177	1371626	1439318
	LDF Contribution in Total Tax Revenue	79.68	73.51	74.18	71.91	68.53

Source: MoLD/Udle 2008

The above table shows the gradual increment in municipal taxes collection. LDF's contribution in municipal tax revenue becomes 68.53 from 79.68 in the five years period. The contribution of municipal tax revenue in total expenditure is given below in tabular form:

Table 16**Tax Revenue Contribution in Total Expenditure (NRs. In 000)**

Tax Revenue	FY 03/04	FY 04/05	FY 05/06	FY 06/07	FY 07/08
Taxes	251338	356880	344537	385250	452942
LDF	986099	950470	986640	986376	986376
Total Tax Revenue	1237437	1347350	1331177	1371626	1439318
Total Expenditure	2160153	2726128	2405292	3130922	3547553
Total Tax Revenue in Expenditure (%)	57.28	49.42	55.34	43.80	40.57
% of Tax Revenue in expenditure (excluding LDF)	11.64	13.09	14.32	12.30	12.76

Source: MoLD/udle, 2008

Municipalities are the potential areas of local revenue generation. They are the centre of economic activities. Municipalities have been given authority to collect various taxes, fees, service charges, property rental etc as internal revenue. Considering fiscal balance and fulfillment of funding gap municipalities need the financial support from higher levels government and international financial institutions and development agencies. The internal revenue generated by the municipality and the financial resources given by the central and provincial governments comprises the municipal revenue. The external resources to the municipalities can be received as grants and loans.

Municipalities in Nepal are urban governing units. They need fund to operate and provide services to the inhabitant of the city. Therefore, they are entitled to levy tax, charges and fees to meet expenditure incurred in the provisions of services. "The theories on Public Finance define tax as, is a compulsory levy payable by an economic unit to the government without any corresponding entitlement to receive a definite and direct quid pro quo from the government."²⁰³ In the context of local government unit like municipality, the tax is compulsory levy payable by the municipal inhabitants. Municipal tax should be similar to government's taxes that is: canon of equality, canon of convenience and canon of economy, canon of productivity, canon of buoyancy, canon of flexibility, canon of simplicity and canon

²⁰³ Bansidhar Ghimire, Alternative Municipal Financing, (2004) , Kathmandu: GTZ /udle /MOLD/LBFC, p. 4.

of diversity (Ghimire et.al). In Nepal municipalities are assigned taxes by the LSGA 1999.

The chapter 8 of LSGA has made the provision of Municipal taxes, fees, services and fares. According to the LSGA the tax assignment to Nepalese municipalities include land revenue and house and land tax, rent tax, enterprise tax, vehicle tax, integrated property tax, entertainment tax, commercial video tax and advertisement tax. The revenue of the Nepalese municipalities comprises local taxes fees and fines, property rental, other revenues, grants from the government, loans and miscellaneous income. The following table gives the trends of municipal revenue in Nepal.

Table 17
Municipal Revenue and Tax Collection
NRs '000'

Revenue Heads	FY 061/62 (04/05)	FY 062/63 (05/06)	FY 063/64 (06/07)	FY 064/65 (07/08)	FY 065/66 (08/09)
Local taxes	1347350	1331777	1371626	1439318	2447589
Fees and fines	408828	385288	443161	510094	343969
Property rental	90148	79059	86298	107072	97535
Other revenues	87211	72370	43547	50941	73167
Miscellaneous income	73443	91972	258492	114047	314196
Grants	705097	655653	1100609	1200088	2375947
Loans	23985	39844	47778	28491	28072
Balance forward	368876	194115	246212	626154	413984
Total Revenue	3105538	2849479	3597724	4076205	6394280
LDF (Included) in Local taxes)	990470	986640	986376	986376	1816023

Source: adopted from MoLD/udle (2010)²⁰⁴

²⁰⁴ Detailed Revenue and Expenditure Breakdown with Budget and Key Financial Indicators of 58 Municipality MoLD/CBFC/Udle 2010, 2010, p. AII 1-2.

The contribution of local taxes of municipalities in total revenue is 38.28. If we deduct the LDF share in the local taxes the real contribution in total revenue remains only 9.88 percent. The real taxes collection by the municipal efforts clearly shows the high dependency on central efforts and the grants.

After the promulgation of LSGA 1999, the fiscal decentralization including municipal taxation in Nepal has been recognized. LSGA can be call as a milestone for municipal taxation. Both tax and non tax revenue bases have been assigned to the municipality. Due to inadequate attention for capacity of municipality as well as imperfect devolution in general did not support municipalities to enhance the tax revenues. High dependency on octroi before LSFA and on LDF after LSGA adoption promoted the negligence in municipal taxation. The local tax collection by the municipalities after LSGA's adoption is given below:

Table 18

The Revenue collected by 58 municipalities from the local taxes (municipal taxes)
NRs '000'

FY	Total taxes in NRs 000	Total Internal Revenue in NRs	% of local taxes in own source revenue
2055/2056 (1998/1999)	872710	1042302	87.73
2056/2057 (1999/2000)	1053194	1273034	82.73
2057/2058 (2000/2001)	1166447	1511395	77.18
2058/2059 (2001/2002)	1368168	1764736	77.53
2059/2060 (2002/2003)	1248413	1707970	73.09
2060/2061 (2003/2004)	1237436	1765491	70.09
2061/2062 (2004/2005)	1347350	1933537	69.68
2062/2063 (2005/2006)	1331777	1867894	71.30
2063/2064 (2006/2007)	1371626	1944633	70.53
2064/2065 (2007/2008)	1439378	2107425	68.30
2065/2066)(2008/2009)	2447589	3262281	75.03

Sources: adopted from MLD/udle (2004, 2005, 2010)

As mentioned above the octroi/LDF is the main own source revenue. After deduction of octroi/LDF the real efforts made by the municipality can be observed. The collected octroi and distributed LDF by the MoLD in the same period mentioned above table is presented below:

Table 19
The octroi/LDF Received by the municipalities in NRs '000'

FY	Octroi/LDF	Total own source Revenue	% of LDF in total own source revenue
2055/2056	682772	1042302	65.51
2056/2057	879675	1273034	69.10
2057/2058	987409	1511395	65.33
2058/2059	1066291	1764736	60.42
2059/2060	989238	1707970	57.92
2060/2061	986099	1765491	55.85
2061/2062	990470	1933537	51.23
2062/2063	986640	1867894	52.82
2063/2064	986376	1944633	50.72
2064/2065	986376	2107425	46.80
2065/2066	1816023	3262281	55.67

Source: adopted from MLD/udle (2004, 2005, 2010)

6.5 Municipal Tax Potentiality and Utilization

The assigned functions to the any level of government needs the financial resources fiscal autonomy is one of the major indicators for smooth and functional local governments including municipality. The concept of revenue assignment is primarily based on the origin of the tax and non tax revenue prior to assign tax to any level of government the potential tax bases to be analyzed. Finding appropriate taxes to municipality is the precondition in designing municipal taxation. Bird has formulated a table to examine to examine the appropriateness of different tax to local bodies. Tax table is as follows:

Local Taxes

Criteria	Property Tax	Income Tax	Sales Tax	Business Tax
Mobility	+	-	-	-
Adequacy	-	+	-	?
Buoyancy	-	+	+	+
Stability	+	-	-	-
Exportability	+	+	+	-
Visibility	+	+	+	-
Fairness	+	+	?	-
Acceptability	-	-	?	-
Administration	-	+	?	+

Source: Ghimire (2008 p6) , +/- Good to the extent that it tells on residents bad to the extent that it fails on non residents ? Indeterminate

Property tax has 5 good 4 bad criteria. Similarly income tax has 3 good 5 bad 1 indeterminate criteria. The Criteria stated in the table are generalized, but they indicate the problems in revenue assignments. In fact all the taxes have good and bad criteria and a textbook cannot prescribe an exact criteria even good and bad from every perspective.

Assigning potential tax bases and exploiting existing potentiality need to be match. There are very few studies made on the potentiality of municipal taxes. Based on the some studies made by LBFC, MUAN and urban finance experts of gtz/udle Mr.Ghimire has summarized as follows ²⁰⁵ :

- Municipalities have been realizing only about 30 percent of this potential capacity
- Tax administration of municipalities, needs reform
- Record system or information system in municipalities is much more below than the required standard
- Municipalities need higher levels of help to enhance their capacity in all aspect of municipal functions

²⁰⁵ Ghimire , Bansidhar , op.cit.148,P5

- Municipalities need to introduce "Corporate Accounting System" to make their financial transactions more transparent and accountable.

The problems of municipal taxation start from the non-utilization of its tax-revenue potentialities. Therefore, full utilization of tax potentials in the municipalities is very crucial especially in the countries like Nepal. The revenues assigned to municipalities are mostly based on the rule of origin or location fixed properties like land and buildings and income from renting these properties are the major municipal resources. In order to estimate additional resources that could be mobilized through extra efforts, administrative reforms and tax rates reform, and assessment of revenue potential. The potential collection is an ideal situation where the condition of 100% voluntary compliance prevails and in actual situation may not be attainable.

Taxpayer's attitude towards municipal services and the expenditure, low credibility are the basic reasons for low levels of compliance. Enforcement mechanism for utilizing tax potentiality in the municipalities determines the efficiency of the revenue mobilization including tax revenues enhancement. Furthermore, the human resource development for municipal tax revenue enhancement and institutional capacity strengthening are two major problems to utilize the available municipal tax revenue potentials.

CHAPTER VII

FINDINGS, SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

7.1 Findings

Theoretical perspectives, policy framework, institutional capacity and ideas of respondents are reviewed and analyzed above. Based on the study and analysis the findings of the study are given below;

- The implementation of LSGA in general is weak and the level of understanding and effectiveness in exercising given powers varies among the local bodies including municipalities.
- The four pillars of fiscal decentralization, expenditure assignment, revenue assignment, Inter-governmental fiscal transfers and local borrowing are not matched and perfectly interlinked to make effective fiscal decentralization.
- Despite LSGA has assigned responsibilities and fiscal powers to DDC, VDC and municipalities followed the devolution model of decentralization more authorities are exercised by the line Agencies. They are still following the deconcentration model which was adopted by the most of the developing countries in the second half of the 20th century. The 23 contradicting laws with LSGA 1999 provisions have yet to be amended.
- There is no standard of local services including municipal services. Similarly there is no hierarchical linkage among local bodies and the line agencies to deliver services to the people.
- It is observed and experienced that the lack of influential and accountable mechanism to coordinate between central planning,

Programme and budgeting. The central planning and budgetary authorities' behavior are observed as giver to local bodies rather than worried about real local needs. The central budgetary system has dual practices of central and district level budget allocation.

- Urban governance is not paid adequate attention in central policies and practices because most of the policies developed by the centre are predominantly rural focused.
- Legal provisions for municipality, sub-metro Politian city and metro Politian city are too general and ignoring the capacity and implement ability of the responsibilities of different categories of the municipalities. There is no any preparation for asymmetric decentralization for existing local bodies. The drafting process of the new constitution and state restructuring has also ignored it.
- Although the grant allocation for local bodies is based on the formula, but there is no formula based allocation criteria in the central budgetary system in allocating budget for line ministry as well as field offices. It is ad hoc and incremental.
- Local bodies receive grant about 1 percent of the GDP as grant and 4 percent of government total budget. Similarly, municipal grant comparing to the GDP is 0.24 percent and the grant comparing to the total GON budget is 1 percent.
- Neither central political leadership is committed for fiscal decentralization nor is the local political leadership adequately knowledgeable and accountable as required.
- The specific plan for local governance reform, devolution and municipal revenue enhancement are not found during the study.
- The central revenue enhancement plan, changes in central revenue policies and municipal revenue collection system are not interlinked.

The municipal internal revenue is not found reflected in the national account.

- In the process of devolution, it is observed and found that only the responsibilities have been shifted to local bodies. But the respective central government's officials (civil servants) were not transferred. For example, the personnel working on property tax in the tax offices were not transferred to municipalities and the personnel working for the land tax in the Land Tax administration Offices were not transferred to VDC and Municipalities whereas the property tax and land tax authorities were handed over to the municipalities and VDCs.
- The lack of supportive attitude and behavior in the government agencies both at the central and local level is a constraint for fiscal decentralization. It is one of the causes of weakening municipal tax administration.
- Limited fiscal decentralization has been adopted.
- A scientific and predictable Inter-governmental fiscal transfer system is a precondition in designing fiscal decentralization either federal or unitary system of governance.
- Constitutional, policy and legal provisions on fiscal decentralization and political commitment for federalism is more supportive for fiscal decentralization.
- Most of the local bodies including municipalities are not viable in terms of economies of scale, natural resources endowment and even basic capability to carry out the responsibilities given by the LSGA.
- No local tax experts are found at both at the central and local level during the research and researcher's more than one decade's working experiences of Local Development Officer in DDCs, and Under Secretary, Joint Secretary and Member Secretary of LBFC in the Ministry of Local

Development. Similarly, there is no plan for enhancing capacity of local bodies and MOLD focusing on local tax revenues as well as municipal taxation.

- Municipalities like Kathmandu Metropolitan, Sub- Metropolitans and highly populated municipalities are not prepared to cope up with the vertical growth in their respective areas. Adequate plans, policies and legal framework are not existed to facilitate, monitor and control haphazard high rise building and other urban infrastructures.
- Fiscal accountability is one of the major challenges of fiscal decentralization in the local bodies including municipalities. Political vacuum (absence of elected representatives since more than a decade) in local bodies has weakened the institutional accountability. Attempt to substitute it by all – party mechanism has been controversial.
- The role of LBFC is not pro-actively fulfilled. The capability of LBFC is weak. There are no permanent professional staffs.
- The mandate of LBFC is advisory and recommendatory. In the resources allocation and decision making process it has no defined role. There is no another separate legally mandated leading institution to work on fiscal decentralization.
- Local Bodies Associations including Municipal Association of Nepal are neither professional nor represented appropriately to expedite devolution and fiscal decentralization.
- Although the local political environment is not that much conducive, municipalities are collecting taxes in the absence of elected representatives. They are trying to enhance tax revenue in an incremental way. Due to lack of adopting ‘finance should follow the functions’ principle in the municipality, people are not able to get more services even if a municipality increases the tax revenues

- The current scope and structure of LBFC cannot lead and provide sufficient input for devolution of fiscal power and state restructuring as well as constitution writing.
- The tasks assigned by LSGA to local bodies including municipalities are not matched with funding mechanism and functionaries. So operational problems are gradually resolved by the LBs.
- Although the given tax bases to municipality are too narrow to yield adequate revenue, most of the municipalities are not able to exploit the existing revenue potentiality.
- Due to the lack of elected representatives since more than a decade, there is no formal mechanism to articulate the political will and commitment in the municipality. The accountability is very weak and monitoring mechanism is not effective. Consequently revenue mobilization is shadowed by the expenditure on centrally transferred funds.
- There is no revenue plan but most of the municipalities have indicative expenditure plan. Due to low revenue generation and inadequate transfers from the centre to discharge the services there is a negative circle of low revenue generation, low service delivery and low capital investment. This cyclical problem is a major constraint to fulfill the growing expenditure need to the rapid urbanization in urban and semi- urban centers.
- Current process of designing federal system and local governance as well as municipal management is not taken seriously. The future of local bodies and their authorities are regressively presented comparing the LSGA in the preliminary draft of the constitution.
- The current expenditure of all municipalities is 36.33 percent, whereas the current cost of the Nepalgunj and Kathmandu municipalities is higher and Biratnagar, Gorkha and Pokhara municipalities current cost is lower than the all municipalities' average current expenditure. Similarly, the average capital investment of all municipalities is 48.94 percent. The capital

investment of Biratnagar , Kathmandu, Gorkha , Pokhara and Nepalgunj are 49.12, 43.39,48.10,60.27 and 36.50 percent respectively. The total GON current expenditure is 58.15 percent which is higher than the average all municipal current expenditure and capital investment of GON is 33.27 percent which is much lower than the average municipal capital expenditure.

- The own source revenue excluding local development fee in Gorkha municipality is lowest (10.77 percent) and Kathmandu is the highest (34.78) among the sample municipalities. It shows that the single metro politan city Kathmandu is not able to collect revenue to meet the expenditure need. It is also highly depended on the central transfer. It has further proved that without efficient and accountable management even the highest potentiality of the country cannot be exploited.
- There is no defined area for borrowing to municipalities and practice of borrowing is not recognized by the commercial banks and financial companies. Only one government owned monopolized financial organization i.e., Town Development Fund is providing limited loan to the municipalities. There is no borrowing practice in DDC and VDC in Nepal.
- Municipalities are not adequately transparent and accountable as require.
- Municipal tax revenue is not directly linked with services to be delivered and people are not adequately aware about tax compliance.
- Central government line agencies at the district level are not much supportive to enhance municipal taxes and resolve the issues on fiscal decentralization.
- Lack of skilled staffs in local bodies including municipalities is one of the major problems for municipal management. In addition to that the centrally deputed secretaries including executive officers of municipalities are not fully accountable to the local people. They are more accountable to their bosses and the minister in the capital i.e., Kathmandu. This tendency

is against the basic prerequisite of local governance i. e., hire and fire authorities to be fully exercised by the respective local government/ body.

- Despite of the various constraints like inadequate knowledge and skills on municipal taxes, inadequate information, data base, record keeping , unevenly distributed revenue potentiality and lack of accountable elected leadership, the efforts made by the municipalities are positive and the revenue collection trend is incremental.
- Better infrastructure and regular upkeep promote voluntary compliance of municipal taxes. But due to poor infrastructure in Nepalese municipalities including sample municipalities, much of the revenue potential remains unharnessed.

As per the increased revenue ratio in municipalities there are no visible services received by the tax payers and general people in the municipalities.

7.2 Summary

The governance system all over the world is facing many problems to meet the aspiration of the people and enhance people participation. In the crossroad of political system and governance reform decentralization is seen as a useful tool and solution to different kinds of problems. Especially, in the developing countries democracy and decentralization are considered two sides of the coin for creating harmonized society. The top down approach has often failed to promote development, reduce poverty and strengthen local democracy. Disappointment has been particularly high with rural development Programme, many of which were initiated, designed and executed by central government agencies/representatives with little or no input from the communities.

In most of the developing countries, urban governance and municipal management has not been considered as a prioritized area of governance reform. The rapid urbanization requires more autonomy with sufficient powers to address the challenges breed by urbanization and the opportunities as well as benefit to share people. Local self governance in urban area is critical to foster economic development. For the

overall development and citizen engagement in exercising democratic power, decentralization is needed. In many developed countries cities are enjoying more autonomous power for their prosperity.

There is no one system and modality that can be generally adopted in all the countries. Similarly, there is no "one size fits all" design which can be applicable for decentralized governance. Governance reflects the social values and the quality of governments in different layers in any country. Different types of decentralization like deconcentration, delegation, devolution, marketization and a mix of two or more have been practiced in different countries. But, we can categorize it broadly as asymmetric and as symmetric model.

In Nepal, governance system is predominantly centralistic. From the beginning of the statecraft most of the state power has been concentrated at the capital. After the advent of democracy in 1950 the deconcentrated model of decentralization initiated. The changes occurred in the political system could not handed over the power to the lower level of government (local Bodies). In the name of administrative development and local self governance many administrative commissions and decentralization commissions/committees were formed and submitted reports accordingly. But real decentralization of power could not happen. The incremental and ad-hoc model of decentralized governance was adopted but there are still many issues of decentralization in design and operation.

Political transition on the way to federalism is an excuse for sometime not to localizing powers. The politicians and senior administrators are still reluctant to devolve power at the nearest point of the people with blending functions, funds and functionaries. Local bodies are working with underfunded and unfunded mandates. The elite capture in local resources and opportunities exists in all the local bodies i.e. DDC, VDC and Municipalities. The service delivery gap that is supposed to be delivered by the line agencies (extended areas of central line ministries) is creating confusion on the local bodies performance due to overlapping, inadequate capacity and resources available to them.

On the one hand overall service delivery is weak and governance is poor in many aspects of state responsibilities and accountability. The political culture is not matured

for conducive decentralization and deepening local democracy followed by inclusive local governance system on the other. The institutional capacity both at the centre and local level is weak for effective decentralization and enhancing it further.

Despite inefficiency, limitations and weakness of decentralization, there is high chance and opportunity to devolve more power to the lower layers of government. The political slogan for populism is providing support to devolution if it is articulated perfectly and professionally. The juncture of state restructuring and federalism is directing towards decentralization with more fiscal resources. The raising awareness of the people, efforts on social mobilization and other means of empowering people to generate more demand is creating climate for decentralization. Citizen participation in governance, political freedom, political stability, rule of law, efficient and equitable service delivery, human development, fiscal and economic management and equitable and inclusive governance are the driving forces for decentralization in Nepal.

Fiscal decentralization is the key to success decentralization. It is more technical and complicated in designing. The conflicting interests in the division of fiscal resources, un-clarity on shared roles, development of scientific transfer system and equalization in service delivery are some of the main elements that should be considered in designing fiscal decentralization.

Globally, fiscal federalism has grown its importance, because modern development in transportation, social communication, technology, industrial organization, globalization and knowledge based societies have all contributed to simultaneous needs for both greater and smaller political units. In Nepal the raising aspirations of the people have to manage by the awaited federalism. So fiscal decentralization and fiscal federalism are equally important. The important aspect of federalism is shared and autonomous self-governance. Professionals, interest groups and other stakeholders are highly sensitive to who pays what and who gets what in the context of federalism and state restructuring. These are concerned with the design of fiscal decentralization when decision making is among various orders of government. The design of fiscal decentralization entails division of powers for taxing spending and regulatory functions as well as fiscal arrangements that accompany such arrangements. The revenue assignment to municipalities in this context is very

important to fulfill the expenditure need to rapidly urbanizing municipalities and potential areas to be developed as municipality.

In this study fiscal decentralization and its pillars are analyzed. The municipal taxation has strong link with fiscal decentralization which needs institutional capacity at both central and local level. The summary of the study in these different components are given below.

(a) Expenditure Assignment

- Expenditure assignment to various levels of government is the most fundamental elements of fiscal decentralization. It is the first and most important pillar of fiscal decentralization. It determines the scope of other pillars. In other words fiscal decentralizations design depends on the expenditure assignment. Without expenditure assignment the other assignments cannot be determined in advance because it opens the other aspects of fiscal decentralization.
- The expenditure assignment between central government agencies and local bodies and local bodies themselves highly overlap. Due to overlap the overall service delivery and the accountability of the service providers is very weak. There is a big gap in service provisioning and real delivery to the people.
- The mind set of centralization (power up to me) has weakened expenditure assignment and the principle "finance should follow the function" has not been materialized.
- Due to mismatch between expenditure assignment and the funds (revenue assignment and fiscal transfer) local bodies including municipalities are working with unfunded and underfunded mandates. Expenditure assignment itself is a major challenge of fiscal decentralization within the current frame of governance and even for the forthcoming federal Nepal it will be most critical issue.

- Expenditure assignment between central agencies and LBs is under the problems of duplication, overlapping and ambiguity and prevailing contradicting acts with LSGA is making role delineation unclear.
- No clarity of expenditure assignment even in the proposed drafting of new constitution.
- The expenditure assigned to municipalities is not fulfilled due to inadequate political commitment, funding gap, lack of capable human resources and weak institutional capacity.
- The assignment of public services to local government or to metropolitan or regional governments can be used on considerations such as economies of scale, economies of scope (appropriate bundling of local public services to improve efficiency through information and coordination economies and enhanced accountability thorough voter participation and cost recovery) and cost benefit spillovers, proximity to beneficiaries, consumer preferences and budgetary choices about the composition of spending.
- The information revolution and globalization are posing special challenges to constitutional assignment within countries. The information revolution, by letting the sun shine on government operations empowers citizens to demand greater accountability from their governments.
- The efficient provision of public services fiscal efficiency, regional equity, redistributive role of the public sector, provision of quasi-private goods and shared responsibilities and preservation of internal common markets are expenditure assignments principles which should considered in assigning expenditure and needs to update.

(b) Revenue Assignment

- Revenue assignment is a basic component of fiscal decentralization for fiscal autonomy of different tiers of government.
- Revenue assignment has direct link with expenditure assignment because revenue assignment is generally guided by spending requirements at different levels and cannot be determined in advance.
- The division of revenue sources among different levels of governments constitutes the tax assignment problem. Four general principles require consideration in assigning taxing powers to various governments are economic efficiency criterion, national equity considerations, administrative feasibility criterion and fiscal need or revenue adequacy criterion.
- In Nepal LSGA 1999 allows local bodies including municipalities to levy taxes on centrally defined bases. Most of the revenue accrues under land, property and natural resources.
- Municipal tax base is not adequate in many smaller and new municipalities. So they are not able to manage current expenditure by the own source revenues.
- Urban governance needs wider authority so as to make it full autonomous. The tax bases of municipalities are to some extent psychologically biased rural circumstances as well as generalizing tendency.
- The revenue authorities assigned to Nepalese municipalities are not fully utilized due to unevenly distributed revenue potentiality, variance in capacity and inadequate political commitment as well as weak accountability. But the efforts made by the municipalities are positive and the revenue collection trend is incremental.

(c) Inter-governmental Fiscal Transfer

- Instruments of Inter-governmental finance have an important bearing on efficiency, equity and accountability in a fiscally devolved system. A sound and rational Inter-governmental fiscal transfer system is precondition in designing fiscal decentralization system in any country either federal or unitary.
- A system of Inter-governmental transfers attempts to address vertical and horizontal imbalances. In Nepal estimates of the imbalance are not systematically drawn up. The weak and asymmetric implementation of expenditure assignment does not lend itself to computation of clear measures of expenditure needs due to overlapping responsibilities and allocation of the budget fiscal transfers is not practiced in a consolidated manner. Different institutions are transferring fiscal resources to line agencies and LB differently.
- The broad objectives of fiscal transfers to fulfill national and regional efficiency and equity are identified as follows:
 - i. Bridging vertical fiscal gaps
 - ii. Bridging the fiscal disparities through fiscal equalization transfers
 - iii. Setting national minimum standards.
 - iv. Compensating for benefit spillovers
 - v. Influencing local priorities
 - vi. Dealing with infrastructure deficiencies and crating macroeconomic stability in depressed regions
 - vii. Supporting capacity enhancement to the weaker LBs
 - viii. Ensuring services to be delivered as defined by the national standards.

In Nepal Fiscal transfer is not scientific. The formula base transfer system is in practice only for the block grant to LBs provided by the GON. But the divisible pool given by MOF itself is ad-hoc.

- Local bodies in Nepal are receiving both the conditional and unconditional grants.
- LBs dependency on the grant provided by the central government is high. The total transfers to local level are ad-hoc. There is no formula and criteria for line agencies for fiscal transfers.
- Municipalities are highly depended on indirect tax sources and central transfers. The LDF is the major source of municipalities which is centrally collected and administered.
- The trend of transfers to municipalities is increasing from 13 percent in 2054/055 to 39 percent in 2065/066 out of total revenue of the municipalities. In the sample municipalities Gorkha has received the highest transfer i.e. 57.74 percent out of total revenue.

(d) Local Borrowing

- Local borrowing is necessary for LBs when expenditure needs could not meet by available revenues. Local borrowing is practiced in different ways. The standard limitation and investment menu for the loan have no single model that can be used in general. The eligibility criteria and the ceiling for loans to local government can be defined by the legal and policy framework. It is understood that unlimited loan to the local bodies is not possible to maintain fiscal balance and macroeconomic stability.
- Local bodies in Nepal may raise loans or receive borrowings with or without pledging any of its movable and immovable property owned and possessed by it or under guarantee given by the GON from a bank or any other organization according to the policy adopted by the respective council. This provision is made by LSGA. There is no any other detail procedure about local borrowing except TDF procedure of borrowing to municipalities.

- The TDF is the only institution that has direct approach to municipalities to get loan. The market and financial organizations are neither marketing the opportunities to the municipalities nor are municipalities' credit worthy to the financial institutions.
- Most of the sample municipalities have taken loan from TDF. But the investment menu for the loan is not clear and municipalities are taking loans without considering the optimum utilization and pay back.

The expenditure assignment, revenue assignment, Inter-governmental fiscal transfers and local borrowing are the four pillars of fiscal decentralization. All the pillars are interrelated directly and indirectly. In designing fiscally devolved decentralized system each pillar should be designed perfectly for the smooth functioning.

In Nepal, fiscal decentralization in real practice is less priority in agenda which is not paying attention in clear expenditure assignment. Since expenditure assignment is not clear it is very difficult to clearly design other pillars. The prospectus of fiscal decentralization in Nepal is potential. Political changes, peoples, awareness and right based approach as well as greater demand of service delivery are the driving forces of fiscal decentralization. To use its prospectus we have to address the challenges of fiscal decentralization which are as follows;

- Lack of political and bureaucratic will
- Centralizing mindset at the centre and political vacuum (absence of elected representatives) in Local bodies.
- Lack of common understanding among stakeholders in devolving powers.
- Overlapping problems are giving space for ad-hoc transfers and misleading transparency as well as accountability.
- Poor institutional capacity of LBs and weak monitoring capacity of the centre.

- Political culture for power sharing and deepening democracy at local level is still far.
- To make a shift from centre to local in terms of functions, funds and functionaries is a complicated task which needs collective efforts.
- Insufficient understanding on the role of municipalities.
- Rapid urbanization is also a challenge for fiscal decentralization.

Despite of challenges of fiscal decentralization there is prospects as well. Considering the country context the following prospects can be pointed out:

- Constitutional, Policy and legal frame are decentralization oriented and enforcing more resource devolution to the lower level of government.
- State restructuring issues have come up which is opening a number of areas focusing on fiscal decentralization and local taxes, as well as revenue sharing.
- Empowered citizens with adequate awareness and constitution making process are the strong basis for positive future.
- Increasing realization by the politicians, academicians and bureaucrats for the need of fiscal decentralization is supportive to enhance it.
- Global wave on more recognition on local democracy and decentralization is pressing policy makers to devolve more powers.
- Urban centers are becoming the hub of socio-political, eco-technical and cultural activities and cities could generate huge resources as cities being concentrated opportunity of production, consumption and employment.

(e) Municipal Taxation

- Municipalities in Nepal are depended with central resources, guidance and laws. There is no culture to collect tax and deliver services to the people. There is no adequate knowledge and positive attitude on "the more tax collected the more services can be delivery and the more services delivered the more taxes can be collected."
- Globally cities are considered center of economic activities where opportunities are concentrated. Accordingly cities/municipalities are about to synonym of local taxes. Because municipalities have more potentialities compare to rural areas. On the one hand LSGA has provided the tax bases having less tax yielding potentials on the other hand municipalities are not exploiting the potentiality they have.
- It is more or less attitudinal problem the politicians have phobia about taxation. The administrators are without commitment.
- There is no revenue enhancement plan in Nepalese municipalities including sample municipalities as they are more interested in preparing expenditure plan.
- Municipal revenue is very insignificant except in the Kathmandu and few other big municipalities in terms of population and economic activities.
- People are not aware about tax compliance and payment and inadequate understanding on own roles and responsibilities.
- There is inadequate coordination and complementary supplementary relationship between municipalities, local administration and line agencies as well as central agencies to enhance municipal taxes.

- Information and data base tax assessment, record keeping, collection and expenditure credibility of the concern municipalities are the major aspects that are not managed properly.
- There is no specific linkage between services and taxes in municipalities.
- It is not visible and verifiable that the ratio of increased tax revenues and the services received by the tax payers and general people in the municipalities.
- House and land tax/Integrated property tax and professional tax are the highest potential tax bases with higher contribution in tax revenue. Advertisement tax is also more potential in metro and sub-metro cities it is collected perfectly.

(f) Institutional Capacity

- Administrative effectiveness is one of the critical elements for fiscal decentralization and municipal taxation. The institutional capacity from central level to municipal level is the determinant factor for functional fiscal decentralization. Since fiscal resources are the concerned of people and service delivery is based on the availability of fiscal resource designing fiscal decentralization is the milestone to create harmonized as well as balanced development of all the regions of the country. For the equitable distribution of fiscal resources and maintaining vertical and horizontal fiscal balance the institutional capacity and effectiveness of all the institutions in different levels are required. Fiscal decentralization is multi layer business among the different tiers of government under which many institutions need to be involved to make it efficient and effective. Similarly the defined roles and responsibilities of different institutions need to be fulfilled cooperatively in given time in a professional way.

- In Nepal, there is no specific strong leading and authorized central institution to enhance fiscal decentralization. There is a high level committee called Decentralization, Monitoring and Implementation Committee (DIMC) chaired by the Prime Minister. Probably it is the very higher level committee in terms of composition and dignitaries as members. But it is not functional as envisaged by the LSGA. After the adoption of LSGA in last 12 years the committee's meeting occurred only four times. In the meetings the researcher as an observer noticed that no single proposal came from the political front. Similarly the bureaucratic leadership of MOLD has also been changed frequently and in the selection of the administrative leader, there is no cadre system which resulted inadequate leading capacity to expedite decentralization in a professional manner. In other way MOLD has still hangover of line ministry which is not adequately capacitated to devolve more powers to LBs. It has no high profile to influence other ministries to coordinate equal footing ministries to devolve powers to LBs. It is not serious to strengthen LBFC's capacity.
- Ministry of Finance and National planning commission are responsible to allocate national budget. Their orientation is still centralized. They do not have specific human resources for fiscal decentralization and their attitude is incremental rather than big bang in devolving fiscal powers.
- Central institutions are predominantly rural oriented and there is power up to me syndrome in sectoral ministries and sometimes within MOLD in dispersing power to local bodies.
- Local Bodies fiscal commission (LBFC) is the only institution to support fiscal decentralization in Nepal. Although LSGA has given limited role to the commission but GON has widened its role to some extent. The role of the commission is not functional as expected by the LSGA. Within MOLD it is in Low profile. The commission is neither professional nor it has adequate professionals in its secretariat. The

current scope and structure cannot lead and provide sufficient inputs for state restructuring as well as constitution writing.

Within the commission's limitation, it has contributed to some extent through its efforts like studies, MC/PMs administering and other limited activities to enhance fiscal decentralization. Currently LGCDP has been supporting LBFC in rolling out and administering MCs/PMs and financial as well as technical back up. But the core staffs of its secretariat are not cadre base professional and dedicated to work for long time. As former minded secretary it is observed that LBFCs is alternate platform for MOLD bureaucrats to get better placement.

Devolving power to the lower level of government cannot produce the result unless the institutions are not designed appropriately and capacitated as per the requirement. For the utilization of fiscal authorities including municipal taxes municipal capacity is milestone. Nepalese municipalities are formed based on the indicators defined by the LSGA. Only Population, physical facilities and internal revenue earning are some indicators that are required for municipality. There is no human resource indicators need to be fulfilled by the rural area to become municipality. So institutional capacity of Nepalese municipality is weak and strengthening is incremental. Fiscal authorities are being used by the municipalities in ad-hoc basis. There is no adequate cadre based and knowledge based institutional capacity enhancing mechanism in the municipalities. Political vision and support for institutional development is not clear and proactive. Incremental approach and circumstantial pressures are the key factors that are enforcing municipalities to work. In an ad-hoc basis and incremental necessity, Nepalese municipal efforts and increasing tax collection trend is credit worthy. But for the effective utilization of municipal potentials to enhance tax revenues there are the following major issues.

- Lack of political will and instability in both politically and administratively.
- Inadequate legal provision, weak organizational capability and inadequate skilled human resources and motivation.

- Weaknesses in data base, assessment, collection and procedural activities.
- Inadequate vertical and horizontal coordination.
- There is immature taxpaying and distribution culture followed by the transparency and accountability.
- Legacy of guided decentralization, dependency syndrome and weak implementation capacity to exploit tax potentials are some hindrance in municipalities.
- Taxation is not directly link with provision and delivery efficiency of municipal administration. So there is no pressure for strengthening institutional capacity focusing on tax revenues.

7.3 Conclusion and Recommendations

7.3.1 Fiscal Decentralization

Fiscal decentralization is increasingly demanded by the people in different parts of the world. The impact of globalization, development of information technology, empowering people and deepening local democracy are the major pressures for governance reform and service delivery.

Decentralization with fiscal powers is one of the major agenda of governance reform and outcome of political changes in developing and transitional countries. Consequently, a large number of countries are re-examining the roles of various order of government to improve their ability to serve people more effectively and efficiently. Fiscal decentralization is concerned with the design of fiscal constitutions that is how taxing, spending and regulatory functions are allocated among different levels of government and how Inter-governmental fiscal transfers are structured. These arrangements are of fundamental importance to the efficient and equitable provision of public services which needs to link accountability in each and every pillar of fiscal decentralization.

In Nepal, statecraft is highly centralized when it way started to date. After political changes occurred the decentralizing efforts got priority. But the efforts could not get continuity. Anyhow administrative reforms and local self- governance efforts were made and decentralization was adopted as incremental. The LSGA is the past efforts outcome on decentralization which is the mile stone for fiscal decentralization. The conclusion and recommendation on fiscal decentralization drawn by the study are as follows:

- Decentralization is a political process which needs higher political commitment.
- The four pillars of fiscal decentralization i.e. expenditure assignment, revenue assignment, Inter-governmental fiscal transfers and local borrowing are interrelated. So they should be designed considering the cross pillar relations and impact.
- Devolution must be blended with the elements i. e. functions, funds and functionaries.
- Under the forth coming federal system local government should be constitutionally guaranteed.
- The journey of fiscal decentralization starts from the expenditure assignment. In Nepal overlapping problems are existed due to conflicting acts/laws with LSGA. The role is not delineated clearly among central agencies and local bodies and between the local bodies themselves. The clarity in expenditure assignment among tiers of government is the first condition to refine the LSGA and its effective implementation even for the drafting of new constitution and it should be considered as a prime task.
- The role delineation among different tiers of government should be clear. Similarly, the contradicting laws with LSGA are urgent. Without removing overlapping, duplication and ambiguity on expenditure assignment the decentralized system will not be smooth functioning. In

designing the fiscal federalism in both federal and unitary system, the shared responsibilities among the tiers of government must be framed clearly.

- Revenue assignment should consider the core value that is finance should follow the functions. In municipalities the tax base can be broaden in accordance to the economic growth. Nepalese local bodies including municipalities are not able to exploit the existing revenue potentials. In line with the pace of urbanization municipalities need to give wider authorities to make fully autonomous. The asymmetric assignment of revenue will be more appropriate for Nepalese local government. In the process of devolution the skilled human resource should also be devolved. It should not repeat the past practices of land tax and property tax handed over without trained human resources to local bodies. Both the expenditure assignment and revenue assignment to be linked with accountability.
- On the one hand revenue assignment should be linked with the expenditure responsibilities and local bodies including municipalities should exploit the revenue potentials on the other hand.
- A professionally sound and rationale Inter-governmental fiscal transfer mechanism is a must in both unitary and federal system. It should be able to maintain vertical and horizontal fiscal balance among the different layers of government. Fiscal transfer should not be the constraint for local Bodies autonomy and must not increase the dependency. Transfers designing are a continuous process and need to be considered expenditure and revenue potentials of local bodies. In Nepal formula based transfer system is applicable only for unconditional block grants to local bodies. It should be applicable for overall budgetary system as well as sectoral transfers to their respective line agencies. MCs/PMs is a very good tools for process and performance evaluation so this system must be enhanced and

indicators need to be more result based as well as impact oriented in the future.

- A scientific, reliable and equitable fiscal transfer system is a precondition in designing and implementing fiscal decentralization in the countries either federal or unitary. A fully authorized leading institution is needed to equalize and maintain vertical and horizontal fiscal balance.
- Local borrowing is the means of acquiring additional resources. In Nepal local bodies are neither bankable nor the commercial banks are motivated to invest in local bodies. Only municipalities are getting loan from TDF. But the investment menu is not specified. The loan investment area to be defined and fiscal discipline as well as repayment guarantee to be considered. Long term plan for municipal loan investment and repayment mechanism to be developed. The PPP modality may be useful to attract local capital and provide service in the municipality.
- Fiscal discipline and credibility of municipalities are motivating factors to the banks and financial organizations. So reducing fiduciary risks and defining the investment menu for borrowing will assist to fulfill expenditure needs in the municipalities.

7.3.2 Municipal Taxation

Globally, cities are economic center. They are symbol of civility and development. For fiscal decentralization cities are more potential especially for the taxation. In a competitive world of twenty first century municipalities have to provide more services to their people. Managing public services in the cities need huge money. To fulfill this need municipalities have levy the taxes. The taxes and services in municipalities are mutually inclusive.

In Nepal, municipal taxation is not developed and services provided by the municipalities are limited. Similarly tax compliance is also weak. Institutional

capacity is not adequate and environment is not that much conducive for taxation. Practically municipalities are levying taxes in an ad-hoc basis based on the guidance given by the LSGA and its regulation. In the context of rapid urbanization, municipalities have no adequate infrastructures and limited services are being delivered. The gap between services and fund could be bridged by the municipal taxation. It is one of the potential areas that can enhance fiscal decentralization. The current tax bases will not provide sufficient resources to the cities under federal Nepal. The following measures are proposed for effective taxation system in municipalities which support for the effective fiscal decentralization:

- Knowledgeable, committed and honest political leaders at local level are necessary to run the fiscally devolved system with effective taxation system in the municipality.
- Municipal responsibilities must be linked with taxes assignment to deliver services and enjoy the fiscal autonomy by the municipalities in an accountable manner.
- The authorities to municipalities need to be broadly based than the current provisions.
- Municipal tax potentials and legal provisions should be functionally linked and asymmetric tax provision will be appropriate to assign tax authorities to the varying municipalities in terms of capacity and potentiality. Considering the small size of geographical areas and less number of populations for economies of scale, most of the municipalities need to restructure to make them more viable.
- Without institutional capacity no tax system will be efficient. So institutional capacity enhancement is strongly recommended for municipal tax enhancement.

- Together with the committed and visionary political leadership, knowledgeable, skillful, committed and honest human resources is one of the prerequisites for efficient municipal taxation system.
- Tax enhancement plan is urgently needed to exploit the potentials and review further devolution of taxation authorities.
- Fiscal transfer should not hamper the motivation to collect the tax revenues. It should be specific and result oriented.
- The principle of no taxation without representation is equally applicable in the municipal taxation. So elected representatives are needed as early as possible for the efficient tax system in the municipalities. Furthermore, political commitment, qualitative and accountable leadership are basic elements for municipal tax enhancement.
- Increased people's awareness, tax compliance, and tie up taxation with service delivery will be more functional to municipal revenue mobilization including tax revenues.
- Financial discipline, corruption control and honesty in expenditure will create conducive environment in municipality to make scientific taxation system.
- The tax base, reasonable rates and compliance need to be increased for more service delivery to meet the rapid urbanization's fiscal need.
- Urban local governance need to be given wider authorities to deepening democracy, deliver services and enhancing local accountability.
- Local young people to be trained on the democratic principles, values, institutions, and motivated to participate in municipal

management. Civic and voters education provides them motivation to learn about good municipal governance and shapes their behavior and habit.

- Monitoring mechanisms for tax and public expenditure to be developed.

7.3.3 Institutional Capacity

Institutional capacity and honesty at both central and local level are fundamentally important for functional fiscal decentralization. If the central institutions are weak and not dedicated to devolve fiscal powers to the lower levels of government the constitutional provisions and legal frame will not work. Similarly, lower levels government's institutional capacity need to be enhanced adequately to distribute benefit to the people from the devolved powers.

In Nepal, there are many institutions engaged in fiscal decentralization in different way. MOF, NPC, MLD, LBFC and Line Ministries are engaged in fiscal decentralization in varying capacity. But there is no efficient and fully dedicated responsible institution for overall fiscal decentralization. From municipality to central level all the institutions are working in an ad-hoc basis and incremental way. Regarding the institutional capability the following recommendations are presented:

- For the effective fiscal decentralization to implement current LSGA to carry out the assigned responsibilities as well as making state restructuring functional and more people friendly a constitutional body with professionals and representing all stakeholders is urgently needed.
- Local bodies including municipalities need to restructure to make them viable units in terms of economies of scale and adequate geographical areas.

- The process of devolving power needs to consider implement ability. It should further pay attention how municipalities can be managed effectively to address the issues on rapid urbanization. It will be better to adopt asymmetric decentralization.
- The responsible central institutions need compulsorily follow the fiscal decentralization rules and planning discipline to motivate the local government/bodies to obey the same rules. The central budget allocation to sectors must be based on the formula. Similarly, the divisible grant pool for local bodies also be determined based on expenditure needs or criteria.
- Elected representatives are the precondition to strengthen accountability with plans both for revenue and expenditure. So local election is to be held immediately.

The over arching conclusion of this study is that fiscal decentralization is the destination of governance reform in both unitary and federal system. The level of fiscal autonomy and its optimum utilization for people's welfare depends on the level of good governance as well as level of awareness in the society. There is no 'one size fits all' system of fiscal decentralization. The country context capacity and level of services delivery determine the degree of fiscal decentralization. Due to globalization, development of information technology and political awareness as well as the ethnic and vulnerable groups are demanding more right based approach in service delivery. It demands more responsive governments in different layer with adequate fiscal resources. Fiscal decentralization is increasingly practiced and more demanding reform measures globally. It strongly demanded, in developing countries, for the distributional justice.

Despite centralistic mind set of policy makers in Nepal, the populist political slogans and people's demands are compelling to think about fiscal decentralization. Considering the policy and legal frame as well as global trends on fiscal decentralization, the central actors both political and

administrative leaders in Nepal should change their centralistic attitude to devolve more power to local government/bodies where beneficiaries can manage services through participative and accountable mechanism. It will contribute in deepening democracy at the local level. The central actors should own the value i.e. the decentralized decision-making ensures the well-being of all of those who are likely to be affected by such decisions. As an incremental approach it has been practiced since last five decades. In contrast to the increasing demand and popularity of the term "fiscal decentralization" particularly in developing countries like Nepal is still ambiguous. Highly centralized planning and budgeting system in Nepal exists in the form of central governments extended arms like agencies service centers, sub-service centers and others front line agencies including public utilities. The LSGA 1999 has assigned responsibilities and fiscal authorities to local bodies. Among the local bodies municipalities are given more direct tax bases and are spelled out in its regulations. It has provisioned the integrated planning at local level but instead of real participatory planning LBs are approving the proposals submitted by the line agencies. The fiscal authorities including taxation to municipalities are not sufficient to carry out the given responsibilities spelled out by the LSGA.

One of the major issues of decentralization in Nepal is highly overlapping responsibilities among line agencies and local bodies themselves. The past legacy of devolving authority without fiscal authorities has promoted imperfect devolution. Consequently local bodies are assigned more unfunded and underfunded mandates. Similarly no central functionaries are devolved to materialize LSGA to local bodies which resulted institutional weakness in local bodies.

Expenditure assignment, revenue assignment fiscal transfers and local borrowing are interrelated in a fiscally devolved system. It is equally important in course of constitution drafting and state restructuring in Nepal. The literatures have described the context, practices and efforts made in the past. This might be the first academic study in the field linking central policy and

municipal practices. It further might be a combination of practical experiences and theoretical perspectives.

The general issues, specified issues and proposed CD activities of the four municipalities mentioned above shows that the basic requirements and the level of knowledge is not adequate to utilize given revenue authorities to enhance revenues as well as expanding public services in the municipalities.

Municipalities are supposed more autonomous and advance local bodies in Nepal. The fiscal decentralization too, will enhance the municipal good governance and will help to localizing services to convert Nepalese municipalities as cities of twenty first century. For the effective municipal governance fair and effective fiscal management is desperately needed. Municipal taxation is taken as a fundamental element for fiscal autonomy to municipalities. A perfect combination of central policy, role delineation, institutional strengthening of local bodies; facilitation and proper implementation at municipal level are interrelated subjects for municipal governance. Necessary data base, procedural simplification, adequate awareness and increasing compliance as well as expenditure credibility in municipalities will help municipal tax revenue enhancement. Ultimately, more funds will be available to spend for service delivery in municipalities.

The study attempts to narrow down the gap by analyzing the policy institutional variables and establishing relationship with fiscal system with specific reference to fiscal decentralization and municipal taxation in Nepal. Designing decentralized system of governance requires a detailed analysis of the four pillars of decentralization with the necessary capacity. Further, separate studies on all the four pillars and specific tax of the municipality will be useful in the field of decentralization as well as fiscal decentralization.

APPENDIX

I. Policy and Central Level

Name of the Respondent: Review

1.	Mr. Neil Webster	UNCDF Nepal
2.	Mr. Bishnu Gauli	Under Secretary, MoLD
3.	Resmi Raj Pandey	Joint Secretary, MoLD
4.	Mr. Khem Raj Nepal	Ex-secretary, MoLD
5.	Mr. Govinda Karki	Under Secretary, MoLD
6.	Mr. LilaMani Poudel	Secretary, OPMCS
7.	Dr. Ganapati Ojha	
8.	Mr. Purusottam Nepal	Under Secretary, MoLD
9.	Mr. Tana Gautam	Secretary, NVC
10.	Dr. Sangram Lama	
11.	Dr. Punya Prasad Neupane	Secretary, GoN
12.	Mr. Arun Regmi	UDLE
13.	Indra Prasad Karki	Governance Export, LGCDP
14.	Indu Ghimira	Under Secretary, MoLD
15.	Dr. Raghu Shrestha	Monitoring Specialist LGCDP
16.	Mr. Dinesh Kumar Thapaliya	Joint Secretary, MoLD
17.	Mr. Udaga Raj Soti	Former Secretary, MoLD
18.	Mr. Lal Shankar Ghimire	Joint Secretary, Foreign Aid Coordination Division MOF
19.	Mr. Ramesh Adhikari	Under Secretary, MoLD
20.	Mr. Mani Ram Sing Mahat	ULDE
21.	Mr. Pratap Kumar Pathak	Secretary, Ministry of Industry
22.	Mr. Hem Raj Lamichane	ADDCN
23.	Mr. Parsuram Upadhya	NAVIN
24.	Mr. Ganesh Pandey	Under Secretary, MoLD
25.	Mr. Babu Ram Gautam	Under Secretary, MoLD
26.	Mr. Purna Chandra Bhattarai	Under Secretary, MoLD

II. MoLD/LBFC Senior Personnel and Experts

Name of the Respondent:

1.	Mr. Yam Nath Sharma	Under Secretary, LBFC
2.	Mr. Ram Chedtttri,	UDL
3.	Mr. Yadab Chpagai	
4.	Mr. Chakrapani Sharma	Section officer, ULD
5.	Mr. Bishu Dutha Gautam	LDO, Jajarkot
6.	Mr. Badri Nath Ghimire	Under Secretary, LBFC
7.	Mr. Shyam Prasad Mainali	Secretary, MoLD
8.	Mr. Narayan Thapa,	Under Secretary, MoLD
9.	Mr. Hemanta Kharel	Special Class officer, MoLD
10.	Mr. Krishna Gyanwali	Secretary (Municipal)
11.	Mr. Kala Nidhi Devkota	MUAN
12.	S.P Shrestha	Social Mobilization Export, LGCDP
13.	Mr. Hem Sharma	Social Mobilization Export, LGCDP
14.	Mr. Uttam Prasad	Under Secretary, MoLD
15.	Mr. Devi Gyanwali	Under Secretary, MoLD
16.	Mr. Gopi Krishna Khanal	NPM, LGCDP
17.	Mr. Shalig Ram Rijal	Under Secretary LBFC
18.	Mr. Krishna Prasad Jaishi	Spoke Person, ADDCN
19.	Mr. Khim Lal Devkota	Fiscal Decentralization Expert, LBFC/LGCDP

III. Name of Key Informants from Municipality Level

Biratnagar

Sn	Name	Position	Organization	Municipality
1	Binod Bhattarai	Admin Officer	Industry organization, Morang	Biratnagar
2	Shom Adhikari		Industry organization, Morang	Biratnagar
3	Badri Narayan Shah	Politician	Terai Madesh Loktantri Party	Biratnagar
4	Ram Lal Shah	Politician	CPN (UML), Morang	Biratnagar
5	Sanjaya Kumar Yadav	Politician	Nepal Sadvabana party (Ananddevi)	Biratnagar
6	Narendra Prasad Homagai	Politician	Nepal trade and pheasant party	
7	Bharat Kumar Neupane	Engineere		
8	Ram Chandra Mahato	Politician	UNCPN (Maoist)	
9	Shobha Kant Lal Das	Politician	CPN (ML)	
10	Arjun Thapalia	Staff		Biratnagar
11	Ramesh Das	Politician	Madeshi Janadhikar Forum, Morang	
12	Dilip Upadhaya	Politician	Nepali Congress	

Kathmandu

Sn	Name	Position	Organization	Municipality
1.	Ms. Bimala Koirala	Section Officer		
2.	Mr. Dipak Adhikari			
3.	Mr. Yadab Ghimire			
4.	Mr. Bir Bahadur Khadka			
5.	Mr. Suman Adhikari	Section Officer		
6.	Mr. Hari Bahadur Kunwar			
7.	Mr. Hari Shrestha	Section Officer		
8.	Mr. Buddha Ratna Manandhar	Account Officer		
9.	Mr. Shiva Raj Adhikari	Account Officer		
10.	Mr. Nar Nidhi Neupane	Tax Officer		
11.	Mr. Ram Prasad Poudel	Section Officer		
12.	Mr. Dhruba Kumar Kafle			
13.	Mr. Mahesh Kafle			

Gorkha

Sn	Name	Position	Organization	Municipality
1	Bisheswor Shrestha	Politician		
2	Ram Kumar Shrestha	Staff		Gorkha
3	Bhagat Babu Joshi	Businessman		
4	Gobardhan Shrest	Politician		
5	Narayan Marahatta	Staff		
6	Raj Kumar Shrestha			
7	Bisheswaer Kattel	Politician and ex-Mayor		
8	Krishna Man Shrestha	Ward Chairman		
9	Ramchandra Adhikari	Staff		
10	Jagwin Gyawali	Staff		
11	Bijaya Bhakta Upadhyay	Staff, Social Development Section		
12	Kalpa Kumar Basnet	Staff		
13	Kiran Babu Kattel	Staff		
14	Jivan Gyanli	Planning officer	DDC Gorkha	
15	Ram Babu Joshi	Businessman		

Pokhara

Sn	Name	Position	Organization	Municipality
1	Anant Prasad Koirala			
2	Tilak Paudel	Executive Officer		Pokhara
3	Kamal Prasad Koirala	Account Officer		
4	Durga Neupane	Programme Officer		
5	Chhabilali Sharma			
6	Purna Bahadur Gurung	Engineering Consultant		
7	Chhabilali Sharma			
8	Purna Bahadur Gurung	Engineering Consultant		
9	Shiv Hari Sharma			
10	Basant Prasad Chalise			
11	Khem Bhandari			
12	Om Raj Paudel			
13	Mahendra Bahadur Godar	Engineer		
14	Sabita Dhungana	Fiscal Officer		
15	Shyam Bastola			

Nepalgang

S.No.	Name	Position	Organization
1.	Ramlal Shrestha	Executive Officer	Nepalgunj Municipality
2.	Mohan Hamal	Adman Officer	Nepalgunj Municipality
3.	Bhoopati Khatri	Revenue Section Chief	Nepalgunj Municipality
4.	Rajan Kumar K.C.	Account Section Chief	Nepalgunj Municipality
5.	Yuvaraj Bikram Ghale	Store Section Chief	Nepalgunj Municipality
6.	Satish Man Shrestha	Revenue Section	Nepalgunj Municipality
7.	Beg Bahadur Sunar	Revenue Section	Nepalgunj Municipality
8.	Shyam Kaji Piya	J. Engineer	Nepalgunj Municipality
9.	Maya Sharma	Legal Section Chief	Nepalgunj Municipality
10.	Krishna Pd. Joshi	Community Sect. Chief	Nepalgunj Municipality
11.	Obiraj Acharya	Revenue Section	Nepalgunj Municipality
12.	Ram Kumar	Revenue Section	Nepalgunj Municipality
13.	Karna Bahadur K.K.	Engineer	Nepalgunj Municipality
14.	Michael Krings	Technical Advisor	RLC Mid-west Npg
15.	Anita Khanal	Finance Officer	Rup
16.	Ram Milan Nepali	Nasu	Nepalgunj Municipality

IV. List of Participants on Focus Group Discussion

Biratnagar Sub-metropolitan City:

S.N. Name

1. Mr. Somlal Subedi, Joint Secretary
2. Mr. Gopal Pd. Regmi, Acting Executive Officer
3. Mr. Pashupati Pokharel, Local Development Officer
4. Mr. Tara Nath Niraula, Com. Development Chief
5. Mr. Umesh Pd. Ojha, Planning Chief
6. Mr. Dilendra Pradhan, Engineer
7. Mr. Dhurba Pd. Dulal, Kharidar
8. Mr. Nandi Keshar Bhandari, Na. Su.
9. Mr. Pushparaj Ghimere, Kharidar
10. Mr. Sumanraj Dhahal, Kharidar
11. Mr. Diknath Pokharel, Mukhiya
12. Mr. Kewal Pokharel, Kharidar
13. Mr. Chitra B. Dangali, Mukhiya
14. Mr. Raj Kumar Biswas, Kharidar
15. Mr. Laxman Singh, Na. Su
16. Mr. Tilak Mani Pokharel, Kharidar
17. Mr. Sunil Pokharel, Sub. Overseer
18. Mr. Bharat Kr. Neupane, Engineer000
19. Mr. Dhanendra Katuwal, Kharidar
20. Mr. Ram Pd. Dahal, Kharidar
21. Mr. Khemraj Timishina, Na. Su.
22. Mr. Mahesh Nepal, Cluster Coordinator

23. Mr. Rudra B. Karki, Kharidar
24. Mr. Binod Koirala, Adm. Officer
25. Mr. Arjun Thapaliya, Tax Officer
26. Mr. Sanjeev Kr. Bhattarai, Accounts Officer
27. Mr. Dashilal Majhi, Health/Sanitation Chief
28. Mr. Ganesh Pd. Timishina, Planning Officer
29. Mr. Kaji Basnest, Revenue Section
30. Mr. K. L. Devkota, Finance Expert
31. Mr. Ram B. Aryal Chhetri, Sr. Program Officer
32. Mr. Punam Kr. Dahal, Na. Su.

Nepalgunj Municipality, 17 March 2010

- | | | |
|-----|----------------------|----------------------------|
| 1. | Anita Khanal | Financial Officer |
| 2. | Rajan KC | Accountant |
| 3. | Ram Milan Nepali | NaSu |
| 4. | Shyam Kaji Piya | Junior Engineer |
| 5. | Yubaraj Bikram Ghale | Store assistant |
| 6. | Min Bdr Malla | District Facilitator LGCDP |
| 7. | Mohan Hamal | Administrative Officer |
| 8. | Bhupati Khatri | Tax supervisor |
| 9. | Satish Man Shrestha | Kharidar |
| 10. | Ram kumar Kalbar | Kharidar |
| 11. | Obi Acharya | Kharidar |
| 12. | Beg Bdr Sunar | Kharidar |
| 13. | Ramlal Shrestha | Executive Officer |
| 14. | Karna Bdr KK | Engineer |
| 15. | Krishna Pd Joshi | Community Manager |
| 16. | Maya Sharma | NaSu |
| 17. | Mical Krings | Garman Volunteer |
| 18. | Biswaraj Dotel | LDO, DDC Banke |
| 19. | Tikaram Pant | CCs, LGCDP |
| 20. | Mr.Som Lal Subedi | |

Gorkha Municipality

1. Raj Kumar Shrestha LDO, Gorkha DDCs
2. Jeevan Gyawali, Planning officer, Gorkha DDC
3. Ram Kumar Shrestha, Section Chief, Municipality
4. Bijay Bhakta Upadhaya, Section Chief, Municipality
5. Nisan Pathak,, Sub Engineer
6. Kiran Kafle, Section Chief
7. Anali Tiwari, Section Chief
8. Prakash Chandra Dhakal
9. Dhoj Basnet
10. Gopal Bahadur Upretay
11. Shila Thapa
12. Tripathi Devkota
13. Jagadishwor Kattel
14. Arjun Kuwar
15. Bijay Maskey
16. Suman Shrestha
17. Som Lal Subedi

Kathmandu Metropolitan City

1. Mr Sanat Kumar Thapa, Department Chief, Financial Management Department
2. Mr Buddha Ratna Manandhar, Section Chief, Budget and Accounts Section
3. Mr Bikas Chitrakar, Accounts Officer, Budget and Accounts Section
4. Mr Suraj Amatya, Computer Operator, Budget and Accounts Section
5. Mahesh Kafle
6. Mr. Ram Prasad Poudel, Section Officer
7. Mr. Nur Nidhi Neupane, Section Officer
8. Mr. Shiv Raj Adhikari, Account Officer
9. Mr. Shankar Kandel, Department Chief, Foreign Relation
10. Mr.Hari Shrestha, Section Officer
11. Mr. Hari Bahadur Kuwar
12. Mr. Suman Adhikari, Section Officer
13. Mr. Yadav Ghimire
14. Mr.Dipak, Adhikari
15. Mr. Bimala Koiral, Section Officer
16. Mr. K.L.Devkota, Finance Expert
17. Mr. Som Lal Subedi

Pokhara Sub-metropolitan City, March 6, 2010

1. Krishna Pd. Koirala, Senior Officer
2. Ananta Pd. Koirala, Account Officer
3. Sibahari Sharma, Tax Officer
4. Kamal Pd. Kiorala, Account Chief
5. Khem Bahadur Bhabdari, Environment Officer
6. Shayam gi Bastola, Engineear
7. Nil Bahadur Karkee, assisstant
8. Sushila Paudel, Assisstant
9. Mohan Pd. Dhungana, Assistant
10. Dura raj Giri, Assisstant
11. Kalpana Baral, Assistant
12. Durga Neupane, Programme Officer
13. Sabita Dhungana, Financial officer
14. Som nath Lamsal, Assistant
15. Bharat raj Paudal, Assisstant
16. Mr.Som Lal Subedi

QUESTIONNAIRE A

Fiscal Decentralization and Municipal Taxation

(Policy and central level)

- Q.1. Do you think the legal and policy frame for fiscal decentralization in Nepal is adequate?
- a) Yes b) No c) partiality adequate
- Q.2. What is your observation on using fiscal authorities by the Municipalities?
- a) Inadequate authorities b) existing authorities are not used adequately
- c) Municipalities are not paying attention to expedite revenue potentiality
- Q.3. What is your opinion regarding relationship between fiscal policies and Municipal taxation?
- a) mismatch between taxes and fiscal resources
- b) imbalance as fiscal frame and taxation
- c) less contribution on expenditure by the tax revenue
- d) all above
- Q.4. How accountable are the Municipalities to their clients in delivering the assigned services?
- a) highly accountable b) moderately accountable
- c) not accountable
- Q.5. What sort of legal mandate of the Fiscal Commission would you suggest for the implementation of the fiscal decentralization?
- a) statutory b) constitutional
- c) ad hoc
- Q.6. How the funding system to Municipalities in Nepal is implemented?
- Q.7. What are the institutional weaknesses of Municipalities in enhancing tax revenues?

- Q.8. How Municipal institutional capacity can be strengthened to mobilize Municipal tax revenue?
- Q.9. Could you mention the major challenges of fiscal decentralization especially in Municipality of Nepal?
- Q.10. What are the elements that we should pay attention for creating conducive environment for effective fiscal decentralization and Municipal taxation?
- Q.11. Are the central institutions (including your own) playing proactive role for effective fiscal decentralization?
- a) yes b) No.
- c) If yes how?/ if no why ?
- Q.12. Could you mention the prospects and challenges of fiscal decentralization and Municipal taxation in Nepal?
- Q.13. What is your opinion on devolving more authority with wider bases to Municipality in Nepal?
- Q.14. Could you highlight present Municipal finance and tax revenue's contribution in Nepalese Municipalities?
- Q.15. Could you give suggestion for effective fiscal decentralization and Municipal taxation in Nepal?

Thank you for giving time to fill this questionnaire

QUESTIONNAIRE B

Fiscal Decentralization and Municipal Taxation in Nepal

(MLD/LBFC senior personnels and expert)

- [illegible]

- Thank you for giving time to fill this questionnaire

QUESTIONNAIRES C

वित्तीय विकेन्द्रीकरण र नगरपालिकाको कर सम्बन्धी प्रश्नावली
Questionnaires on fiscal Decentralization and Municipal Taxation
नगरपालिका तहको लागि (Municipality level)

पहिलो खण्ड (Part One)

वित्तीय विकेन्द्रीकरण (Fiscal Decentralization)

१) नगरपालिकाको स्वायत्तताका लागि वित्तीय विकेन्द्रीकरणको नीतिगत र कानूनी व्यवस्था पर्याप्त मान्नु हुन्छ ?

1. Do you think that existing policy and legal provision of fiscal decentralization is adequate for Municipality to be autonomous?

- | | |
|-----------------------------|-----------------------|
| क) पर्याप्त छैन । | a) Not adequate |
| ख) आंशिक रूपमा पर्याप्त छ । | b) Partially adequate |
| ग) पर्याप्त छ | c) Adequate |

२) तपाईंको नगरपालिकाले आफूले उठाएको राजश्वले कति प्रतिशत कूल खर्च भार व्यहोर्न सकेको छ ?

2. What percentage of annual expenditure of your Municipality is managed from internal revenue?

- | | |
|---------------------------|-------------------|
| क) ५ प्रतिशत भन्दा कम । | a) Less than 5% |
| ख) १० प्रतिशत भन्दा कम । | b) Less than 10 % |
| ग) १५ प्रतिशत भन्दा कम । | c) Less than 15 % |
| घ) २० प्रतिशत भन्दा कम । | d) Less than 20 % |
| ङ) २० प्रतिशत भन्दा बढि । | e) More than 20% |

- ३) वित्तीय अधिकार र नगरपालिकाको कर अधिकारको प्रयोगको स्थिति कस्तो पाउनु भएको छ ?
3. How have you found the use of fiscal authority and Municipal taxation authority?
- क) अधिकारको कमी छ ।
- a) Less authority
- ख) भएका अधिकारको पनि प्रयोग हुन सकेको छैन ।
- b) Even given authority could not use
- ग) अधिकारको प्रयोग गर्न भन्दा वैकल्पिक श्रोतको खोजीमा बढी ध्यान गएको छ ।
- c) More attention is focused on searching alternative sources from the centre rather than using present authority.
- ४) वित्तीय नीति एवं संरचना र नगरपालिकाको कर अधिकारको अन्तरसम्बन्ध कस्तो पाउनु भएको छ ?
4. How have you found interrelation between fiscal policy& structure and Municipal taxation authority?
- क) काम र वित्तीय श्रोतको तालमेल मिलेको छैन ।
- a) No match between responsibility and fiscal resources
- ख) समग्र वित्तीय खाका र करको सम्बन्ध सन्तुलित छैन ।
- b) Imbalance relation between fiscal structure and taxation
- ग) वित्तीय आवश्यकता र करको हिस्साको अनुपातमा करको हिस्सा कमजोर छ ।
- c) Minimal/low share of tax in proportion to fiscal needs
- घ) माथिका सबै अवस्थाहरु विद्यमान छन् ।
- d) All the above mentioned situation prevalence

५) नगरपालिकालाई स्थानीय स्वायत्त शासन ऐन २०५५ ले तोकेका जिम्मेवारीहरूमध्ये नगरपालिकाले पूरा गरेका बढिमा ५ वटा मुख्य कार्यहरू उल्लेख गरिदिनु हुन्छ कि ?

5. Please mention at most five main responsibilities/tasks carried out by Municipality out of the responsibilities/tasks provisioned in the LSGA 2055 for the Municipality.

दोश्रो खण्ड (Part Second)

नगरपालिकाको कर (Municipal Taxation)

१) तपाईंको नगरपालिकाको करको सवैभन्दा धेरै कर संकलन संभाव्यता भएको श्रोत कुन हो ?

1. What is the most potential source of tax in your Municipality?

- | | |
|--------------------------------------|----------------------------|
| क) सम्पत्ति कर । | a) Property tax |
| ख) व्यवसाय कर । | b) Occupation tax |
| ग) मनोरञ्जन कर । | c) Entertainment tax |
| घ) विज्ञापन कर । | d) Advertisement tax |
| ङ) अन्य कुनै भए उल्लेख गरी दिनुहोस । | e) Others (if any specify) |

२) यो नगरपालिकाको सवै भन्दा बढी राजस्व संकलन हुन सक्ने गैरकर राजस्व श्रोत कुन हो ?

2. What is the main source of revenue collection from non-tax sources in your Municipality?

- | | |
|---------------------|-----------------------|
| क) सेवा शुल्क । | a) Service charge |
| ख) सिफारिश दस्तुर । | b) Recommendation fee |
| ग) नवीकरण दस्तुर । | c) Renew charge |
| घ) अन्य । | d) Othres |

३) यो नगरपालिकामा सम्भाव्यता (Potentiality) को पूरै प्रयोग भएको कराधार कुन हो?

3 What type of tax your Municipality has fully utilized its potential?

- | | |
|---------------------|----------------------|
| क) सम्पत्ति कर | a) Property tax |
| ख) व्यवसाय कर | b) Occupation tax |
| ग) मनोरञ्जन कर | c) Entertainment tax |
| घ) विज्ञापन कर | d) Advertisement tax |
| ङ) अन्य | e) Other s |
| च) कुनैपनि छैन/होईन | f) None |

छ) यी मध्ये बुंदा सम्भावना बढी उपयोग भएको छ ।

g) Out of the above potentiality is more used

४) कर अधिकारको पूर्ण प्रयोग हुन नसक्नुको मुख्य कारण कुन हो ?

4. What is the main reason for not implementing full authority of tax?

क) राजनितिक प्रतिवद्धता र सहयोग ।

a) Lack of political commitment and support

ख) दक्ष जनशक्तिको कमी ।

b) Lack of skill manpower

ग) राजनीतिक क्षेत्र र कर्मचारी दुवैको उदासीनता ।

c) Frustration in both the political sector and staff.

घ) सेवाको जिम्मेवारी र क्राधिकारमा मेल नहुनु ।

d) Inconsistency between responsibility and authority in tax

ङ) माथिका सबै

c) All the above mentioned situation exists

५) नगरपालिकामा स्थानीय विकास शुल्कको विकल्प कसरी जुटाउनु पर्छ ?

5 What should be alternative arrangement to local development fee in Municipality?

क) विद्यमान करको पूरै उपयोग ।

a) Full utilization of existing tax system

ख) थप राजस्व अधिकारको व्यवस्था ।

b) Additional authority for revenue

ग) क र ख दुवै व्यवस्था ।

c) Both the above system/arrangement

६) तपाईंको नगरपालिकामा राजस्व योजना तयार भै कार्यान्वयन भएको छ ?

6. Has your Municipality prepared revenue plan?

If yes how it is implemented:

If no why not prepared:

- | | |
|--|----------------------------|
| क) छ | a) Yes |
| ख) छैन | b) No |
| ग) दीर्घकालीन योजना छ | c) there is long term plan |
| घ) बार्षिक योजना बनाउदा राजश्व अनुमान गरिने गरिन्छ । | |
| d) Revenue estimated during annual plan formulation | |
| घ) राजस्व योजनामा कुनै चासो नै छैन । | |
| e) No interest is revenue plan | |

७) नगरपालिकाले आन्तरिक राजस्वको अनुपातमा जनतालाई सेवा वढाउन सकेको छ ?

7. Has your Municipality increased the services to citizens in proportion to increase in internal revenue?

- | | |
|---|--|
| क) उठेको राजस्वले सेवा प्रवाहमा थप योजदान गरेको छ । | |
| a) Collected revenue contributed additionally in service delivery | |
| ख) राजस्व संकलन र खर्चमा खासै अन्तर छैन । | |
| b) No significant difference between revenue collection and expenditure | |
| ग) राजस्व बढेकोले सेवा पढिएको जनताले अनुभव गरेका छन् । | |
| c) Citizens realized service from Municipality with increase in revenue | |
| घ) सेवा र आन्तरिक राजस्वको सम्बद्धता छैन । | |
| d) No relation between service delivery and revenue | |

८) नगरपालिकाको कर राजस्व बढाउन के गर्नुपर्ला ?

8. What should be done to increase tax revenue of Municipality?

क) राजनितिक समझदारी र प्रतिबद्धता ।

a) Political understanding & commitment.

ख) कर परामर्श समितिको क्रियाशिलता र दक्षता

b) Pro-active and capable Local Tax Advisory Committee

ग) जनशक्ति विकास र ईमान्दारिता ।

c) Human resource development & honesty among staff

घ) जनचेतना बृद्धि र सेवासंग आवद्धता ।

d) Increase in people's awareness and tie up with service delivery

ङ) बढी कर संकलन हुन सक्ने अधिकार थप गर्ने ।

e) Add authority to increase tax collection

च) माथिको सबै ।

f) All the above mentioned suggestions are applicable

९) निर्वाचित जनप्रतिनिधि नहुँदा कर संकलनमा कस्तो असर परेको छ ?

9. How tax collection is affected in the absence of elected representatives?

क) दिर्घकालीन नीति छैन ।

a) No long term policy.

ख) करदाता सचेतना बढाउन सकिएको ।

b) Could not make tax payer aware

ग) करदातासंगको पहुँच बढाउन सकिएको छैन ।

c) Could not increase compliance with tax payer

घ) सबै असर परेको छ ।

d) All the above mentioned points

१०) नगरपालिकाको कर प्रणालीका कमी कमजोरीहरु के के हुन उल्लेख गरिदिनु हुन्छ कि ?

10. Will you please mention the weakness in tax system of Municipality?

११) नगरपालिकाको कर बृद्धि गरी नगरबासीलाई सेवा प्रदान गर्न के गर्नु उपर्युक्त हुन्छ सुझाव पेश गर्नुहोस् ?

11. Will you please suggest what Municipality should do to provide services to citizens by increasing the tax?

तेश्रो खण्ड (Third Part)

संस्थागत अवस्था (Institutional Status)

१) दिईएको कर अधिकारको प्रयोग गर्न नगरपालिकाको संस्थागत क्षमता कस्तो छ ?

1. How is the institutional capacity of Municipality to use the tax authority as provisioned in LSGA

- | | |
|-------------------------------------|--------------------------------------|
| क) पर्याप्त | a) Adequate |
| ख) अपर्याप्त | b) Inadequate |
| ग) सुधार गरे पर्याप्त हुने | c) Will be adequate with improvement |
| घ) सुधार गर्न धेरै मेहनत गर्नुपर्ने | d) Need big effort to improve |

२) नगरपालिकाको संगठन, व्यवहार र संरचनामा के सुधार गरे कर बृद्धि हुने देख्नुहुन्छ ? ठिक भए (✓) बेठिक भए (×) चिन्ह लगाउनुहोस् ।

2. What type of improvement or measures in the organization, structure and working culture of Municipality will increase tax revenue? (Please tick mark)

क) छुट्टै कर शाखा / भएको शाखाको सुदृढीकरण ।

a) Separate Tax Section / strengthen existing section

ख) वडातहमा शाखाको व्यवस्था ।

b) Establish section at Ward level

ग) राजनीतिक क्षेत्रको संलग्नता ।

- c) Political sector involvement
 - घ) नीति क्षेत्रसंगको साभेदारी ।
 - d) Partnership with private sector
 - ङ) कार्यसम्पादन मूल्यांकन र कार्य सम्पादन राम्रो गर्नेको कदर गर्ने ।
 - e) Performance evaluation and reward best performing staff
 - च) ज्ञानमा आधारित संगठन ।
 - f) Knowledge based institution
 - छ) जवाफदेही संगठन ।
 - g) Accountable institution
- ३) कर संकलनमा नगरपालिकाको संगठनात्मक पक्ष कस्तो छ ? (✓) चिन्ह लगाउनुहोस्
3. How is the institutional aspect of Municipality in tax collection?
- क) दक्ष र सकारात्मक ।
 - a. Capable and affirmative attitude
 - ख) असक्षम र नकारात्मक ।
 - b. Incapable and negative attitude
 - ग) क्षमता विकास गरे सकारात्मक र उपलब्धीमूलक हुने ।
 - c. Will be capable and affirmative if capacity developed
 - घ) करको दायरा फराकिलो भए विद्यमान संगठनले नै काम गर्न सक्नु ।
 - d. Present structure can work if widen the scope of tax
 - ङ) आमूल परिवर्तन गर्नुपर्ने ।
 - e. Need to revamp

४) कर संकलनमा राजनीतिक क्षेत्रको व्यवहार कस्तो छ ?

4 How is the attitude of politician in tax collection?

क) सहयोगी र सक्रिय ।

a) Supportive and active

ख) उदासिन र वास्ता नगर्ने ।

b) Passive and not giving attention

ग) कर्मचारीलाई दोष दिने र जिम्मेवारी नलिने

c) Allegation to staff and not taking responsibility

घ) संकलनभन्दा वितरणमा बढी ध्यान दिने ।

e) In an average Tax Section is weak

५) नगरपालिकामा कर शाखा छ भने हैसियत कस्तो छ ?

5 Is Tax Section established in Municipality? Yes /no

If yes what is the situation:

क) आकर्षक छ, सबै कर्मचारी वस्न रुचाउँछन् ।

a) Attractive and all the staff want to work in Tax Section

ख) आकर्षक छैन, कर्मचारी वस्न रुचाउँदैनन् ।

a) Not attractive and staff do not want in Tax Section

ग) शाखा औषत भन्दा राम्रो मानिन्छ ।

c) In an average Tax Section is considered to work as good

घ) शाखा औषतमा कमजोर छ ।

d) In an average Tax Section is weak

- ६) राजस्व संकलनको शिलसिलामा कर्मचारीको व्यवहार कस्तो पाउनु भएको छ ? आफ्नो अनुभव मिल्नेमा (✓) चिन्ह लगाउनुहोस्
6. How do you found the behaviour of staff in the context of collection (please mark in appropriate box)
- क) सक्रियता कम छ । a) Inactive
- ख) शाखागत समन्वय छैन । b) No coordination between sections
- ग) सृजनात्मक र सकृय (Pro-active) भएर काम गर्छन् ।
- c) Creative and pro-active
- घ) काम गराउन कठिन छ । d) Difficult to engage in work
- ड) भने पछि काम हुन्छ । e) Perform task as per instruction
- ७) कस्तो व्यवस्था गर्नु भन्ने कर संकलनमा प्रभावकारिता ल्याउन सकिन्छ ? रोजाइमा चिन्ह लगाउनुहोस् ।)
7. What type of system should be adopted to make tax collection effective? (Please tick mark in appropriate)
- क) कामको मुल्याङ्कन गरी पुरस्कार र दण्डको व्यवस्था ।
- a) Reward and punishment on the basis of performance evaluation
- ख) खर्चको विश्वसनीयता र सेवा बृद्धि ।
- b) Reliability in expenditure and expand services
- ग) न्यूनतम खर्चमा कर संकलन ।
- c) Collect tax in minimum cost
- घ) राजनीतिक समन्वय र कर सुधार ।
- d) Political coordination and improvement in tax policy
- ड) जनचेतना र संगठन सुधार ।
- e) Citizen awareness and improvement in organization
- च) माथिका सबै ।
- f) All the above mentioned points are applicable

८) कर संकलन वृद्धि गरि संगठन प्रभावकारी बनाउन के उपाए अवलम्बन गरेमा उपयोगी होला ? सुझाव दिनुहोस् ।

8. What measures will be suitable to make organization effective by increasing tax collection? Please provide suggestions.

तपाईंको बहुमूल्य विचार र समयको लागि धन्यवाद !

Thanks for your valuable suggestions and cooperation !

उत्तरदाताको नाम :

Name of the respondent:

पेशा :

Occupation:

QUESTIONNAIRE D

Question/Issues on Focus Group Discussion

- I. Fiscal Decentralization
 1. What are your observations on policy and legal provisions for fiscal decentralization and municipal autonomy?
 2. What is the student on fiscal authorities and their use in Biratnager Sub-metro Politian city?
 3. In the content of Municipal tax revenues contribution on total expenditure how you can increase the contribution of tax revenues on total capital expenditure?
 4. What are the strengths and weaknesses of fiscal policy and framework and their interrelationship with municipal tax assignment?
 5. What are the major services that have been provided by the municipality as assigned by the Local Self-Governance Act 1999?
 6. Are you facing funding gap? What are the issues on expenditure assignment, revenue assignment and fiscal transfer in your municipality?
 7. Borrowing from
- II. Municipal Taxation
 1. Identify the highest potential tax base and highest contributor tax base in your municipality and rank other three potential tax and non tax revenue base.
 2. How municipality is exploiting the tax potentiality and which tax base are fully exploited as they have potentiality. If tax potentialities are not fully utilized identify the issues and present the solution to reserve the issues.
 3. Do you have revenue enhancement plan? What is your strategy to increase the tax revenue? Are you able to identify the alternatives of Local Development fee?
 4. Are you facing any uneasy by the absence of elected representative? Is it hampering the collection efficiency?

5. What are the major services that are borne by the municipal tax and do you increase the ratio of services in terms of increased revenue. Analyze the tax revenue collection trend since last five years.
6. How we can increase the municipal taxation and services to the people?
7. What are the strengths and weakness of municipal tax system and how we can resolve the weaknesses?

III. Institution Aspect

1. Do you have adequate institutional capacity to utilize the current tax authorities to your municipality? If not how we can strengthen the institutional capacity in a sustainable way?
2. What are the major aspects of municipal organizational behavior and structure that needs to improve to create a conducive tax environment and increase the overall budgetary efficiency in the municipality?
3. Do you have supportive political behavior for tax revenue enhancement and what is your opinion on incremental or radical changes in the institution for enhancing tax revenue?
4. Do you have separate tax section/department? Of so analyze the bureaucratic behavior to the tax payers.
5. How we can enhance collection efficiency? And what are the other suggestions if any?

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