

“WHERE WE STAND ACTUALLY?” DELIBERATE BETWEEN DETERMINANTS
OF FISCAL FEDERALISM AND ECONOMIC WELFARE IN NEPAL: AN
EMPIRICAL ANALYSIS

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SATYA RAJ JOSHI

Exam Roll No:

Central Department of Economics (CEDECON)

Tribhuvan University, Kirtipur

Kathmandu, Nepal

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LETTER OF RECOMMENDATION

This thesis entitled “WHERE WE STAND ACTUALLY?” DELIBERATE BETWEEN DETERMINANTS OF FISCAL FEDERALISM AND ECONOMIC WELFARE IN NEPAL: AN EMPIRICAL ANALYSIS has been prepared by Mr. Satya Raj Joshi under my supervision. I hereby recommended this thesis for examination by the thesis committee as a partial fulfillment of the requirement for the Degree of Master of Arts in Economics.

.....
Associate Prof. Uma Shankar Prasad, PhD
(Thesis Supervisor)

Date: 21st June, 2016

: 7th Ashad, 2073

APPROVAL LETTER

We certify that this thesis entitled **“WHERE WE STAND ACTUALLY?” DELIBERATE BETWEEN DETERMINANTS OF FISCAL FEDERALISM AND ECONOMIC WELFARE IN NEPAL: AN EMPIRICAL ANALYSIS**” submitted by Mr. Satya Raj Joshi to the Central Department of Economics, Faculty of Humanities and Social Sciences, Tribhuvan University, in partial fulfillment of the requirements for the Degree of MASTER OF ARTS in ECONOMICS has been found satisfactory in scope and quality. Therefore, we accept this thesis as a part of the aforesaid degree.

Thesis Committee:

Prof. Ram Prasad Gyanwaly, PHD
(Head of the Department)

.....

Prof. Nilam Kumar Sharma, PHD
(External Examiner)

.....

Assoc. Prof. Uma Shankar Prasad, PHD
(Thesis Supervisor)

.....

Date: 21st June, 2016

: 7th Ashad, 2073

DECLARATION

I hereby this submission is my own work and that, to the best of my knowledge, belief and wisdom this dissertation contains no material previously published by any other person or institution except where due acknowledgement has been made. No part of this research has been presented for another degree or diploma at any institution. Errors committed in this research are strictly mine.



.....
Satya Raj Joshi

21st June, 2016

.....
Date

❁ Goodness, Beauty and Truth ❁



*Bahunam janmanam ante
jnanavan mam prapadyate
vasudevah sarvam iti
sa mahatma su-durlabhah*

“After many births and deaths, he who actually in knowledge surrenders unto me, knows me to be the cause of all causes and all that is. Such a great soul is very rare.” (BG 7-19)

❁ DEDICATION ❁

-This dissertation is mainly dedicated to Lord Shiva, Krishna, My first guru my Papa and My benevolent mother. “Who redeemed my life from destruction; who crowned me with loving-kindness and tender mercies”.

-To all known and unknown teachers, gurus, avatars, Monk's, Buddhas, Yogis, Sages, philosophers and unnamed higher spirits (not in a particular order) who bestow knowledge and wisdoms on me in this life time.

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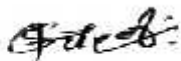
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.....
Satya R. Joshi

21st June, 2016

ABSTRACT

Fiscal Federalism- the devolution of unitary powers to lower levels of government - has become an important theme of governance in many developing countries in recent years. Accordingly, obediently restructuring of governmental functions and finances between the national and subnational tiers of government has entered the core of the development debate. A general conclusion emerging from this inquiry of theoretical and empirical literature on intergovernmental fiscal relations is that sub-national governments need to be given access to adequate resources to do the job with which they are entrusted. At the same time they must also be accountable for what they do with these resources. Moreover, like all public policies, intergovernmental fiscal policies must take into account both the political constraints facing policy makers, such as the strength of different provinces and groups in political decisions, and economic constraints such as the stage of development of financial markets.

As same expect and circumstance, although, Nepal is undergoing a major transition toward introducing a system of democratic, socialism-oriented, and federal governance. At this glance, consist of structural changes dealing with reorganization of the country into provinces, assignment of resources and responsibilities to the different tiers of government, and fiscal arrangements for dealing with the emerging vertical and horizontal imbalances is always crucial. Nonetheless, under what circumstances should a country choose a federal form of government? Most common people are not clear why should they prefer a federal form over a unitary or a confederal system. In fact, the concept of federalism can invoke varying emotions. There are countries such as Sri Lanka where the word “federalism” in some circles can evoke unpleasant if not hostile, response. In India, the constitution refers to Indian republic as a “Union of States” and not a federal country. In Nepal, however, most political parties view federalism as a concomitant of democracy itself.

No doubts, fiscal federalism is unarguably a potent economic strategy that can be used to maximize provision of public services as well promote macroeconomic stability. Central to the success of fiscal federalization, is clarity in revenue and expenditure authority and responsibilities. The urgent reform that is required is the need for government to redress the prevailing fiscal mismatch at subnational government levels through appropriate

policies to increase tax revenues to subnational governments as well as reforms of expenditure responsibilities to enhance their efficiency in the provision of public services. But, premised on the analysis, it is deducible that the centralist system of fiscal relations, critical issue of over-dependence on direct tax revenue, conflicts over sharing principle and disharmonious federal-Province relations are obstinate challenges that are threatening harmonious fiscal relations in Nepal and the continued existence of Nepal as a federal state. Thus, this thesis investigates the problems inherent in the creation of federalism in Nepal.

Within this background, this thesis tries to investigate major determinants of fiscal federalizing amendments via by analyzing present geo-political and macroeconomic strata in Nepal. Specifically, it seeks the major components of fiscal federalism theory and its disputes in Nepal. Thus, this study investigates the underlying factors which promotes or inhibits evolution, structure, and practices of fiscal federalism in Nepal, and determines major ideological constraint. Within this aim, this inquiry analysed the evolution of fiscal federalism, evolved theoretical elucidation of federalism as well as dwelled extensively on the nature and crisis of fiscal relations in Nepal and concluded that fiscal relations are highly lopsided as they favour the Federal Government against the various state and local governments. The Federal government always receives larger amount in the sharing formula and with less impact on the people. The lopsided nature of fiscal arrangement has so far generated suspicion, apathy and constant overt and covert conflict.

The major finding of this research conclude that fiscal federalism in Nepal is characterized by extensive vertical and horizontal imbalances, which have become very contentious and volatile because subnational governments lack financial autonomy in the current fiscal architecture. Thus, we have used the information and theories to investigate what the disagreements on federalism are based on, what might have caused them, and whether they have any adverse effects. Our findings have shown that while there are in fact serious disagreements on the subject, they are solvable if only there is adequate political will to do so. This means that the largest problems lie in the ideological differences and understanding of democratic structures and the parties' struggles for power. What seems to be motivating the politicians to delay federalism is that they fear they might lose their power and privilege and it has become evident that for their motivations to change something radical must happen.

Agreeing with the above diagnostic, we attempt to take a step further and to provide an explanation for the many inefficient features of Nepalese fiscal federalism. In order to do that, we apply and further develop an approach, presented in Spiller and Tommasi (2000) that tries to explain public policies as the outcome of political transactions. These approach argues that the nature and characteristics of the observed policies will be conditioned by the rules of the political game under which those transactions / policies are made. Hence, it refocuses “policy recommendations” from the level of *policy reform* to the level of *institutional reforms*, with emphasis on political institutions.

In achieving this, the inquiry adopted both empirical and context-sensitive analytical methods by relying on secondary sources for data gathering. We have used the information and theories to investigate what the disagreements on federalism are based on, what might have caused them, and whether they have any adverse effects. The inquiry, however, concluded that the age-long hegemony of centralism as well as the proposed federal mechanism by constitution of Nepal 2015 is need to major reconsideration. Inquiries verdicts have shown that while there are in fact serious disagreements on the subject, they are solvable if only there is adequate political will to do so. This means that the largest problem lies in the ideological differences and understanding of fiscal structures and the resource mobilization mechanism among proposed structure.

21st June, 2016.....
Satya Raj Joshi.....
Date

RESEARCH MOTIVATION

Nepal is among the poorest and least developed countries in the world, with about one-quarter of its population living below the poverty line (23.8%). Agriculture is the mainstay of the economy, providing a livelihood for more than 70% of the population and accounting for a little over one-third of GDP. Likewise, in recent decades Nepal is heavily dependent on remittances, which amount to as much as 25-30% of GDP. Looking behind, per capita income of nation is approximately \$724 which mostly derived from agriculture and remittance. Equally, life expectancy is average 68.9 (68.2 year for men and 70.8 for women) resulting from mass poverty, infectious diseases and further aggravated by poor nutrition and lack of hygiene and sanitation, symbolized some of the major obstacles to harmonious and well-balanced development of the country. Similarly, lack of infrastructure development, low level of national productivity, unemployment, political instability, and sudden fluctuations combined with poor economic stratum that hardly meets the needs of the population, *brain-drain*, and retard the development process in general. Industrial activity mainly involves the processing of agricultural products, including pulses, jute, sugarcane, tobacco, and grain. However, Nepal has considerable scope for exploiting its potential in hydropower, with an estimated 42,000 MW of commercially feasible capacity, but political uncertainty and a difficult business climate have hampered national-foreign investment. Additional challenges to Nepal's growth include its landlocked geographic location, persistent power shortages, underdeveloped transportation infrastructure, civil strife and labor unrest, and its susceptibility to natural disaster.

Moreover, suffering from two unexpected economic devastation (April, 25 earthquakes and India's undeclared trade blocked) Nepal is skirmishing against them and trying to stabilize her economy. Economic growth is projected to slide further in FY2016 due to slow recovery from the earthquakes, political strife on the Terai plains bordering India, and an unfavorable monsoon for the second year running. Earthquake recovery has been dismayingly slow largely because the establishment of the National Reconstruction Authority was greatly delayed by political differences on its organizational structure and leadership.

In light of the delayed implementation of reconstruction programs, trade and transit disruption, and the unfavorable monsoon, GDP growth is projected to slow further to 1.5% in FY2016, below the government's revised projection of 2.0%. Very low growth is seen in services, particularly in wholesale and retail trade, transport and communication, and tourism, which are worst affected by the supply disruptions. The Ministry of Agricultural Development expects

harvests of paddy to drop by 10.0% and maize by 5.0%, slowing agriculture growth to a projected 0.5%. Industry is projected to see little or no growth owing to fuel shortages and the lack of raw materials for manufacturing and construction. GDP growth in FY2017 could rebound to 4.8%, but this assumes a normal monsoon, the National Reconstruction Authority becoming fully operational and accelerating reconstruction, normal cross-border trade, and progress in resolving domestic political tensions.

At the mean time, Nepal is undergoing a major transition toward introducing a system of democratic, socialism-oriented, and federal governance. At this glance, consist of structural changes dealing with reorganization of the country into provinces, assignment of resources and responsibilities to the different tiers of government, and fiscal arrangements for dealing with the emerging vertical and horizontal imbalances is always crucial. Nonetheless, under what circumstances should a country choose a federal form of government? Most common people are not clear why should they prefer a federal form over a unitary or a confederal system. In fact, the concept of federalism can invoke varying emotions. There are countries such as Sri Lanka where the word “federalism” in some circles can evoke unpleasant if not hostile, response. In India, the constitution refers to Indian republic as a “Union of States” and not a federal country (Rao, 2014). In Nepal, however, most political parties view federalism as a concomitant of democracy itself.

Under this scenario, Nepal is in the midst of a major political, administrative and fiscal restructuring reform moving towards a federal government structure to enhance governance and improve public service delivery. A new promulgated constitution of Nepal declares three levels of government; Federal, Provincial, and Local along with some arrangements for autonomous regions, protected areas and special economic zones as appropriate. The excessive objectives, declared in the *Article 56* of the constitution, articulate the basic structure of the nation and these ideals should be treated as fundamental in the governance of the country. It was recognized by the constitution that a federal system of governance would be more suitable for the successful realisation of the national economic prosperity and development goals, and accordingly the functional responsibilities were assigned to various layers of governments. In the process of distribution of functional subjects to different governments, the Constitution has assigned majority of subjects, which are directly related to social and economic developments, to the new amendments of fiscal regime in Nepal.

However, financially justifiable and economically functional sub-national delineation is going to be perhaps the most challenging aspect to give Nepal a federal shape. All three major aspects – tax point transfers, equalisation grant and distribution of natural resources among the

provinces – involve larger number of murkier issues than the easier ones. Apart from these, several other components of fiscal relations between the central and sub-national governments, financial management and its processes within the state must also be decided to effectively devolve power to the people at the grassroots. Such issues may relate, but not limited to planning, economic diplomacy, money market and specialised institutions for both fiscal and financial architecture. Given Nepal's poor governance and slanted nature of understanding about fiscal federalism even at the top-rung of political leadership, the country seems to be making emotive than spontaneous jump to fiscal federal structure.

Thus, there are many reasons why these issues deserve more meaningful treatise, before the country could decide on the actual frame of federalism, essentially the fiscal federalism. Since the provinces and LGs will be having the correct information regarding the factual situations existing in different social sectors, they will be able to launch apposite programmes. For the effective implementation of programmes relating to such subjects, revenue resources are also provided by the Constitution through assigning certain subjects of taxation exclusively to the federal governments. However, considering the possibility of mismatch between the expenditure relating to the functional subjects under the jurisdiction of tile provinces and the revenue resources made available to them, provisions are made in the Constitution for the devolution of resources from the federation to the lower level and to make such transfers as judicious as possible, an independent constitutional agency is constituted to determine the quantum and modus operandi of such transfers.

In other aspects, fiscal federalization, which mirrors the amount of fiscal autonomy and responsibility accorded to subnational government has been an important subject in the policy equation of many developing, transition, and developed countries. It is widely believed that the role of the federal government should adopt effective fiscal policies and enhance welfare activities that should foster holistic peace and prosperity. In this context, this inquiry offers special reference to the reflecting contemporary hegemony and practices towards fiscal federalism amendments in Nepal, more specifically, this inquiry tries to decisively scrutinize the pros and cons of the fiscal 'ism' dogma of Nepal based on the salient features of 2015's constitution of Nepal and attempts to recommend the adjustment required in the model by analysing the actual geo-political and macroeconomics strata of the nation.

Thus, the major motivation for conducting this research is to be supportive for the government in establishing the proper fiscal ism model for Nepal. In concise, this inquiry endeavour to investigate some insights on deliberate between determinants of fiscal federalization amendment and economic welfare in Nepal by principally look at least four extent; (i)

catalyzing overall economic condition of nation and connecting it for financial sustainability, economic viability and effective resources exploits possibility of the subnational tiers of governments, ii) Specifically, it seeks to analyze the possible effects of federalism relating to economic growth, resource allocation, revenue and expenditure diversification mechanism, and its challenges in Nepal, iii) examines the evolution, structure, and practices of fiscal federalism in Nepal, investigate the underlying factors promoting or inhibiting the suitable practice of fiscal federalism in our context, and determine the extent of fiscal federalization under the new constitution thereby analyzing it's adoptability and durability in our context and (iv) As we know that federalism is recent experience of Nepalese circumstances, therefore another important dimension in this research is establishing research agenda that promotes effective fiscal mechanism at present milieu.

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ABBREVIATION USED

ACCDN	Association of District Development Committees of Nepal
ADB	Asian Development Bank
ANRFRR	Allocation of Natural Resources, Financial Rights and Revenues Committee
APM	All Party Mechanism
ARC	Administrative Restructuring Commission
CA	Constituent Assembly
CDO	Chief District Officer
CG	Central Government
DTCO	District Treasury Control Office
DG	Disadvantaged Group
DASU	Decentralization Advisory Support Unit
DDC	District Development Committee
DFGS	Determination of Form of Governance of State Committee
DIP	Decentralization Implementation Plan
DIMC	Decentralization and Implementation Monitoring Committee
DOLIDAR	Department of Local Infrastructure and Development of Agricultural Roads
FG	Federal Government
GON	Government of Nepal
HALT	Housing and Land Tax
IAP	Immediate Action Plan
IPT	Integrated Property Tax
LB	Local Bodies
LB FAR	Local Body Financial Administration Regulations
LBFC	Local Body Fiscal Commission
LDF	Local Development Fund
LGs	Local Government s
LGCDP	Local Governance and Community Development Program
LDCs	Least Developed Countries
LSGA	Local Self-Governance Act

LSGA/R	Local Self Governance Act/ Regulation
MCPM	Minimum Condition and Performance Measures
MOF	Ministry of Finance
MUAN	Municipal Association of Nepal
NAVDC	National Association of Village Development Committees
NFBs	Net Fiscal Benefits (NFBs)
NFC	National Finance Commission
NPC	National Planning Commission
OSR	Own Source Revenues
PGs	Province Governments
SRDSP	State Restructuring and Division of State Powers Committee
UNCDF	United National Capital Development Fund
UNDP	United Nations Development Programme
VDC	Village Development Committee

CHAPTER ONE

RATIONALE- KNOWING DIFFERENTLY: SETTING THE SCENE

“Federalization has, not only an administrative value, but also a civic dimension, since it increases the opportunities for citizens to take interest in public affairs; it makes them get accustomed to using freedom. And from the accumulation of these local, active, pernickety freedoms, is born the most efficient counterweight against the claims of the central government, even if it were supported by an impersonal, collective will.”

-A. De Tocqueville (1805-1859) in “A History of Decentralisation”, World Bank (2003)

1.1 Chapter Overview

This chapter is milestone of my entire research. The main design of this chapter is govern from the present platform of emerging dispute towards fiscal federalism explosions in Nepal. Thus, the chapter tolerate to establish present research agenda with special reference to contemporary macroeconomic strata and geo-political aspects of the nation thereby re/¹examining existing hegemony, beliefs and nature of fiscal ism amendment by aiming to make it more welfare-sensitive and contextual. For this, this chapter includes purpose of the study, problem statement, research question, limitation of the study and structural design of the inquiry. It also embrace the rationale of the study - its derivative, the inquire agendas, why is it worth-doing? How does it contribute to the field of fiscal knowledge? And also, begins to tell little bit about my journey started to serve the discrete nature of this study.

1.2 Seen Setting: Catalyzing the Research Agenda

As quotation mentioned above, most of socio-economic researchers agree that federalism has not only a political/administrative merit, but also significant for eco-financial dimension via cultivating individual to national holistic welfare. Considering this fact and standing present economic contest in Nepal, although, we are going to implement new constitution by means of applying the model of ‘*holding together*²’ federal state. However,

¹ I have used the symbolism of slash (/) to represent the dialectical relationship between sometime opposing attributes. Thus, this notion slash (/) represents my dialectical thinking and expression.

² This approach is evident in the creation of the Belgian, Spanish and Indian federations. Holding-together should be taken literally here; it is either federal reforms or territorial

the critically remarkable question ‘what/how economic/fiscal federalism procedure (also, closely related to Economic Model or Fiscal Transfer Mechanism) should be espoused under the provision of newly promulgated constitution?’ is still moot.

Nevertheless, in other words, federalism is a relatively recent and archetypal concept that has lately enjoyed a new wave of interest from political circumstances in Nepal. Perhaps, the reason for such a revival lies primarily in the fact that this is a strategy that is being utilized by an increasing number of developing nations in their quest for rapid economic self-development and growth (e.g., see Bird 1993; Rodden 2004 as cited in Rizvanov, 2014). In particular, many less developed countries (LDCs) implement federalism and decentralization in order to gain credibility in the political arena and achieve greater efficiency in terms of socio-economic performance. And, the general motif beyond that is diffusion and devolution of power and authority from the national to states and local governments is widely associated with an ability to radically improve the quality of governance (Fan et al. 2008; Rondinelli 1989, 59-60; White 2011, Rizvanov, 2014).

Equivalently, in the wake of the Gross National Development (GND) debate, there has been an increased interest in the empirical relationship between economic federalism via economic growth and development. It has been claimed that the gross national prosperity will rise only when a nation adopts equiparallel resource mobilization policy and that this provides an economic incentive to invest in gross national happiness and economic welfare. Nepal is perhaps the most interesting of all economic researches for those concerned in economic federalism practice which may examine problems encountered in resource mobilization by the government of federalization is crucial for economic welfare so that it has become a key policy for the ‘*citizen-centric*’ good governance in present scenario.

As same regard, moreover, a deep-seated question is how effective model of fiscal federalism offers significant opportunities to improve government accountability by exerting stronger pressures both from below (demand) and above (supply) aspects. To provide a contextual answer, it is important to know how purposed economic model in

disintegration. This meant that the Indian federation, for example, was not a result of individual states negotiating, like in the American case but rather a central act of the constituent assembly. This resulted in a relatively undemocratic formation of the federal Indian democracy, as opposed to the American “coming-together” approach (Stepan, 2001: 218-19).

nation have articulated the efficiency and accountability gains that could accrue from federalism reforms. There is a consensus, however, that developing countries (such as Nepal) are generally more isolated to devolution their authority in local body; more people are excluding to expand power and more are uneducated to know how to use their resources effectively. But whether fiscal federalism actually causes lower levels of development is still an open and critical question.

Going beyond the history of Nepal, decentralization has been a key policy for every government since 1950s and it has been taken as a strong policy tool for equitable resource allocation and poverty reduction ambition (NPC report, 2013). From the Panchayat regime to the New Federal Republic Nepal, the government is adopting the fundamental policy for rural development in development agenda. Donor agencies are more engaged in the decentralization policy implementation and huge amount of aid/loan from donor agencies have been provided in this sector. Local Self-Governance Act 1999, its regulation 2000, Local Bodies Financial Administration Regulation 2007, Decentralization Implementation Plan (DIP) are some legal provisions for effective fiscal federalization. Inclusive Local Council was elected in the last local level election but the local bodies are now lacking the elected bodies and hence, facing lot of problems in implementing the projects due to lack of political consensus. Even so, due to many critical reasons related to political volatility, weak political commitments, poor economic development still we are struggling to implement grassroots federalism policy which may helps to build gross national economic prosperity and welfare.

However, the present Constitution of Nepal has opens the door and travelled a meaningful journey towards edifying strong pillar of federalized structure of nation with lots of ups and downs and twists and turning. Although, this was a history-making period of the nation with new hope, experience and learning. At its manifest of first time in history (on September 20, 2015), the constitution formally declared Nepal a Socialism-oriented Federal Democratic Republic. PREAMBLE³ of the Constitution expresses the obligation

³ *“expressing commitment to create the bases of socialism by adopting democratic norms and values, including peoples' competitive multi-party democratic governance system, civil liberty, fundamental rights, human rights, adult franchise, periodic elections, complete press freedom and an independent, impartial and competent judiciary, and the concept of rule of law, NOW THEREFORE, in order to fulfill the aspirations for perpetual peace, good governance, development and prosperity through the medium of federal democratic*

to eliminate “the centralized and unitary form of the nation” as a means to end ‘*de facto level*’ discrimination. Similarly, Article 56(2) also declares The State powers of Nepal shall be used by the federal, provincial and the local level in accordance with this constitution. The progress since then has been not formally constructed, but political parties, members of the National Assembly, academics think-tanks, and bureaucrats have constantly discussed and debated about the nature and type of economic model (fiscal federalization policy) that Nepal should adopt under new provision of constitution. The government of Nepal along with National Plan Commission and other think-tanks have been working on various related aspects, although there has been a kind of political stalemate holding back further tangible progress for different demands.

Federalism as a system of governance, with fiscal federalism as its key component, will provide a new fiscal framework for Nepal (Srivastava, 2011). Within this framework, governments at different tiers will work toward providing a more equitable and efficient supply of public goods, such as judiciary and administration, as well as merit services, such as education and health, to citizens in different provinces and stronger, more equitable, transparent and regionally better balanced economic growth. Such a system has been adopted by many modern nations, big and small. Nepal will also need to develop its own federal fiscal structure, suited to its special features, in terms of geography, ethnic composition, locational patterns of economic activity, and availability of natural resources.⁴

Meanwhile, the international experiences show that without economic autonomy and prosperity political autonomy should not take any place. So, political and fiscal federalism will need to evolve at the same time. As political powers are devolved to the states, this will create more political space to absorb the competition for power. The new fiscal system in Nepal will inevitably take into account the changing face of modern economies, characterized by globalization, localization, liberalization, widespread use of information technology, a significant role for markets and the private sector, and the remarkable growth of the service sector. At the same time, the new governance structure should unleash the so far dormant growth potential of the Nepalese economy by harnessing the

republican system of governance, hereby promulgate this Constitution through the Constituent Assembly (PREAMBLE of constitution of Nepal).

⁴ Srivastava D.k, (2011). Key Elements of a New Fiscal Regime in Federal Nepal. Madras School of Economics Chennai, India and Prepared for the Forum of Federations Ottawa, Canada.

massive hydropower potential, tourism development, forest resources, agricultural potential, infrastructure development, and edifice human capital.

In Nepal, not only is average economic growth low compared with that of some nearby Asian countries, but many areas also remain quite underdeveloped. Government capacities are limited and remote areas of the country are underserved. A recent ADBDFID-ILO study entitled '*Development Constraints in Nepal*' (2014) observes that "compared with other countries in South Asia, Nepal's government is small, centralized, and has relatively low capacity to reach beyond the Kathmandu Valley, which constrains delivery of public services to a majority of the population. Many positions in the government, especially in remote districts, remain vacant." The expectation from the federal system is that it will improve the geographic spread of economic growth and extend the reach of government services more evenly, even to remote areas of the country.

Fiscal federalism can potentially provide the framework for unlocking this potential by ensuring peace and harmony, holistic national economic welfare and providing a means of expression for ethnic and regional preferences and priorities. Some foresee Srivastava (2011) put that fiscal federalism is an idea which asserts that in a multi-tier structure of governance, central and sub-national governments work as economic players, competing, cooperating and coordinating with each other within a set of rules to promote the welfare of the citizens by equitable and efficient delivery of services (p.9). Likewise, in globally nearly 40 % of the world's population, in about 29 countries (Nepal is most recent country who adopted this structure), have espoused federal structures of governance. World widely, many well-established federal countries have continued to evolve and change according to the demand of inter/national interest and emergence. In India, for example, the number of states has continued to change over time. In Australia, the new Intergovernmental Agreement has made the entire Goods and Services Tax (GST) revenue distributable among the provinces. It is important to not think in terms of a "frozen" or "icy" constitution, but rather a framework that provides for change.

Under this scenario, this study presents major deterrents of fiscal federalism amendments within the framework of present macroeconomic indicators. The structure is evaluated from the point of view of the obligations set out in the Constitution, and from the point of view of the ideology of a building economic autonomy and welfare in the nation. Exertions of the various constituent elements are outlined, and their relevance for center and

province are discussed. As expected, assorted policy options for reforming the fiscal arrangements to improve the efficiency and equity of the social and economic welfare and the functioning of the federation from the province's perspective are proposed. This is being done on the basis of extensive review of the theoretical underpinnings and the international practices of fiscal federalism aspects. With the process of federalization being carried out so far, this study tries to chart out a road map where the process should be moved forward in the true sense of its commitments.

1.2.1 Decentralization, Federalism and Fiscal Federalism: Myths, Dilemma and Reality

Many scholars have tried to conceptualize federalism and they have remarkably treated the problem of conceptualizing federalism and a number of articles and books bear the explanatory success. Decentralization⁵ means different thing to different people. Politicians, administrators and development professionals use the term decentralization in various ways and there is no definite standard definition. Thus there are linked definitions of federalism and decentralization brought out by different scholars. However, all of them convey the same meaning. Work (2002) and Cheema and Rondinelli defined decentralization as the devolution of responsibilities for management, planning, and resource raising and allocation from the central government to the local bodies. Decentralism is associated to the subsidiarity concept in which the functions need to be devolved to the lowest level of social order that is competent of accomplishing them.

Correspondingly, the UNDP (1999) also defines decentralization or federalizing governance as the process of authority restructuring whereby it creates a system of coresponsibility between the regional, local and central levels of governance institutions and this is in accordance with the subsidiarity principle. Thus, it increases the overall effectiveness and quality of the governance system and it also boost the sub national government's authority and capacity. They further Provence that decentralization: escalates the voices of the people in all the decisions; supplements people's capacity development; increases the responsiveness of the government; and enhances the transparency and accountability and thus, it contributes towards strengthening good

⁵ Some school of thought widely used federalism is synonyms of Decentralization. Thus, the author is also convinced federalism and decentralization is 'two eyes at single men' and contextually used it by proper meaning.

governance. Another renounce economist, Rizal P. Dhurba (2001) identified the two fundamental dimensions of decentralization as:

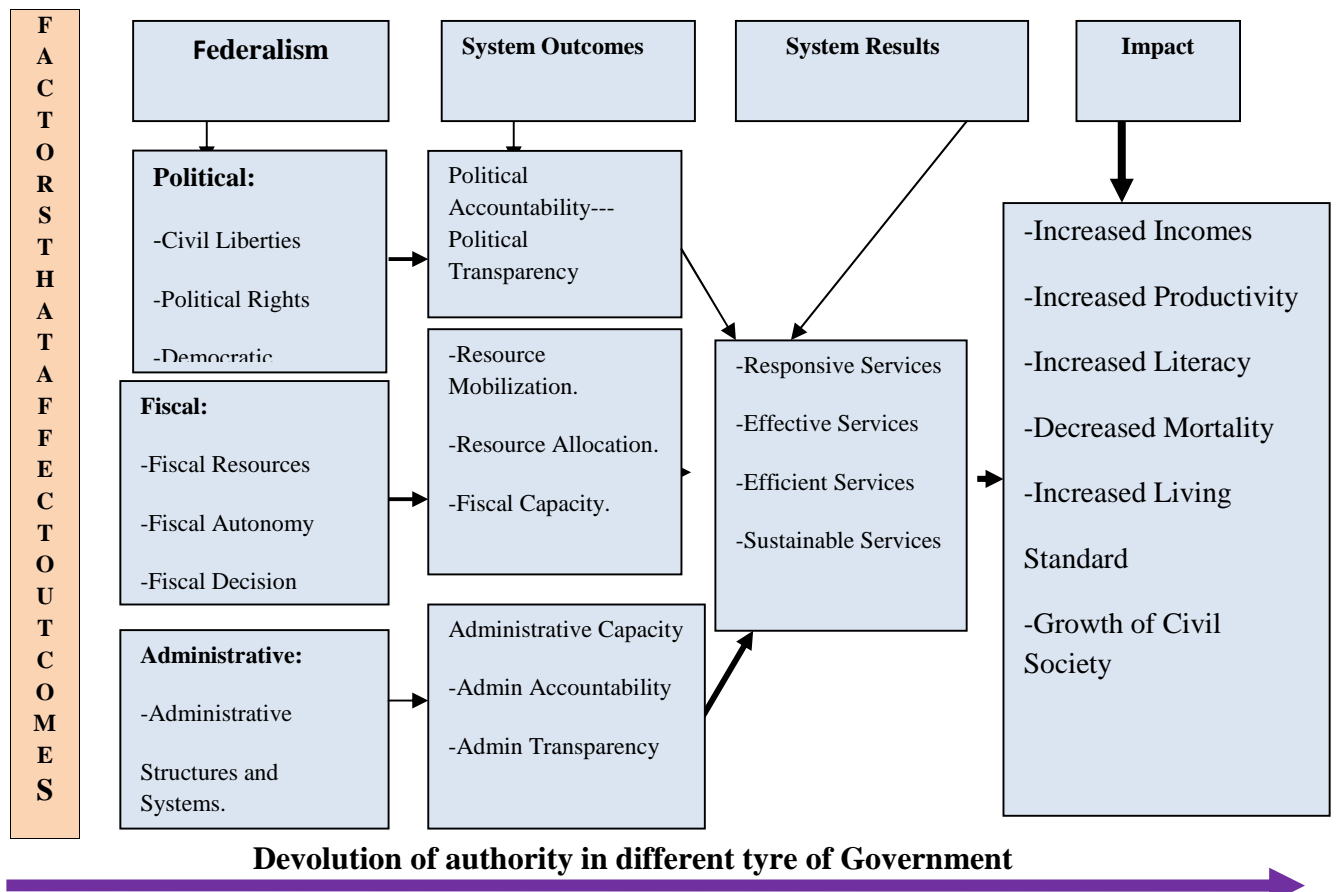
- ✓ Decentralization as means; where decentralization is the process of transferring functions and power from the central government to the local government units and organizations.
- ✓ Decentralization as a philosophy; where decentralization entails the sharing of power and functions between and among the various levels of governments and enables them to identify and respond to the local needs and priorities, mobilize and allocate resources and deliver services.

He further states the three principal objectives of decentralization as following:

- ✓ Enhance national development throughout the country especially in the underdeveloped regions and areas.
- ✓ Enable equal sharing of development responsibilities for the central and local authorities and equal bearing of the national burden of managing and exercising functions related to national development.
- ✓ Enlarge the government capability and capacity to deliver better services to the people and to enrich the knowledge, skill, ability and competency of the people allied with the development related public and non public organizations and local government institutions.

Thus, all the definition of decentralization propounded by the various scholars and writers passed on same connotation and conclude that federalism brings government closer to the people and empowers people to participate in and influence the decision made with their close community. However, there are no prescribed rules and regulations governing the decentralization process that apply to all countries. Federalism tends to takes different forms in different countries according to the objectives driving the change in structure of government. Federalization in its three fronts is presented in the figure 1.1 below;

Figure 1.1 different dimensions (types) of Federalism



Source: Author's construction with the help of Parker, Andrew N 1995.⁶

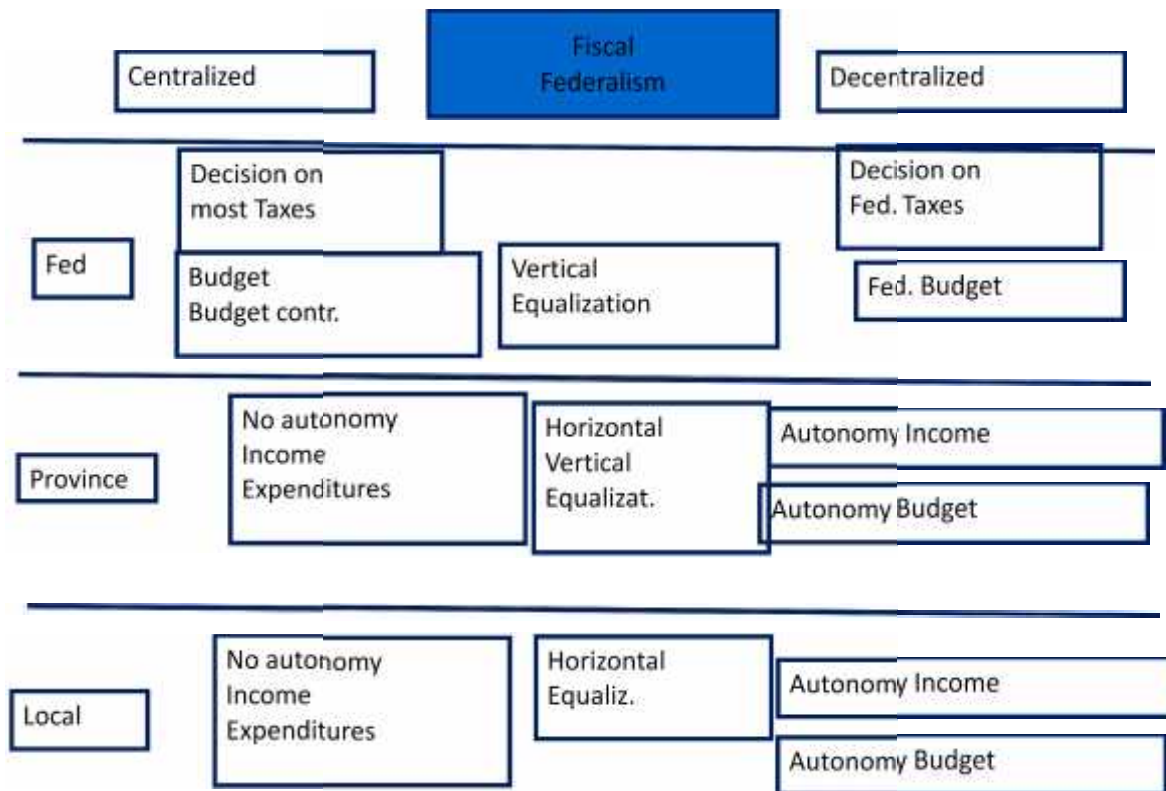
Then, *what is fiscal federalism?* There is not exact and universal answer of this question. However, most of academic literature defines fiscal federalism comprises the financial aspects of devolution authority to sobnational tyres of governments. Fiscal federalization generally refers to the process of changing the source and distribution of resource availability at the local levels of governments. It also defines how and in what ways the revenues and expenditures are organized among the different tyres of government within the national financial framework. For the local governments to fully deliver the potential benefits of decentralization they need to be financially and jurisdictionally empowered and autonomous, thus fiscal federalization is conceptualized by UNDP (2005) as the empowerment of communities and citizens by fiscally empowering their local governments. They further specified the four pillars of fiscal federalization as:

- ✓ The assignment of expenditure responsibilities to different government levels;
- ✓ The assignment of tax and revenue sources to different government levels;
- ✓ Intergovernmental Fiscal transfers; and

⁶ *Decentralization: the way forward for rural development? Policy Research working paper 1475, the World Bank, Washington DC*

- ✓ Sub national borrowing.

Figure 1.1 Fiscal Federalism Amalgamate



Likewise, Davey, K. (2003) states that Fiscal federalism covers two interrelated issues: the first being the division of revenue sources and spending responsibilities between the different levels of government and the second being the amount of discretionary power given to the local and the regional governments for determining their revenues and expenditures. These combined dimensions have a major impact on the reality of decentralization in its broader political and administrative sense. He further declares that the amount of power and responsibility the regional and local governments actually exercise depends significantly on: ranges of public services they finance; the adequacy of the revenues to take up these responsibilities; the amount of the choices they have in apportioning their budget to the desired/required services; and the availability of the authority to determine the rates of their taxes and charges.

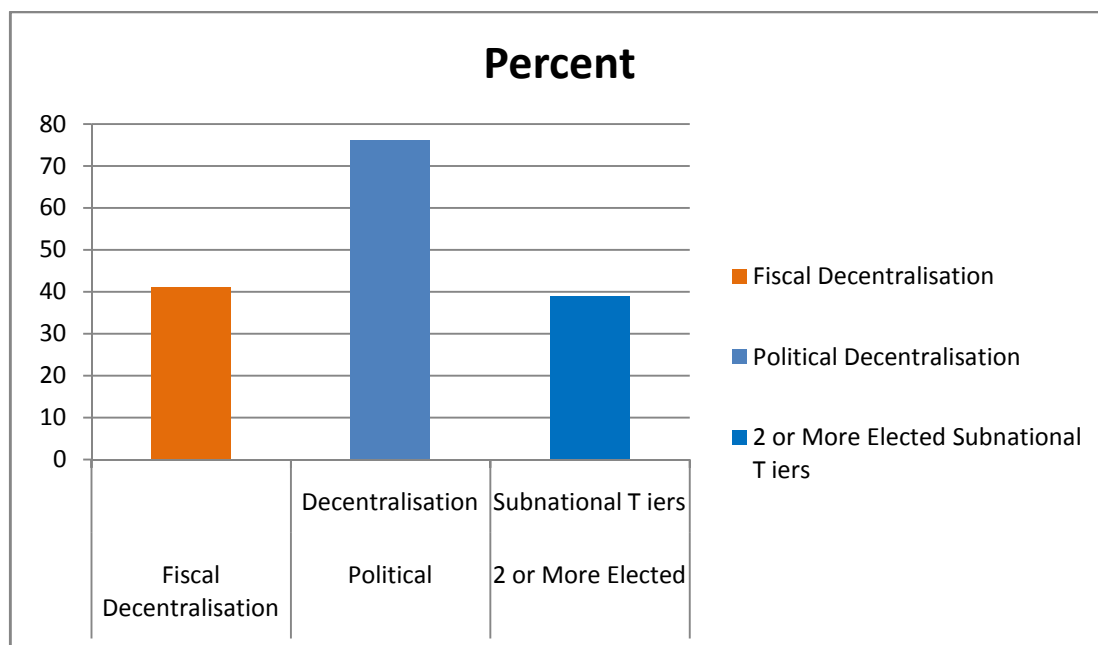
According to the Wiki Answers, Fiscal federalization can take the form of;

- ✓ Self-financing through user charges,

- ✓ Co-financing or co-production in which the users of the goods and services participate in providing it through monetary or labor contributions;
- ✓ Introducing/increasing property taxes, sales taxes and indirect charges to expand the local revenues;
- ✓ Intergovernmental transfers in which the central government transfers the general revenues from the taxes collected to the local governments for their general and specific uses.
- ✓ Authorization of municipal borrowing and the mobilization of either national or local government resources through loan guarantees.

Overall, nowadays federalism is buzz notion especially in LDCs and in/indirectly decentralization (Federalism itself a form of decentralization) had been flourishing all over the world and almost every country is undergoing some form of decentralization, political, fiscal, administrative, or functional decentralization. World Development Report (2000/2012) state that entering the 21 Century, 96 of the 127 countries surveyed are 76% politically decentralized, 42 countries or 33% have 2 or more elected sub national tiers and 52 countries have 41% fiscal decentralization. This is depicted in the figure 1.2 below:

Figure 1.2: World' Decentralization Practice⁷



⁷ Source: author construction with the help of World Development Report (2000/2010). These statistics are based on a survey of 127 countries for which fiscal and political decentralization data could be collected. Decentralization Table: A1 WDR 1999/2000.

1.3 Statement of the Problem

A Himalayan holy states wedged between two emerging global powers, India in the east, west and south with an open border and China in the north, Nepal is least developed, landlocked, geographically disadvantageously placed, and economically vulnerable nation of enormous ecological diversity. Having huge potentiality for development and prosperity Nepal is still in the list of the poorest countries in the world, which is directing her efforts in accelerating the pace of her economic development. Majority of population is still much below the poverty line. The agro and import-dominated economy is further worsened by the complicated geographical situation. Various factors like the landlocked situation, poor resource mobilization, lack of entrepreneurs, lack of institutional commitment, erratic government policies, political instability, etc. are responsible for the slow pace of development in Nepal. It has a population of 28 million and its GDP growth rate is 3%. The per capita GDP of Nepal is 721 US dollar and GDP is only 15 billion dollar (Human Development Index-2015).

In spite of recent geo-political progress, now it is struggling to cope with the worst earthquake-2072⁸ and fighting against India's undeclared blocked⁹. The magnitude 7.9 earthquake struck some 80km northwest of the capital Kathmandu and has affected eight million people; just less than one-third of the population with upwards of 9,500 people has been slayed. The economic losses could be as much as \$10bn, according to an estimate from US Geological Survey. The cost of rebuilding is \$8.40bn, according to PDAN.

⁸ The 7.8 magnitude earthquake that rocked Nepal on 25 April, 2015 and the many subsequent aftershocks have imposed a huge human and economic toll on the country, with over 9,500 deaths and some 25,000 injured. Millions of people have been affected in other ways and directly influenced 40% of the whole Nepalese people. According to PDNA report, after the earthquake, 22 thousand houses were destroyed and approximately 60000 houses and working places were severely damaged. The economic losses could be as much as 706 billion; according to an estimate from Post Disaster Needs Assessment- PDNA report.

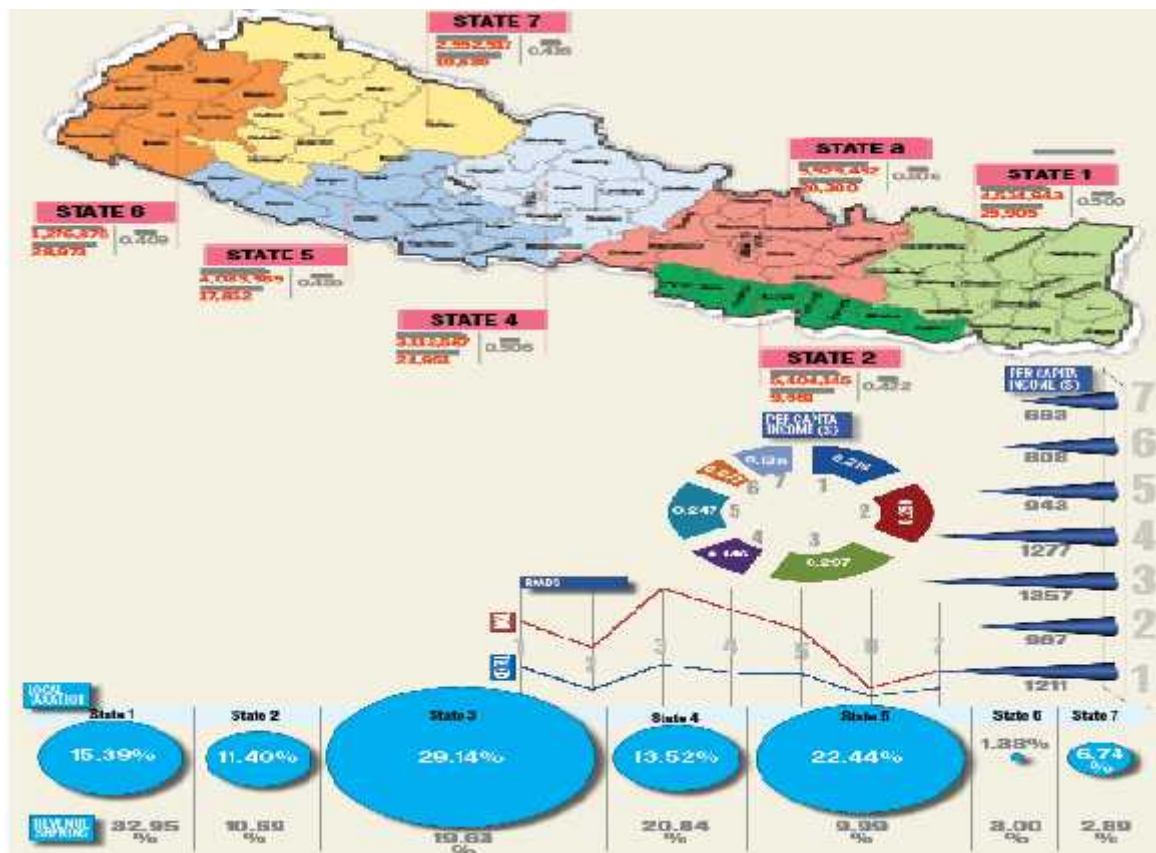
⁹ Nepal promulgated the New Constitution with signatures of 90 percent of the Constituent Assembly (CA) II members on September 20, 2015. The world congratulated Nepal for its success, but Nepal's '*roji-roti-beti*' closest neighbor India sent a cold-note and a mild-warning. India informally conveyed a proposed 7-point constitutional amendment the following day supporting 10 percent of Nepal's CA II, which are agitating Madhesi groups. Such amendments interfere with landlocked Nepal's sovereign and internal affairs, but Nepal was full of confusion in answering it. Finally, India backwards in February 5, 2016.

Similarly, India's undeclared blocked has bust Nepalese economy more than accuse of earthquakes devastation. All this in a country with economic growth that was already isolated, with an unemployment rate of more than 40 per cent, and suffer by those two unexpected economic wreckage, Nepal is in the critical phase of a major political, administrative and fiscal restructuring reform moving towards a federal government structure to enhance governance and improve public service delivery. A new constitution expresses the obligation to eliminate "the centralized and unitary form of the State" as a means to end '*de facto level*' discrimination, with expectations of three levels of government along with some arrangements for seven autonomous Provinces, protected areas and special areas as appropriate (See in fig. 1.3).

Although, these ongoing efforts are being formulated against the background of the current sub-national governance structure, which is largely based on the Local Self Governance Act (LSGA, 1999). The LSGA was a major decentralization reform at the time, introducing a number of key reform initiatives. One important component was the focus on fiscal dimensions giving more expenditure and revenue authority and resources to local bodies (LBs), namely the Village Development Committee (VDC), Municipalities (MUNS), and the District Development Committees (DDC). Despite these bold initiatives under LSGA, however, the Nepalese government structure remained highly centralized, unable to address many of the pressing governance and service delivery problems. In fact, the underperformance of the seven province and related reforms was partially an impetus for the ongoing effort to restructure Nepal into a federal governance system, seeking to clarify and re-establish the political, administrative and fiscal dimensions of government in order to enhance efficiency, effectiveness and accountability.

Beside this fact, the debate about fiscal federalism is remaining full of myths and some degree of hegemony. The crux of the matter of fostering holistic national welfare is how the sub-national units of federation-call them provinces-should be formed; should they be along territorial lines, ethnic-language lines, or a combination thereof? Moreover, the debate has been counter-productive, as it has focused on the choice of the bases of federation, as if that is a goal in itself. Instead, the debate should revolve around what type of federation would help achieve equality of opportunity, rapid economic growth, inclusive democracy, and socioeconomic harmony. The economic agenda that should have been front and centre in choosing the bases of federation is completely missing in the debate.

Fig: 1.3 Demographic and economic Strata of the seven provinces of federal Republic Nepal¹⁰



However, the solution given, seven-province federation is not totally equity/equitable because such federation has less possibility of adopting equity and growth-enhancing economic policies, mobilizing resources efficiently, maintaining harmony among the population, and taking full advantage of international markets. Another main problem of this model is how to generate resources. Based on this sketch, if we examine the current trend of revenue generation, we see that it is concentrated in only four places: Kathmandu (province-3), Parsa and Morang (province-2) and Rupandehi (province-4), as far provinces 1,5,6,7 does not seems capable for their executive overheads. Kathmandu alone accounts for 42% of the total revenue. Revenue allocation is a base of financial balance at different levels of the government. Based on the resources and their possible impact, the sharing of fiscal power and resources is one of the main potential areas of conflict in a federal Province¹¹.

¹⁰ Source: www.google.com or <http://kathmandupost.ekantipur.com/news/2015-09-05/the-7-state-model.html>

¹¹ Proper data are used from the cites of National Statistics Bureau, World bank reports and UNDP.

Table 2: Revenue

Districts	% of Approximate Revenue
Kathmandu	42 %
Parsa	21 %
Morang	8 %
Rupandehi	7 %
Kaski	4 %
Banke	3 %
Dhanusha	3 %
Makwanpur	3 %
Total	94 %

source: Department of Inland Revenue

Similarly, the Madhes-based parties, in particular, said that they would not accept such a model of federalization. Now, even as the present constitution has proposed a Seven-Provence model, the protests continue. Still, it is unlikely that the major parties will significantly alter the proposed model. It would therefore, be wise to critically analyse the socio-economic aspects of the proposed provinces and accordingly introduce new policies and programmes. These snapshots take into account Province indices such as population, geographical area, the Human Development Index, per capita income, agriculture production, roads, revenues, etc. However, there are vague disparities among those provinces. An interesting finding from the agriculture production indices is that as with other variables, Province Three comes out on top. Province Two comes in second. Those districts comprising Province Three, such as Kavrepalanchok, Dhading and Chitwan, among others, have very good agriculture production and livestock rearing capacities. As per the central revenue collection figures, Province Three contributes the lion's share of the revenue, followed by Provinces One, Two and Five. Provinces Four, Six and Seven would not be economically viable even if the revenue they generated were used solely within their boundaries. All the data sets presented in the analysis clearly reveal that the proposed Provinces are asymmetrical vis-à-vis the many variables taken into account. And the indices show that Provinces Six and Seven are the poorest among the seven proposed.

Thus, if appropriate mechanisms for the distribution of fiscal power are absent, it can create conflict later. Federal countries like USA, Australia, Spain, Malaysia and Germany are relatively centralised in their distribution of fiscal powers (i.e., the central government has the main power to collect tax and other revenues), compared to Switzerland (which divide the right to taxation amongst the 3 levels), Brazil and Canada (which leave the right to raise revenue mainly in the hands of the federal units). If revenue means and expenditure needs for the various federal units are mismatched, it can lead to tension and dysfunction. Similar argument Shah (2014) put that vertical fiscal gaps and revenue autonomy at sub-national orders of government remain areas of concern in federal countries where the centralisation of taxation powers is greater than necessary to meet federal expenditures, inclusive of its spending power. This leads to undue central influence and political control over sub-national policies, and can even undermine bottom up accountability. This is a concern at the Province level in Australia, Germany, India, Mexico, Canada, Malaysia, Nigeria, Russia, Spain and South Africa. Hence, clearly defining fiscal relations, tax assignment and tax-based revenue sharing mechanisms is also significantly crucial.

Furthermore, another important problem related to deceiving economic welfare in Nepal is service delivery issue. Based in new constitution (2015), Nepal, politically and administratively divided into *Seven Pradesh* (province). However, for a number of reasons, yet this service delivery model not been able to build in concrete shape. Many challenges and other factors are responsible for this. In brief sketch; firstly, *Tarai-Madesh* linked issues-agenda and lack of national unity and integrity leads defecation of implementation of constitution. Secondly, a long chain is involved between the service delivery units at local levels and the ministries in terms of budgeting, planning, programming, and staffing. Thirdly, because of the 240 year's centralized nature, there is very little scope for matching budget allocation and programming with local needs. Fourthly, the local people and authorities have almost no control over the staff and budget of the CG offices. And the quality of services being delivered by the central agencies is still low. These shows, wide horizontal fiscal disparity are also a visible problem. Uneven distribution of economic bases, disparity in infrastructure development, and low tax efforts of the nation are major factors for the existing wide horizontal fiscal disparity across the Nation.

Likewise, failure to slice up equal sources of income among the federal-provinces would lead to economic disparity and massive development gap. Economy, income sources, distribution of natural resources and the mechanism to maintain good governance and transparency are the fundamentals for the prosperity and economic growth of the federal system. The costs would be higher when the nation really embarks upon the federal system. The federal system increases the financial burden and gross expenses in totality. Experts believe that there would be a three-fold increase in the expenses. How will the costs be managed? Although, Nepal has a limited source of income, and the concern is; would the existing source of income meet the vertical increase in the federal costs? How are we going to build these basic infrastructures in the mountains and hills? It would be imperative to manage instantly at least a layer of development and other physical infrastructure projects in the mountain and hilly region when the country goes into the federal system. How are we going to manage the financial resources even to meet the start-up expenses? Thus, the million dollar question is still unsettled.

As we know that adopting a federal model alone will not resolve the problems instantly unless they are scientifically sliced up, equitably resourced, ethnically balanced and effectively governed. The success of the federal structure will depend not only on the constitutional framework, assignment of resources and responsibilities, and an institutional framework for fiscal transfers, but also on delivering economic outcomes that augment the welfare of people by equitable and efficient delivery of services and by increasing overall economic growth, with a better regional balance.

Beyond that isolation, this dissertation attempts to critically assess the practice of fiscal federalism *visa-á-vis* the arrangements of the Federal Constitution as well as the viability in future. More so, this study looks at the key elements of a new fiscal regime in Nepal, which will assist the shift toward fiscal federalism. Overall, given the sensitivity and dynamics of the issues involved in this research the study seeks to provide answers to the following research questions; (i) could present proposed model of federalism can pilots for significant macroeconomic welfare in Nepal? (ii) If so, what are the factors inhibiting or promoting the principles and practice of fiscal federalism in Nepal? (iii) What are the major challenges towards fiscal amendments in Nepal? (iv) What are the key economic indicators towards effective fiscal arrangements, revenue allocation strategy, expenditure

obligations and resource mobilization authority under the salient features of the newly promulgated constitution of Nepal and recent reforms?

1.4 Significance of the study

In Nepalese research platform, the lack of a establish model, where fiscal federalism and national holistic prosperity are interlinked, demands a thorough and in-depth academic research illustrating the major determinants of fiscal federalism towards holistic economic welfare within a present geo-political economy setting. As this circumstance, this thesis is an attempt towards this direction in order to fill this academic gap in public economic literature. Thus, the primary significant of this research is to investigate the fiscal setting under which the evolution of fiscal federalism and devolution process takes place and progressions through which it helps to establish little milestones for effective fiscal arrangements in Nepal.

The highly centralized state-building strategy and assimilationist policy during the past century had failed to bring political stability, democratization, and economic prosperity in Nepal (Adhikari, 2015). As a response to the assimilationist policy that ignored and/or concealed the existence of ethnic, cultural, language and economic distributive pluralism, the multicultural federal system affirms equality and rights of the Nepal to Self-determination including secession. As general motif towards federalism in Nepal is associated with equal access to public services of citizens irrespective of their state residence, political stability, accommodation of diversity, individual and collective rights, democracy, budget autonomy and provinces' tax sovereignty etc. Hence, the most contextual significance of this study was undertaken to take "stock" of the current fiscal federalism discourses and exercises in Nepal with respect to virtue of the Constitution of Nepal (2015) vis-à-vis their practice. Thus, the theoretical model of this thesis therefore is expected to bridge the current theoretical gap and contributes to both academic and policy-making circles.

Similarly, focusing specifically on resource mobilization, taxation assignment, expenditure transfer, revenue compulsion, intergovernmental fiscal transfers and local borrowing, the study lays the foundation for a planned functional analysis (activity mapping) of specific sectors across different levels of sub-national governments which will be closely aligned with the work undertaken by effective fiscal-transfer mechanism. More extensively, this

inquiry comes across at the key elements of a new fiscal regime in Nepal, which will facilitate the transition toward fiscal federalism and helps to build economic welfare in entire nation. So, the study no doubt will also have multidimensional significance for various areas. Typically, these are Table 1.4.1 below;

Table 1.4.1 Significance of the study

Advocacy and Service delivery	Other significance
<ul style="list-style-type: none"> ➤ <i>Placing pressure on the central government to move proactively and more quickly in support of the fiscal federalism process which foster holistic economic welfare,</i> ➤ <i>Contribute to evolving procedures, practices and policies of wider relevance for federalization processes in Nepal,</i> ➤ <i>Carry out functional analysis across different tiers and relevant sectors based on the reports of government efforts as they related to the fiscal provision and make recommendations to allocations of responsibilities in light of the new proposed structure,</i> ➤ <i>Prepare recommendations on policy framework required to implement the constitutional provisions in regards to expenditure and revenue assignments as they relate to different tires of governments allied with the provision of Nepal's constitution (2015) and recent reforms and practices.</i> 	<ul style="list-style-type: none"> <i>-Significance to all citizen</i> <i>-Significance to policy formulators and academically professional.</i> <i>-Significance to government bodies and policymaker such as National Plan commission.</i> <i>-Interested outside parties such as NGOs, INGOs, academic researchers, scholars, involved learners, professionals etc.</i>

1.5 Rationale of the Study and Constructed Research Questions

To the best of my knowledge, no in-depth theoretical study has been carried out so far to examine the relationship between fiscal federalism, welfare, and possible federal supportive economic model in Nepalese context. However, the Federal Constitution ensures considerable political, fiscal, and administrative powers to the states so that less or more my research question are generated from present constitutional arrangement and try to determine their affairs, to have discretionary authority in allocating their fiscal capacity that reflects local preferences. Thus, this empirical analysis has dual Rationale. Firstly, as mentioned in the significant and problem statement session, I will tries to compare well established fiscal federalization policy towards holistic economic welfare and checked

either they feasible in our context or not. Second, the holistic intend the drive of this study is seeking the answer of following research question as formulated in table (1.2)

Table 1.5.1 Research purpose and corresponding research question

Motive or Purpose	Constructed research question
1. To understand and characterize overall economic status of Nepal with special reference to some selected macroeconomic indicators.	a) <i>Where we stand actually?</i> <i>-This question related to overall macroeconomics status of Nepal.</i>
	b) <i>What are the major economic agenda of Nepalese federalizing process?</i> <i>-This question typically deliberated on the matter regards; considerable factors and their impacts on fiscal reform.</i>
2. Examine the evolution, structure and practices of fiscal federalism in Nepal; 3. Determine the actual faces beyond fiscal arrangements in Nepal;	a) <i>Is federalism improves national holistic economic welfare? If so, what types of fiscal federalism strategy towards national economic welfare?</i>
	b) <i>What are the factors inhibiting or promoting the principles and practice of fiscal federalism amendments in Nepal?</i>
4. To examine the key economic policy towards effective fiscal arrangements, revenue allocation strategy or taxation, expenditure assignment and resource mobilization authority under the salient features of the newly promulgated constitution (2015). 5. To categorize general challenges towards fiscal federalism amendments in Nepal according to the provision of newel constitution.	a) <i>Could present constitutional (fiscal) arrangements can pilots for significant macro-economic welfare in Nepal?</i>
	b) <i>What are areas for improvement on the legislative instruments?</i>
	c) <i>What are the sailent feature of present constitution towards effective fiscal arrangements, revenue allocation strategy, expenditure responsibilities, and research mobilization authority?</i>
	d) <i>What major challenges to be arise and how they could be solved?</i>

1.6 Goal Setting and Objectives of the Study

Perhaps the main advantage of empirical studies in social sciences is to provide an in-depth analysis of phenomena of interest. The main goal of this study is to equip an insight into the contrivances of the fiscal diversification attempts within the context of present reform in Nepal. Thus, the expected goal of this inquiry is also govern from the effective

fiscal federalism amendments in Nepal which helps to foster holistic economic prosperity and welfare anticipation.

Academically, fiscal federalism is the product of the reciprocal and dynamic interaction between different tiers of government, and therefore poses questions as to how the nature and conditions of the financial relations in any federal system affect the production and distribution of the wealth of a nation. In particular it influences how political decisions and interests influence the location of economic activities and the distribution of the costs and benefits of these activities. Economic federalism and local autonomy have become an interesting topic until today because studies about fiscal federalization are not only considered from economic perspective but also from other outlook such as politic, geographic, other motifs. Beside this fact, sometimes the findings do not give the same conclusion among researchers about the effect of fiscal federalism creates oh holistic economic welfare or not. Some scholars' like Davoodi and Zou (1998) showed that fiscal federalization did not give significant effect on economic growth in developing country. Meanwhile, Iimi (2005) and Malik (2006) obtained different result that is effective fiscal transfer policy gives positive effect on economic growth.

Scrutinizing those scenarios, Nepal is undergoing a major transition toward introducing a system of *socialism-oriented democratic* and federal governance. Probably but surely, the transition toward fiscal federalism will have two interlinked phases: Phase 1 will consist of structural changes dealing with reorganization of the country into provinces, assignment of resources and responsibilities to the different tiers of government, and institutional arrangements for dealing with the emerging vertical and horizontal imbalances. In Phase 2, the design of fiscal transfers, administrative restructuring, issues of cooperation and coordination among the centre and the provinces, and capacity building will need to be put in place. But still Nepal is struggling to construct concrete provision towards effective fiscal federalism policy. So, besides exploring the theoretical foundations that link these two concepts, this study seeks to undertake an in-depth empirical study that will cover the width and breadth of a country (Nepal) to see whether a link exists between fiscal federalism amendments practices in Nepal.

Based on this regard, the main aim of this inquiry is to provide a review of the fiscal arrangements with a view to their suitability for achieving the objectives of the federation - the so-called federal and economic union -both from the point of view of Nepal as a whole

and from the point of view of fostering national level economic welfare. Therefore, the main objective is to evaluate the current deeds, and where appropriate to suggest suitable reforms. The objectives of the fiscal arrangements as set out by the Nepalese Constitution, as enunciated in federal-provincial agreements, and as generally accepted by economists and policy experts are used to set the context for a description of the arrangements. Then the various problems that exist with the current arrangements are outlined. The relevance of these problems for federalism towards economic welfare is discussed. Finally, various policy options for reform of the fiscal arrangements are proposed and evaluated. Thus, the overall objective of this study is to investigate the relationship between fiscal federalism amendment and macroeconomic performance in Nepal. In this background, the study aims to;

- ✓ To demonstrate actual socioeconomic status of nation and connecting it with possible fiscal reform in nation;
- ✓ Investigate and categories various agenda and expectation which promotes or inhibits to the context based federalism practice in Nepal;
- ✓ Determine the salient feature of present constitutional reforms towards macroeconomic performance: resource mobilization, revenue allocation, and expenditure arrangement patterns in Nepal;
- ✓ To explore the economic and non-economic possibilities those have been applied in future fiscal setting in Nepalese contexts;
- ✓ To explore and identify vertical and horizontal imbalances obligation those have been foster viable fiscal arrangements in Nepalese context;
- ✓ To provide some recommendation options that may helps to execute the reasonable fiscal rearrangements in Nepalese context, etc.

1.7 Unturned stone and limitations of the study

The focus of this study is on the process of culturally relevant nature of fiscal federalism amendment practices in Nepal with allied from a constitutional scenery which shore up by professional accounts of the applicable strategy and emerging practice among Nepalese geo-political setting. Although, federalism related misconception and its impact on long-term fiscal setting is not explored and identified in this research. Likewise, as common limitation of qualitative inquiry, this inquiry is also beyond hypothesis testing methods and general strata related to scientific research.

Thus, in one sense it is imitated on context-based (auto/ethnographic¹²) research paradigm. Similarly, demographic factors and its impact on fiscal federalism amendments are not analyzed unless federal government use them to compare and contrast previous and current institutional techniques.

Likewise, a major problem that is often associated with studies like this is the accuracy of data available on economic variables. Another is the issue of secondary data being filled with estimation errors. In addition, there are often discrepancies in the data presented by various organizations such as the Central Bank of Nepal (CBN), National Bureau of Statistics (NBS), International Financial Statistics (IFS), International Monetary Fund (IMF), and the World Bank. Thus if there are errors in composition of data and its consequent effects on estimation results, this cast doubt on the validity and reliability of the econometric results generated in this study. But this is a common problem faced by studies which make use of secondary data. The study however tried to minimize these discrepancies in the data from various sources. So, the expected results and findings in this dissertation are correct and reliable to the extent that the data used are presumed accurate from the various secondary sources they were generated from. Another major limitation was the inability of the researcher to acquire and master in time relevant econometric software and other related manuals for data analysis which hampered the timely completion of this study. Finally as an issue of copyright, my inquiry deliberated; “Copyright: a system of monopoly privilege over the expression of ideas that enables government to stop consumer-friendly economic development and reward uncompetitive and legally privileged elites to fleece the public through surreptitious use of coercion.”

- Jeffrey Tucker

1.8 Structural Design of the Inquiry

My overall dissertation has been separated into seven chapters. Each chapter portrays the nodal events towards fiscal federalization amendments in Nepal and they are interlinked with macroeconomic statement and possibility in nation. I would like to discuss the outline of the chapters in brief. My reflections through academic narration, metaphoric pictures,

¹² According to Joshi (2014, p. 66) auto/ethnography is the research methodology of choice-telling the contexts of others and self for the purpose of arriving at a better understanding of the culture and self being researched.

co-relevant stories, statistical charts, and figures gain from secondary data sources are the major acumen in this inquiry. Analysis and interpretation, review and citations have been conveyed together in each chapter. My study has been governed by multiple research paradigms in order to bring out a more complete picture of the research. According to Taylor, Luitel, Settlemaier (2011), and Joshi, (2014) multi-paradigmatic research gives more opportunity for transformative research design and transforming ideology towards research agenda. So, I employed the '*context-based*' emerging paradigms, thereby giving myself the opportunity for critical self-reflection, offering socio-economic voice and expectations and multi-perspectival thinking/knowing. My dissertation chapters are mainly structured on following ways:

Chapter I provides a broad introduction to research topic, how and why this topic is selected, and what external or internal environment plays the vital role in the selection of this issue, significance of the study, purpose of the study, research questions, some scenarios and unturned stones of my dissertation that build primarily platform of the entire research.

Chapter II deals with the conceptual and theoretical background, covering literature on the important theories relevant to my research agenda regarding to fiscal federalism theory and practices among global to Nepalese scenarios.

Chapter III is a description of the methodology that was used to carry out the research. It controls my research process and situates me in the culture of mixed research genre of social research. It describes the rigor of my research and its nature. It provides detailed descriptions of the methods and methodology, procedure, quality standards, philosophical and ethical considerations that are bounded the inquiry into logical framework.

Chapter IV contains contemporary macroeconomics status of Nepal and tried to link what factors pilots the faces behind fiscal federalism amendments in Nepal. It provides detailed information of about macroeconomics strata and reality of the nation with the help of some statistical approach. Likewise, this chapter helps to find out the answer of my first set of research question thereby evaluating relevant myths, reality, and hegemony in political economy towards possible fiscal amendments schema in Nepal.

Chapter V provides a framework of my emerging images towards fiscal federalism expectations in Nepal. This chapter is aimed to cover three separate but relevant themes

with significant impact on the political economy of Nepal and lays a particular background that helps to understand the theme of this thesis. And, more indisputably this chapter provide contextual answer of my second set of research question with amalgam aspects.

Chapter VI provides the wider landscapes of unraveling nature the three interconnected fiscal issue i.e. Resource mobilization, revenue allocation, and expenditure responsibilities based on Nepalese fiscal federalism amendments. It also gives a picture of how deconxtualized nature of fiscal transfer system exists in our fiscal system. In thematic, this chapter presents key issues, trends, and challenges of research mobilization, revenue allocation, taxation and fiscal federalism in Nepal under the newly promulgated constitutional provision. Moreover, the chapter also in/directly highlights a number of suggestions that would stimulate increase in tax revenue and guarantee fiscal assignment acceptable to the federal and sub-national government. This chapter also revels to the answer of my third set of research question.

Chapter VII gives a synthesis view of my research and epilogue to my research landscapes. Thus, the chapter demonstrates to overall metamorphosis of my research journey in terms of catalysing some administrative/political change and changes through actions for the reason that conceptual/behavioural transformation leads effective federalism amendments in real sense. Within this hope and expectations, this chapter draws a brief conclusion of the federalization system in Nepal focusing on the prior chapters and provides some appropriate recommendations to the conclusions drawn from the overall inquiry.

1.9 Chapter summary

This chapter was the way and basis platform towards this research. Thus, it contained existing research questions that are to be answered in the coming chapters. It aims to address the research questions to be addressed during the research endeavor and the consequence of the research. It also briefly presents the delimitation of study and chapter outline of the entire research endeavour. Beginning with my tenderfeet in gaining the sensitivity of research, I walked through the following footsteps: selecting the research topic, provides a broad introduction to research topic, problem statement (how and why this topic is selected, and what external environment plays the role of selection this issue), significance of the study, purpose of the study, research questions, some scenarios and unturned stone of my dissertation that guided my entire research.

CHAPTER TWO

THEORETICAL FRAMEWORK AND EMPIRICAL EVIDENCE

“It doesn’t matter what you think, it only matters how you think”

-Christopher Hitchens

2.1 Chapter overview

The main purpose of this chapter is to share the in-depth doctrine of different theories related with the present research. Thus, this chapter are going to explore general premise about fiscal federalism and economic welfare. Several books, articles, internet sources, journals and dissertation paper available in Nepalese (some extends international context) were studied. Although, there is no dearth of academic literature on federalism, but the issue of fiscal federalism and fiscal restructuring is relatively a new topic in Nepal. Therefore, literature dealing with these aspects in the Nepalese context is limited. Meanwhile, federalism in general is an important subject in political economics; hence, there is an abundance of academic contributions by leading scholars.

As this globe, the literature on federalism provides the perspectives to understand transitions and global cases to illustrate which model may be best suited for the context of Nepal. In this thesis, several articles and papers by contemporary scholars will be reviewed to understand the different perspectives and approaches to understand the issue of federal system in Nepal. First, the general theory on federalism will be examined to help understand the demand for federalism. Second, literature on economic demands for federalism in multi-provisional societies will also be examined in order to understand what causes such demands and what some possibilities are. One of the fundamental precepts of economic theory is that the unit of decision making should be the lowest level possible in consonance with the objective of allocative efficiency. This is the primary motive behind federalization. The institutions of fiscal federalism vary widely across the world, because each country’s fiscal institutions are dependent on local circumstances, political and economic factors. It is therefore necessary to undertake a comparison of the divergent experiences of different countries. Also the theoretical, methodological, and empirical literature on the subject of fiscal federalism is quite vast and extensive. Overall, this

chapter attempts to provide insightful and copious review of the concepts, methodology, and empirical issues on determinants' of fiscal federalism towards economic welfare.

2.2 Cleansing previous revise quest: shrewd about third-eye Review¹³

In methodological perspectives, review the relevant literature was searched for key journals, websites, reference lists, sometime using electronic databases, and advice from key contacts. At this process I have followed two-stage review, which involved:

Phases 1: Screening and coding of studies for the thematic overview

Of course, I'm a puerile researcher. Thus, for me, cramming others' contribution is not an annotated bibliography, and it should not be just a series of disjointed paragraphs and also summarizing not different books, articles and journals. Here, the literature I have identified must be soulfully read, critically analyze, consciously synthesized and coherently and logically structured and meaningfully relevance in my study. So, locating myself in others contribution is not simply copying others' ideas in blain manner. But it involves the systematic identification, identical location, and analysis of documents containing information related to my research agenda. It helps me to find related traineeships on my selecting research problem, and definitely these documents can include articles, abstracts, reviews, monographs, dissertations, thesis, other research reports, internet browsers, electronic media and so forth.

Phase 2: Screening and rating of studies for the in-depth review

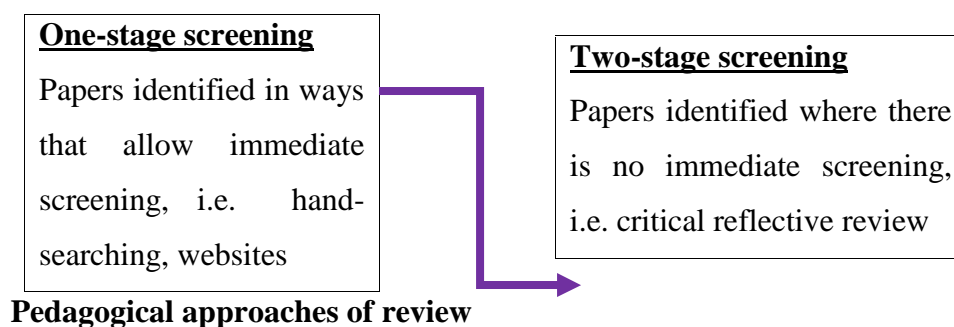
In second phase of my review, studies that met further inclusion criteria relating to relevance and clarity of reporting were then selected for this stage three: in-depth review. All studies selected for this stage were empirical rather than theoretical, and both quantitative and qualitative research methods were considered. So, the major purpose of second phases screening in my research is to determine what has already been done that

¹³ Third eye review is recent trend of reviewing academic literatures. This image constructed by Joshi, 2013 on his master's level dissertation. According to him, '*Third eye review*' is not cramming others' contribution is an annotated bibliography, and it should not be just a series of disjointed paragraphs and also summarizing of different books, articles and journals. Here, the literatures I have identified are soulfully read, critically analyzed, consciously synthesized and coherently and logically structured and meaningfully relevant in my study. So, '*Third-eye-review*' is not simply copying others' ideas in blain manner. But it involves the systematic identification, identical location, and analysis of documents containing information related to my research agenda.

relates to my topic. As a result, it also gives me some ontological, epistemological and axiological understanding and insight which I want to place my research within a logical frame. So, Phase 2 review can provide the balanced-frame to my research which helps to capture its aims and objective, and indications of what to be done can help me in justifying the significance of my study. Another important purpose of studying the literature is to discover research strategies and specific data collection approaches that have or have not been productive in investigations of topics similar to mine. This information will help me to avoid or accept other researchers' mistakes and profits from their experiences. It may suggest the approaches and procedures that everyone previously had not considered.

This phase of review also helped me to interpret my research procedure, methodology and analysis with the coherence structure. Furthermore, it provides the wider horizon of different fiscal federalism theories and philosophies which is essential for a successful research. Moreover, this phase has also provided me with an opportunity to identify the gaps that were existed in the body of literature and to afford a rationale for how the proposed study may contribute to the existing body of knowledge. Figure 2.1 shows the process in full detail.

Figure 2.2.1: Filtering of papers from searching to mapping to in-depth review



Moreover, there is a very imitated of literature present on this topic of relationship between determinants between fiscal federalism and economic welfare as it has been the topic of great debate over the years especially in terms of its implications on developing and transitional economies which are undergoing structural changes. It has been also the matter of concern for many researchers whether the effects are more noticeable in the relation between determinants of fiscal federalism and its impacts on economic welfare. To examine the key economic indicators of effective fiscal arrangements, revenue allocation design, taxation and research mobilization authority under the salient features of the newly

promulgated constitution (2015). So, this section is divided into Four parts: (i) seen setting: cross country experiences, (ii) review of theoretical v/s thematic foundation and (iii) reviews of empirical studies (iv) theories of change.

2.3 Seen Setting: Connecting ‘cross-country’ Experiences

In the literature of public economics federalism or more specifically the fiscal federalization is not a new issue. Rather it goes back to the fiftieth decade of the last century when Teibout (1956) and Musgrave (1959) presented their respective pioneering works. This literature has a range of researches that involve the structure of the public sector and types of government that are best suited to fulfill these functions. Since that, economists and policy makers theorised the issues of fiscal decentralisation to assess its various impacts on economics and governance of a country and the well-being of her people.

Acknowledged the eco-political controversy around the world, the question emerges how the effective federalism policy pilots significant influence on economic development of a country and its regions. What are the transmission channels of fiscal federalism on economic welfare? Additionally, the question arises: what is the influence of federalism on the regional growth processes. Which contribution to regional development should be ascribed to cooperative fiscal federalism or fiscal competition?

Since the theoretical results on the impact of fiscal federalism on economic development are ambiguous, empirical studies might shed some light on the issue. The empirical studies testing this hypothesis do however not provide consistent results. This holds for cross-country studies as well as for studies on single countries. From the experiences of cross country studies, Davoodi and Zou (1998) find a weakly significant negative relation between the degree of fiscal federalism and the average growth rate of GDP per capita for a sample of 46 countries over the period from 1970 to 1989. For the sub-sample of industrial countries this effect is not significant. However, the negative influence for developing countries, anyhow, is robust though only weakly significant as well. According to these estimates, an additional decentralization of spending by 10 percent reduces the growth of real GDP per capita in developing countries by 0.7 – 0.8 percentage points. Woller and Philipps (1998) also cannot find a robust relation between economic growth

and decentralization, using a sample with a lower number of developing countries and a shorter time-period.

Similarly, in a recent analysis for average economic growth of the past 25 years in a cross-section of 91 countries, Enikolopov and Zhuravskaya (2003) show that the effects of fiscal federalization depend to a large extent on the structure of the party system as well as on the degree of 'subordination' of subnational levels. According to them, especially in developing and transition countries, the age of the most important political parties is favorable to the positive effects of federalization on economic growth. In countries with a – in this respect weaker – party system, a 10 percent increase of decentralization of revenue decreases real per capita GDP growth by 0.14 percentage-points. These results are in contrast to those of Martinez-Vazquez and McNab (2002) according to whom the decentralization of revenue significantly reduces the growth of real GDP per capita of developed countries, but not of the developing and transition countries. Yilmaz (2000) analyzes the different effects of fiscal decentralization in 17 unitary and 13 federal countries for the period 1971-1990 with annual data. Decentralization of expenditures to the local level increases the growth of real GDP per capita in unitary states more strongly than in federal states. However, the decentralization to the intermediate level in federations is not significant. Thieben (2003) analyzes the average growth rates of real GDP per capita for a cross-section of 21 developed countries in the period 1973-1998 and in a parallel study (Thieben 2003a) for a panel of 26 countries between 1981 and 1995. According to his estimates a 10 percent increase of decentralization of expenditures increases the growth of real GDP per capita by 0.12-0.15 percentage points in high-income countries. However, the relation between federalism and economic growth might be non-linear, because the quadratic term of expenditure decentralization is significantly negative.

Similarly, some other empirical results concerning the impact of federalization on economic growth for individual countries also appear to be ambiguous. To date the discussion is limited to China, the US, and Germany. Zhang and Zou (1998) note a significantly negative effect of fiscal federalism on economic growth in 28 Chinese provinces, using annual data between 1987 and 1993. Jin, Qian and Weingast (1999), however, report a weekly significant positive effect of expenditure decentralization on economic growth of almost the same sample of Chinese provinces over time. The most important difference between the studies is the use of time dummies that are not included

by Zhang and Zou (1998). Consequently, symmetric shocks are not adequately controlled for. Lin and Liu (2000) strengthen the result of a positive relation between federalization and economic growth in Chinese provinces for the period 1970 to 1993 for the revenue side. In addition, higher responsibility of public budgets at the provincial level is connected with increased economic growth. These authors also use time dummies in addition to fixed cross-section effects. The relevance for the estimates of using time dummies points to the strong economic dynamics in China. The sometimes enormously high Chinese growth rates apparently cannot be captured by structural variables alone so that auxiliary variables for the individual years are necessary for correctly specifying the econometric model. Thus, for China, there might well exist a positive relation between federalization of governmental activity and economic growth.

Similarly, Xie, Zou and Davoodi (1999) in a time-series analysis for the US from 1951 to 1992, claim that the effect of federalism in US is equilibrium. They ascribe this to the fact that differences in decentralization at the Province or local level do not exert statistically significant effects on real GDP growth. Akai and Sakata (2002), however, offer evidence to the contrary for US States.

Beside those facts, considering additional explanatory factors and various indicators for the degree of fiscal federalism, they find a positive influence on economic growth. If expenditure decentralization increases by 10%, the growth of GDP per capita increases by 1.6 to 3.2 percentage points. Similarly, Behnisch, Büttner and Stegarescu (2002), notice a positive effect of increasing federal activities – measured by the share of expenditure at the federal level – on total German productivity growth in a time series analysis from 1950 to 1990. Supporting this view Weingast (1995) emphasizes the advantages of a “market-preserving federalism”. Starting from a “fundamental political dilemma”, according to which “a government strong enough to protect property rights and enforce contracts is also strong enough to confiscate the wealth of its citizens” (p. 1), competitive federalism reduces the size of government interventions and thus helps to maintain market efficiency. Similar conclusions can be drawn from the political economy analysis by Brennan and Buchanan (1980). Weingast (1995) does however not provide precise considerations as to the growth effects of federalism. He only mentions the advantageous development in England in the 18th century and in the US in the 19th century as evidence of market-preserving federalism. Rodden and Rose-Ackerman (1997) doubt the simplicity of the argument. Instead of serving the interests of mobile investors, sub-federal jurisdictions

may be captured by local interest groups and introduces protectionist measures in order to shelter them from external competition. Whether federalism produces market-preserving or protectionist policies, thus depends on additional institutional safeguards¹⁴.

Going beyond the history of world experiences, Ludema and Wooton (2000), Kind, Knarvik and Schjelderup (2000), Baldwin and Krugman (2004), and Brakman, Garretsen and Van Marrewijk (2003) challenge this view from the perspective of the New Economic Geography by analyzing the impact of fiscal competition on the economic development of central and peripheral regions. The advantages of agglomerations in the economic centers permit them to raise higher taxes than the peripheral regions. An example from the EU may illustrate this. Northern Italy offers firms an excellent infrastructure, well-established relations with customers and suppliers, and a highly qualified workforce such that it can afford the relatively high Italian tax burden. Peripheral regions, like Ireland, have hardly any alternative to balance their locational disadvantages than tax policy and public investment in infrastructure. They need to attract economic activity by an appropriate mix of taxes and public services. Harmonization or centralization of fiscal competencies would take from peripheral regions the few instruments to compensate for their locational disadvantages vis-à-vis the central regions, and it would therefore be harmful for regional development. It is nevertheless questionable whether government policies are sufficiently powerful to compensate for these strong locational advantages of central regions. These theoretical studies cast doubts as to the success of grants to foster regional development.

Another line of research corroborates this view. It is often hypothesized that fiscal federalism with far-reaching competencies of the subnational levels to decide on revenue and spending leads to an unfavorable regional distribution of income such that poor regions become poorer and rich regions become richer (see the discussion in Feld 2002, Feld and Kirchgässner 2003 as well as Thierstein et al. 2003). The more affluent taxpayers sort themselves in regions where the tax burden is lower. Poor regions, however, supposedly need to levy high taxes to finance the 'necessary' infrastructure for catching up with richer regions. If these jurisdictions enter fiscal competition, the economic differences between regions are exacerbated. Instead of having a regional convergence, divergence of regional incomes results. The policy conclusion from this reasoning is clear: Fiscal

¹⁴ For a more extensive survey of the theoretical and empirical studies investigating the impact of fiscal federalism on economic growth, see Feld, Zimmermann and Döring (2003, 2003a)

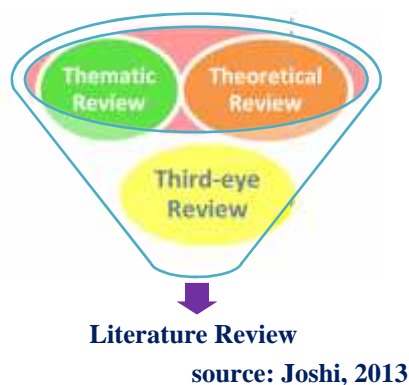
competition should be eliminated by harmonization or centralization and it should be supplemented by grants that equalize regional fiscal capacity. Cooperative federalism is the policy conclusion.

Given these arguments, fiscal federalism might influence economic development in several ways that also depend on the perspective adopted. First, it could be asked whether fiscal competition or fiscal cooperation between sub-federal jurisdictions has an effect on economic growth of the sub-federal jurisdictions. In that case, fiscal competition theoretically has ambiguous effects because on the one hand it might induce higher efficiency of public goods' provision and higher political innovation in that region and hence a better economic performance of the regions or Provinces. Similarly, fiscal competition or cooperation could foster economic welfare of the whole country by exploiting efficiency potential in the provision of the public good. Again, there is an ambiguous assessment of the relation between economic development and fiscal federalism. On the one hand, and quite simply, fiscal federalism might lead to a more efficient allocation of labor and capital in central regions that are the main growth poles of the economy. In addition, the incentives from fiscal competition to innovate and provide public services more efficiently reduce the waste of resources in the economy as a whole. From that perspective, grants mainly provide negative incentives to successful regions in exploiting their economic potential because transfers in a horizontal fiscal equalization system have the effect of a tax on the additional revenue that could accrue by the location of new taxpayers. On the other hand, fiscal competition may deprive the poorer regions' structural change stimulating higher overall growth rates when completed. In this case, the positive impact of grants to induce structural change in recipient regions needs to compensate for the negative incentives for donor regions in order to have an overall positive impact on economic development of a country.

2.4 Review of Theoretical vs. Thematic Foundation

In this session, I have tried to discuss the erudition theories that have served as sources of ideas, enabling insight into existing nature of fiscal federalism and its academic theories via thematic and theoretical perspectives. Considering the problem of economic federalism towards holistic economics welfare in Nepal under present federal system, unfortunately no systematic studies have been made available till recently when the federal government began to induce series of fiscal and financial reforms on the national economy. Perhaps,

the lack of such systematic studies refers to two reasons; first, as we are earlier stages of



the federative arrangements, and there is lack of conceptual awareness on Nepalese researchers/scholars towards fiscal federalism. Hence it became difficult to obtain reliable fiscal data to conduct researches investigating fiscal decentralization issues. Second, the government stance had also been a barrier in the sense that issues related to inter-province disparities had

been discouraged in public discussion for several reasons need not to be dwelled here.

However, the basic assumption of this study of course is that, effective fiscal federalism policy cultivate holistic economic welfare, at least in terms of fiscal capacities, financial capabilities and basic services provision are main factors in interprovince disparities. Therefore, the type of literature being reviewed below is the one that deals with fiscal decentralization issues that focus on the recent reform of constitution towards federal financial accords.

2.4.1 Fiscal Federalism: A Brief Introduction

As it is common in social science disciplines, there is no one fixed definition for the term federalism, therefore, federalism is defined in many different ways. But at the heart of all definitions lies the division of power between the national (central) government and the different subnational units constitute the federation. These subnational units or constituents have different designations in different federal systems, they may be States, regions, provinces, republics or cantons. Whatever they are, they surrender certain proportion of their sovereignty to the federal on the basis of certain contracts (Salih, 1995; p.22) ¹⁵.

To avoid more theoretical abstraction only two widely recognized definitions would be considered here. Bearing in mind that the conceptual differences in the definitions refer to the different forms of federations adopted by the different countries. A classical definition of political nature of federalism has been formulated by one of the early political scientists, Wheare (1956) argues that: federalism means there should be division of powers between

¹⁵ Salih, Kamal Osman, "How Federalism Function in U.S.A", in, Salih, Hassan M. et al, (eds.), *Federalism in the Sudan*, Khartoum University Press, 1995; p.22.

the central and unit governments. Each of which in its own sphere is coordinated with the others; each government must act directly on the people; each must be limited to its own sphere of action; and each must within that sphere be independent of the others. This normative view of federalism is generally acceptable in the classical forms of federations (i.e. U.S.A, Canada, Switzerland and Australia) but at least two of these points are inapplicable to some of the newly formed federations. To overcome such problems encountered in this definition, Karl (1974, P; 255), re-defined federalism as a horizontal distribution of government functions among geographical units in such a way that each level of government enjoys a partial sovereignty within its territory.

Fiscal federalism is a subfield of public economics that studies which expenditure functions and revenue raising powers are best decentralized and to what degree. The foundation of fiscal federalism was laid by Samuelson's theory of public expenditure (1954) and Musgrave's theory of public finance (1959). Subsequently the literature gained further ground through the seminal contributions of Tiebout (1956), Oates (1972) and Brennan and Buchanan (1980). Currently, the literature is seeing a second wave of contributions generally referred to as the Second Generation Theory (sgt) of fiscal federalism (Qian & Eingast, 1997).

Interestingly, the word 'federalism' in fiscal federalism context does not refer to a specific form of government, neither does it imply that a government should be federal to apply the principles it offered. However, because of the difference in the political context, legislation, and fiscal principles resulting from different forms of government (e.g. whether it is unitary or federal), the application of fiscal federalism principles obviously provide different opportunities and results.¹⁶ Likewise, fiscal federalism is most often used in the earlier studies on the fiscal relation between multi-tier governments, most notably in the works of Musgrave (1959) and Oates (1972, 1993).

It is not to be confused with fiscal decentralization. Fiscal decentralization is highly related to fiscal federalism. Generally speaking, the concept introduced by fiscal federalism is put into practice by fiscal decentralization. Sharma (2005) clarified that fiscal federalism constitutes a set of guiding principles, a guiding concept that helps in designing financial relations between the national and subnational levels of the government. Fiscal

¹⁶ **Ibid**

decentralization, on the other hand, is a process of applying the principles of fiscal federalism. Boschmann (2008) referred to fiscal federalism as the structure of financial and broader relationships between central and subordinate levels of government. The process of altering the structure of fiscal federalism by devolving powers to lower levels of government is generally known as fiscal decentralization. However an essentially, fiscal federalism is a states of affairs, whereas fiscal decentralization is a specific process meant to alter that states of affairs.

2.4.2 Theories of fiscal federalism

The foundations for the initial theory of Fiscal Federalism were laid by Kenneth Arrow, Richard Musgrave, and Paul Sadweh Samuelson. Samuelson's two important papers (1954, 1955) on the theory of public goods, Arrows discourse (1970) on the roles of the public and private sectors and Musgrave's book (1959) on public finance provided the framework for what became accepted as the proper role of the Provenance in the economy. The theory was later to be known as "Decentralisation Theorem" (Ozo-Eson, 2005). This framework identifies three roles for the government sector. These are correcting various dimensions of market failure, maintaining macroeconomic stability, and redressing income inequality. The central government is responsible for the correction of market failure and maintenance of macroeconomic stability, while the subnational governments and the central government are jointly responsible for redressing income inequality (Ozon-Eson, 2005).

Each tier of government is seen as seeking to maximize the social welfare of the citizens within its jurisdiction. This multi-layered quest becomes very important where public goods exists, the consumption of which is not national in character, but localized. In such circumstances, local outputs targeted at local demands by respective local jurisdictions clearly provide higher social welfare than central provision. This principle, which Oates (1972) has formalized into the "Decentralization Theorem" constitutes the basic foundation for what may be referred to as the first generation theory of fiscal decentralization (Oates, 2006a; Bird, 2009). The theory focuses on situations where different levels of government provide efficient levels of outputs of public goods "for those goods whose special patterns of benefits are encompassed by the geographical scope of their jurisdictions" (Oates, 2006b). Such situation came to be known as "perfect mapping" or "fiscal equivalence" (Ma, 1995; Olson, 1996).

Nevertheless, it was also recognized that, given the multiplicity of local goods with varying geographical patterns of consumption, there was hardly any level of government that could produce a perfecting mapping for all public goods. Thus, it is recognized that there would be local public goods with inter-jurisdictional spill-over. For example, a road may confer public goods characteristics, the benefits of which are enjoyed beyond the local authority. The local authority may then under-provide for such a good. To avoid this, the theory then resort to traditional Pigouvian subsidies, requiring the central government to provide matching grants to the lower level government so that it can maximize holistic economic welfare. Based on the preceding, the role of government in maximizing social welfare through public goods provision is assigned to the lower tiers of government. The other two roles of income distribution and stabilization are regarded as suitable for the central government.

From the foregoing, the role assignment which flows from the basic theory of fiscal federalism is summarized as follows: The central government is expected to ensure equitable distribution of income, maintain macroeconomic stability, and provide public goods that are national in character. Decentralized levels of government on the other hand are expected to concentrate on the provision of local public good with the central government providing targeted grants in cases where there are jurisdictional spill-overs associated with local public goods.

Once the assignment of roles had been carried out, the next step in the theoretical framework is to determine the appropriate taxing framework. In addressing this tax assignment problem, attention is paid to the need to avoid distortions resulting from decentralized taxation of mobile tax bases. Gordon (1983) emphasizes that the extensive application of non-benefit taxes on mobile factors at decentralized levels of government could result in distortions in the location of economic activity.

Following from the assignment of functions, taxes that matched more effectively the assigned functions are also assigned to the relevant tier or level of government. For example, progressive income tax is suited to the functions of income redistribution and macro-economic stabilization and is therefore assigned to the central government. On the other hand, property taxes and user fees were deemed more appropriate for local governments. Benefits taxes are also prescribed for decentralized governments based on the conclusion that such taxes promote economic efficiency when dealing with mobile economic units, be they individual or firms (Olson, 1982).

The final element of this basic theory is the need for fiscal equalization. This is in the form of lump sum transfers from the central government to decentralized governments. The arguments for equalization are mainly two. The first which is on efficiency grounds sees equalization as a way of correcting for distorted migration patterns. The second is to provide assistance to poorer regions or jurisdictions. Equalization is important in a number of federations. For example, Canada has an elaborate equalization scheme built into her inter-governmental fiscal arrangements (Boadway and Hobson, 2009; Weingast, 1995).

It necessary to point out that recent literature emphasizes the importance of reliance on own revenues for financing local budgets. A number of authors (Weingast, 1997; Mckinnon, 1997) draw attention to the dangers of decentralized levels of government relying too heavily on intergovernmental transfers for financing their budgets. These are lessons that Nepal's fiscal system should draw from in order to ensure macroeconomic stability. Likewise, over the years, major theories of fiscal federalism have shifted from an economic efficiency-oriented focus to a broader focus involving social and political factors. The first generation theory (FGT) is largely normative and focused on maximizing social welfare. The second generation theory (SGT) is built on FGT, but assumes that political factors (e.g. the motivation of voters and public officials) can come into conflict with social welfare maximization.

2.4.2.1 First generation theory

Perhaps, the best way to describe First Generation Theory (FGT) is to consider the three branches of public finance introduced by Musgrave (1959): macroeconomic stabilization, income redistribution, and resource allocation. While the first and second objectives are considered more attainable under central control, decentralization has been argued to improve allocation. Indeed, the main drive behind FGT is the advantage subnational governments have over national government in catering to local preferences. In effect, fiscal delegation allows welfare gains from a more efficient allocation of public sector resources, barring cost advantages at the central level.

This principle is also present in the paper by Tiebout (1956) who expanded Samuelson's work (1954) on the nature of public goods by introducing local public goods. In Tiebout's model consumer-voters move to communities that best satisfy their preferences relating to the provision of such goods (i.e. Tiebout sorting). As such, local expenditure can rely on a preference revelation mechanism that is more effective than the political mechanism which

suffers from freeriding. Therefore the true demand for local public goods is met (and taxed) efficiently. The idea that decentralized provision of public services, reflecting local preferences and costs, maximizes welfare, is captured in Oates' Decentralization Theorem (DT):

For a public good—the consumption of which is defined over geographical subsets of the total population, and for which the costs of providing each level of the good are the same for the central or for the respective local government—it will always be more efficient (or at least as efficient) for local governments to provide Pareto-efficient levels of output for their respective jurisdictions than for the central government to provide any specified and uniform level of output across all jurisdictions (Oates 1972, p. 35).

In short, FGT presents a trade off of allocative efficiency (federalization) versus economies of scale and spill-over internalization (centralization). In recent phenomenon, this trend has actively been supported by supranational institutions like the World Bank and the OECD and has evidently contributed to the empirical literature, albeit with mixed results regarding the impact of fiscal decentralization.

2.4.2.2 Second Generation Theory

Second Generation Theory takes a different approach to fiscal decentralization and is more articulate about the conditions under which decentralization is (not) appropriate (see e.g. Prud'Homme (1995), Tanzi (1996)). As Weingast (2006), p.3 points out, second generation literature is varied and large, and there is no clear demarcation between the generations. Essentially, the initial trade-off in FGT still holds: “[...] *the key insight remains that heterogeneity and spillovers are correctly at the heart of the debate about the gains from [de-]centralization* (Besley and Coate, (2003), p. 2628).”

As a starting point, Oates (2005) distinguishes between two broad sources from which SGT draws. The *first* stream of influence springs from public choice theory and political economy. Indeed, SGT is often referred to as the political economy approach to fiscal federalism as it takes into account political institutions and their incentives. Unlike SGT but in the spirit of Brennan and Buchanan (1980), SGT drops the assumption of a benevolent, welfare maximizing government. Instead participants in political processes are thought to have their own objective functions, maximizing utility within the political and fiscal constraints. The *second* source of contributions comes from the literature on information problems.

Besides Oates (2005), Lockwood (2006), Weingast (2006) and Porcelli (2009) also review contributions to Second Generation Theory. Lockwood in particular considers two basic arguments in SGT, the preference matching argument and the electoral accountability argument. The first argument refers to the reasoning introduced by FGT that decentralization brings government closer to the people. In effect, decentralization improves allocative efficiency because public services are more aligned with local preferences. Despite the logic behind this claim, Lockwood argues that FGT cannot substantiate the preference matching argument without relying on the assumption of policy uniformity in a centralized system, which implies a uniform level of public goods across all regions. SGT on the other hand can.

This follows from FGT's explicit assignment of spending and taxing responsibilities to different levels of government, based on their appropriateness at these levels and the role they play in society. Furthermore, FGT noted the use of transfers to internalize spillovers and level the playing field among local governments (i.e. fiscal equalization), effectively filling the gap between own tax revenue and spending. sgt however places more emphasis on the incentives created by such a discrepancy - often referred to as the Vertical Fiscal Imbalance (VFI). More in particular, a Province of high VFI has been associated with irresponsible fiscal behavior.

2.5 Mechanisms of Federalism: Economic Theory

What effective federal mechanism hysteries for holistic (national) economic growth and development? Perhaps, the question is open. However, in academically, there are many arguments towards this issue. As summarized by Qian and Weingast (1997), the first argument was originally made by Friedrich Hayek (1945) who asserted that better spending decisions can be made on as local a level as possible due to the fact that the government located closer to the people possesses better information concerning the needs to those people than a more central (and distant) government would. As succinctly summarized by White (2011), the logic is that "if a government can perform closer to the people it is meant to serve, the people will get more out of government and, in turn, will be more willing to accept that government's authority." The second argument, advanced by Tiebout (1956) in favor of federalism, is that the resultant competition between subnational units allows citizens to better satisfy their preferences in such a system by appealing to that level which is better able to "do its job." Yet another, somewhat less accentuated alleged

benefit of federalism and decentralization lies in the greater stipulated innovation in such systems. According to this proposition, for the reason that local governments are in control of smaller pool of resources, they can be used as “laboratories” for policy experimentation since failures are more likely to be localized and hence smaller in terms of damage (Bretton 2000, as cited on Lizvanov, 2014).

2.6 Research Gap and Theory of Change

I have been interested to read some literature which may help my research in a systematic way. For the essence of this, I have tried to search for some legitimate sources, which help me to simplify in to establish effective correlation on my research agenda and context. But painfully, within the literature available in Nepalese context, I have found no similar research regarding to my topic.

Nonetheless, I hope, the existing literature provides a good insight about many variables that affect fiscal decentralisation. The literature, however, overlooks the link between fiscal federalism and promotion of welfare in all constituents of the federating units. That is to say it does not sufficiently cover the correlation between national holistic welfare and decentralisation of fiscal decision making. Thus, to bridge this theoretical gap I have develop a legislative bargaining model under fiscal federalism and assess its impact on welfare maximisation for the Nation.

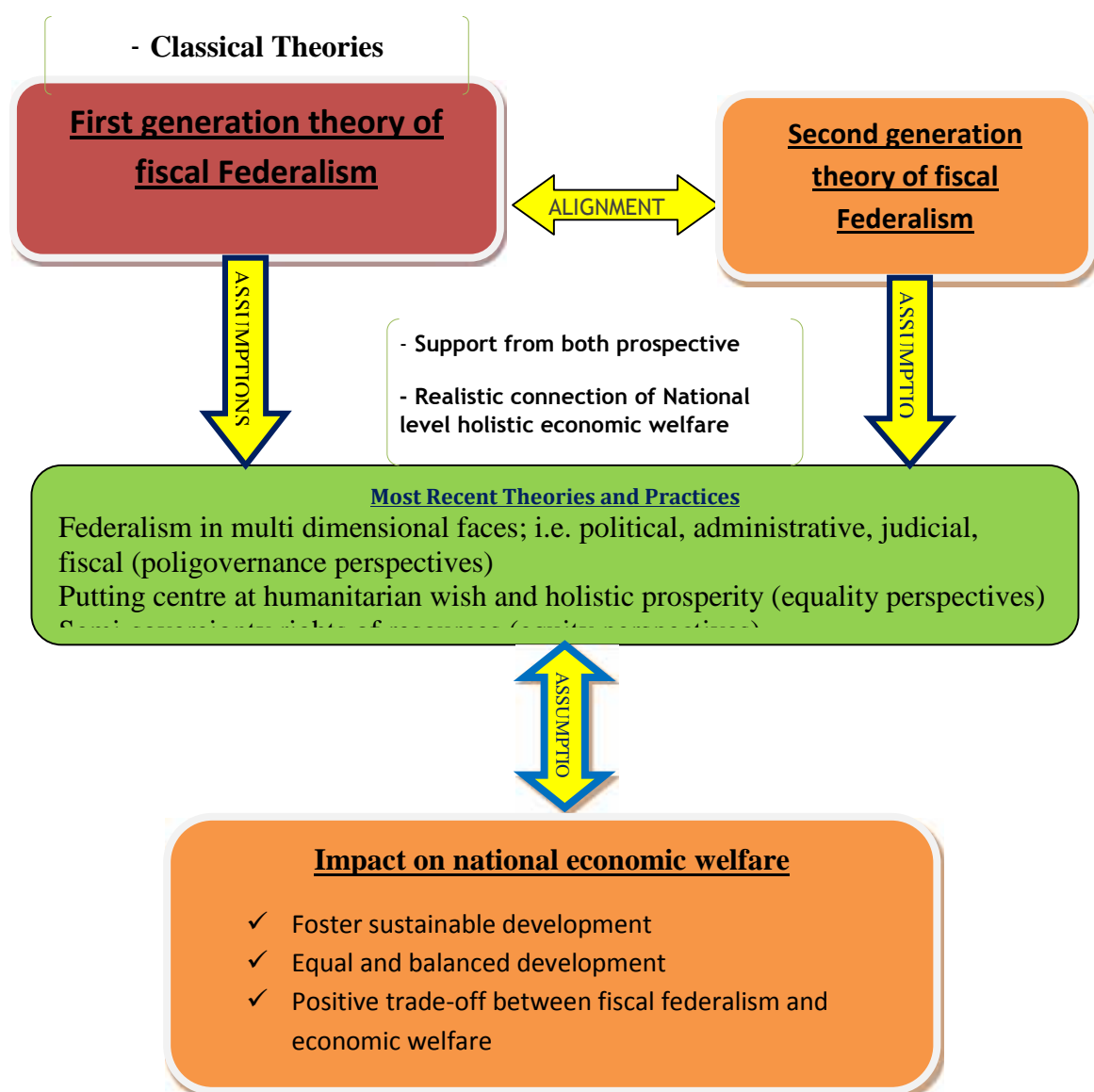
Meanwhile, reviewing the empirical literature of the impact of fiscal decentralisation in general and fiscal decentralisation on national economic welfare in particular raises couple of issues. Firstly, empirical studies offer contradictory results. Literature surveyed in this chapter shows that some studies present mixed relationship between fiscal decentralisation and economic welfare while other studies reveal a negative relationship. Therefore, it is plausible to believe that the current literature is inconclusive regarding the impact of fiscal decentralisation and its impact on economic welfare.

Furthermore, majority of the studies are sector or programme-specific and failed to assess the overall impact of decentralisation countrywide. Another potential limitation with existing empirical literature is of its emphasis on cross-country analysis that confronts with problems of coping with the external shocks, different institutions, political regimes, different socio-economic settings and other exogenous factors. These and many other concerned limitations within the empirical literature warrant a compressive empirical study

to evaluate the direct and indirect – through pro-poor social and economic services – impact of fiscal decentralisation on poverty.

Similarly, I found that there is emerging worldview related to change of theories. A theory of change should ideally show the steps of an intervention, its precise goals, the causal mechanisms by which change should occur, and the assumptions underlying each stage. Thus, the recent theory of changes among nature of fiscal federalism (theory and practice) and research gap is conceptualized in following figure (Figure 2.2).

Figure 2.6.2 Theory of Change



2.7 Chapter Summary

This chapter covered the in-depth literature that I found to better prepare myself for the research. The areas explored included different existing beliefs, ideas, culture, philosophy, theories and practices concerning to the coherence schema that towards my research inquiry. Thus, in this chapter, I reviewed different literatures related to my research issues. I went through different literatures regarding multi-paradigmatic research platform by investigating different horizon of fiscal federalism theories which may implement in Nepal as well. Federalism is a relatively universal concept and the conditions for its sustenance are often presumed to be same elsewhere. Thus this work, though primarily about the federalization in Nepal, would adopt global approach to the issues discussed in order to gain the theoretical concepts. The literatures cited in this thesis are predicated on the themes of federalism, their principles, the rationale for decentralization and the risk and disadvantages of federalism. The purpose of this review is to give an understanding of the previous studies and place the present study in the larger context

CHAPTER THREE

METHODOLOGICAL QUEST: AN EMPIRICAL ANALYSIS

“You have to trust yourself, not research. Not testing. Testing helps, but you have to trust your own taste. If your taste says something isn't any good, don't let research rationalize that out of its own truth.”

-Brian Grazer

3.1 Chapter overview

This chapter deals mainly with the issues like how and why the research work is conducted. Therefore, I have given brief explanation of those necessary areas such as paradigmatic consideration, research methods and methodology, theoretical references, philosophical considerations, ethical issues and quality standards that guide and address my research question in coherence structure. Drawing on multiple research landscapes, I designed an empirical and phenomenological inquiry as to bring an integral perspective to steer and control the research rigor. Based on this regards, I designed a mixed method as to bring a fundamental outlook to my research.

3.2 Cleansing Methodological Quest: Knowing about Qualitative v/s Quantitative

In my view, research methodology is the heart of every successful research because it gives awareness for the researcher and readers. In this research, I have followed a mixed method. By situating myself as a centre of data generator, I have tried to uncover the academic nature of fiscal federalism and their convenient reflexivity of phenomenon, context and Nepalese atmosphere which is simultaneously occurred in the present political economics milieu. So, I guess the research is best suited by following both qualitative and quantitative methodology.

At its core, qualitative research helps to investigate and answer questions about the practices, beliefs, culture, expectation and whole setting within particular periphery via multiple perspectives. So, I have selected qualitative research because I believe that the central motif beyond federalizing process in Nepal is ‘improving human condition’ and qualitative inquiry helps to unpack the complexities of the human condition within the

socioeconomic platform. Moreover, qualitative studies allow me to examine effectiveness of fiscal federalism ideology within diverse culture in an authentic, multiethnic natural setting, where conclusions are drawn being based on human reflexivity; beliefs of trusting multiple realities and possibilities. It has also helped me to provide the geo-political hegemony and truth towards fiscal federalism, i.e. hierarchism, social stratification, inclusion, sexism, equity, equality and social justices, and how they have put impacts on succession on fiscal federalism practice in Nepalese context.

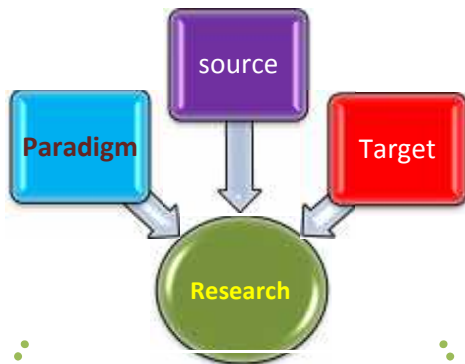
Similarly, by utilizing quantitative research, I can pursue new angles towards fiscal federalism practices by the help of global experiences. Thus, the core strength of quantitative paradigm on this inquiry is its ability to provide complex description of how I have been able to address my research agenda in coherence, justifiable and statistical manner.

Overall, by purchasing mixed research, my grasped beliefs and experiences (in/directly those experiences are grounded from present geo-political context of Nepal) are at the central acumen of this inquiry. More likely, my (as a citizen, economics learners and its fellow researcher-educator) voices, feelings, awareness, tenets, dogma and ideology, illusions, expectation, beliefs, emotions, values and reflections towards present practices of fiscal federalism in Nepal are the core decisive outfits in meaning-making process. Overall, in this research, my approach of inquiry is based on the landscape of qualitative v/s quantitative procedure, ranging from postmodern thinking (Denzin & Lincoln, 2000), to ideological perspectives (Lather, 1991), to philosophical stances (Schwandt, 2000) to context-sensitive procedural guidelines (Joshi, 2014).

3.3 Mixed introspection in my research: forming as an ‘*context-sensitive researcher*’

The synonymic representation of life is learning. Of course, we learn from our past, our present for the purpose of better future. Sometime we learn from pain...from pleasure...from love...from hate...but we all try to escape our life for the sake of upcoming betterment (Joshi, 2013). The same thing I experience when I sit to conduct this dissertation. Remembering the very beginning moment of my research journey, numerous times I just spend my days to vague trouble and confusion. Some intangible forces are hunting me to rise a dozen of questions like Luitel (2009) and Joshi (2013) conveyed, ‘Which method are you going to carry out to conduct the research?’ ‘Are you confident

that the methodology you have selected is suitable for your research question or agenda?’



.....
Source: Author's construction

‘Are you sure that your idea or perspective is meaningful for others?’ Because, it is truly enormous issue to think about whether my ideas are beneficial and meaningful for others or not, and if my ideas are not suitable in upcoming context then what will be the worthiness of my research?

.....
 Similarly, how my personal experiences are relevance for other readers? How my beliefs effect on others’ beliefs? How my way of thinking is representing the others’ thinking? What are the significance proofs of my way of narrating in the field of Nepalese economy? How to represent data from my lived experiences? How to present them in a coherent structure? How can other people trust on assemble hi/stories? Which data, hi/story or experiences are important to put in the research? How can I fit those chronicles in the research?

Dozens of question arise on my mind when I prepared to conduct this research. However, I believe, research is an ongoing process of investigation and an examination of a subject from different level of inception. More exactly, it is a hunt for the truth. It is getting to know a subject by reading up on it, reflecting, playing with the ideas, choosing the areas that have interest and following up on them. A research design is a plan of action. It is a plan for collecting and analysing data in an economic, efficient and relevant manner. Same connection, Philips (2013) put it is a ‘research is self empowerment’.

Motivating by empirical scenery of conducting research, it helps me to reflect on my experiences as an economics learner and consider how these have influenced my ontological, epistemological and methodological positions underlying this study. For making it more chromatic structure in previous chapter, I discuss the research literature highlighting the disparity between current hegemony, beliefs towards nature of fiscal federalism and contemporary practice, and explain my adoption of a participatory action research methodology.

Moreover, I came to realize empirical study is research through social inquiry. I felt it is the exact way what I need. Then I feel investigating self expectations may be the best technique for investigating others. Because, we all are the part of same society and once

falling is also impact for others live hood. I know most Nepalese people are feeling and express same hegemony of fiscal federalism practices towards holistic economic welfare dilemma at least present context.

3.4 Building Muscular Method of Inquiry: Capturing Some Ideas from Grounded Theory

In order to help explain the development of my own methodological positioning, I capered some ideas from grounded theory. Of course, my ontological and epistemological positions lead me towards adopting a ‘grounded theory research’ methodology, which resonates with my aim of working contextually with development, as active participants ‘in’ research, in order to bring about desirable social change. After reading some literature related grounded theory, I found that it is action based research which is based on a collaborative approach between academics think tank and researcher, generates research data which is “crucial to developing an understanding of theory-in-practice”, more exactly, providing an alternative notion of evidence-based practice. Similarly, I also came to realize grounded theory research has as its purpose the building of theories, theoretical models, and concepts through a researcher’s inductive process during the research process. Likewise, a model of grounded theory research which is phenomenological, emancipatory, critical, participative, collaborative, and recursive in nature. As well as producing knowledge through its findings, grounded theory research promotes World Bank’s concept of “*Effective fiscal decentralization itself of ends of national development*” slogan thereby building more profound understanding of concept of federalizing national structure.

3.5 Theoretical Framework: Plug of Equilibrium

The theoretical framework that this research work is based on is the theory of fiscal federalism by (Musgrave, 1959). This theory is also known as the “Trilogy”. According to this theory, the roles of the Provence in the economy include; efficient allocation of resources, equitable distribution of income and wealth, and stabilization (maintaining full employment levels of employment and output at stable prices). The theoretical framework in question was basically a Keynesian one which canvassed for an activist role of the states in economic affairs.

The theory posits that role of allocation of resources is best performed by the sub-national governments, while later two roles (stabilization and re-distribution) are best perform by

the central government. According to the theory, when this is obtained in an economy, it will expand the capacity of sub-national governments'. Increase economic activities at sub-national level and results to monetary expansion. The implication of this is that the resulting monetary expansion would have effects on indicators of macroeconomic performance; inflation rate, interest rate, exchange rate, and economic growth. The effects of the monetary expansion on these macroeconomic variables could be positive or negative. This study assumes that the monetary expansion would lead to increased inflation and interest rate, depreciation of the exchange rate, while the higher output of both the public and private enterprises cause an increase in aggregate real income (that is economic growth).

3.6 Conceptual Framework of Fiscal Federalization and Economic Growth

The theory of fiscal federalization suggests many reasons to expect better public service delivery at the local level. It tends to improve the efficiency of resource allocation which is related with both allocative and productive efficiency (Oates 1999).

The relationship between fiscal federalization and economic growth has been analyzed by a number of economists during the last three decades. Linking economic growth and fiscal decentralization together according to Eller and Breuss (2004) has mainly three reasons: firstly, growth is seen as an objective of fiscal federalization and efficiency in the allocation of resources in the public sector; secondly, it is an explicit intention of governments to adopt policies that lead to a sustained increase in per capita income and, thirdly, per capita growth is easier to measure and to interpret than other economic performance indicators. While theoretical examinations started with the pioneer publications of Tiebout (1956), Musgrave (1959) and Oates (1972), empirical analysis regarding the role of economic growth on fiscal decentralization started at the end of the 1970s and estimations concerning the direct impact of fiscal decentralization on economic growth have only been conducted since the end of the 1990s.

Both theoretical and empirical analyses tend to be inconclusive and come up with ambiguous and differing results. Woller and Phillips (1998) have analyzed the impact of fiscal decentralization to the LDC economic growth. According to them, development is widely debated in the development literature. Accordingly in their study, they have presented an empirical examination of the relationship between the level of fiscal

decentralization and economic growth rates across a sample of twenty-three LDCs from 1974 to 1991. They failed to find any strong relationship between the fiscal decentralization and economic growth.

Martinez-Vazquez and McNab (2003) have questioned the impact of fiscal decentralization to the economic growth and they doubted for being the little research on the causation line from decentralization to growth, interestingly, there has been extensive empirical analysis of the reverse question: to what extent is the level of decentralization a function of the level of economic development? It is well documented that most measures of fiscal decentralization across countries, such as share of expenditures or revenues of sub-national governments in the general government budget, are positively correlated with the level of economic development, generally measured by per capita income.

Using data from Chinese provinces, Zhang and Zou (1998) found a negative relationship between the ratio of provincial government spending to central government spending and provincial economic growth. That finding contradicts the often-asserted hypothesis that greater fiscal decentralization is associated with higher economic growth. However, Akai and Sakata (2002) found a positive relationship between fiscal decentralization within US provinces and province economic growth.

The empirical literatures as highlighted indicate that impact of fiscal decentralization on economic growth and development is widely debated in development literature. The basic economic argument for fiscal decentralization is that it differentiates the provision of local outputs according to local tastes and circumstances, thereby increasing the effectiveness and efficiency of economic development planning and implementation, particularly that which relates to economic growth and development.

3.6.1 Empirical Methodology: Identifying and Classifying Fiscal Consolidation Attempts

As outlined in the introductory chapter, a primary task of this thesis is to examine the distinct roles of both central and sub-central governments during national fiscal consolidation attempts and to discuss those factors which make certain consolidation attempts more likely to be successful than others. In the final chapter we assess the implications of alternative levels and forms of decentralisation on the consolidation

process and empirically test whether decentralisation itself ultimately impacts on the probability of success. To undertake these objectives it is necessary at the outset to outline the methodologies we adopt both to identify consolidation attempts and to measure their success. In this chapter I take time to outline and discuss the techniques applied. In doing so, we also outline some possible alternative approaches and discuss the robustness of our analysis.

We refer to fiscal arrangement as a large and discretionary attempt by a country/government to improve their fiscal consolidation.¹⁷ Both elements (large *and* discretionary) are necessary needs of a fiscal arrangement. We are therefore, interested in examining episodes where there were significant reductions in the fiscal deficit or increases in the fiscal surplus as a direct result of intentional policy shifts. For the purpose of the current investigation is mainly based on following econometrics models;

3.6.1 The Production Function Approach (Roy, 2005)

The Production Function (PF) approach, by explicitly modelling potential output, has a firmer base in economic theory. Use of the PF methodology has become increasingly popular in recent years in the light of advancements in data collection. For example, the European Commission has recently replaced the use of the HP filter and adopted their own PF approach.

To calculate potential output under the production function approach the starting point involves specifying an appropriate functional form for the economy's production function. The usual assumption is of a Cobb-Douglas production function with two productive factors (labour and capital) and constant returns to scale-

$$\ln Y = \ln A + a \ln N + (1-a) \ln K + \ln E \dots \dots \dots (2.3)$$

Or,

$$y = a + an + (1-a)k + e \dots \dots \dots (2.4)$$

where Y is output, N is labour, K is capital, E is total factor productivity and *a* is the intensity of labour vis-a.-vis capital. In order to implement the PF approach it is necessary to have accurate measures (or estimates) of all factors of production. Clearly, while data on K and N are readily available obtaining a measure of total factor productivity (E) is more difficult.

¹⁷ In the literature, fiscal consolidations are also referred to as positive fiscal adjustments or fiscal reforms.

However, for a given value of α , the total factor productivity series, E , can be calculated as the residual from an estimation of equation 2.4. By applying a detrending technique such as the HP or Kalman filter to this residual it is then possible to obtain a measure of trend total factor productivity (e^*). Subsequently, by putting this generated series into the production function, along with the stock of capital (which is assumed to be fully utilised - for why this assumption is made) and potential employment (NAIRU), it is possible to obtain a measure of potential output (y^p).

Having calculated potential output, it is then possible to obtain a measure of the output gap and hence estimate the structural fiscal stance.

The main advantage of this methodology is the presence of a sound theoretical foundation and the explicit calculation of potential rather than trend GDP. However, its principle limitation is the depth and spread of data required. To make estimates of potential output, a set of assumptions (e.g. the exact form of the production function to be estimated) and auxiliary estimates are required (e.g. an estimate of total factor productivity, an estimate of the NAIRU and an estimate of the stock of capital). The drawback of this procedure is that the estimates involve several sources of uncertainty and potential estimation and measurement errors, which hamper the reliability of the potential output and output gap estimates. Such issues are likely to be of added concern when one is applying the technique across a number of different countries.

Further, as in the HP approach, the reliability of the estimates of potential output and hence also cyclically adjusted budget balances, are particularly troublesome during periods of a major structural change in the economy. In particular, the assumption that unemployment fluctuates around some stable, or slowly changing, value for NAIRU, or that the production function itself remains stable over time, may be inappropriate. Despite the apparent difficulties, information on structural breaks (e.g. changes in productivity, technology, production structure, capital stock, labour markets) can be more flexibly incorporated in the production function framework than is the case with the HP trend estimation method.

3.6.2 A legislative Bargaining Model of Fiscal Federalism

In this section I have tried to construct a legislative bargaining model and examine comparative efficiency of upper tier and lower tier systems of government for the supply

of public goods under a game theory frame work. The model specifically looks at the role of federal transfers in poverty reduction under fiscal federalism. We postulate that in fiscal federalism environment where the legislative assemblies (either federal/central or provincial/Provence) are represented by members, representing their respective subnational jurisdictions (provincial or local). The model shows that in bargaining game framework a legislative body would involve in such a game where the end result is the efficient allocation of public resources among the federal decision making at the bargaining equilibrium, the ratio of local/subnational expenditure to total expenditure is increasing in the federal transfer ratio. The model predicts that federal transfers help in reducing poverty. Since the federal transfers increase the fiscal decentralisation hence the model demonstrates that fiscal decentralisation and poverty are negatively correlated.

To make the argument as clear as possible, we assume that the conventional argument (for example: Cremer and Palfrey, 1996; Alesina and Spolare, 1997; Bolton and Roland, 1997; Ellingsen, 1998; Lockwood, 2002; Oberholzer-Gee and Strumpf, 2002; Besley and Coate, 2003), fiscal federalism of spill over across the provinces/districts does not work. Moreover, the voter difference in electing the representatives from the districts or provinces for provincial and federal legislative assemblies is homogeneous; i.e. there are no voter preferences across the provinces or districts. Thus, the outcome between national and subnational government is entirely due to the bargaining game that would take place in legislative assembly.

This issue is important for several reasons. Most importantly, there is a common believe that fiscal and political federalism is a key reform for the better social service delivery, because it not increases the accountability of local representatives to their voters, but equally the local politicians due to their proximity to locality can better identify and locate the economic projects that can suffice to the public needs and interest (Bahl and Martinez-Vasquez, 2006; Hindrisk and Lockwood, 2009).

Moreover, the model aims to fill a gap in the theoretical literature that we believe is quite sizeable. We understand that there is no existing work that assess the economic outcome and enhances the public spending, particularly on those sectors which potentially have a sizeable affect on the poor, in a political economy setting. So the key objective of this model is to contribute to the existing theoretical literature of fiscal and political federalism by achieving this overarching goal. Our model is a static model with one period, tow

provinces of a federation and each province contains two districts. The districts are asymmetric; that is they not equal in size and population.

3.6.3 Fiscal Federalism and Economic Growth Model

The two-sector production function framework by Barro (1990) was adopted as the theoretical framework for the study. Barro's framework provides a set of models for investigating the relationship between fiscal federalism and macroeconomic performance indicators such as growth of aggregate output, inflation rate, interest rate, and exchange rate. The model assumes that macroeconomic performance is influenced by policy variables other than the technical relationship between capital and labour (Barro, 1990; Aigbokhan, 1999). The flexibility introduced by policy variables has made the model popular in the analysis of macroeconomic performance of nations especially developing countries (Aigbokhan, 1999).

The model developed in this study is an extension of the models adopted by Aigbokhan, (1996) and (1999). The model assumes that the economy consists of two broad sectors, public

(G) and private (P) whose output depends on labour (L) and capital (K). In addition, the output of G exercises some externality effect on output in P. The production function of the economy is thus:

$$Y = f(L, KP, KG) \dots\dots\dots(3.1)$$

Where, the subscripts denote sectoral inputs:

KP = Private capital per labor

KG = Public capital per labor

The production functions of the respective sectors are thus:

$$YP = P(LP, KP, G) \dots\dots\dots(3.2)$$

$$YG = G(LG, KG)$$

Total inputs are given as:

$$LT = LP + LG \dots\dots\dots(3.4)$$

$$KT = KP + KG \dots\dots\dots(3.5)$$

Total output Y is given as the sum of sectoral output or a function of sectoral inputs:

$$Y = YP + YG \dots\dots\dots(3.6)$$

The model further assumes that the public sector comprises of three subsectors and, by extension, that public spending is carried out by three levels of government: federal (f), Province (s), and local (m). Thus:

$$Y = a_0 + LT + KT + GT + \mu \dots\dots\dots(3.7)$$

The study assumes that the size of government tends to influence growth rate Aigbokhan (1996) and that fiscal decentralization tends to reduce the size of government (Ehdaie, 1994; Aigbokhan, 1999). Drawing on the foregoing evidence, the study postulates that fiscal decentralization has an impact on economic growth. Theoretically, fiscal decentralization is expected to foster growth through allocative efficiency and efficiency of service delivery.

However, there is no consensus in the empirical literature on the direction of impact. A strand of the empirical literature reveals that increased decentralization tends to impact negatively on growth (Zhang and Zou, 1996; Davoodi and Zou, 1997; Aigbokhan, 1999). Another strand of the empirical literature reveals that decentralization has a positive impact on economic growth (Chete, 1998; Feltenstein and Iwata, 2005). Thus, the impact of fiscal decentralization on growth is an empirical issue.

3.6.4 Conceptual Framework of Fiscal Federalization and Economic Growth

The theory of fiscal federalization suggests many reasons to expect better public service delivery at the local level. It tends to improve the efficiency of resource allocation which is related with both allocative and productive efficiency (Oates 1999).

The relationship between fiscal federalization and economic growth has been analyzed by a number of economists during the last three decades. Linking economic growth and fiscal decentralization together according to Eller and Breuss (2004) has mainly three reasons: firstly, growth is seen as an objective of fiscal federalization and efficiency in the allocation of resources in the public sector; secondly, it is an explicit intention of governments to adopt policies that lead to a sustained increase in per capita income and, thirdly, per capita growth is easier to measure and to interpret than other economic performance indicators. While theoretical examinations started with the pioneer publications of Tiebout (1956), Musgrave (1959) and Oates (1972), empirical analysis regarding the role of economic growth on fiscal decentralization started at the end of the 1970s and estimations concerning the direct impact of fiscal decentralization on economic growth have only been conducted since the end of the 1990s.

Likewise, Martinez-Vazquez and McNab (2003) have questioned the impact of fiscal decentralization to the economic growth and they doubted for being the little research on the causation line from decentralization to growth, interestingly, there has been extensive empirical analysis of the reverse question: to what extent is the level of decentralization a function of the level of economic development? It is well documented that most measures of fiscal decentralization across countries, such as share of expenditures or revenues of sub-national governments in the general government budget, are positively correlated with the level of economic development, generally measured by per capita income.

Using data from Chinese provinces, Zhang and Zou (1998) found a negative relationship between the ratio of provincial government spending to central government spending and provincial economic growth. That finding contradicts the often-asserted hypothesis that greater fiscal decentralization is associated with higher economic growth. However, Akai and Sakata (2002) found a positive relationship between fiscal decentralization within US provinces and province economic growth.

The empirical literatures as highlighted indicate that impact of fiscal decentralization on economic growth and development is widely debated in development literature. The basic economic argument for fiscal decentralization is that it differentiates the provision of local outputs according to local tastes and circumstances, thereby increasing the effectiveness and efficiency of economic development planning and implementation, particularly that which relates to economic growth and development.

3.7 Laminations of Methods

As we are starting phase towards implementation of federalism and there is not any concrete mechanism which leads to effective federalism method had been establish at least in present context. Thus, this inquiry is also inadequate to implementation of above mentioned model. However, the general expectation of this inquiry is in/directly asserted on those models and tried to apply aforesaid moulds. And the beyond motif of this inquiry is the focus of this study is on the process of culturally relevant nature of federalism with support from an political authority which shore up by social welfare accounts of the applicable mechanism and emerging practice among Nepalese fiscal setting. Although, various quantitative rigors, econometrics models and their correlation on Nepalese economic development is not explored and identified in this research. Likewise, as

common limitation of qualitative inquiry, this inquiry is also beyond micro-economic analysis and strata thereby absolute controlled statistical approaches. However, as rationality of research methodology I strictly aware that the worthiness of Carl Hiaasen's message as he mentioned; "You can do the best research and be making the strongest intellectual argument, but if readers don't get past the third paragraph you've wasted your energy and valuable ink.

3.7 Empirical Data Sources

The scope of the study is undoubtedly vast. However, the present study is confined to the functional efficiency of the Constitutional provisions relating to fiscal federalism and to highlight the important issue prevailing in that field. More concretely, this study is an analytical study based on the application of macroeconomic theory of the public sector. The study is based on secondary data. Data published from various government and non-government organizations are used to analyze the situation. The crucial areas of Nepalese fiscal federalism are analysed with the help of the global experiences, reports of various commissions and committees, economic surveys, budget speeches and plan documents published by the Ministry of Finance, National Planning Commission and various reports published by the Local Body, scholar's creed, Parliamentary declarations, and in the Nepal's legislatures are the major sources of statistical information.

Likewise, researcher also depended on the Reports of Various Finance Commissions, Nepal Rastra Bank Bulletins, various official website, and the assorted Reports of the IMF, UNDP, World Bank related to fiscal federalism and public economics of Nepal are noteworthy on this inquiry. Similarly, the sources of data were Ministry of Finance, Ministry of Local Development, Local Body Fiscal Commission, National Planning Commission (NPC), Central Bureau of Statistics (CBS), Financial Comptroller General Office (FCGO), Office of Auditor General (OAG), UDLE/GTZ, Asian Development Bank, Central Library of TU Kirtipur, secretariat of Association of District Development Committees of Nepal (ADDCN), and various web pages including www.google.com, libraries as per need.

Moreover, much of the primary data used are political papers related to the federal structure or the peace process – such as the Comprehensive Peace Agreement, the Interim Constitution and Concept Papers, which are working papers from Constituent Assembly

committees. Some of these documents have been translated from Nepali into English, which can have the effect that important points have been lost in the translation. All of these are, nonetheless, official documents and as such official translations. These government papers, even though they might not give us a comprehensive picture of how the situation and development towards a democracy is in Nepal, will at the very least give us a hint of what the different political parties have agreed to do and where they can find common ground, which will guide us towards the disagreements in the debate. The Concept Papers give a thorough description of the suggestions from the Province Restructuring Committee that will help us to understand the suggested federal structure and the possible outcome in relation to stability. Furthermore, the debate the suggestions have spurred between the political parties paints a good picture of the political parties' different ideologies, their disagreements and lack of compromise. The Concept Papers will be used in collaboration with academic articles to cover the debate on federalism. The academic articles give us a nuanced picture of the debate on federalism and theoretical arguments regarding the pros and cons of different federal models.

3.8 Data Processing Procedure

The collected data through secondary sources were tabulated in different ways according to the requirement of the study. Then the data of various years are compared on the basis of average, ratios and trend analysis.

3.9 Data Presentation and Analysis

In the process of data analysis and data plot, data are presented with the help of tables, bar diagrams, pie chart, figures and other diagrams and analyzed in descriptive manner according to the requirement of the study. The description is given the table so that it will be easy to understand.

3.10 Quality Standards: Addressing issue of Research Validity and Reliability

In the field of mixed research; quality standard is very important tool to measuring its worthiness. Perhaps, in empirical study; without quality there is no meaning of research. Thus, all research is based on some underlying assumptions about what constitutes 'valid' research. The paradigm using in research is identify the quality of research. If we do not use any paradigm in research then it has no value and nobody believe in the research. So, I

foretell that both my pedagogical and methodological positions will be criticised by some for being 'ideological' (Wright, 2015). As I already acknowledge that contemporary thought has indeed shaped research ideology which is grounded from recent reforms in Nepalese federalization system. However, I would contend that, by denying the futures results of federalization in Nepal, this research just govern from present assumptions.

Motivating such ideology, my affirmation that the current hegemony or scenery of federalized practice should not be taken for granted, is seen as a normative or unmoveable assumption. Similarly, I would argue, from a critical perspective, that the value of my research is that it seeks to develop theories which challenge un/revealing practice of federalism, rather than merely describing or accounting for its 'universal' existence (Wright, 2012). Therefore, I give careful deliberation to questions of 'Validity' and 'Reliability' in my research, recognising that such notions may be interpreted and applied very differently from alternative perspectives. Many researchers advocating action research question the 'Validity' of more orthodox research methodologies on the basis that they alienate human subjects and are exploitative, i.e. they preserve the powerful position of dominant cultures "through monopolizing the development and use of knowledge to the disadvantage of the communities in which the research takes place" (Reason, 1994, p. 328). They accept the partiality of action research which "rejects the notion of an objective, value-free approach to knowledge generation in favor of an explicitly political, socially engaged, and democratic practice" (Brydon-Miller, et al., 2003, p. 13 as cited on Ibid, 2015).

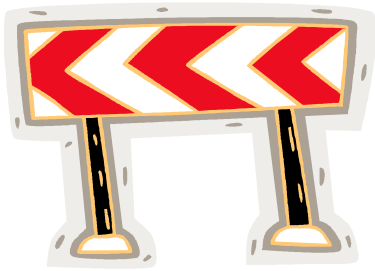
Lincoln and Guba (2003) propose alternatives to the notion of 'validity', commonly used by positivist researchers. They argue that the concepts of 'authenticity' and 'trustworthiness' are more appropriate for ensuring the rigour of both the application of method, and the interpretation of findings, within qualitative research. By helping Wright, (2015) idea about ensuring trustworthiness in research, I draw upon these alternative concepts, in developing my own framework for ensuring trustworthiness in my research, which is detailed on following table 3.10;

Table 3.10: Application Framework for Ensuring Research Trustworthiness

Criteria for ensuring Validity and Reliability:	Aspects of the Research Design:
Credibility of the Research processes	<ul style="list-style-type: none"> J Constructing multi-paradigmatic research space J Processes are derived from comparable research schemes, i.e. articulated, context based research, and methods drawn from grounded theory.
Researcher's credibility	<ul style="list-style-type: none"> J Data analysis and generation process is based on critical reflexivity J 'Reflexivity' through maintaining a reflective journal and 'code log'. J Dialectical Logic for representation of antonyms voices
Credibility of the relationships between researcher and Research rigor	<ul style="list-style-type: none"> J 'Prolonged engagement' through selecting a data from various sectors. J Transparency and openness regarding the aims and processes of the research. J 'critical-reflection' approach to data generating.
Credibility of the data generation	<p>'Triangulation' through data from similar research context, interviews, short reports, student surveys and research journal field notes (both mine and scholars).</p> <ul style="list-style-type: none"> • 'Iterative questioning' through following aspects; <ul style="list-style-type: none"> ➤ Critical project <i>Finger pointing (to others)– critiquing others (social system, myths, attitude, beliefs, practice, tradition)</i> <i>Finger pointing: critical self reflection</i> ➤ Phenomenology: <i>Investigation of phenomenon of society and context</i> ➤ Multiple Genre: <i>Representation of different subjective layers through textual construction (Graph, figures, footnotes)</i> ➤ Envisioning : <i>Going beyond critiques and finger pointing</i> ➤ To interpret the pedagogical culture and context, to reflect the situation critically, develop the vision of transformative learning for personal, professional and culture integration.
Credibility of the Data plotting and generation	<ul style="list-style-type: none"> J 'Plugging in' the data to theories J Data generation rather than data collection J Pictures from Nepal to global experience J Considering alternative interpretations of data analysis from different perspectives.
Conformability	<ul style="list-style-type: none"> • 'Triangulation' and 'reflexivity'.

3.11 Ethical Consideration

By consuming secondary data as a main data sources, I have soberly respecting the privacy of secondary data inhabitants. And, I have also respect their tenant dignity, privacy, ethics and quality of work during the process of this inquiry. Because of the empirical nature of the research, it was clear that my role as a researcher would need to commit a significant



amount of my ethical consideration and boundary to the inquiry. Such ethical obligations grasp several risks and moral issues, associated with intellectual property right issue, which were considered when planning and conducting the research intend. Firstly, the constructive and grounded nature of the research necessarily means that the process is unpredictable, messy and difficult to manage (Smith, et al., 2010). Secondly, there is a possibility that some school of thought might reject my own analysis of the situation, or that raised levels of consciousness amongst scenarios that emerged. Rather those two prophesy, I have tried to balance on my inquiry.

3.12 Chapter summary

This chapter is a description of the methodology that was used in carrying out the research. It controls my overall research process and situates me in the culture of context-sensitive genre of empirical research. It describes the rigor of my research and its nature. It provides detailed descriptions of the research design, procedure, quality standards, philosophical and ethical considerations. Drawing mixed methodology, I have designed a critical phenomenological and grounded theory to bring an integral perspective to my research. Critical phenomenological (*context based*) study has helped me to represent contemporary hegemony, issues and practices towards fiscal federalism amendments in Nepal. Likewise, grounded theory helps me to shape my resource rigors with in logical framework.

CHAPTER FOUR

“WHERE WE STAND ACTUALLY?” FACES BEHIND FISCAL FEDERALISM IN NEPAL

“Sometimes miracles are necessary, natural phenomena, or great disasters in order to shake, to awaken, and to open the eyes of misled nations about their interests, [nations] oppressed by others that simulate friendship, and reciprocal interest. Nepal needed the earthquake to open her eyes and to little by little escape from slavery and total ruin¹⁸”

4.1 Chapter overview

Nepal is a land-locked country of South Asia situated between two giant and globally emerging countries of the world - India and China. It is placed on the north by Tibetan region of China and on the west, south and east by the states of Uttar Pradesh, Bihar and West Bengal of India respectively. According to the latest census of 2011, Nepal's total population was 26.9 million with annual average growth rate of 1.5 percent during the last decade 2001-2011. It lies along the southern slopes of the Central Himalayas between latitude 26 22' N and longitude 80 4' E to 88 12' F and the average breadth of the country is about 160 km mainly along the southern slopes of the Himalayas. The country has an area of 147, 181 km and extends about 885 km east to west in shape of an elongated rectangle. The constitution of Nepal, 2015 has provisioned Nepal to be a federal state. The consensus about the model of federal structure has yet to be decided and implemented.

The country's basic economic structure over the years has remained more or less the same with agriculture and remittance as the main source of livelihood. Although the share of agricultural occupation in total labour force has declined from 94 percent in 1975 to 64 percent in 2015, this occupation continues to dominate as a major occupation of the total labour force. The proportion of employed population engaged in primary sector (agriculture, forestry and fishing) has declined from 94 percent in 1971 to 64 percent in 2015. Moreover, this sector is dominated by traditional method of production and largely depends upon the monsoon. Due to the topography, only 18 percent of the total land area is under cultivation. Growth in gross domestic product (GDP) fell to 3.0% in FY2015 (ended 15 July 2015) from 5.1% a year earlier after earthquakes in April and May 2015 caused

¹⁸ Vandelli M.E. *The paradox of natural disaster*. Professional journal, vl. (29, p. xii).

extensive damage to homes and other infrastructure and caused transport and supply disruptions. Growth in services, which account for over half of GDP, slowed to 3.9%, the lowest since 2012, as wholesale and retail trade, transport, tourism, and financial services were disrupted. Expansion in agriculture, which suffered earlier from an unfavorable monsoon, slowed to 1.9%. Persistent supply-side constraints, especially power shortages, held back growth in industry to a lackluster 2.6%.¹⁹

Based on this context, although, we are going to implement federal structure of the nation as expecting holistic prosperity and sustainable development. On this wish, the main treatise of this chapter lays an actual ground and provides a motivation for the theoretical strata and macroeconomic scrutiny that will build muscular platform of this inquiry. Moreover, this chapter analyze the fiscal faces towards suitable state restructuring and federalization amendments debate in Nepal. More concretely, this chapter provide the answer of my first set of research question.

4.2 Seen Setting: Concise Sketch of emerging discourses towards federalism in Nepal

Nepal, home of Mt. Everest, the world's highest mountain, is also home to one of the world's highest poverty rates. It ranks 146 out of 188 countries in terms of the entire gross domestic product per person, according to the World Human Development-Index, 2015. Even Haiti, the poorest country in the Americas, is richer than Nepal. Nepal has seen enormous strikes that have shut down schools, buses and roads. Many of the strikers are being fashioned after Maoist revolution²⁰. Similarly, security concerns relating to the earthquakes, India's undeclared barrier on oil and trade, Tarai-Madhesh conflict have led to a decrease in entire economy directly or indirectly.

Looking behind, per capita income of nation is approximately \$724 which mostly derived from agriculture and remittance; is one of the Least Developed Countries (LDCs), and one of the poorest (23.8%)²¹, in the world. Equally, life expectancy is average 68.9 (68.2 year for men and 70.8 for women) resulting from mass poverty, infectious diseases and further

¹⁹ Source: [Asian Development Outlook 2016](#)

²⁰ The '*Maoist revolution*' started by the Communist Party of Nepal (Maoist) on 13 February 1996, with the aim of overthrowing the Nepalese monarchy and establishing a 'People's Republic'. It ended with the Comprehensive Peace Accord signed on 21 November 2006.

²¹ Human Development Index, 2015

aggravated by poor nutrition and lack of hygiene and sanitation, symbolized some of the major obstacles to harmonious and well-balanced development of the country. Similarly, lack of infrastructure development, low level of national productivity, unemployment, political instability, and sudden fluctuations combined with poor economic stratum that hardly meets the needs of the population, *brain-drain*, and retard the development process in general.

Moreover, suffering from two unexpected economic devastation (April, 25 earthquakes and India's undeclared trade blocked) Nepal is skirmishing against them and trying to stabilize her economy. At the mean time, Nepal is undergoing a major transition toward introducing a system of democratic, socialism-oriented, and federal governance. At this glance, consist of structural changes dealing with reorganization of the country into provinces, assignment of resources and responsibilities to the different tiers of government, and fiscal arrangements for dealing with the emerging vertical and horizontal imbalances is always crucial.

Nonetheless, under what circumstances should a country choose a federal form of government? Most common people are not clear why should they prefer a federal form over a unitary or a confederal system. In fact, the concept of federalism can invoke varying emotions. There are countries such as Sri Lanka where the word "federalism" in some circles can evoke unpleasant if not hostile, response. In India, the constitution refers to Indian republic as a "Union of States" and not a federal country (Rao, 2014). In Nepal, however, most political parties view federalism as a concomitant of democracy itself.

Amusingly, common people seem to be not fully conversant about what federalism is about. The recent survey conducted by the Washington D.C based independent advocacy agency - Vision for Nepal Foundation has shown that of the 2500 respondents in electronic polling, only 58 per cent of the people assert they were aware of federalism and the stakes involved in Province restructuring. Only 42.9 per cent of the respondents favoured federalism as a form of governance whereas almost 39.3 per cent completely rejected the idea²². This demonstrates that there is significant gap in the knowledge among the people about how federalism will pan out in the country and what it entails. At the same time, in a situation where there is considerable inter-personal, inter-ethnic and inter-regional

²² Fiscal federalism in Nepal by M. Govinda Rao, 2014.

diversities and disparities in the levels of living, if federalism is advocated in terms of improving the living conditions of the disadvantaged and reducing the disparities, failure to achieve them may bring in a lot of dissatisfaction leading to chaos and return of retrograde system of governance. Federalism is not a panacea for all ills afflicting the society. As mentioned earlier, it cannot be designed to solve all types of diversities.

Nepal is a country with significant economic, sociolinguistic and ethnic diversities. As already mentioned, there are extreme inter-district economic disparity is exemplified the fact that in 2014-015, 12 districts around Kathmandu collected over 94 per cent of the total revenues and the remaining 63 districts collected the balance 6 per cent. In fact, Kathmandu alone collected 42 per cent of the revenues indicating the concentration of economic activities predominantly in urban agglomerations, particularly in the capital region (Budhathoki, 2012, as cited on Roy, 2014). Incident has shown that the challenges of present political crisis is restructure the governance system in Nepal into a federal form to take the country on the path of economic, political and social development are dreadful. Even, The Constituent Assembly, despite deliberations for six years failed to reach a consensus on the basic issue of the number of Provinces itself.

However, the vital issue of whether the number of Provinces should be determined according to economic viability or to accommodate national economic prosperity is still unseen. The fact of the matter is that neither of these can be a sole criterion for determining the number of Provinces but the economic viability is important to ensure fiscal autonomy, but given the concentration of revenues in the districts close to Kathmandu, it would be difficult to draw the boundaries based entirely on economic considerations.

4.3 Technical Diversion and Perspectives of fiscal arrangements in Nepal

The problem in the context of Nepal has been much more contentious as demonstrated in the inability of the political common argument to settle the matter (Ranjitkar, 2014). Till a date, the issues posed debated in the main relate to whether the number of provinces should depend upon their economic viability vs. identity based division. Although, the constitution of Nepal (2015) in SCHEDULE - 4 (RELATING TO CLAUSE (3) OF

ARTICLE 56 also clearly confirmed seven provinces²³. However, till a date, there is not significant economic viability can be determined which is one of the major challenges of federal reform is to address the disparities created by caste/ethnic, class and regional discrimination. Even so, disparities created by caste/ethnic discrimination cannot be eliminated merely by acknowledging the identity of different caste/ethnic groups and making it the sole basis of federalisation. Identity may empower the communities and give them political autonomy, but without resources and financial capability, identity does not eliminate disparities (Ray, 2014).

As currently divided, out of the total national revenue, 85% is generated from province two and three and the remaining 15% from other five provinces. This shows provinces 1, 4,5,6,7 are unable to finance even their administrative expenditure. Such asymmetric picture of revenue collection and expenditure in the present administrative units is highlighted by those who see a bleak picture for a federalised Nepal. If the present Province of revenue and expenditure is considered as a determining factor, the picture at a macro level from another perspective, districts belonging to Terai, eastern, central and western and far-western regions generate revenue to the scale that is not sufficient to meet general expenditure of respective provinces.

Standing on ground reality, the mountains and hills contain 77% of the land whereas the Terai comprises 23%. Out of the total land, only 17 is considerable. About 1,700,000 hectares of land can be irrigated and harvested. Of this, a mere 300,000 hectares (13%) are located in the mountain-hills that depend on the annual rainfall for growing crops. The annual harvest from this part is just 13 per cent and has to feed 52 per cent of the population of the 51 mountain districts, which hardly meets their need for half the year. The multi-million dollar irrigation projects built by the government irrigate only 10 per cent of the land in the hills while the rest goes to the Terai.

Roads are the mainstay of economic development. Some of the mountain districts still don't have access to roads. Forty hill districts touch onto roads, but more than 90 per cent are earthen. Public transport hardly runs for half the year as they get muddy and slippery during the rainy season. Out of the 22,000 rural roads across the country, 63 per cent of them are in the Terai. Similarly, 55 per cent of the targeted 6,200 km-long agricultural

²³ *See more: Annex 2*

road is estimated to be constructed in the Terai region (Rao, 2014). In terms of development infrastructure and resources, much of them are concentrated in the Terai region. Schools, colleges, hospitals, nursing homes, roads, electricity, TV, FM radio stations, big irrigation projects and many others are in the Terai districts in comparison to the mountain and hilly region. Because of this, hundreds of thousands of people migrate to the Terai from the hills every year.

Compared to the mountains and hills, the Terai is more developed and has more resources in terms of development infrastructure, highways, industries and arable land. Another hurdle to development in the hills is the rugged terrain. Given the rugged geography, how can a federal system trickle down development opportunities to the people in regions like the Karnali? Thus, more than ethnicity, the debate on federalism should look at how equal distribution of resources can be made. Otherwise, it will lead to a gap in economic prosperity and growth among the provinces, resulting in poverty, backwardness and frustration among the people.

In this scenario, restructuring state discourse in Nepal minerals is more difficult to exploit. Nepal's natural resources are unequally distributed throughout the country, with some regions being richer than others in natural resources. People's lives and livelihoods have a direct relationship with the natural resources that are closed to them. The federal policy and role are very important to amplify the benefits people can obtain from natural resources. The Province must ensure that the people who live close to natural resource receive maximum benefit from them, while at the same time preserving and protecting these resources. The Province also has to make sure that the benefits of these resources are distributed to those who are far from such resources. One of the weaknesses of Nepal's centralised and unitary system is the inability to do so. Hence, maximising the benefits of natural resources and distributing them equitably throughout the country is one of the major objectives of state restructuring in Nepal. Thus, based on above mentioned scenario there are many emerging perspectives related to effective fiscal reform corresponding to federal restructuring in Nepal.

4.3.1 Perspectives of Research Utilization

Nepal's main resources are natural resources. Some of these resources, such as water resources, forests, natural herbs, river and fertile land, are easily exploitable, whereas state

reform and fiscal arrangements discourse in Nepal minerals are more difficult to exploit. It is widely acknowledged that provinces proposed in the Tarai are economically viable even at the formative phase and provinces proposed in hills are rich in natural resources which mean these are potentially viable as well. Alberta, a province of Canada, is one example of a poor province with rich natural resources that could turn into a prosperous province in future *Balancing Identity and Viability* (Watts, 2011). Thus, less or more, Nepal's economy depends on its natural resources. Water and forests, if well managed and maintained, can become resource bases for economic transformation process. Moreover, Nepal has the potential to decouple growth from rising carbon emissions by leveraging hydropower as a source of energy for the economy. By increasing the amount of low-carbon electricity generated through hydropower, Nepal can remove a major constraint to growth across the economy – the lack of reliable and regular energy supply.

In addition, providing electricity in rural areas will contribute to expanding the area of land under irrigation, and further diversify the rural economy, allowing poor households to become more integrated in the economy. In the long term, surplus energy from hydropower can be sold to India and other SAARC countries to generate foreign currency reserves, thus causal to reversing Nepal's trade deficit. Likewise, sustainable harvesting of timber and Non Timber Forest Products (NTFPs) offer localised benefits to communities. Forests can potentially be leveraged to access flows of carbon finance aimed at preserving and increasing the stock of carbon locked in trees and soils. However, remaining on a low-carbon high-growth path requires prudent management of Nepal's natural resources – its natural capital. While the stock of natural capital can be converted into other forms of capital, such as human, infrastructure, and financial reserves, these endowments can also be misused and depleted. As depletion is largely irreversible, it also represents an opportunity cost if chances to extract economic benefits are missed.

Nepal's natural resources are unequally distributed throughout the country, with some regions being richer than others in natural resources. People's lives and livelihoods have a direct relationship with the natural resources that are closed to them. The Province's policy and role are very important to amplify the benefits people can obtain from natural resources. The Province must ensure that the people who live close to natural resource receive maximum benefit from them, while at the same time preserving and protecting these resources. The Province also has to make sure that the benefits of these resources are

distributed to those who are far from such resources. Hence, maximising the benefits of natural resources and distributing them equitably throughout the country is one of the major objectives of Province restructuring in Nepal.

4.3.2 Perspectives of Equal Existence and Development

As general view, the present model of provinces of federal Nepal is unequal, some will be relatively developed and others underdeveloped. In 2014/15, total government expenditure was NRs 338,804 million or NRs 12,788 per capita. This is a large increase from average per capita expenditure of NRs 3,871 in 2004/05. Almost two-thirds of all government spending (61 percent) went to the Central region in 2014/15, compared with 6 percent in the Far-Western region, which received the lowest share. By population, the Central region has the highest per capita expenditure (NRs 21,636) and the Eastern region the lowest (NRs 6,785)²⁴.

However, we cannot deny the political relevance of the existence of poor provinces. No doubt provinces proposed in mid and far-west hill will live as federal units with food deficiency and revenue deficiency. But we cannot deny the value of these areas to be existed as distinct political units, provinces. Thus, there is emerging perspectives that capability of provinces to be formed in underdeveloped areas, i.e. mid and far-west hills, can be enhanced over the years by a system of economic equalization, an indispensable part of a federal system. And there is need to build strong mechanism for reducing the financial gap between developed and underdeveloped provinces. The centre extracts more revenues from a developed province and distributes more resources to least developed provinces. Perhaps this is the reason why architects of identity-based federalism defended their recommendation for a provision for centralised revenue collection system.

4.3.3 Interdependence and Conflict Resolution Perspective

The development approach is too ambitious in seeking self-reliant provinces. Federalism is a system that promotes interdependence among the provinces. In one way or another, provinces are dependent on each other. Some provinces may be rich in one particular area (i.e. Pradesh-7 is hydropower and forest potentiality) and others in different sector (i.e. Pradesh-3 in human resource and capital mobilization). Exchanges of knowledge, skills, technology, resources, and productions among the provinces will produce a system of

²⁴ Data's are taken from FCGO data sources and National Population Census 2011.

interdependence among the federal units. Besides, the CSRDSP has a directive provision that inter-province relations should be guided by the principles of mutual cooperation, coordination and coexistence. It, indeed, speaks for a system of inter-provincial loans and grants.

Similarly, conflict among the provinces on shared natural resources cannot be denied. So the concerned thematic committees of the CA suggested a number of conflict resolution mechanisms, i.e. inter-provincial council, natural resource commission, national fiscal commission and others. Nepal is formally declared as a federal Province in large measure because of the *Aadibashi-Janajati* movement and *Madhes* uprisings. But then again remarkable question is arising how Tharuwan “*solo-ethnicity*” should be adhered. Discourse began in line with pro- and anti-federalism that was later converted into committed versus reluctant federalist discourse. Since the demand of ethnic autonomy preceded the federal idea, the question of identity and inclusion has obviously prevailed from the very beginning but it is increasingly challenged by proponents of the development approach. Three of the largest social groups of the country – janajati, Madhesi and Khas-Arya – are split on the question of Nepali federalism; the first two groups stand together for maximizing the ethnic and regional contents whereas the later opts to de-ethnicise the federalism process in Nepal.

4.3.4 Perspectives related to Evolving Politics and Implications

Over the past several decades, Nepal has witnessed significant political and economic instability. Since the restoration of multi-party democracy in 1990 alone, more than twenty-five different governments have been formed and numerous cabinet reshuffles and no-confidence motions have occurred. Nepal has made some encouraging progress in development since it emerged from self-imposed isolation in the 1950s, at which time it had virtually no infrastructure. Access to basic public services such as primary education, health care, electricity, and sanitation has increased significantly since that time. Almost 90 percent of Nepal’s primary-aged school children are now enrolled in school. The infant mortality rate has dropped from 165 (per 1,000 live births) in 1970 to 24 in 2015. Although still among the lowest in South Asia, life expectancy has increased to 69 years. Nepal made the transition from absolute monarchy to federal democratic state in 2008. Unfortunately, the politics of inclusive growth in Nepal are marked by: high political fragmentation; political instability; zero-sum decision-making government practices; tacit

consensus on economic management; personality-driven processes and political vacuums; limited domestic pressure for reform; and an unclear form of federal government. Furthermore, the effectiveness of the bureaucracy and public administration are constrained by patronage and corruption, lower capacity, little government coordination or policy coherence, low accountability.

Since 2011 to 2015 alone, the total number of “Bandhs²⁵” in the country is estimated to be around 1996 events of general strike (according to NRB, data analysis shows that average direct cost of general strikes stood at NRs 1.8 billion per strike day and NRs 47 billion per year at current prices during 2008-2015). Similarly, present Tarai-Madesh strike directly impacts entire economy and the lost output at this strikes accounted for almost 50% of the annual gross output which country’s economy was close to being fully paralyzed. What is not sufficiently appreciated by most commentators and intellectuals is that political instability is not a phenomenon confined exclusively at present’. At this scenario, the question that sensibly arises is to “*what extent this kind of political instability has impacted the economy?*”

4.4 “But where we stand actually?” Constraints to economic growth in Nepal

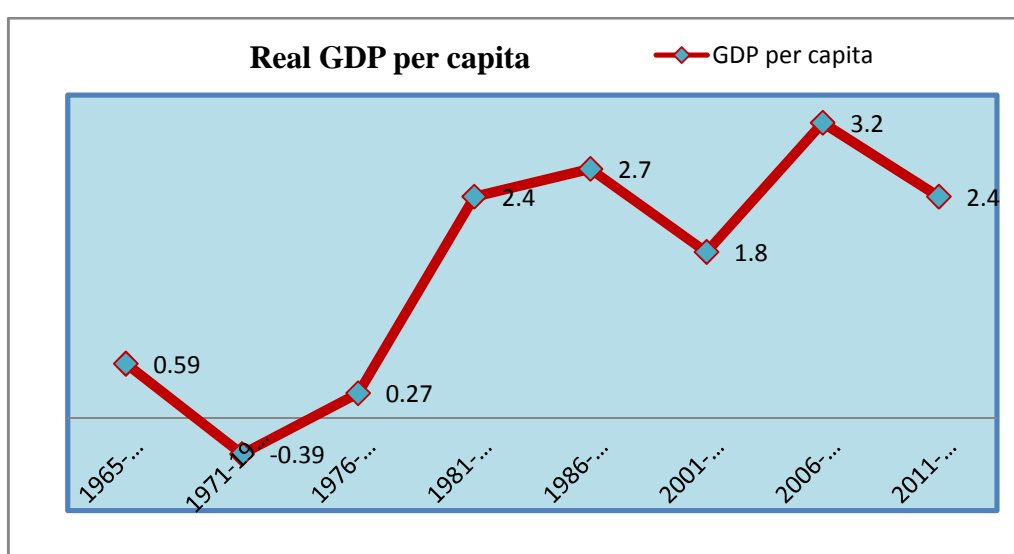
Nepal has set itself economic growth target of 7%, and aims to become a middle-income country by 2022 (NPC 2013). Sustaining high levels of economic growth will be important for Nepal, not just in increasing levels of income, but also in maintaining federalized reform in Nation. Achieving such levels of growth will require alleviating binding constraints to economic growth, as well as structurally transforming the economy to higher levels of productivity. However, Nepal has not achieved meaningful structural economic transformation – where labour moves from lower to higher productive activities. Historically, the majority of the people in Nepal were embedded in agriculture (more than 75 percent in the early 1990s).

However, at present, labour has been moving out of agriculture, largely to find employment in foreign labour markets. About three-fourths of those entering the labour market annually find employment in labour markets in the Middle and South East Asia.

²⁵ The general strikes have been counted at individual district level. It means that if there was a nationwide strike (Nepal Bandh) called on, and then total strike number is counted equal to the number of district being affected. See more; The economic cost of general strikes in Nepal, NRB economic review, Vol. 26, April 2014.

Similarly, average growth in real gross domestic product (GDP) in Nepal was 4.2% between 1974 and 2015. Also, GDP growth has been positive, except for some periods in the 1980s. In the 1990s, growth increased to 4.8%, and then subsequently declined to 4% over the 2000s (a period of civil conflict in Nepal). Most recently (2010-2012), GDP has been growing at an average of 4.4%, slightly above the historical average. While GDP growth in Nepal is less volatile, it remains low in comparison with other low-income countries where the average GDP growth from 2011 to 2015 was 2.4%. The present growth trajectory is below the government's growth targets (see red line in Figure 4.1).

Figure 4.6: Real GDP annual growth (in%) over the past 45 year period ²⁶



Only between 2006 and 2010 did GDP per capita growth return to above the 1981-85 average (see Figure 1). Economic growth is largely due to an increasing population, and increases in GDP per capita are due to labour moving from lower to higher productive economic sectors. Economic growth is not driven by changes to productivity within specific economic sectors (UNCTAD 2013), and hence unlikely to be sustainable. Similarly, the capital stock of Nepal is very low comparatively in the region, and the country has a combined building and infrastructure net capital stock as calculated using the method in Daniell and Wenzel (2014) on data up until 2015, of 38.8 billion USD. The gross capital stock of all structures, contents, equipment and materials is equal to around 59.1 billion USD. The GDP of Nepal is currently around 19.71 billion US\$ as of April

²⁶ Note: Y-axis – percentage; X-axis – years. Source: Author's calculation using WDI data (accessed January, 2016).

25th 2015, using forward projections and current exchange rates of 101.8 Nepalese Rupees to the USD.

4.5 Nepalese Economy: Ground Reality

Nepal is a developing country sandwiched between the two giant economies of the world: China and India. Nepal has emerged from a decade long civil war recently and it is in the process of implementing a new constitution. In this context, Nepal's political parties (there are more than twenty) and civil societies are actively debating which political system Nepal should adopt under its new constitution. However, a rather more important question – what economic policies should Nepal adopt under the new constitution, has rarely been discussed. There is no better time to start this discussion as the economy and the political system are strongly tied to each other. This question has become even more important after the *2015's massive Earthquake* shook the country and **India's trade blocked** that claimed more than 9500 lives and destroyed numerous important infrastructures.

The economy of Nepal has been more affected by the Indian economy than the Chinese economy for various reasons. First, unlike the Nepal-India border which is relatively loose and open, the border between Nepal and China is strongly regulated. Second, Nepal is connected to India through a denser road network – thanks to the flat Nepal-India border. In contrast, Nepal and China are geographically separated by the Himalayas. In addition, Nepal and India have fixed currency exchange rate and stronger social/cultural ties compared to China. More recently, the struggle between China and India on who should lead over the region has provided both opportunities and dilemma in Nepal.

Figure 4.5: GDP per Capita Trend

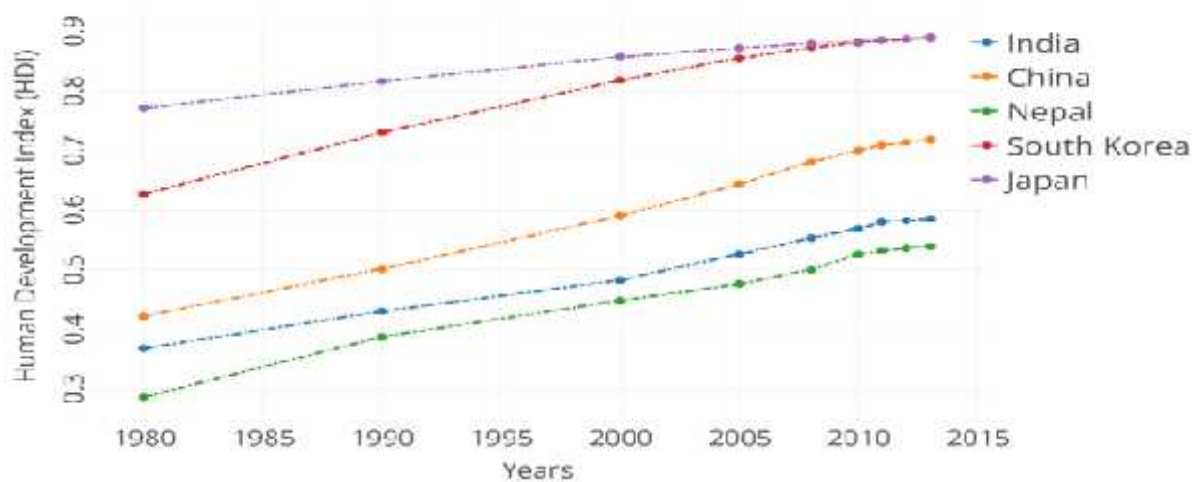


Data source: [Asian Development Outlook 2016](#)

4.5.1 Human Development Index

HDI, proposed by Pakistani economist Mahbub ul Haq and Indian economist Amartya Sen in 1990, is a composite index of four statistics: life expectancy at birth, the adult literacy rate, a combined school enrollment ratio, and GDP per capita in purchasing power parity terms. The trend of HDI in Figure 4.3 shows that Nepal has fallen behind its neighbors although the trend is improving over time. Japan and Korea appear to have reached saturation in terms of HDI. Nepal and India's HDI is even lower than that of Korea and Japan in 1980.

Figure 4.5.1: Human Development Index



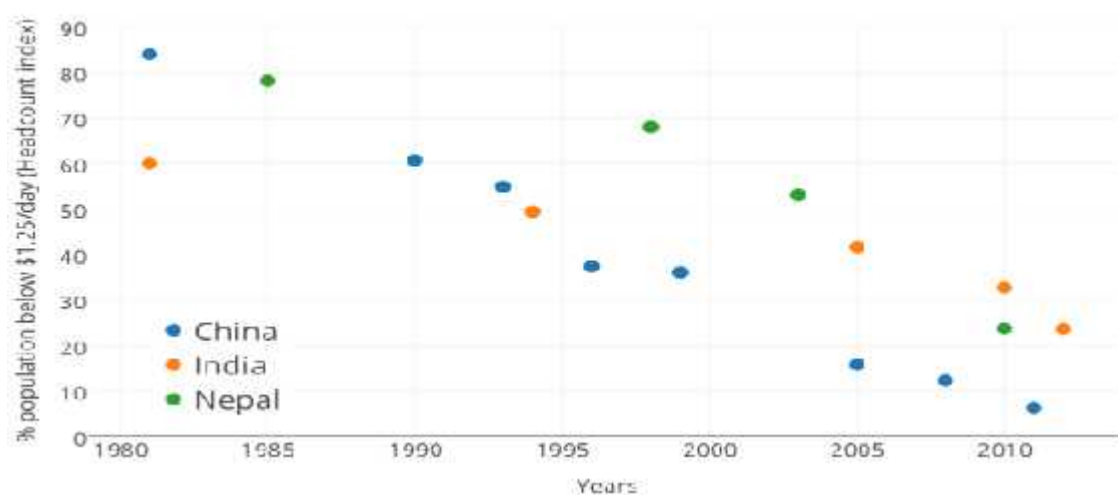
Data source: UNDP.

4.5.2 Poverty

With the view of economic growth, it needs first to increase productivity of all the economic factors such as labor, production and market. In context to capitalism practice in global economy, Nepal has to promote more competitive privatization of goods and services and create a friendly environment for FDI (foreign direct investment). Maintaining the value of currency and supply and controlling steep down inflation it is possible to control on decreasing purchasing power parity. Sen (2005) mentions that- "It is not economic growth that enables the people more freedom but the enhancing capacity of the people to access the sources makes the real sense of development". Therefore, the strategy to rapid social transformation is poverty alleviation through capacity building.

The headcount index for China, India, and Nepal is presented in Figure 3, which shows that these countries do not seem very different in terms of poverty. The percentage of population living below \$1.25 per day in Nepal has fallen to about 24% by 2010 which is comparable to that of India. China looks remarkably successful in bringing down this indicator to less than 10% by 2010.

Figure 4.5.2: Poverty Headcount Index below \$1.25/day (PPP).



Data source: The World Bank.

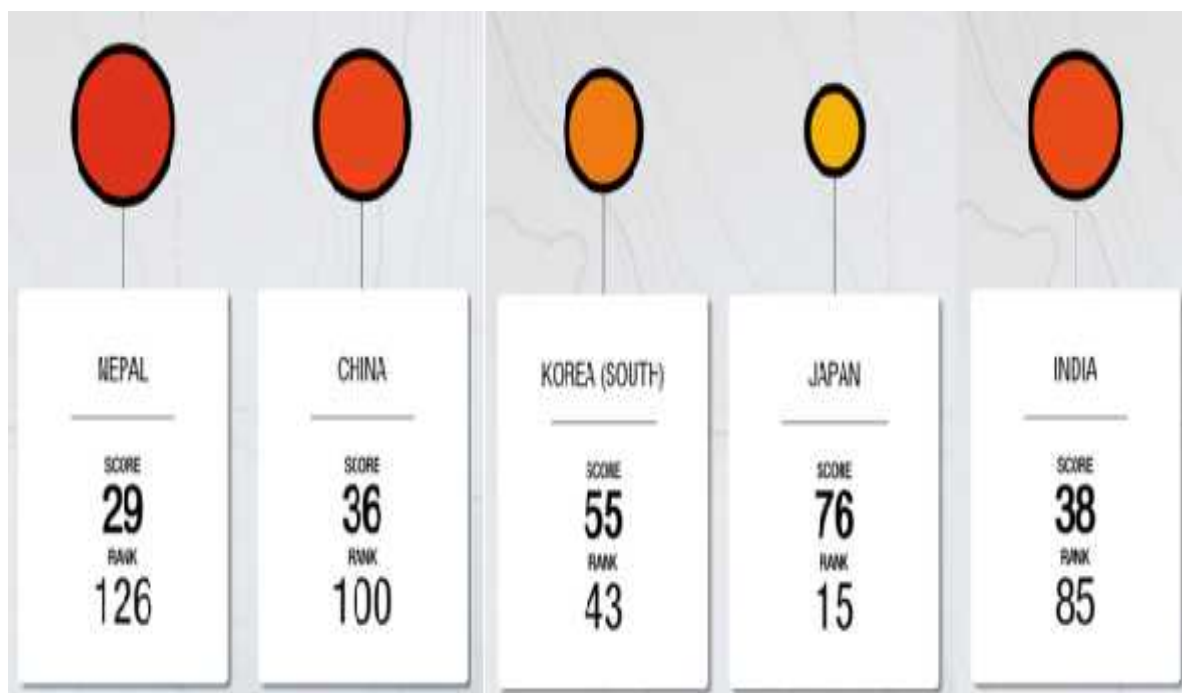
4.5.3 Widespread Corruption

Corruption is one of the major problems in developing countries including Nepal, India, and China. With Nepal's score on the corruption perception index being the highest among the countries being compared, corruption is one of the major constraints in Nepal's development. High corruption in Nepal can be attributed to a number of factors. First, although there are a number of acts and regulations meant to curtail corruption, these have been weakly enforced. Second, the salary and incentives of the civil service employees are very low which may have increased corruption. A better performance-based reward and punishment system could potentially reduce this problem. Third, a decade of political instability has restricted the effective implementation of existing anti-corruption policies. Nepal's bureaucracy is resistant to change, which is in fact more powerful than the government. The corruption is highly institutionalized in Nepal within the bureaucracy. A commission for investigation of abuse of authority (CIAA) was formed after the establishment of democracy in Nepal in 1990. CIAA has been very effective in recent years for curtailing corruption. CIAA is often criticized for catching only the small fish

while leaving the big fish responsible for more significant corruption untouched. The boom of NGO's and media also have helped curtail corruption by raising awareness among the people. Despite the increasing anti-corruption activities, corruption has not reduced as expected. In this context, a stronger intervention at the political level may be an effective strategy in controlling corruption.

The corruption perception index data by Transparency International (Figure 4.5) shows that there may be a strong correlation between corruption and economic growth. For example, Japan is the least corrupt countries among the five countries being compared, and Nepal is the most corrupt country. This is generally consistent with the growth trend data in earlier GDP report with the exception that China seems to be more corrupt than India despite its higher GDP, although the difference is not very high.

Figure 4.5.4 Corruption Perception Index for 2014



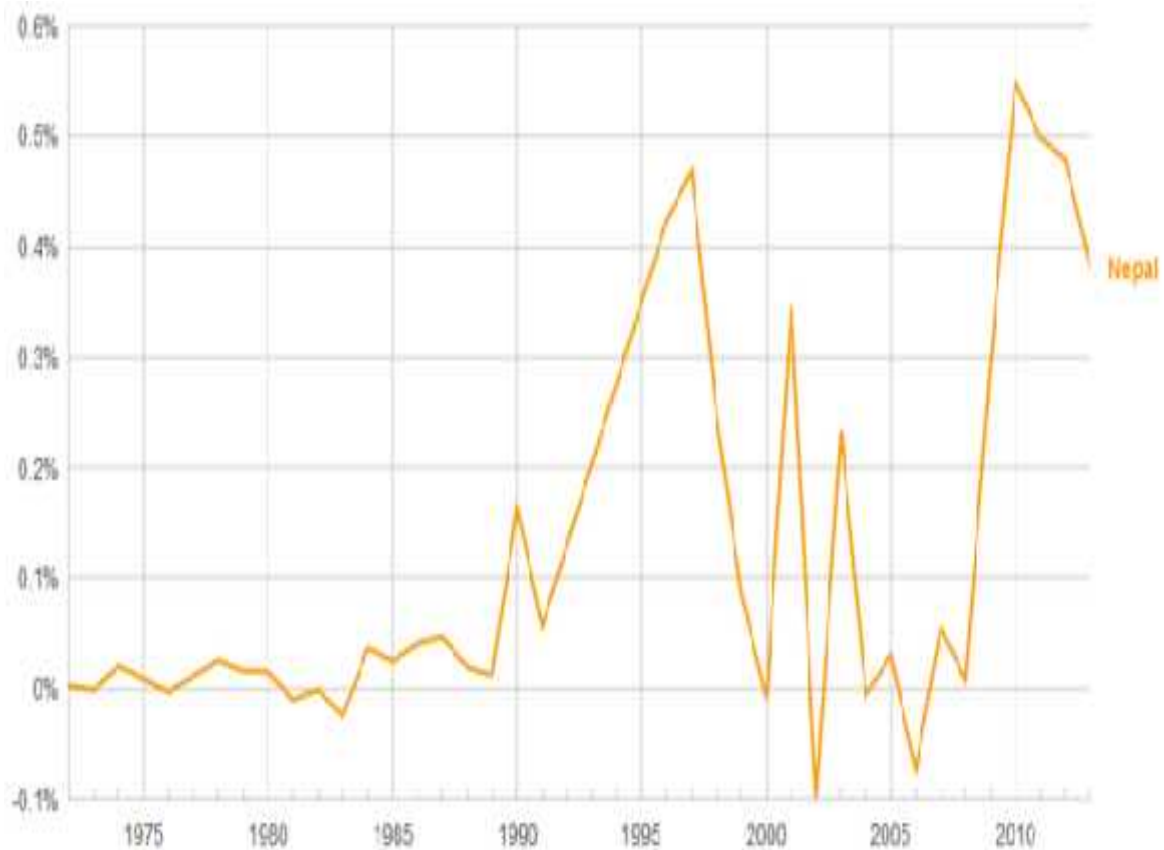
Data source: [Transparency International](#).

4.5.5 Foreign Direct Investment

Foreign direct investment (FDI) in Nepal as percentage of GDP is presented in Figure 6. FDI seems to have increased after around 2006 reaching a peak in 2010 after which it again decreased. FDI being less than 0.5% of GDP at present does not seem to be a large contributor in Nepal's economy. This is one area where Nepal could potentially benefit in the future if an investment-friendly environment is created. In particular, the hydropower

sector can benefit greatly from FDI given the current hiatus in developing large-scale hydropower projects due to the lack of investment capital.

Figure 4.8.5 Timeline of Foreign Direct Investment as percentage of GDP

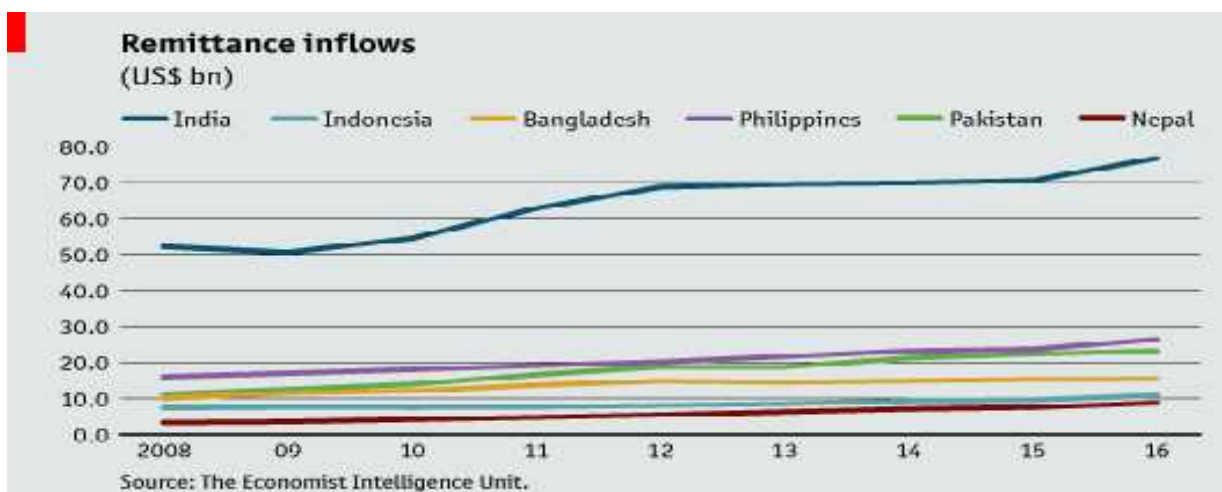


Data source: The World Bank.

4.5.6 Remittances

Total workers' remittances received for the countries being compared is presented in Figure 7 below. The contribution to GDP from remittances for Nepal seems spectacular hitting more than 20% after 2010. This is consistent with the increasing trend of workers going abroad for work mainly in the Middle Eastern countries, Korea, India and other countries. For more developed countries like China, Japan and Korea, remittances appear to be a small fraction of the total GDP though large in total volumes. For India, remittances only contribute to about 3% of total GDP at present. The increasing trend of migrant workers in recent decades can be attributed to a multiple reasons including rising unemployment as a result of the Maoist-led civil war, increasing activities of manpower companies, and the swift development of information and technology that penetrated through the rural villages.

Figure 4.5.6: Total workers' remittances and compensation received as % of GDP.



Data source: The World Bank.

4.5.7 Politics and Development Paradigms

Two distinct theories have been proposed by two Nobel laureates Friedrich Hayek and Karl Gunnar Myrdal for development. Hayek's economic development theory was more liberal and argued that free markets can solve many societal problems in their own. His arguments supported the strengthening of communities at the grassroots level. In contrast, Myrdal's view was that the development effort would be largely ineffective unless there were regulations backed by compulsion. He basically promoted top-down state planning. For example, growth production requires machines, which individuals may not be able to purchase. For this reason, Myrdal supported more state intervention to help individuals and communities overcome market failures. Nepal seems to be following both paradigms at different times. The presence of left wings groups represented by communist parties including the Maoists have been defending a more state oriented view like Myrdal's while other political parties mainly the Nepali Congress have been defending a more capitalistic and free market economy. In Nepal's context, as raised by many economists, the question is not whether more or less state but a better state. Political stability is a great challenge in Nepal. Although, Nepal formally became a federal democratic regime after the promulgation of 2015's constitution, there has been much turbulence in its political system. However, continuous political instability severely hindered Nepal's economic growth which can be seen in all the indicators of development presented above.

4.5.8 Utilization of s Resources

Nepal is not poor in terms of utilizations of resources. There is huge potential for hydropower development but merely a small fraction of it has been harnessed. Currently the installed capacity of hydropower is about 600 MW while the demand is well above 900 MW. Load shedding up to 15 hours a day is common in winter seasons in Nepal. About 60% of the total population of Nepal does not have access to electricity as light source, let alone the luxury of appliances. Industrial development has not expanded in Nepal due to a lack of reliable power supplies. India is the sole supplier of fossil fuels in Nepal and the demand for petroleum products has been rising exponentially. Because of a poor supply chain, supply of petroleum products can be interrupted for several days in a year. The issue often becomes the agenda of politics for the opposition parties.

One of the major problems in Nepal's hydropower development is that many rivers have been shared with India and there are numerous water rights issues between Nepal and India. Most recently, Nepal signed three major hydropower deals which, if implemented, can revolutionize Nepal's industrial sector while fostering overall development. Nepal recently gave a green light to the GMR groups, an Indian company, for a historic 900 MW upper Karnali hydroelectric project worth a \$1.4 billion. Nepal also signed PDA with India's Satluj Jalvidyut Nigam Limited (SJVNL) for another 900 MW hydro project Arun III in November, 2014 (ekantipur). Similarly, Three Gorges Corps., a Chinese company was given orders to execute the 750 MW West Seti River hydropower project worth \$1.6 billion. While these projects have shown hope in Nepal's development, their implementation still seem very far off given the government's lack of experience, geography- and weather-related barriers, and social and environmental problems. In addition, it is not clear how much Nepal will really benefit from these projects because the Project Development Agreement (PDA) may not be in favor of Nepal given the inequality of bargaining power between Nepal and India or China.

Tourism is yet another potential which is recently booming with the increase in publicity through various tourism activities such as the celebration of Visit Nepal Year 2011. Tourism contributed to about 8.2% of the total GDP in 2013. The tourism industry is one such sector where private entities have invested more than the government. However, the private sector has the tendency to focus on its own private gain and is not solely

responsible for managing and preserving the common or public points of attraction. Government's role is very important in preserving and managing such public purposes. The agricultural sector is the backbone of Nepal's economy and contributes about one-third of the gross domestic product. However, this sector remains traditional to date and the agricultural productivity is very low. If agricultural practices are modernized like what Deng did in China, agriculture could substantially enhance economic growth in Nepal and by reducing the dependency of Nepal on India.

4.5.9 Trade and Finance

Nepal became the member of world trade organization in April, 23, 2004 so its impact on Nepal's economy has not been clearly seen yet. The membership can bring opportunities for Nepal in the sense that the Nepalese products and services will get access to global markets with equal treatment compared to other member states. However, it can also bring negative consequences by encroachment of foreign multinational companies that can shadow local enterprises. Although Nepal's export has increased with the growth of carpet and garment industries after 2000, negative consequences have been observed recently—the import to export ratio has increased from 2.31 to 3.40 from pre accession period to post accession period. In this context, Nepal should focus on increasing exports which can potentially be achieved by formulating appropriate market policies and better connecting Nepalese market with Chinese/Indian as well as the global market through air and road network. The current trade deficit ratio is 1:9.

Figure 4.5.6: five year trend of Nepal's imports, exports and trade balance

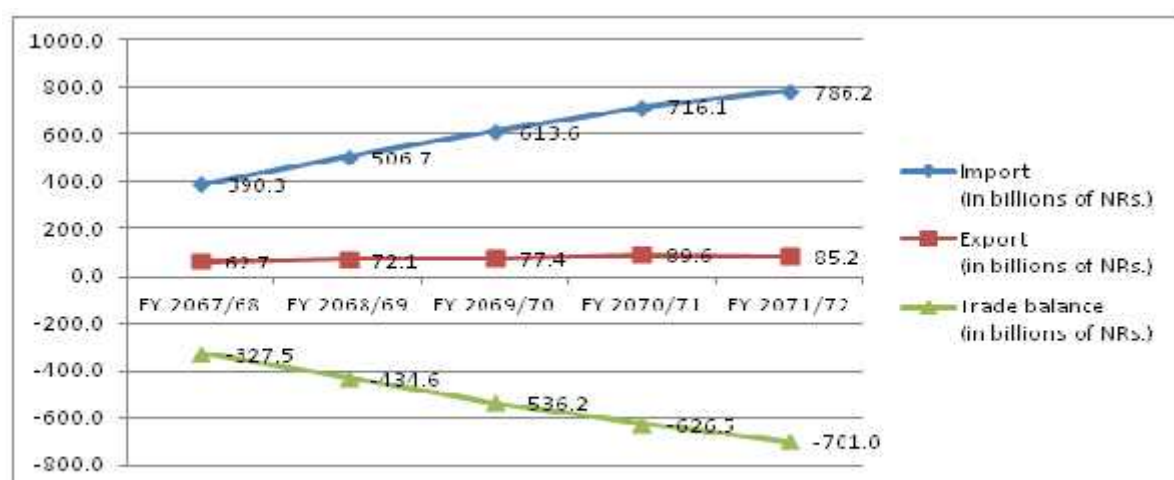


Figure 1: Five-year trend of Nepal's imports, exports and trade balance

Source: Department of Customs (Nepal)

4.5.10 Trailing Globe of Nepalese Economy: Earthquake and Trade Blocked by India

Nepal is a hotspot for geophysical and climatic hazards. The country is relatively ranked very high in terms of vulnerability to natural calamities. The risk is believed to be increasing very rapidly mainly due to the growth in population, especially in urban and urbanizing areas. The hypocenter of the Mw 7.8 earthquake on April 25, 2015 at 6:11 UTC (11:56 local time) was located around 80 kilometers northeast of Kathmandu, Nepal and at an 18 kilometer depth (GEOFON) in a densely populated region.

Nepal promulgated the New Constitution with signatures of 90 percent of the Constituent Assembly (CA) II members on September 20, 2015. The world congratulated Nepal for its success, but Nepal's '*roji-roti-beti*' closest neighbor India sent a cold-note and a mild-warning. India informally conveyed a proposed 7-point constitutional amendment the following day supporting 10 percent of Nepal's CA II, which are agitating Madhesi groups. Such amendments interfere with landlocked Nepal's sovereign and internal affairs, but Nepal was full of confusion in answering it. Moreover, India initiated an undeclared transit trade warfare, blocking Nepo-India borders. The blocking at borders is freezing the life of all Nepalis. Even a present date, Nepal suffers from an acute shortage of cooking and oxygen gas, gasoline, medicines and other daily humanitarian supplies. Worse still, India's transit warfare was conducted in a period when Nepo-China borders were blocked by the post-Earthquake. Strikes, blockades and protests against Nepal's new constitution have cost the economy more than \$1bn, according to the Federation of Nepalese Chambers of Commerce and Industry (FNCCI) – just months after the country was struck by a series of devastating earthquakes. The president of the FNCCI, Pashupati Murarka²⁷, described the crisis as the country's worst economic disaster. "The economy has been almost completely stalled for the past two months," Murarka said. "The impact is worse than the earthquake."

4.6 Chapter summary

Experiences all over the world shows embarking into federalization system as an expensive affair which most of the poor countries sees it as an element that impedes their decentralization initiatives and efforts. Same beliefs, fiscal federalism amendments in Nepal also required heavy consideration of abovementioned sectors. Because of the

²⁷ *Unofficial or informal discourses by Murarka and researcher during the research period.*

country's tardy disposal of the isolation policy as late as 1990's, it had it has still vulnerable and underdeveloped. In its federalization initiative, it is well known that weak economic growth and its unequal distribution are the major causes of political unrest and dissatisfaction in Nepal.

Thus, a general conclusion emerging from this chapter regards on current macroeconomic strata towards fiscal relations is that sub-national governments need to be given access to adequate resources to do the job with which they are entrusted. At the same time they must also be accountable for what they do with these resources. Another conclusion is that questions on how to organise intergovernmental fiscal systems should be approached in the specific circumstances of Nepal in a manner that is consistent with achieving the relevant policy objectives. These objectives include efficient allocation of resources, income distribution and macroeconomic stabilisation. Furthermore, they may include objectives such as achieving 'regional balance' in the country. Often, there will be conflicts not only between these objectives, but also between local and central perceptions on the weights to be attached to them. Moreover, like all public policies, intergovernmental fiscal policies must take into account both the political constraints facing policy makers, such as the strength of different provinces and groups in political decisions, and economic constraints such as the stage of development of financial markets (Bird & Vaillancourt 1998). Finally, this chapter shows that most of the macroeconomic and fiscal indicators have not been satisfactory in Nepalese fiscal amendments process till a date.

CHAPTER FIVE

THE PARADOX OF FISCAL FEDERALISM AMENDMENTS IN NEPAL

The system was created with the intention of combining the different advantages which result from the magnitude and the littleness of nation.
-Alexis de Tocqueville, Democracy in America

5.1 Chapter overview

This chapter is aimed to cover three separate but relevant themes with significant impact on the political economy of Nepal and lays a particular background that helps to understand the theme of this thesis. More indisputably, this chapter provide contextual answer of my second set of research question with amalgam aspects. Involving it with previous chapter, the central aim of this chapter is also demonstrate how federalism was introduced in Nepal as a political and fiscal subject and thereby seeking a contextual answer of the question; *“What are the factors inhibiting or promoting the principles and practice of fiscal federalism amendments in Nepal? What major challenges to be arise and how they could be solved?”*

By aiming this, the chapter dices on three dimensions. First, the chapter contains current financial environment within constitutional aspects and fiscal policy reform in Nepal. It briefly investigates the economic and political factors that affect the process of fiscal policy and decision making process in Nepal and tried to investigate what extend present constitutional arrangements meets the demands of ‘*people-centric*’ fiscal ism. Interconnectivity, this section also discusses the problems facing the fiscal policy making, as well as the general expectations of the fiscal policy amendments in Nepal. Secondly, it also presents the key challenges that impacts smooth implementation of the decentralization system in Nepal. In addition, it illustrates the strengths and weakness of policies and their impact on other indicators of the economy. Finally, it seeks some insight which leads effective fiscal policy towards holistic economic welfare.

5.2 Fiscal Federalism in Nepal: History, Practice, and Unlearn Lesson

Undoubtedly, the topic of federalization has received considerable attention over the last three decades both in developed and developing countries for different reasons. The developed countries seek to put in place a more effective public services delivery

mechanism, especially as an alternative to the unitary model. The developing countries seek to escape from the centralised planning of the political economy, which causes inefficiency in public services delivery and generates malfunctioning in governance and encourages bureaucratic corruption (Johnston, 2000; Fisman and Gatti, 2002).

If we go back to the Nepalese history, formally the decentralization of governance in Nepal began in 1960s. Since then the process has undergone significant changes over time. The Constitution of the Kingdom of Nepal 1990 has aimed to develop Nepal as a welfare state in order to provide social, economic and political justice to all citizens. Accordingly, it has established a number of fundamental directive principles and policies of the state espousing equitable distribution of resources, opportunities and benefits to all citizens, removing social and economic inequalities across regions and social groups, maximum involvement of citizens in the governance process through decentralization, positive discrimination in health care, education, housing and employment to socially and economically disadvantaged communities, raising productivity in agricultural sector and increased emphasis on rural development. Decentralized system of governance is one of the fundamental policies to achieve those objectives outlined in the constitution.

Post 1990s period may be considered as the landmark in the development of decentralization process in the country. Various reform measures were initiated to strengthen the process of decentralization in the country. Two Acts have been enacted so far on decentralization following the new Constitution: The VDC, Municipality and DDC Acts 1991 and the Local Self-Governance Act 1999. The former was only the continuation of the earlier system with a different nomenclature while the later was designed on the basis of the report of the High Level Decentralization Coordination Committee 1997. The Local Self-Governance Act 1999 has provisioned broad based organizational structure, devolution of authorities, special provision to include women and disadvantaged communities, planned development process and judicial authorities to local bodies. Whether the Act has provided enough legal basis for the development of a capable, responsive and accountable local self-governance system is itself an issue (Paudyal, 2013). However, looking at the experience of the past 17 years in general and after the legislation of the Act in particular, it seems that more and more party-political rivalry and unhealthy competition among all development players have created a confusion and chaotic situation at the local level.

However, the 1990 Constitution strongly backed democratic institutions and also created an environment for ethno-politics, although it did not address many relevant issues. After about six years, an insurgency, led by the then Communist Party of Nepal (Maoist), broke out, challenging the political system with a 40-point demand. This led to a 10-year civil war between the insurgents and government forces that claimed about 13,000 lives and internally displaced from 100,000 to 150,000 people. The objectives of the LSGA were put on the back burner in the absence of locally elected bodies for a long period.

The conflict resulted in the dissolution of cabinet and parliament, and the assumption of absolute power by the King. This armed conflict officially ended with the signing of the Comprehensive Peace Agreement (CPA) between the Government of Nepal and the Maoists on November 21, 2006. The CPA outlined the terms of peace and political reform. Although it did not specifically refer to the “federalization” of Nepal, it articulated the commitment of pursuing a democratic and progressive restructuring of the province. This brought the Maoists and the major political parties together, and replaced the 1990 Constitution with the Interim Constitution of 2007, setting the stage for further democratic changes. The institution of monarchy was abolished, and federalization became one of the most significant agenda in Nepal. The *Madhesi* movement, which broke out after the promulgation of the 2007 Interim Constitution, brought forward the demand for ism more intensely by pressing for self- and shared-rule and proportional participation in province organs.²⁸

This background shows that the decentralization exercise in Nepal is not viably flourishing. Some progress was made, but all these exercises were accomplished within the framework of a unitary state, with or without an enabling democratic environment. Although, lots of movements and arrangements have been developed for decentralization process in Nepal, however, the implementation of these efforts is not satisfactory and even though, some case counterproductive. The decentralization has become only the policy debate issue but the political consensus for effective decentralization has not been developed yet and it is much more directed by the donors (Adhikari, 2014). Based on this context, however, The Democratic Republic Constitution of Nepal 2015 has provided the

²⁸ Adhikari, Bipin(2010), framework for transition to ism in Nepal: lessons from comparative experiences.

model of federal structure based on the recommendation presented by the Committee on Natural Resources, Economic Rights, and Revenue Allocation.

5.3 The Present Constitutional Context: General Issues and Arrangements

There are various sections in the Constitution of Nepal (2015) have a bearing on the fiscal arrangements, and some of these are more important than others. At the core of fiscal ism is the assignment of legislative responsibilities, which are mainly set out in Part 10 (Section 115-125) for the government, Part 16 (Sections 203-2013 for the provinces, and part 19 (Sections 228-230) for local authority. Constitution of Nepal (2015) clearly defines fiscal ism procedures according to the three level of governing (Federal, Provision, and Local)²⁹.

Exhaustively looked at, Nepalese Constitution encloses the basic stipulations of classical ism. The Legislative powers are demarcated and distributed between the union, province(s), and the local governments³⁰ and three lengthy lists of legislative subjects of these governments³¹ are integrated in the Constitution itself. There shall be the provinces with the districts listed in **Schedule-4** that prevail at the commencement of this Constitution in Nepal.³² The territorial jurisdiction of laws enacted by various governments is also stipulated by the constitution.³³ Dealing with the Executive powers of the Union, Province and the Local Governments, the Constitution declares that they are coextensive with their respective legislative powers.³⁴ By vesting the original and exclusive jurisdiction upon the Supreme Court of Nepal³⁵ on disputes between the federal and the province(s) governments, inbuilt mechanism is assured in the Constitution to ensure effective operation of the governance with least friction, wastage and overlapping. Beautifully, inclusive Democracy and ism are the essential features of our constitution and are part of its basic structure.

²⁹See more: Constitution of Nepal (2015), Constituent Assembly Secretariat Singha Durbar UNOFFICIAL TRANSLATION BY Nepal law society, IDEA and UNDP.

³⁰ Articles 56 of the Constitution

³¹ Schedule 4 to 9 of the Constitution

³² Article 56(3)

³³ Article 245

³⁴ As per Articles 75 and 162 of the Constitution, the executive power of the federal and the Province Governments extend to the laws made by them with an exception that in the case of concurrent legislation the federal laws shall be administered by the province's machinery unless otherwise specifically provided for.

³⁵ Article 133

However, there is no unanimity about the nature of the Constitution. The degree of ism under Nepal Constitution has been a subject of incessant debate. Assorted expert and different political parties have taken different ideological positions calling it as unitary, with unitary characteristics, cooperative, etc. While interpreting the federal characteristics of the Nepalese Constitution, the political party (mainly in *Tarai-Madhesh* based party) also expressed divergent views.

Scrutiny of **SCHEDULE 4** to **SCHEDULE 9** of the Constitution reveals that the subjects which is directly related to the federalism amendments, are assigned to the constitution. Assigning subjects of social welfare to the exclusive jurisdiction of the nation means positive obligation upon the three tiers of government to deliver optimal services to the society in these sectors. These subjects are result oriented and successful implementation of programmes in respect of these subjects is directly related to the social development of general population. In view of the constitutional mandate contained in the preamble, it is obvious that the provinces and local government are duty bound to ensure positive results in the functional sectors assigned to them.

A cursory view of various provisions in the Constitution relating to the fiscal ism relations gives an impression that it has taken into account the various aspects of classical fiscalism³⁶. It appears that the distribution of functional subjects of exclusive jurisdiction to national and sub-national governments and allocation of the subjects of taxation to various layers of governments are in conformity with the principles of optimal services,

³⁶ The primary consideration in allocating subjects of exclusive jurisdiction to various governments should be the benefit incidence. The "Decentralisation Theorem" suggests that the subjects, the services of which are nationwide in their benefit incidence, should be given to the national government and the subjects, the services of which are local in their benefit incidence, should be given to the local governments. Stabilisation and redistributive functions, which involves macroeconomic policies, should be assigned to the national governments and the allocative functions may be shared between the national and local governments depending upon the benefit incidence. See W.E. Oates, *Fiscal ism* (1972). p. 35. For an effective fiscal administration, the subjects of taxation should be allotted to various governments on the basis of certain principles. Subjects with national base should be allotted to the national government and subjects with local base should be allotted to local governments. Subjects, which are susceptible to multiple taxation, should be under the national government and in all cases the levy should be cost effective. Where a tax can be evaded by shifting the habitation, such taxes should be within the jurisdiction of the national governments. See Hugh Dalton, *Principles of Public Finance* (1970), pp. 29-47

cost effectiveness, equity, easy compliance, and evasion preventive. Despite the above distribution of the subjects of taxation to the federal, Province and the Local Governments, if the Provinces are confronted with fiscal deficiency, it is constitutionally provided for the transfer of resources from the Centre to the Provinces under the recommendations of the National Natural Resources and Fiscal Commission³⁷.

Since functional responsibilities are allotted to the Federal, Province, and the local Governments, it is a condition precedent that adequate resources are also made available to the governments to deliver their responsibilities effectively. But while allotting resources to the three layers of governments, apart from the consideration of adequacy of resources, certain other important aspects in respect of fiscal administration are also to be taken into account. Efficiency in tax collection, prevention of evasion, avoidance of duplication of levy, cost of compliance etc., are some of the important facets that are to be considered for efficient fiscal governance. Likewise, effectuating *adequacy principle* and *public fiancé logic* simultaneously in the operational field is the major impasse or achieving efficient fiscal governance in a set up. The real challenge in achieving an effective fiscalism under Nepal's Constitution is about striking a balance between these two important aspects in the area of fiscal governance. Similarly, in the field of fiscal governance also the Constitution perceives a structure. The subjects of Taxes and Duties are distributed between the Federal, Province, and Local Governments. In order to have an operationally efficient fiscalism, the subjects of taxation are to be allotted to different layers of government on the basis of economic as well as administrative rationales.

Based on this expectation, the provisions under the Nepal's Constitution for the devolution of resources among three tiers of government are mainly intended to fill the resource gaps and leads vague vertical and horizontal imbalances. From the current status it can be seen that these mechanism have not helped the province(s) to balance their revenue and expenditure. This is a very serious constitutional problem. Unless this problem is inexplicable, problems in a major area in the fiscal federalism under Nepal's Constitution cannot be solved.

³⁷ Constitution of Nepal constructs National Natural Resources and Fiscal Commission as a constitutional commission for dealing national fiscal issues and arrangements (Constitution of Nepal, Part 26)

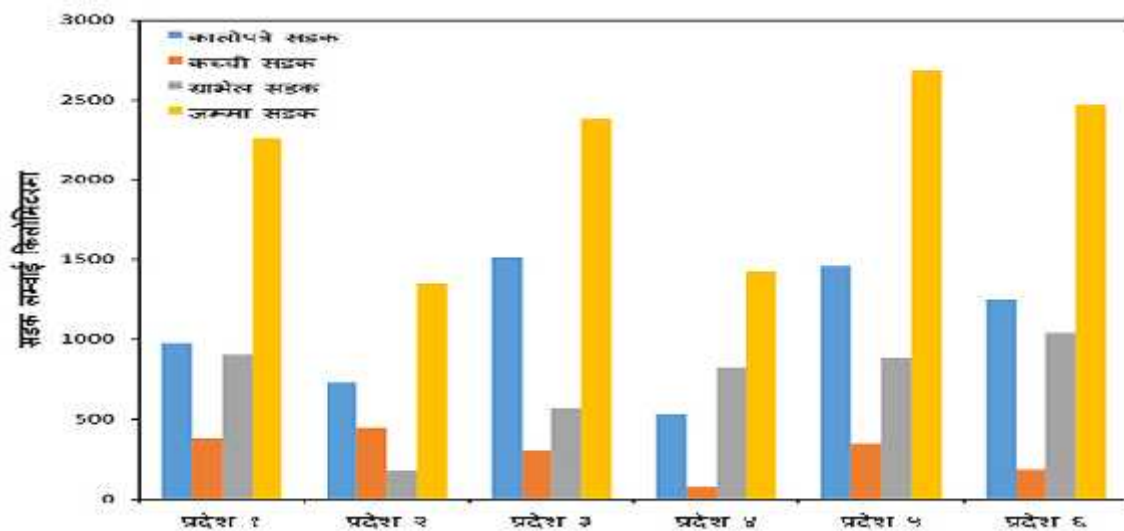
Table5.3 Present Socio/Economic Status of Proposed Provinces

Present socio/economic status of proposed Provinces					
Province	Area(Km²)	Population at (%)	Population density	GDP at %	Per capita income at %
1	25,905 (17.60)	17.12	175	17.46	52,973
2	9,661 (6.56)	20.24	559	16.23	41,226
3	20,301 (13.79)	20.87	272	31.90	79,032
4	21,504 (14.61)	9.11	112	9.29	53,058
5	19,838 (13.48)	17.14	229	14.91	45,229
6	30,435 (20.68)	5.73	50	3.87	35,045
7	19,539 (13.28)	9.63	131	6.43	34,0287
Nepal	1,47,181	2,64,94,504	180		51,879
Source: Researcher's construction with the help of Human Development Index 2015					
Note: The districts Nawalparashi and Rukum' s data has been divided into two section					

For example, the proposed Province 'THREE' has a distinct position among the other Province(s) in respect of developmental indicators. In the case of high literacy, high life expectancy and low infant mortality, high rate of enrolment of girl's in schools, low maternal mortality rate, low birth rate etc., Pradesh-3 stands much above all other Nepal's provinces. Pradesh-3 has the highest human development index among Nepal's Provinces despite relatively low per capita income. This Pradesh-3 characterised by comparatively high social development with low economic growth, has been acclaimed as an example for the welfare of the people and betterment of their social, cultural and political situation if there is an effective intervention of public action in this direction despite poor economic. Meanwhile, Pradesh-6 and Pradesh-7 is relatively weak even though to meet at least their administrative deeds.

Likewise, the mountains and hills contain 77% of the land whereas the Terai comprises 23%. Out of the total land, only 17% is considered arable. About 1,700,000 hectares of land can be irrigated and harvested. Of this, a mere 300,000 hectares (13%) are located in the mountain-hills that depend on the annual rainfall for growing crops. The annual harvest from this part is just 13% and has to feed 52% of the population of the 51 mountain districts, which hardly meets their need for half the year. The multi-million dollar

irrigation projects built by the government irrigate only 10% of the land in the hills while the rest goes to the Terai.



Source: <http://www.onlinekhabar.com/2015/08/314005/>

Roads are the mainstay of economic development. Some of the mountain districts still don't have access to roads. Forty hill districts touch onto roads, but more than 90% are earthen. Public transport hardly runs for half the year as they get muddy and slippery during the rainy season. Out of the 22,000 rural roads across the country, 63% of them are in the Terai. Similarly, 55% of the targeted 6,200 km-long agricultural road is estimated to be constructed in the Terai region. In terms of development infrastructure and resources, much of them are concentrated in the Terai region. Schools, colleges, hospitals, nursing homes, roads, electricity, TV, FM radio stations, big irrigation projects and many others are in the Terai districts in comparison to the mountain and hilly region. Because of this, hundreds of thousands of people migrate to the Terai from the hills every year.

Thus, compared to the mountains and hills, the Terai is more developed and has more resources in terms of development infrastructure, highways, industries and arable land. Another hurdle to development in the hills is the rugged terrain. Given the rugged geography, how can a federal system trickle down development opportunities to the people in regions like the Karnali? Thus, more than ethnicity, the debate on federalism should look at how equal distribution of resources can be made. Otherwise, it will lead to a gap in economic prosperity and growth among the federal provinces, resulting in poverty, backwardness and frustration among the people.

Within this scenario, the sharing of fiscal power and resources is one of the main potential areas of conflict in a Province. Thus, if appropriate mechanisms for the distribution of fiscal power are absent, it can create conflict later. Federal countries like Australia, Spain, Malaysia and Germany are relatively centralised in their distribution of fiscal powers (i.e., the central government has the main power to collect tax and other revenues), compared to Switzerland (which divide the right to taxation amongst the 3 levels), Brazil and Canada (which leave the right to raise revenue mainly in the hands of the federal units).

Likewise, the exertion of inappropriate distribution of resources between the central and sub-national governments, the consequent vertical and horizontal imbalances, resource gaps of the Province governments, inadequate and operationally defective transfer of resources from the federal government to the Province governments, etc. are not unique to the Nepal's set up alone. Many constitutions in the world are also facing similar problems. But, they have addressed these problems and have formulated some methods to solve them. To what extent such methods can be incorporated in the Nepal's Constitution and implemented in the functional areas of centre-province fiscal relations is a matter to be probed into.

Vertical fiscal gaps and revenue autonomy at sub-national orders of government remain areas of concern in federal countries where the centralisation of taxation powers is greater than necessary to meet federal expenditures, inclusive of its spending power. This leads to undue central influence and political control over sub-national policies, and can even undermine bottom up accountability. Considering all these aspects, it can be definitely said that there is vague horizontal and vertical imbalances towards implementation of federalism in Nepal.

Thus, there seem many reasons that the challenge of achieving the holistic level economic welfare is being unsuccessful according to purposed federal structure. However, political regime in Nepal has been changed and the state is under the process of restructuring. The Central State is going to be a Federal State through Constitutional Assembly. There is still debate in political circle about whether decentralization or Federal State would be an effective solution for the equitable development of Nepal. Despite the above achievements and initiatives, the absence of national level political arguments has constrained the effective implementation of federalism and local governance system. The major gaps and challenges observed are enumerated below:

- ✓ The concept and meaning of federalism/devolution are differently understood. The different understanding among different sectors has resulted in lagging the initiation arrangements of federalization process in Nepal;
- ✓ There is still debate between constitutional reforms. Most of *Madesh-Based* political parties and some others *Adhibashi-Janjati, Thaar* community does not take ownership of present constitution and they are campaigns against Constitution.
- ✓ Orientation and commitment of central level government institutions towards federalism in taking its advantages and ownership is not fully realized by the sectors
- ✓ The numeric structure of the Nation (How many provinces are suitable for nation) has not yet been decided by the Constitutional Assembly. Hence, there is not clear sight for the federalism in this changed political system.
- ✓ Unclear division of tasks across levels of government and between the Sub national sectors (overlapping functions between federal, provinces and , local bodies);
- ✓ Lack of clarity on LB revenue bases, revenue potential and revenue sharing system between layers of government and between LBs (this leads mismatch between expenditure responsibilities and revenue powers and fiscal capacity);
- ✓ Weak incentive or structure for fiscal autonomy and unclear expenditure needs and financial impact of the transfer of tasks devolved to LBs; and poor mechanism to enforce accountability.

5.4 Linking Bridge: What Fiscal ism Principle should we Know/(Adotp)?

Of course we are caterpillar phase to implement federalism attempts in Nepal. Fiscal federalism, from the very beginning, raised several fundamental issues. The assignment of responsibilities among federating units in Nepal has also created problems. First, there was the question of how each level of government would be given adequate fiscal powers to enable it maximize its revenue and discharge its constitutional duties and still preserve its fiscal autonomy. While a reduction of fiscal independence through central administration of a particular tax may conflict with the principle of fiscal independence of Provinces and LGs the hard choice might be between more fiscal powers and less revenue, or less fiscal powers and more revenue. The introduction of value added tax (VAT) which replaces

states sales tax and administered by the federal government is an example of one of such conflicts.

Second, there were problems of allocating the centrally collected revenue equitably among three levels of governments. Although, there are yet not to be fully acceptable principles for sharing revenue but in order to resolve this problem, various principles had been established global practices and, so we need take advantages from them. Likewise, another issue is the dominance of the federal government in the sharing of national resources from the common purse popularly known as the Federation Account. Thus, we need to chart out clear mechanism of fiscal transfer system among the different level of government. Third, fiscal federalism had been encumbered in the past by non-jurisdictional problems such as imbalance in population, size of land area, resource endowments and levels of development. Consequently, there has been a Hogue gap between the purposed provinces and the revenues they are able to raise on their own. This sharp difference between the very rich and the very poor levels of government tended to influence the principles applied in favour of poorer Provinces, and sometimes at the expense of the richer ones.

This seems that as federalism progresses a mismatch between expenditure requirements, revenue collection and fiscal capacity emerges leading to vertical and horizontal fiscal imbalances. To contain these imbalances across the level of government a system of intergovernmental fiscal transfer is adopted. Such transfers from Central government to proposed provinces and LGs are made in the form various conditional and unconditional grants. Overtime, such resource transfer from central government to local government units helped minimize, to some extent at least, contain the vertical as well as the horizontal imbalances among local bodies. Nevertheless, Local Bodies are still facing serious financial crisis in implementing various economic and social development programmes to meet the expectation of its people.

Thus, the Nepal's' fiscal structuring should adopts the different formulas that have been consistently increased the financial powers of the federal government as well as the other levels of government. We need to value that if the three tiers of government in a federal system were to simultaneously intervene in a market economy, without coordination, and perform the role of the public sector, the situation will be chaotic. Therefore, in order to ensure sustainable growth and national development, it is necessary to understand and institutionalize the policy issues of fiscal federalism. For resolving abovementioned

dispute, we should adopt following general principle of fiscal federalism purposed by Agiobenebo (1999) and World Bank (2005);

The Principle of Diversity and The Principle of Equivalence: One justification for the adoption of system is its ability to ensure unity in the midst of extreme diversities. So, the fiscal system must provide scope for variety and differences to adequately accommodate the supply of national, regional (province) and local goods. Similarly, the various public goods have different geographical incidence. Therefore, allocation efficiency requires the equalization of local advantages arising from interjurisdictional differences with a combination of taxes and public goods and services. The principle of fiscal equivalence implies that each level of government should finance its assigned functions with funds it raises itself. However carried to extreme this would lead to significant inefficiencies in tax collection from many revenue sources and distortions to locational choices of individuals and firms (Aleksander, 2012).

Correction of Spillover Effects principle: Efficiency of fiscal ism requires that inter-jurisdictional externalities be corrected for by the system. Spillover effects or interjurisdictional externalities refer to externalities (both benefits enjoyed and harm suffered) by residents of different geo-political units because benefit regions for many public goods and services are open entities. This requirement is intended to control for what in the fiscal decentralization literature is referred to as the “central city exploitation thesis”, exploitation of economies of scale and the rationale for intergovernmental grant.

Minimum Provision of Essential Public Goods and Services: This principle requires that fiscal ism should assure all citizens that, irrespective of where they reside, they will be provided with a minimum level of certain essential public goods and services.

Fiscal Equalization and Efficiency Principle:: Where there exists pronounced regional imbalance in resource endowment and concomitant differences in fiscal capacity of subnational governments, there is the need for some degree of fiscal equalization among the federating units of government to ensure minimum level of public goods and services. Likewise, there are two dimensions in a two-step hierarchy in efficiency principle. Firstly, it requires that, collectively, the set of criteria directing fiscal ism should ensure efficiency in the allocation of resources in the efficiency sense. Secondly, it requires that the collective principles of intergovernmental fiscal relations should ensure that each level of

government maximizes its internal revenue earnings at minimum tax efforts with optimal distortion.

The Principle of Derivation and The Principle of Locational Neutrality: This principles requires that the components units of a federation be able to control some of their preferences in their own way with their own resources. Likewise, Locational choices of both individuals and firms are influenced by interregional fiscal differences. Thus, some degree of locational interference appears to be an inevitable cost of fiscal ism given the natural differences in resources endowment, differences in tax capacity and effort. Policy therefore seeks to minimize the distortions arising from such interference.

The Principle of Centralized Stabilization and The Principle of Centralized Redistribution: The principle requires the use of fiscal instruments for achieving macro policy objectives (stabilization, growth, employment etc.) at the national level. Similarly, the redistribution function of fiscal policy through progressive taxation and expenditure programmes should be centralized at the level. This principle is mutually consistent with that of the principle of locational neutrality. In other words, if the redistribution function is decentralized, it can lead to distortions in locational decisions these principles are not mutually consistent. Consequently, they are difficult to adhere to simultaneously. Some of them conflict, thus calling for trade-offs. For example, the principle of diversity may conflict with that of locational neutrality with attendant socio-economic costs. Also the principle of equalization of fiscal position, in an attempt to achieve horizontal equity, may conflict with the efficiency criterion because of the disincentive effects of the former on labour mobility and productivity.

Principle in Efficiency in the Internal Economic Union: This requires that labour, capital, goods and services be able to move across provincial boundaries both unfettered and undistorted by provincial policies. Like all economic objectives, this one is not absolute: there may be legitimate social and political objectives served by provincial policies that interfere with inter-provincial trade, such as language policies, cultural policies, and policies that foster provincial social and development objectives. Achieving efficiency in the internal economic union involves measures of both *negative integration* and *positive integration*. The former entails proscriptions on provincial behaviour that distorts interprovincial flows or discriminates against non-residents. The latter involves

measures, such as tax, spending and regulatory harmonization, that facilitate inter-provincial flows.

Technical Diversion on Fiscal Equity: Since the principle of fiscal equity is critical to the design of the fiscal arrangements, it is worth digressing to mention the circumstances in which it might be violated in a federation. The notion equity-like persons ought to be treated alike by the public sector -to a setting. In the field of political economy, this is based on the idea that citizenship entitles all persons to be 'counted' equally from the point of view of government policy. Such belief demand that '*horizontal equity*' would require that like-persons be treated equally by both the central and provincial levels of government wherever they reside. Thus, fiscal equity is based on the notion of horizontal equity-the ideal that like-persons be treated alike by the fiscal system. The development of net fiscal benefits (NFBs) idea has been also one method to create horizontal equity in a federation. So, the vertical and horizon equity is necessary for sustainable growth and development. Based on this regard there should be three causes. In the first case, if provinces differ in the proportions of their population to whom public services are directed, they will differ in the per capita expenditures required to satisfy those needs. In the second case, if they differ in their endowment of natural resources, they will be able to provide a given level of public services at lower tax rates to their residents. The third case of differences in residence-based revenue sources, such as income, payrolls, or sales, is subtler.

5.5 Major Problems towards Fiscal Federalising Arrangements in Nepal

Unfortunately, there is not any the admirable design of the federalism model which is perfect on every context. Although, Nepal is a multi ethnic, multi-linguistic and multi-religious country thus the issue related ethical based federalism is itself a great challenge in Nepal. However, in economic aspects there is significant need to ensure sustainability and independence of sub-national units. The sub-national units will have to be resourced with equal share of distribution of revenue sources and natural resources. Each Province has to be federalised in such a way that it is in a position to function sustainably. The other reality is that the federal system increases the financial burden, and the start-up cost may amount to billions of rupees every year. That is why, federalising the country into a number of smaller states may not help them to be economically feasible and sustainable as limited resources get divided into many halves.

There are numbers of problems that confront the current fiscal federalism system in Nepal. The debate on the economics of federalism should especially look at two dimensions, first financial sustainability, economic policies and resources of the federal provinces, and second the start-up costs required for setting up the basic physical infrastructure of a federal province. Our ruling political class must understand that federalism without economic growth can't be sustainable and uplift the people's economic standard. Therefore, economic and fiscal basis should be viewed as the backbone of the federal system.

Another important dimension in federalism must be to ensure equitable distribution of revenue sources. Failure to slice up equal sources of income among the federal provinces would lead to economic disparity and development gap. Economy, income sources, distribution of natural resources and the mechanism to maintain good governance and transparency are the fundamentals for the prosperity and economic growth of the federal system.

The costs would be higher when the nation really embarks upon the federal system. The federal system increases the financial burden and gross expenses in totality. Experts believe that there would be a three-fold increase in the expenses. How will the costs be managed? Nepal has a limited source of income, and the concern is; would the existing source of income meet the vertical increase in the federal costs?

Likewise, in revenue collection perspective, Kathmandu, Birgunj, Bhairahawa, Biratnagar, Jhapa and Nepalgunj are the main revenue outlets, which collect more than 80% of the total revenue every year. And the collected revenue goes to all 75 districts of Nepal. If we look at proposed province 6 and 7, they are able to collect hardly 20% of the administrative expenses through the revenue. Thus, if we fail to allocate equal sources of income among the federal states, some already backward western regions will continue to remain so even in the federal system. To deal with such inequality and backwardness in a federal system, a strong financial equalisation policy needs to be agreed upon before Nepal opts for a federation, which can be an effective tool to manage conflict and cooperation in a new federal system.

This shows that Nepalese fiscal ism also suffer from many dogma and challenges. Thus, in this section, we have tried to review some of the general problems of the current arrangements and reform, especially those that are important in upcoming days. Therefore, this section presents the key challenges that impacts smooth implementation of the

federalization system in Nepal. Although, Decentralization has reached a significant height in Nepal, attributing to the heightened drive towards federalization mentioned in the prior chapters. However, federalization system in Nepal is still confronted with challenges and some major challenges adequate by this inquiry are focused on the following Seven key areas;

- ❖ Equalization
- ❖ Issue regards Administrative and Executive Capacity
- ❖ Lack of Technical Knowledge and Technical Overheads
- ❖ Treatment of Natural Resources and issue of Sustainability
- ❖ Lack of Facilitating Infrastructure
- ❖ Intergovernmental Fund Transfer Mechanism
- ❖ Other Problems with Fiscal Federalism

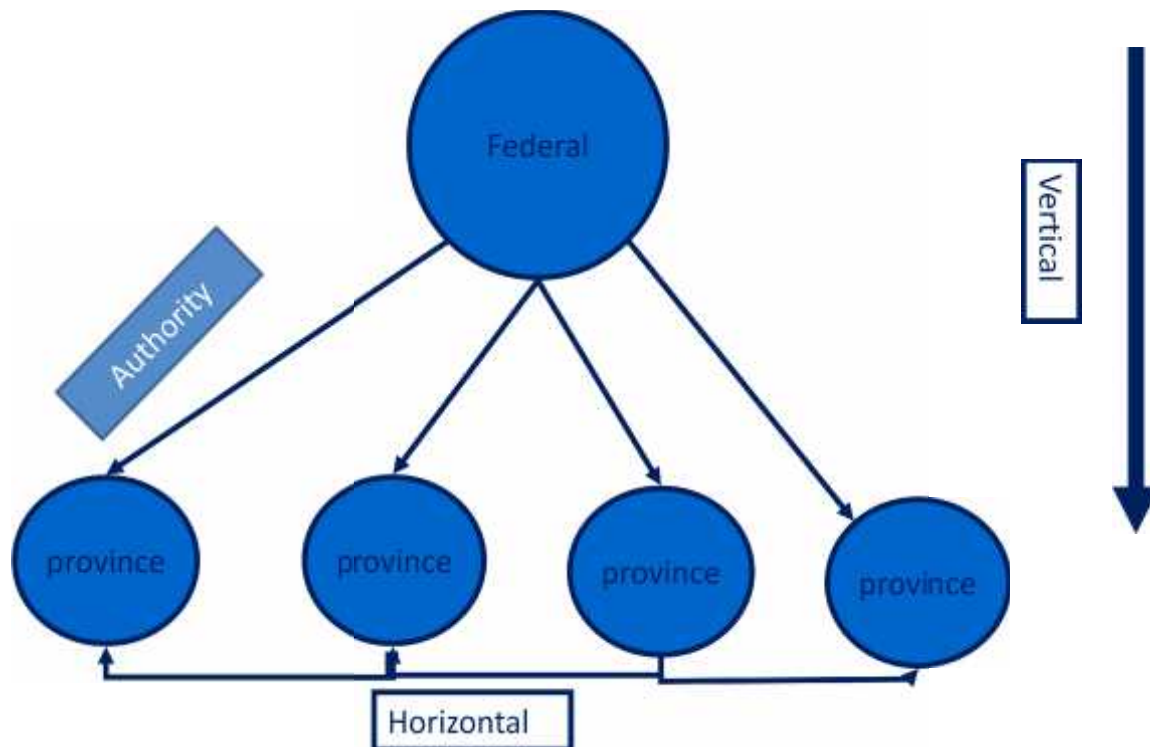
5.5.1 Equalization

As we know, equalization is the backbone of the every federal system. However, at present scenario, the central government collects the major part of taxes and the Central Development Region (most of Part of this Region belongs to *Pradesh-3*) collects around 80% of total revenue which includes the contribution of custom duties. Even if custom is taken out, the share of the Central Development Region will be high. In the same sketch, provinces 6 and 7 have a weak revenue base relative to their expenditure responsibilities. More concretely, if we examine the current trend of revenue generation, we see that it is concentrated in only four places: Kathmandu (prvince-3), Parsa and Morang (province-2) and Rupandehi (province-4), as far provinces 1,5,6,7 does not seems capable for their executive overheads. Kathmandu alone accounts for 48% of the total revenue. Revenue allocation is a base of financial balance at different levels of the government. Based on the resources and their possible impact, the sharing of fiscal power and resources is one of the main potential areas of conflict in a federal Provence.

Same context Prasad, U.S (2015) put that the expenditure of local level at VDCs, DDCs and municipalities is very small in comparison to total government expenditure. In the fiscal year 2013/14, expenditure of the local level was only 8 per cent of total government expenditure (LBFC, 2015). The revenue generated by the local levels is not sufficient to meet their expenditure responsibilities. In the fiscal year 2013/14, the share of local body's revenue was only 12.1 per cent of total revenue collection of the government (LBFC,

2015).³⁸ This shows that, Local governments in most federations have a weak revenue base relative to their expenditure responsibilities. Therefore, the local governments highly depend on transfers.

Fig; 5.5.1 Theoretical Ideology of Fiscal Equalization in Nepal



However, the goal of Equalization is fiscal equity-to ensure that the provinces have the fiscal capacity to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. Absolute comparability is not attainable for various reasons. For one, the provinces undertake a wide variety of responsibilities and finance them in a wide variety of ways to meet the differing needs of their residents. Given the diversity of provincial fiscal policies and needs, the meaning of comparability is not clear-cut.

Moreover, the provinces face very different physical and cost conditions. If it is more costly to provide public services in, say, remote areas, there will be a trade-off between efficiency and horizontal equity that will preclude absolutely equal access to public services from being achievable, or even desirable. Indeed, differences in the level and quality of public services may be greater between urban and rural areas within provinces

³⁸ Prasad Uma Shankar, (2015), Nepal's Fiscal Federalism Model in the New Constitution: Agenda for Amendments, NRB Review, Kathmandu, Nepal.

than between comparably situated persons across provinces. As well, as with any redistributive program, Equalization inevitably brings with it adverse incentive effects that may temper the extent to which full fiscal equity can be achieved.

Likewise, there is strongly exists another problem that is affected by '*substantive equalization*' in Nepal, such as regional development that may affect program design. And, perhaps the thorniest issue is the apparent contradiction between equalizing resource revenues on the one hand, and the provincial 'ownership' of natural resources hinted at in constructional provision on the other.

5.5.2 Issue regards Administrative and Executive Capacity

The debate on a federal system has also been limited only to its political dimension. The parties and their leaders were obsessed with this issue because they were interested in breaking down one centre and making multiple centres with shared political power. If political power sharing becomes the core interest of the stakeholders while restructuring, it is a problem as their intention to share political power usually does not extend much beyond the political elites. However, state restructuring goes far beyond power sharing. It cuts across of almost all dimensions of the states and, if carefully devised and effectively implemented, it can extend right down to the grassroots and transform the lives of the common people.

The federalization process in Nepal entailed a major shift in the roles of the government at all levels. This is expected as delegation creates more opportunities for local autonomy and responsiveness to more specialized constituencies. It also gives sub national governments more room to fail if specific steps are not taken to build local technical and managerial capacity (World Bank, 2002). Thus, the power/authority devolution process in Nepal of course shifted the existing role of the sub-national government to that of proactive and engaging development facilitator, assisting and enabling communities to identify priorities and to allocate and utilize resources efficiently and effectively for development project.

However, one major factor that has beset federalization system in Nepal has been the capacity problem, especially at the proposed provinces and local level and even the central government suffers some height of capacity constraints. If we critically look at the purposed model of federalism, there is lack of executive staffs at the blocks. As a result the province and LGs will become more isolated on their development. Thus, due to the

additional responsibilities at the states and also due to the lack of executive staff at the province, the province heads has been performing the dual role of governance and the routine administration and thus, there is conflict of interest where the province head is responsible for implementing and auditing his decisions and actions. Expansion of government's capital expenditure is a must to meet the target of achieving country's development and higher economic growth rate. However, the average ratio of capital expenditure to GDP in the purposed model of federalism has remained huge vertical and horizontal gap. Hence, improving policywide, structural, administrative aspects in order to achieve high economic growth rate through expansion of capital expenditure is a daunting task. Thus, issue regards administrative and executive capacity should be a major challenge in fiscal ism amendments in Nepal.

In terms of size, Nepal is smaller even to some of the states in India. Even countries like Pakistan which is four times bigger than Nepal has only four federal Provinces. But from the development perspective, the smaller the federal provinces, the more difficulty they face in being sustainable. Small provinces get scanty share of resources which will be insufficient even to meet the daily administrative costs and development works.

India, US, Canada and other successful countries had already attained a layer of physical infrastructure and resources when they entered into federalism. Therefore, they did not have any financial problems in the federalising process. But that is not the case with Nepal because Nepal is adopting a federal model from scratch. We don't have enough the logistics and resources even to meet the start-up costs.

The costs will be automatically higher as the present day physical infrastructure will not be enough to sustain the federal system. New legislative, judiciary and executive, and other buildings and infrastructure have to be constructed, requiring colossal amounts of money. It is a reality that we have not been able to reconstruct infrastructure like bridges, schools, offices of the village development committees, government buildings destroyed during the conflict due to lack of resources.

Thus, the million dollar question is: how are we going to build these basic infrastructures in the mountains and hills? It would be imperative to manage instantly at least a layer of development and other physical infrastructure projects in the mountain and hilly region when the country goes into the federal system. How are we going to manage the financial resources even to meet the start-up expenses? Adopting a federal model alone will not

resolve the problems instantly unless they are scientifically sliced up, equitably resourced, ethnically balanced and effectively governed.

5.5.2 Lack of Technical Knowledge and Technical Overheads

To take the dividends of state restructuring down to the grassroots level, the technical capability, and skills of provinces becomes a crucial factor. The capability of a province is mostly about human resources. It covers the availability of human resources in the nation and the capacity of provinces to generate and spend revenue (fiscal federalism). However, there has not been much debate either on fiscal federalism or the technical capacity of proposed provinces to discharge their constitutional responsibilities and bring the dividends of states restructuring to the grassroots.

Although, the federalised system has placed increasing workload to the new leaders and also demanded for transparency, efficiency and accountability. They shoulder more responsibilities. Valuing and having the capacity to systematically monitor, evaluate, report, review progress and document all this are essential from the centre down to subnational level. Thus, for the proposed provinces to shoulder their new roles and responsibilities effectively and discharge their assigned critical functions ably, the existing capacities of local governments and institutions will have to be enhanced considerably. Here the immensely critical factors that will determine the success that the local government will enjoy in carrying out their function and responsibilities would be the institutional capacity building and human resources development at local levels. Thus, achieving this will require improvement in the quality and numbers of administrative and technical staff in Province and blocks (local governments). Equipment of the community leaders with technical knowledge and fluency over the general policy issues that comes with policy issues were very vital. However, in the current scenario, there is reluctance among the civil servants to serve in rural areas and also the line ministries tends to retain their most qualified personnel in the centre. Many of the local leaders are hardly literate and in many instances, the local leaders are not even in the position to distinguish between the role of federal government and local.

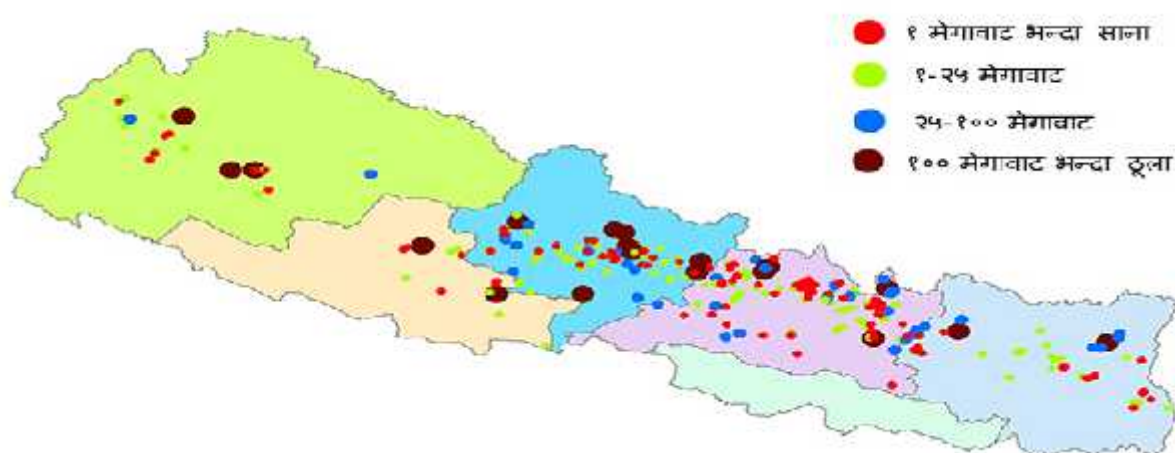
This form of capacity constraint has been one of the most challenging counter forces to federalized Nepal. Thus, lack of such technical knowledge and being not fluent with the local efficiency poses serious problem for future federal Nepal.

5.5.3 Treatment of Natural Resources and Issue of Sustainability

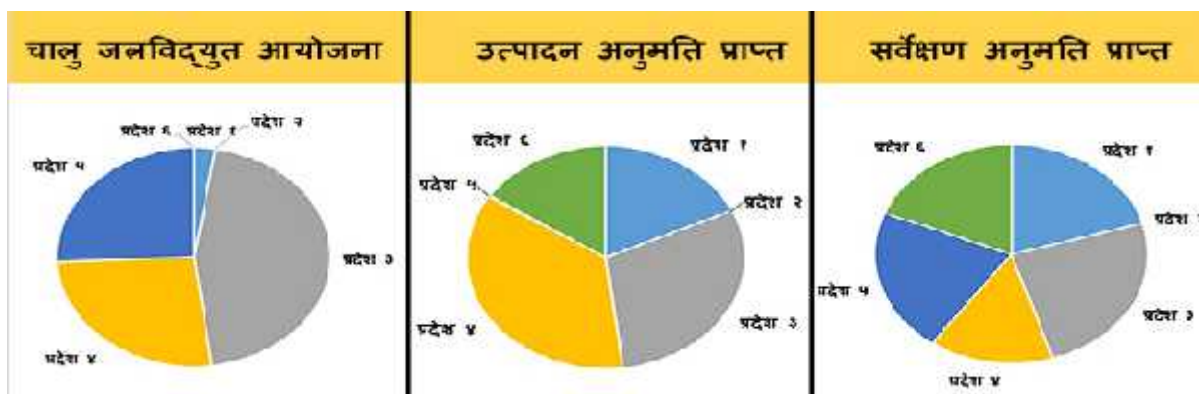
Although, natural resource revenues are very different from other sources. Some natural resources are variable between federation and sub-national governments within federation. But most are immobile. Since most of the natural resources are immobile, revenues from these resources can be assigned to the local levels. However, resources are almost concentrated in only some parts of the country, tensions could arise in sharing process.

The treatment of provincial resource revenues in the federalism is always crucial. As alluded above, Nepal's main resources are natural resources. Some of these resources, such as forests, natural herbs, rivers and fertile land, are easily exploitable, whereas states Restructuring and Federalism Discourse in Nepal minerals are more difficult to exploit. Nepal's natural resources are unequally distributed throughout the country, with some regions being richer than others in natural resources. People's lives and livelihoods have a direct relationship with the natural resources that are closed to them. The Province's policy and role are very important to amplify the benefits people can obtain from natural resources. The Province must ensure that the people who live close to natural resource receive maximum benefit from them, while at the same time preserving and protecting these resources. The Province also has to make sure that the benefits of these resources are distributed to those who are far from such resources. One of the weaknesses of Nepal's centralised and unitary system is the inability to do so. Hence, maximising the benefits of natural resources and distributing them equitably throughout the country is one of the major objectives of Province restructuring in Nepal.

Figure: 5.1: Map of hydro electricity Of Nepal³⁹



³⁹ Pradesh 6 and 7 are combined.



Another problem that arises with resources is that some of the benefits can accrue to the province in a form other than revenues. An example of this might be hydroelectricity rents. Rather than collecting revenues from hydroelectric firms in the form of taxes, provincial governments may instead use hydroelectric facilities to provide cheaper electricity to its domestic residents and firms. This is not uncommon in the case where hydroelectric utilities are provincial public corporations. Of course, some of these lower prices will give rise to increased incomes to local producers, which then enter into the Equalization formula, and to that extent the problem is undone. Revenue sharing from hydropower will be a controversial issue in Nepal. Hydropower resources are highly concentrated in a small number of hill and mountain areas. It will create conflict if the revenues generated from hydropower will not be shared by wide discussion and after national consensus. The royalties of hydroelectricity could be shared by the sub-national governments.

5.5.3 Lack of Facilitating Infrastructure

As we know, poor reliability and access to power are the most serious infrastructure bottlenecks to growth. Increasing access to electricity in a timely and cost-effective manner is one of the most significant development challenges facing Nepal today. Efforts to reduce the 16-hour load-shedding during the dry season have been unsuccessful. Ironically, Nepal has one of the largest untapped hydropower resources in the world – an estimated 83,000 MW of hydropower potential.

Inadequate and disproportionate development of the physical infrastructure like transportation, communication, electricity is also a major development issue which has retarded the overall development of the nation. Majority of the rural areas in Nepal have not been integrated into the mainstream of the economy because basic infrastructure including road, electricity, communication have not yet reached out to these areas. We

have been facing the severe problem of energy crisis including huge burden of load shedding despite the huge hydroelectricity potential within the country. Failure to match demand with adequate production and supply of electricity has adversely affected all sectors of the economy. There is a lack of drinking water and inadequate development of the irrigation system within the economy. One of the challenges to the economy is, thus, how to develop adequate physical infrastructure in proportionate manner in the economy including expansion of the agricultural roads, access of remote districts to the road networks, production and supply of hydroelectricity as per the demand through the investment in this area.

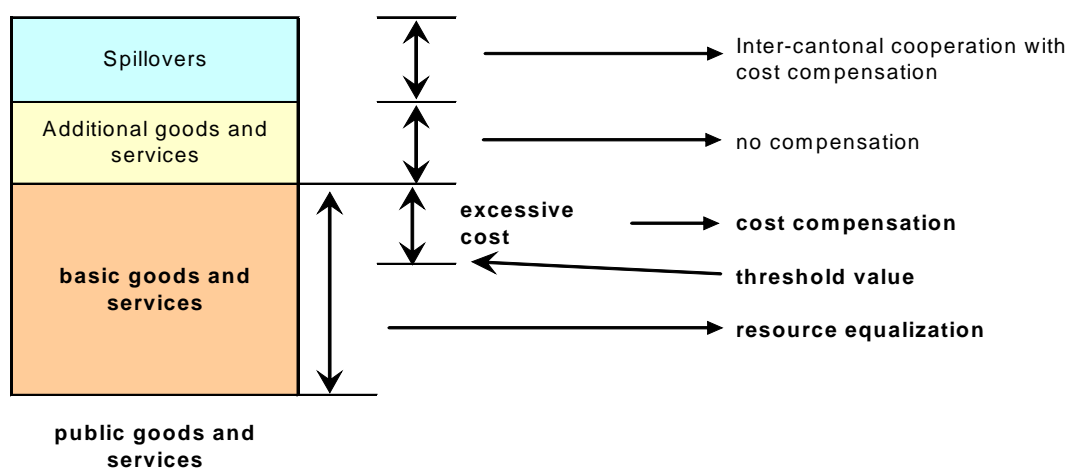
Thus, poor physical connectivity has been another major challenge to Nepal's federal efforts. Its road density is one of the lowest in South Asia. Over one-third of the people in the hills are more than four hours away from an all-weather road. In addition, two district headquarters are yet to be connected by road. The quality of the road network is also poor –60% of the road network, including most rural roads, cannot provide all-weather connectivity.

As Nepal moves towards a people-centric federal based development approach and empowers people at the grass root level to make their own decisions on issues affecting their community, a certain level of facilitating infrastructures like the roads, telecommunication facilities, electricity and information technology facilities are indispensable. However Nepal still has many blocks without the access to roads, telephone services, banking institutions, postal services and etc. It is also a tremendous challenge to deliver information to the people at the local level given our rugged terrain and geographical barriers. Inadequacy of the facilitating infrastructures makes it extremely difficult both for the blocks to interact with the higher level of government or the higher level of government reaching down to the local governments for the provision of the public services. For example: When the materials for the construction of the development infrastructure have to be transported by head load to the far flung villages from the nearest road point, it becomes very tedious and takes a lot of time often delaying the implementation of the development plans. Thus, the lack of these facilitating infrastructures had been a serious predicament for the effective implementation of the federalism process in Nepal.

5.5.5 Intergovernmental Fund Transfer Mechanism

Still there is a lack of clear policy and legislation about the fund transfer system of Government of Nepal. Although the performance based grant system is good initiative, its evaluation procedure needs to be implemented impartially and measurement indicators must be more pragmatic so that each tiers of government will have equal chances to show their performance. It is important to have a very strong and effective monitoring system at center to carry out monitoring in quarterly basis that contribute to correct procedural weaknesses of the local government bodies in time. Moreover, the reporting system is also very vital for policy makers. It is realized that neither there is uniformity in report format nor the report is prepared in the stipulated time frame by the local government bodies in Nepal.

Fig: 5.5.5 Concept of Financial Equalization



Center grant transfer system emphasizes process rather than output of the service delivered by the local government. The Government of Nepal does not provide grant in line with the approved annual program and budget by the respective local government council. Formula based grant system of Government of Nepal should be effective. Likewise, there is no good monitoring and motivation mechanism of the programs and projects implemented at the local level. There is no scientific and practical forecasting system of revenue for coming fiscal year at district level. It is necessary to discourage the process of formulating plans based on access and power of certain groups of the society. There should be special treatment for the province having very low internal revenue. For example, the ceiling of using internal revenue in administrative purpose is same for all provinces. Thus development of effective intergovernmental fund transfer mechanism is one major problem of federalism in Nepal.

While designing the intergovernmental transfer system it is important to take note of the international practices. The following universal principles of transfer design provides a good guidance for designing a system of fiscal transfer that is theoretically sound and hopefully less problems in its implementation;

- Should provide adequate resources to LBs that balances national priorities and Province autonomy
- The formula should be fair, especially for poor jurisdictions
- Transfers should be provided in a predictable manner. The formula should be stable Simple, transparent, and understandable
- Should not create negative incentives for revenue mobilization, neither induce inefficient expenditure choices
- General allocation transfers or equalization transfers should be granted as unconditional lump-sum grants, and
- During the introducing of the new system it should avoid sudden large changes in funding for local governments.

5.5.5 Other Problems with Fiscal Federalism

- Unequal distribution of means and resources between the provinces may cause unequal development and misunderstanding among the provinces.
- There may be conflict between the provinces regarding the use of natural resources of border areas.
- Federal system of government is more expensive so that there may be lack of sufficient budget for its successful operation.
- There may be misunderstanding between federal government and provincial government regarding the sharing of power and authorities.
- The provinces may demand for a different and a separate state which can threaten the national integrity and indivisibility of the nation
- In Nepal, labor shortage at the local level has been observed as a major capacity constraint for the execution of the federalism. Thus, the labor shortage will be one great challenge for upcoming days in federal Nepal. Even in decentralization policy, the UNDP (2005) observed that most blocks (VDCs, DDCs, Municipality) of Nepal are not able to implement their

planned activities and the sector heads go beyond their role as facilitator and force them to complete the work on time.

5.6 Chapter summary

The fiscal federalism amendment in Nepal is suffering by many challenges as discussed above. Challenges have been faced in the planning and implementation process. The federalization of tasks to the blocks has called for increased capacities to discharge new roles and face new risks. Thus, incapacity at the proposed province(s) and LGs had been a serious concern for the moment, which has to be carefully addressed. The sustainability of the blocks is questionable, given the limited tax base. It calls for continuous and unfailing requirement for the Province to provide annual subsidies and expertise for the development of the Blocks.

Despite the substantial powers being devolved to the different types of governments, the local authority is facing resource constraints to effectively utilize the powers and authorities being devolved. However, we should also understand the resource position of the government, where the country depends almost entirely on external assistance for capital investments. A pressing problem faced by the federalism process is also the uncoordinated approach to addressing decentralization system especially when dealing with donor supported development activities. This calls for streamlining the approach through better coordination mechanisms. The delays in the implementation of developmental activities occur as a result of lack of proper coordination between the sectors, local governments, central governments and provinces. Thus, a system that connects all the players and stakeholders in the process of federalization would result in avoidance of duplications, overlaps, and over-planning of power sharing/using activities.

CHAPTER- SIX

RESOURCE MOBILIZATION, REVENUE ALLOCATION, EXPENDITURE TASKS AND FISCAL ISM IN THE CASE OF NEPAL: ISSUES, CHALLENGES AND POLICY OPTION

“Taxation is theft, purely and simply even though it is theft on a grand and colossal scale which no acknowledged criminals could hope to match. It is a compulsory seizure of the property of the State’s inhabitants, or subjects.”

– Murray N. Rothbard

6.1 Chapter overview

To review and analyze the right treatment of the natural resources, revenue and expenditure assignment among different tiers of government is very crucial while studying the fiscal federalism. Thus, this chapter deliberate within those three interconnected issue; resource mobilization, revenue allocation and expenditure assignment and its signification relation on fiscal setting. Although, Nepal operates three tiers of government; Federal, Province and LGs with separate revenue, expenditure, and assigned responsibilities each. However, till a date, both vertical and horizontal revenue in Nepal is swallowing up in controversy. More likely, this chapter presents key issues, trends, and challenges of resource mobilization, revenue allocation, expenditure responsibilities towards fiscal federalism amendments in Nepal under the newly promulgated constitutional provision. In addition, the chapter in/directly highlights a number of suggestions that would stimulate increase in tax and non-tax revenue and guarantee fiscal assignment acceptable to the federal and sub-national government.

6.2 General Expectation and Issue towards Efficiency of Fiscal Arrangement

The choice of whether a country becomes unitary system, confederation or a federation is a political decision. This political decision once made, have implications for political government, fiscal management and economic development as well as the attainment of social stability (Okunroumu, 1996). However most of economic scholars including Aigbokhan (1997), Olowonmi (2000), and (Afolabi, 1999), believe that the exceedingly

important goal of any government is efficient allocation of resources and efficient distribution of national wealth. This problem is apprehensive that how the revenue apportioned to the central government can be shared among these aforementioned tiers of government.

While, generally issues allied with expenditure and revenue assignments, inter-Province(s) resource transfers, resource sharing and devolution of economic power and authority in each level or tiers come within the orbit of fiscal federalism. Theoretically, more and more public services assigned to the local governments may be appropriate from the point of view of delegating more expenditure power from the center to the local governments. But, in Nepal's context the initial conditions complicate the matter. The institutional setup and the absorptive capacity at the local level vary quite distinctly. Similarly, the large variation in socio-economic conditions among different classes, various castes and ethnic groups complicate the problem of expenditure targeting at the local level. The interrelated problem arises as a result of the initial condition reflecting a very large gap in the level of socio-economic development between urban and rural areas as well as remote and more accessible regions or areas.

Although, an emerging view across the political spectrum and present constitutional setup seems that such a problem could be resolved through the means of revenue assignment, inter-states resource transfers and resource sharing (Wagle, 2015). However, the authority to impose more and more taxes at the local level does not solve the problem either. But the resource mobilization at the local level again is based on the existing level of socio-economic development and future revenue potentials. The latter is additionally linked to, among others, the resources in general and natural resources in particular at the disposal of the proposed sub-national or local government which will vary widely.

Based on this context, a priory right of the Province(s) or LGs in the resources within the boundary could be an appropriate approach, this will not be sufficient. More concretely, the present arrangements seem could be more appropriate, in a situation of too much regional developmental variation, it will be still inadequate. The needs of the Provinces or LGs in our context have to be considered taking broad long term socio-economic developmental perspectives including resource potentials into account. This is the most complicated issue to be dealt with.

6.1.1 Allocation of Natural Resources: Issue, Fact and Possibility

As we believe that the most powerful driver of regional development in federations concerns natural resources. As Srivastava, (2011) pointed out; organizing the country in terms of provinces would require that issues concerning the division of natural resources be dealt with in a fair and transparent manner. Many new problems would arise in situations where rivers run across the boundaries of several provinces or a mine is partly located in one province and partly in another. Forest management may also create positive benefits for provinces other than the province where the forest may be located. Conflicts among provinces regarding ownership of natural resources and utilization would require setting up a suitable institutional skeleton.

One of the key development issues in Nepal is how to harness the natural resources available in the economy. We are rich in some resources such as water, forest, minerals etc. Nepal has about 6000 rivers and rivulets. Theoretical potential hydro power of Nepal is estimated to be about 83000 MW whereas sites those are technically feasible for development could generate 44000 MW. However, Nepal has so far been able to produce only a small fraction of this potential resource- only 756MW up to FY 2015/16. We have also minerals deposits of Iron, limestone, Zink and others in many places in the economy, but no detailed survey of these resources has been conducted yet. We have also land with different altitudes capable of producing several type cash and food crops, medicinal herbs, flowers, fruits; vegetables etc. Harnessing forest alongside bio-diversity could also become a potential resource. We can harness water resources through hydroelectricity generation and exporting it to India, and expanding irrigation and drinking water facilities. Nepal has been a tourists' paradise for many years because of incredible natural beauty and man-made to some extent. Nepal can create tourists magnetic atmosphere and can earn huge amount of foreign exchange if the government and private sector both take initiative in constructing tourism infrastructure development. It is also a challenge of developing a country as a tourist destination by conserving and expanding the existing tourists' locations with adequate publicity; and exploration, identification and expansion of the new tourist's sites. Thus, a major challenge to the economy is to harness available natural resources in optimum manner and preserve the renewable as well as non-renewable resources for future generation.

In this respect, the commendations of the water and forest resources are abundant in Nepal and offer considerable economic potential that remains largely undeveloped. Considerable inter-provincial cooperation is needed to develop the hydroelectric and irrigation potential of rivers as they cross provincial boundaries. Similarly, building reservoirs and dams involves the displacement of people in the affected areas that can include parts of different provinces. One of the more frequently asked questions concerns the right to collect revenue from hydroelectric power resources. Hydro-power resources are highly concentrated in a small number of hill and mountain areas. The provinces that have a major share of water resources may need to be given the right to earn income from their hydroelectric resources, but there may be relevant grounds for sharing the overall revenue with the centre or with the other provinces. Water and forests each have special features in the management of natural resources in a federal system. Rivers cross provincial boundaries and upstream exploitation of water for power and irrigation purposes has implications for people downstream.

In such a context, the issues of who “owns” the river and who administers the related activities, and who gets revenues or royalties from its power generation and water usage – i.e. the central or provincial governments – become significant questions. In the case of forests, the geographical location is easily identified and it is easier to identify people and provinces that may be considered as owning forests and being responsible for their maintenance. The development and maintenance of forests give rise to considerable inter-regional and international environmental issues. While provinces may gain direct revenues from timber and non-timber resources, they also need to be rewarded for their contribution to the environmental cause because of the capacity of the forests to serve as a carbon sink. Forests and water are also interlinked as forests play a role in promoting precipitation. There are also livelihood issues concerning local populations who may have been traditionally dependent on the forests. A natural resources commission can play an effective role because the management of forests, rivers and hydroelectric power potential involves national and inter-provincial issues, and the central and provincial governments have to play significant roles.

Overall, the allocation of natural resource revenues to Province governments causes various problems. Horizontal imbalances in fiscal capacity encourage fiscally-induced migration that can be of significant size (Day and Winer, 2006). Other hand, equalization transfers can address this issue, but this can be both costly for the federal government -

especially if it does not have access to these revenues-and politically difficult since the Provinces regard the natural resources as part of their property rights. Moreover, federalization of resource revenues can leave resource producing Provinces with a volatile source of revenue that cannot be set against other revenues as well as at the federal level. The Province governments may also be less able or willing to establish a resource fund to save the revenues for the future, and that will exacerbate the resource curse. Resource-rich Provinces also have a strong temptation to use the revenues for Province-building purpose, by investing in infrastructure and diversification that diverts economic activity from other Provinces.

6.1.2 Sources of Revenue of government of Nepal

The major sources of Revenue of government of Nepal are tax and non-tax revenue. Table 6.1 shows the trend of tax and non tax revenue collection by the central government of last 7 years from fiscal year 2009/10 to 2015/16 and the gross domestic product (GDP) of the same period. The ratio of tax revenue ranks from 10.4% in 2009/10 and 12.4% in 2014/15. The result suggested that tax revenue and GDP ratio was around 15% for 2009/10, however, an average ratio was around 13% for last seven years. The data exhibited that the growth rate of revenue in percentage point was highly fluctuated. The tax revenue has been increased by 33.3% in FY 2010/11. The lowest growth rate was 11.4% in 2007/08.

Similarly, the ratio of total revenue (tax and non-tax revenue) to GDP is between 10.09% and 15.35% in 1996/97 and 2009/10 respectively while the average ratio of 15 years of total revenue to GDP is only 13.01% (Table 6-1).

Table 1: Ratio of Tax and Non Tax Revenue with GDP

Fiscal Year	Tax revenue -GDP Ratio	Non Tax revenue – GDP ratio	Revenue % change
2009/2010	10.4	2.8	22.7
2010/2011	11.8	2.7	33.3
2011/2012	11.4	1.5	27.2
2012/2013	13.0	1.5	23.1
2013/2014	13.9	2.1	21.2
2014/2015	15.3	2.2	22.3
2015/2016	12.4	1.1	(19.4)
Notes			
1. The figure of FY 2014/15 is revised, FY 2015/16 is just preliminary and remaining is actual.			
2. Source: Economic Survey of various fiscal years, Government of Nepal, Ministry of Finance			

However, the economy of Nepal has suffering from different problems like resource constraint, rapid growth of population, aggressive dependence on agriculture, lack of revenue surplus for development, increasing reliance of foreign loans, domination of indirect taxes to direct taxes and widening resource gap.

The different types of resource gap have been defined as follows:

A) Resource Gap (RG1): This is the difference between expenditure and revenue. It is also known as Fiscal Deficit.

$RG1 = \text{Total Government Expenditure} - \text{Total Government Revenue}$

Here, Revenue includes total tax and non-tax revenue and Total expenditure includes both regular and development expenditure. The concept of RG helps us to know the government's capacity to finance the nation's expenditure.

B) Resource Gap (RG2): This is the difference between expenditure and revenue plus foreign grant. It is also known as Budget Deficit.

$RG2 = \text{Total Expenditure} - \text{Total Revenue} - \text{Foreign Grant}$

Here, foreign grant includes both bilateral and multilateral grants.

C) Resource Gap (RG3): This is the difference between expenditure and revenue plus foreign aid (grant or loan) plus internal borrowing. It is also known as Overall Deficit.

$RG3 = \text{Total Expenditure} - \text{Total Revenue} - \text{Foreign Aid (Grant or Loan)} - \text{Internal Borrowing}$

6.1.3 Revenue Distribution Mechanism

The distribution of revenue between central and subnational governments and the allocation of centrally collected revenues among different Provinces is yet another quite complex problem. For instance, almost all revenues (as catalyse in previous chapter) is collected by major FIVE districts (Kathmandu, Birjung, Rupandehi, Jhapa and Morong). The real challenge in this respect is to design a transfer formula that can accommodate poverty criteria while being politically palatable to all. Naturally there may be differences in the resources endowed by the different Provinces.

In this sense, people in relatively affluent Province may enjoy premium services, while those in poorer ones struggle for basic services. Given these disparities in capacities and services provision across Provinces may create fiscal havoc within a federal framework if

it is not handled carefully. Hence, the challenge is twofold: first, to accommodate the growing desires of selected Provinces acquiring greater fiscal autonomy; and second, to design an overall transfer system to satisfy both the desire for more fiscal autonomy on the part of relatively high revenue Provinces and the equity imparities of the relatively low tax capacity Provinces(Courchene & Wabb, 2000; p. 202)⁴⁰.

Too often intergovernmental fiscal arrangements involve only governments but federalism is presumably a system that ought to benefit people. One way to accomplish this would be to ensure that all citizens in the federation have been granted the right for equality of access to a minimum provision of some notional basic public services, such as education and health. Intergovernmental fiscal and financial relations thus become a balanced act between two poles: financially autonomous subnational governments to achieve allocative efficiency, and central government interference to alleviate horizontal disparities. The problem at the very outset requires a prudent design of tax assignment and spending functions between different levels of government over the control of financial resources in the decentralized environment. The problem is further accentuated by the contradictory accountability references. One theoretical approach favors the fiscal responsibility notion which requires that lower tiers of government should be accountable to the central government and not to their local taxpayers or residents. Since they accepted central transfers on the basis of providing public goods and services according to obligations and goals presumed by central government priorities and policy objectives. The subnational governments accept this delegation expecting to maximize their economies and equity goals. The other theoretical approach prefers to the principle of financial autonomy. That is to say, we need to find answers to such questions as:

(One) How to allocate resources rationally?

(Two)How to assign taxing powers reasonably and efficiently?

(Three) How to share revenues? (Fadlalla, 1984; p.1)⁴¹

⁴⁰ Courchene, Thomas and Cayeros Alberto Diaz, "Transfers and the Nature of the Mexican Federation", in Giugala Marcelo M. and Webb, Steven B., (eds.), *Achievement and Challenges of Fiscal Decentralization: Lessons from Mexico*, the World Bank, Washington D.C., 2000; P. 202.

⁴¹ Abdalla, Al – Hadi Abdal Samad, "Intergovernmental Relationships in the Sudan Federal System: Co- operation, Conflict, or Covariance?", in Salih, Hassan M. etal., (eds.), *Federalism in the Sudan*, Khartoum University Press, 1995;p.225.

Or to put it differently, how much fiscalism should there be? And, how intergovernmental fiscal and financial relations should be managed to satisfy both the growing need for local public services and to preserve national integrity and fiscal discipline.

However, till a date there are no clear yardsticks that govern the concrete distribution framework of national resources among the federalized structure in Nepal. How much a Province gets from the center depends on the evaluation view of the holder of the “purse” and dexterity of Province governor, with some intervening political considerations. Governmental units have traditionally been confronted with geometrically rising popular demands for goods and services, while available resources to meet the demands have been rising only arithmetically. There has always been a satisfaction gap. The problem is exacerbated by the mal – allocation of resources and the net result of conventional (Circular) amplifying policies of development that concentrates development efforts where infrastructure and services are already available. All these have backwash effects on federalism” (Abdalla, 1995; p.225).

In this extends, there are a number of reasons why vertical fiscal gaps are maintained. One is that Provinces have different fiscal capacities (i.e., tax bases per capita), and the transfer of revenue-raising exacerbates those differences. To the extent that the federal government assumes responsibility for equalizing Province fiscal capacities, federalization compromises its ability. Unless the equalization system is purely redistributive among Provinces, a minimum fiscal gap is compatible with achieving a given degree of equalization. A second reason is that revenue decentralization reduces the extent of built-in stabilization against regional economic shocks (Von Hagen, 2007). The equalization system is one of the main mechanisms for insuring against such shocks, along with labor mobility and the federal income tax system. Unless the equalization system compensates for revenue decentralization, interregional stabilization will suffer (Shrestha, 2015).

6.3 Constitutional Basis for Tax and Revenue Sharing Arrangements

The two main issues of fiscal federalism are tax assignment and revenue sharing. The great and undeniable issue that the allocation of resources between the two sectors has been concluded and that the concern is with how to raise a given sum of revenue and shared the

proceeds between the various tiers of government. The **SECTION 60**⁴² at present Constitution of Nepal mentions the distribution of sources of revenue which likely represented on figure 6.1.

⁴² (1) The federation, province and the local level entity shall impose tax on subjects within their fiscal jurisdiction and collect revenue from such sources. Provided that with regard to the source that are not included in the concurrent/shared list or in any list at any level, it shall be as determined by the Government of Nepal.

(2) The Government of Nepal shall make necessary arrangements to equitably distribute the revenue generated by it from its sources, between the federation, province and the local level entities.

(3) The amount of the fiscal transfer, the province and the local level entities are to receive shall be as recommended by the National Natural Resources and Fiscal Commission.

(4) The Government of Nepal shall distribute fiscal equalization grants to province and local level entity on the basis of their need for expenditure, their capacity in generating revenue and the efforts made by them.

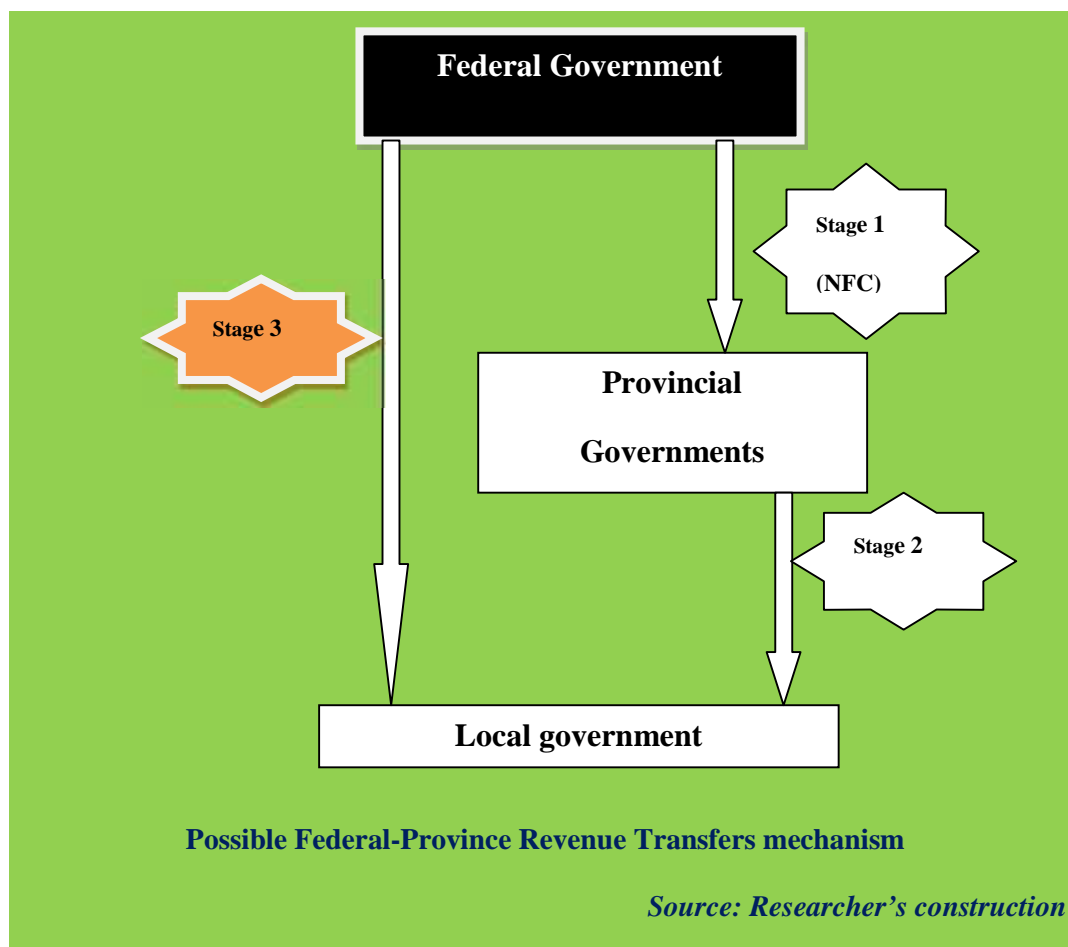
(5) The province shall distribute fiscal equalization grants received from the Government of Nepal and the revenue generated from its sources, to the local level entities under it on the basis of need for their expenditures and their capacity to generate revenue, in accordance with provincial law.

(6) The Government of Nepal shall make arrangements regarding conditional grants to be provided through the Federal Consolidated Fund, complementary grants, or the special grants for other purposes.

(7) The distribution of revenue between the federal, provincial and the local level entity shall be transparent.

(8) While enacting the Federal Act regarding revenue distribution, the matters that need to be included are: national policy, national needs, the autonomy of provinces and local level entities, the service delivery of the provinces and local level entities and the fiscal rights given to them; their capacity to generate revenue; feasibility and use of revenues; their contribution to development works; regional imbalance; poverty and inequality; exclusion, emergency works and the support of meet temporary needs.

Figure 6.1: Revenue Transfer Mechanism under various tiers of Government



However, an important question the study seeks to address from the onset is whether revenue generation should be centralized or decentralized? For convenience, this system is also likely to generate economies of scale in tax administration and prevent revenue loss due to the mobility of taxpayers from one locality to another if such taxes were collected locally. The system is also desirable when considerable weight is attached to tax uniformity across jurisdictions.

It is also important to ask: given the collection system, which sources of funds should be shared and how is the sharing supposed to be done? The choice here is largely between tax base sharing and revenue sharing. Let us consider first, the issue of tax sharing. Which tax bases should be shared to subnational governments? A good tax should have certain qualities like efficiency, equity, revenue adequacy, low administration cost and is able to promote economic stability (World Bank, 2006). However, at the grassroots level where attention is focused on the provision of local goods, only three of these attributes are really

important. They are efficiency, revenue adequacy and administration cost. Virtually all taxes are based on either the ability-to-pay principle or the benefit principle. A meaningful comparison of these principles would require that we hold the tax yield or revenue constant. Since the ability-to-pay principle is geared toward equity issues and the benefit principle towards efficiency issues, it appears that the benefit principle has an edge over and above the ability-to-pay principle in the provision of local goods. This is particularly so if the administration cost is the same for both principles. Charges that are based on the benefit principle can take the form of benefit taxes or user charges. The former would be more appropriate for the provision of public goods, and the latter for the provision of publicly-provided private goods. If such taxes and user charges exist, tax sharing then has the advantage of enhancing the efficient allocation of resources in a locality. For fiscal federalism to succeed there must be fiscal authority over changing the tax bases allocated the different tiers of government. In practice, however, limited autonomy is given to the lower tiers of government in this area so that a uniform rate of taxation can be maintained across the country (Vincent, 2001; Aigbokhan, 1999). As a guide, equity (consistency of revenue means with expenditure needs) and efficiency (minimizing resources cost) criteria suggest that the following principles be used for the assignment of tax bases:

- progressive and redistributive taxes should be centralized, such as personal income tax and corporate income tax;
- taxes suitable for economic stabilization, such as import duties, should also be centralized;
- taxes on mobile factors of production such as gains taxes should be centralized;
- residence-based taxes, such as sales/excise and retail taxes are best suited for Provinces;
- benefit taxes/user charges are usually assigned to the LGs that provides the services such as toll gate levies, hospital and education fees, and motor licences;
- taxes on immobile factors of production, such as land and buildings (property taxes) are assigned to local governments; and
- taxes on natural resources should be assigned to the central government, for the sake of administrative efficiency and uniform practice since the major projects in this field often involve big transnational corporations.

The assignments of fiscal instrument in Nepal were guided by constitutional provision. The federal constitution gave the federal government exclusive power to collect levies like

customs and excise, company tax, education tax and mining rents, VAT etc. All these revenues (with the exception of education tax) are paid into the federation account for distribution among the three tiers of government in line with national constitution. The Provinces and local governments are left with the powers to collect other fees. The main types of tax revenue for the federal and sub-national government are listed in Table 1. Nigeria's local governments have autonomy to perform their functions in line with the constitution. However, the autonomy of local governments is not absolute. They retain their functions and fiscal relations with Provinces and federal government. The Constitution of Nepal 2015 has provided the following responsibilities of the allocation of revenue among the different level of governments.

Table 6.3 Nepal's Federal, Province and Local Tax Jurisdiction and Assignment

Present status of proposed provinces			
Scenery of Taxation	Legal Jurisdiction	Collection	Retention
Import duties	Federal	Federal	Federation account
Excise duties	Federal	Federal	Federation account
Export duties	Federal	Federal	Federation account
Mining rents & royalty	Federal	Federal	Federation account
Hydro-electronic profits tax	Federal	Federal	Federation account
Capital gains tax	Federal	Province	Province
Personal income tax	Federal	Federal	Federal account
Personal income tax: armed & police forces, external affairs officers, non-residents	Province	Province	Province
Capital transfer tax (CTT)	Province	Province	Province
Value added tax	Federal	Federal/Province	Federal/Province
Company tax	Federal	Federal	Federal
Property tax and ratings	Province	Province-Local	Province-Local
Stamp duties	Federal	Province	Province
Gift tax	Federal	Province	Province
Licenses and fees	Local	Local	Local
Motor park dues	Local	Local	Local
Motor vehicle	Province	Local	Local
Entertainment tax	Province	Local	Local
Land registration and survey fees	Federal	Province	Local
Market and trading license and fees	Province	Local	Local
Tourism Charge	Province	Province	Province
Pools betting and other betting taxes	Province	Province	Province
Entertainment tax	Province	Local	Local

Source: (Socialism-oriented Federal Republic of Nepal's Constitution (2015))

Note: Researcher's construction

6.4 Assignment of Expenditure Powers/Responsibilities in Nepal

As we see above **Table 6.2**, the federal government collects major revenue sources. While, there are no solid underlying principles behind the assignment of constitutional functions in Nepal, it is reasonable to infer that considerations of the extent of geographic range of externalities and economies of scale must have weighed heavily in the decision to assign certain responsibilities to the federal government. Indeed, some government responsibilities are such that the incidence of their benefits is nationwide while, for others the various components may call for differential scale of operation. Responsibilities which can be more efficiently undertaken by the federal government than the lower tiers of government, or where the benefit regions cover the entire country include national defence; banking, currency, coinage and legal tender; citizenship; weights and measures; nuclear energy; traffic on federal trunk roads; and external relations (including borrowing and foreign trade). Responsibilities whose benefit areas are more local than national, but with the possibility of spillover effects beyond regional boundaries are placed in the concurrent legislative list. Examples of such activities include industrial, commercial and agricultural development; post-primary education; and secondary health care.

On the hand, responsibilities which are purely local in character, in the sense that the benefits accrue in the main to a limited geographic area within the federation, are usually assigned to local government councils. Such responsibilities include the establishment and maintenance of cemeteries, markets, motor parks, public conveniences and refuse disposal; construction and maintenance of local roads, streets and public parks; provision and maintenance of primary education and primary health care; and the development of agriculture and natural resources. **Table 6.3** shows the assignment of expenditure responsibilities in the Nepal's federal system.

Table 6.4: Constitutional Basis of Expenditure Assignment

Table 6.3 Constitutional Basis of Expenditure Assignment			
Expenditure Category	Service Responsibility	Provision of Service	Comments
Foreign affair	F	F	Benefits/costs are national
Defence	F	F	Benefits/costs are national
International trade	F	F	Benefits/costs are national
Banking and currency	F	F	Benefits/costs are national
Environment	F	F	Benefits/costs are national
Internal commerce	F	F	Benefits/costs are national
Immigration	F	F	Benefits/costs are national
Airways/railways	F	F	Benefits/costs are national

Industry and agriculture	F	F	Significant interprovincial spillover
Education	F,P,L	P,L	Transfers in kind
Health	F,P, L	P,L	Transfers in kind
Social welfare	F,P,L	P,L	Transfers in kind
Police	F,P, L	P,L	Primary local benefits
Highways	F,P,L	P,L	Promotes a common market
Natural resources	F,P, L	P,L	Promotes a common market
Notes: F = federal, P = Province, L = local			
<i>Source: Researcher's construction with the help of the Constitution of Nepal (2015)</i>			

As can be seen from these tables, matters of national interest i.e. defense, foreign affairs, currency, aviation, and price control among others are assigned to the Federal government only. Also, local matters for example marriages, markets, and refuse among others are assigned to local governments. Overall, this structure of assignment of responsibilities agrees with the patterns in most federal states in the world today.

From the analysis above, the constitutionally assigned responsibilities to the three tiers of government have not changed much from what they were at independence. For example the federal government had to take over the running of all universities ostensibly to ensure minimum standards and reduce cost. Also, in response to the crisis in the primary education sector, the federal government had to intervene through the establishment of the national level educational standards. As in most federal systems, the federal government is responsible for economic planning and for policies and programmes geared towards redistribution and stabilization objectives.

Thus, Nepal's expenditure assignment, tax jurisdiction and revenue allocation is disproportionately in favor of federal government and same context, as Prasad, Uma Shankar (2015) argument should be noticeable. According to him, the key sources of revenue such as custom duty, value added tax (VAT), corporate income tax, excise duty and personal income tax which comprise around 80% of total tax revenue are assigned to be collected by the central government. The service charges, punishment and fines and tourism charge are assigned to be collected concurrently by all three levels of governments. In this modality, around 90% of total tax revenue will be under the jurisdiction of the central government. The custom duties by nature have to be collected by the federal government. Therefore, VAT and income taxes will have to be collected

concurrently at both the central and sub-national levels. Other taxes including excise duties will have to be collected by the sub-national governments which will support the expenditure responsibilities of the sub-national governments adequately (Prasad, Uma sanker, 2015). Non-tax revenues derived from the activities of the central government like corporate debt servicing will go to the central government whereas non-tax revenues collected from user charges will have to be assigned to the local governments (Ibid).

Similarly, the internal revenue sources of local and Province government have not been fully exploited. Therefore, concerted effort should be made to boost the internal revenue of the local and Province government. A review of the current revenue sharing formulae to give weight to each tier of government based on the function they perform is imperative. Conflicts, waste and inefficiencies as a result of duplication of services such as primary and secondary education, primary and secondary healthcare services, and water and sanitation services provided by the sub-national government as well as federal government needs to be eliminated especially with the adoption of a cooperative approach to governance. As recommended by Carling (2006), the problems of vertical imbalance can also be corrected from either the expenditure side-by substantially narrowing the Provinces' expenditure responsibilities to fit their limited revenue bases-or from the revenue side-by substantially broadening the Provinces' revenue autonomy and reducing their dependence on commonwealth grants/ federal allocation.

6.5 Lesson learn from The South African Model

South Africa is a federal country with a population of 54 million. It adopted a new constitution in 1996, which provides for a three-tiered governance system—central, nine provinces, and local governments. Article 214 of this constitution is related to equitable sharing and allocations of resources, which has the provisions: “(1) An Act of Parliament must provide for (a) the equitable division of revenue raised nationally among the national, provincial and local spheres of government; b) the determination of each province's equitable share of the provincial share of that revenue; and (c) any other allocations to provinces, local government or municipalities from the national government's share of that revenue, and any conditions on which those allocations may be made. (2) The Act referred to in subsection (1) may be enacted only after the provincial governments, organised local governments, and the Financial and Fiscal

Commission have been consulted, and after any recommendations of the Commission have been considered.”

More specifically, the constitution requires that every year, a Division of Revenue Act determines the equitable division of nationally raised revenue between the national government, the provinces, and local governments/municipalities. Furthermore, the Intergovernmental Fiscal Relations Act (1997) prescribes the process for determining equitable sharing and allocation of nationally-raised revenue. Sections 9 and 10(4) of the Act set out the consultation process to be followed by the Financial and Fiscal Commission (FFC), including recommendations regarding the division of revenue. Section 214 of the constitution requires that the FFC’s recommendations be considered before tabling the division of revenue. Furthermore, the Minister of Finance is required to table a Division of Revenue Bill with the annual budget at the National Assembly. The bill must be accompanied by an Explanatory Memorandum, outlining how government took the FFC’s recommendations into account when determining the division of revenue.

What can be learnt?

It is necessary to mention here that South Africa has adopted a formula-based approach to the equitable division of revenue through a powerful and independent FFC, which has seven constitutional members. The recommendations of these members on the equitable division of the national budget among the three spheres of governments (vertical division) and across provinces and local governments (horizontal division) must be duly incorporated into the division of revenue bill.

In practice, parliamentarians are fully empowered in the resource distribution procedure and the formula-based allocation system is followed in all government agencies. A similar practice has been adopted in India, which has a central and provincial finance commissions. Not only that, another similar practice can be observed in Australia, which has the Commonwealth Grants Commission for this very purpose at both the central and provincial levels. Except for these two countries, other federal countries do not seem to have as effective resource distribution bodies as does South Africa.

In Nepal’s case, neither a vertical nor a horizontal allocations system is present. Instead, inequitable budget distribution is widely practised, which allocates a nominal budget

even to basic service delivery ministries like education, health, agriculture and livestock, and local development. Furthermore, the role of parliament members is also marginalised in the resource distribution procedure. Despite all the ills, however, a few positive initiatives have been observed in the new constitution. A model for a National Natural Resources and Finance Commission has been proposed and it has recommended constitutional rights to this commission. However, formally it is not established till a date.

In conclusion, it would be advisable to adopt a budget distribution provision similar to that of South Africa's in our new constitution, which will create an environment for balanced socio-economic development across the districts. Like in South Africa, the proposed financial commission should be made powerful and independent, so that it will be able to distribute state resources on the basis of equity and proportion.

6.6 Conclusions and chapter summary

This chapter has examined the issue of resource mobilization, revenue allocation and expenditure assignment in Nepal according to the silent feature of 2015's constitutional arrangements. Given the present indications, we assume that both expenditures and revenue resources are likely to remain highly centralized, although constitution of Nepal has set up clear provision about that. They seem regionally imbalanced spread of economic activities, there is likely to be a high degree of vertical and horizontal imbalance, at least in the medium term.

In order to resolve the vertical fiscal gap and imbalance, national policies related to reassign the functions, decentralize tax power to the sub-national governments, tax-base sharing (give autonomy to sub-national governments to levy complementary rates on a national tax-base) etc need to be revised and changed time to time. Moreover, national government should adopt revenue sharing policy and provide formula based unconditional grant to the lower level of governments. The tax and revenue sharing are normally used to tackle the fiscal gap between national and sub-national governments. Revenue sharing from the central government to regional and local governments is necessary for minimizing the vertical imbalances and horizontal inequities. Vertical imbalances arise when regional and local governments have more expenditure responsibilities than the revenues assignments. Horizontal inequities happen due to the different fiscal capacities of

regions and local governments. Both of these issues must be dealt at the central government level; although regional governments could play a mediating role with local governments. In order to address the vertical imbalances and promote the national holistic welfare, revenues collected from VAT, certain natural resources, and Personal Income Tax and certain minor taxes by the central government should have been shared to the sub-national governments by designing an effective tax sharing system. The “piggybacking” approach would be appropriate for the tax sharing to sub-national governments.

Indeed, the success of the federal system of governance will depend not only on the successful delivery of public services such as defence, and merit services such as education and health, but also on laying the foundation for stronger and regionally better balanced economic growth. The key challenges will be to provide reasonably efficient provincial-local administration, create capacities in the Financial Commission and the Natural Resources Commission, and set up machinery for collection and compilation of data, the design of fiscal transfers, and mechanisms of inter-provincial and centre-province-local cooperation and coordination.

Thus, the persistent agitation for resource control especially by federal government (because still we are on preliminary phase of practising federal model) needs to be given urgent attention. Furthermore, government strong commitment needs to be resolved by a mechanism of fiscal transfers. In this context, the Financial Commission and Natural Resources Commission will have a critical role to play. A good deal can be learned from the systems and methodology of transfers in well-established federal systems like those of Canada, Australia and India, among other countries. Thus this inquiry concludes that there is the urgent need for constitutional review especially as it relates to fiscal federalism.

CHAPTER SEVEN

SUMMARY, CONCLUSION AND RECOMMENDATIONS

“For anyone who thinks "profit" is evil, I have a challenge for you: try NOT to get any profit in the next week. Profit simply means increasing how much valuable stuff you have, and if you don't profit, you die. Literally. For example, don't buy any food for a week, because when you buy food (or anything), it's because you value the food MORE than you value the money you trade for it. If you didn't, you wouldn't make the trade. So you PROFIT (and so does the seller) every time you buy something. And every time you sell something, or work for money, etc. So before condemning "profit" (or "greed" or "selfishness," for that matter), see if you can survive without it. Then stop repeating vague collectivist BS, and learn to distinguish between "win/win" events (voluntary exchange) where BOTH sides profit, and "win/lose" events, where one side benefits by harming the other side. By the way, "government" is ALWAYS the latter.”

- Larken Rose

7.1 Chapter overview

This is the final chapter of my inquiry. Thus, this chapter deliberate to the synthesization of my whole investigation. More severely, it examines the fiscal federalism amendments and strata in Nepal focusing on the major themes and motif based on prior chapters and provides some appropriate recommendations in Nepalese policy makers.

7.2 Research Summary and Major Finding

Being 240 years unitary structure of the nation, the exact practice of fiscal federalism in Nepal has been inhibited by the dominance of centralized system itself. Present exercise of Nepalese fiscal amendments concludes that federalism in Nepal had been a key result of the political will and the institutionalization of regulatory system. Although, global experience also shows that federalization system brings the government close to the people and increase quality and quantity of the service delivery thereby establishing subnational tyres of governments. However the federalization in Nepal is fraught with challenges and although, we are in the inauguration phase to apply this concept in our system.

Within this background, this thesis tries to investigate major determinants of fiscal ism amendments via by analyzing present geo-political and macroeconomic strata in Nepal. Specifically, it seeks the major components of fiscal federalism theory and its disputes in Nepal. This study investigates the underlying factors which promotes or inhibits evolution, structure, and practices of fiscal federalism in Nepal, and determines major ideological

constraint. Within this aim, this inquiry analysed the evolution of fiscal federalism, evolved theoretical elucidation of federalism as well as dwelled extensively on the nature and crisis of fiscal relations in Nepal and concluded that fiscal relations are highly lopsided as they favour the Federal Government against the various state and local governments. The Federal government always receives larger amount in the sharing formula and with less impact on the people. The lopsided nature of fiscal arrangement has so far generated suspicion, apathy and constant overt and covert conflict.

No doubts, fiscal federalism is unarguably a potent economic strategy that can be used to maximize provision of public services as well promote macroeconomic stability. Central to the success of fiscal federalization, is clarity in revenue and expenditure authority and responsibilities. The urgent reform that is required is the need for government to redress the prevailing fiscal mismatch at subnational government levels through appropriate policies to increase tax revenues to subnational governments as well as reforms of expenditure responsibilities to enhance their efficiency in the provision of public services. But, premised on the analysis, it is deducible that the centralist system of fiscal relations, critical issue of over-dependence on direct tax revenue, conflicts over sharing principle and disharmonious federal-Province relations are obstinate challenges that are threatening harmonious fiscal relations in Nepal and the continued existence of Nepal as a federal state.

Although fiscal federalism or decentralization is not a new phenomenon, the practices of expenditure and revenue assignment across the levels of governments are varied from countries to countries in the world (Lamichanne, 2012). However, adopting appropriate mechanism of fiscal model is very difficult task in every country. In order to resolve the vertical fiscal gap and imbalance, national policies related to reassign the functions, decentralize tax power to the sub-national governments, tax-base sharing (give autonomy to sub-national governments to levy complementary rates on a national tax-base) etc need to be revised and changed time to time. Moreover, national government should adopt revenue sharing policy and provide formula based unconditional grant to the lower level of governments. The tax and revenue sharing are normally used to tackle the fiscal gap between national and sub-national governments.

Revenue sharing from the central government to regional and local governments is necessary for minimizing the vertical imbalances and horizontal inequities. Vertical

imbalances arise when regional and local governments have more expenditure responsibilities than the revenues assignments. Horizontal inequities happen due to the different fiscal capacities of regions and local governments. Both of these issues must be dealt at the central government level; although regional governments could play a mediating role with local governments. In order to address the vertical imbalances and promote the fiscal decentralization, revenues collected from VAT, certain natural resources, and Personal Income Tax and certain minor taxes by the central government should have been shared to the sub-national governments by designing an effective tax sharing system. The “piggybacking” approach would be appropriate for the tax sharing to sub-national governments (Lamichanne, 2012).

Similarly, the another finding of this inquiry is that there is hitherto no consensus in the literature on the determinants of fiscal ism aspects in Nepal. Thus, his study sheds new light on this topical and contemporary agenda within the field of Nepalese political economy domain thereof probing the financial elevation of the nature and practice of the country’s federal structure using the macroeconomic approach. The study examines three vital aspects of the research problem. These include fiscal federalism challenges-macroeconomic realism nexus in Nepalese fiscal ism setting, issues promoting or inhibiting the principles and practice of fiscal federalism in Nepal, and the extent of fiscal federalization in Nepal. The overall goal is to analyze the possible effects of fiscal federalism amendments in Nepalese context thereby catalysing on some selected indicators of fiscal ism premise: resource allocation, taxation mechanism and expenditure responsibilities with the help of empirical and phenomenological research paradigm.

However, the empirical findings are not novel but it offer strong evidence that the central objective of this inquiry has been building little contribution towards ‘*Nation-Favoured*’ fiscal policy and provides some insight about policy reforms. Overall, this finding conforms to a strand of the literature that establishes links between fiscal federalization, public sector efficiency and macroeconomic stability (Tiebout, 1956; Hunter and Shah, 1998; Stigler, 1957; Oates and Schwah, 1999; Aighokhan, 1999). The study results revealed that;

- ➡ Although, constitutionally Nepal is federal republic state but till a date there is not any viable progressed from a unitary government to a federal one accompanied by

federalization of governance, limited fiscal decentralization, and changes in fiscal arrangement,

- There is incontestable gap between the economic capacity between proposed seven-province model (i.e. province three' revenue allocation capacity is 300% more than province six and seven). By implication this finding suggests that the principles and practice of fiscal federalism in Nepal should have necessarily been guided by the theory of fiscal federalism, and the theory of equal development,
- The major problem could be seen in the mismatch between revenue sources and functions of the various tiers of government. The revenue allocated to the lower tiers of government is lower in comparison to the enormous duties expected of them. This has actually influenced meaningful infrastructural development in the country,
- There is limited degree of fiscal decentralization in Nepal as fiscal responsibility and taxing powers remain considerably centralized over the study period. For this, it is necessity to build strong taxation or revenue allocation mechanism which foster holistic prosperity and substantive development,
- A global experience shows that, fiscal federalization has a significant positive impact on economic growth and national prosperity. By implication, this finding suggests that this could occur when tax and revenue instruments that are best used by the central government are assigned to subnational governments, thereby reducing the efficiency of such instruments,
- Economic and financial mismanagement which is reflected in corruption and financial impropriety of government functionaries have actually affected development in Nigeria especially where leaders in the country are corrupt and self centred.
- Our findings have shown that while there are in fact serious disagreements on the subject, they are solvable if only there is adequate political will to do so. This means that the largest problem lies in the ideological differences and understanding of democratic structures and the parties' struggles for power. What seems to be motivating the politicians to delay federalism is that they fear they might lose their power and privilege and it has become evident that for their motivations to change something radical must happen.

7.3 Research Conclusion and Recommendations

The question “where we stand actually?” deliberate between determinants of fiscal federalism and economic welfare in Nepal has been extensively investigated on fiscal faces in Nepal. With this outskirts, this empirical study goes depth on different dimension towards fiscal amendments in Nepal. Decipher this, the study convinced that sub-national governments need to be given access and autonomous authority to adequate resources to effectively do the job with which they are entrusted. At the same time they must also be accountable for what they do with the resources. To achieve the relevant policy objectives that relate to ensuring a stable fiscal federalism, questions on how to organize intergovernmental fiscal systems should be pragmatically addressed. These objectives include efficient allocation of resources, income distribution, revenue collection, and macroeconomic stabilization. The attainment of these objectives will ensure macroeconomic stability. Finally, all policy changes proposed to address the challenges of fiscal federalism must be vigorously pursued so that macroeconomic stability is not jeopardized in the short and long run. Our leaders should draw lessons from the breakup of Czechoslovakia, Yugoslavia, and the dissolution of the Soviet Union, which represent cases where fiscal federalization has occurred in an extreme form, that is, through the demise of the central government.

We securely need to understand that Federalism is not an end in itself but a means for creating a more prosperous and just society. Nepal’s proposed new federal structure can and must embrace explicit objectives of reducing disparities among geographic regions, people of different communities and income groups. It must promote a more balanced regional development of the country taking full advantage of our abundant natural resources, hydro-power, tourism potential, etc for the benefit of the whole country. It must not lead to narrow provincialism whereby each state jealously guards its resources for itself, but encourages shared prosperity whereby the hydro-power of the hills benefits the Tarai, agriculture potential of the Tarai benefits the hills and mountains, the tourism industry benefits the whole country, and so on. Thus, our federal set up must encourage opportunities for more equitable economic growth and social progress for all; protect our fragile environment, and harness the benefits of globalization that is now penetrating even the remote corners of Nepal. Likewise, Situated between two of the world’s largest and most vibrant economies, Nepal can and must seek to benefit from their prosperity by adopting pragmatic policies and avoiding any ideological dogmatism. Federal models that

ignore this geopolitical reality and prospects for capitalizing on economic links with both of our great neighbours are likely to be short-sighted and self-defeating.

With this prophesy and expectation, this thesis concludes that all these requisites may not have been accomplished by single time but we need focus on continuous improving. It has accomplished these requisites to a certain level despite being fraught with challenges. Thus there is need to address the challenges and this thesis presents some recommendations focusing on the capacity development, need for Highest Level Political and Administrative Support, institutional, cooperation and coordination and roles of different actors to improve the performance of federalization process in the future. Thus, our fiscal federalization proves maximize provision of public sector services as well as promote macroeconomic stability and welfare in upcoming days. Given this understanding and on the basis of findings in this study, the following recommendations are proffered;

7.3.1 Need for Highest Level Political and Administrative Unity & Support

To ensure successful federalization requires the active participation of the entire nation but in fact, there is very low level in participation culture in Nepal. Broad public sector governance and management reforms require the highest level of political and administrative support to ensure widespread stakeholder participation in the initial design and implementation and to ensure widespread accountable ownership for the sustainable realization of the reform results. Public sector reform, especially those related to decentralization, is multi-dimensional involving political, administrative and fiscal components. They involve all stakeholders, across all levels in society such as central and local elected politicians, central and local government officers, bureaucrats and technical staff, cutting across all line ministries and their deconcentrated line departments, NGOs and CSOs, and all citizens within the country and all supportive development partners. To ensure a common vision and coordination of effort requires the highest level leadership to ensure success.

7.3.2 Focus on ‘What Unites Us All, Not What Divides Us’

The Madesh-based party, Maoist and some ethnic and regionalist movements in Nepal tend to focus and emphasize what divides us – Madhesis vs. Pahadis; Bahun-Chhetris vs. Aadhbashi-Janajatis and upper vs. Dalits; the self-appointed progressives versus presumed status quoists – rather than what unites us all as Nepalis.

But far from being progressive, this divisive approach is actually backward-looking as it tends to incite our restless, unemployed youth to look for scapegoats to blame for their misfortune on the real or perceived injustices of the past, rather than helping and mobilizing them to look for what unites us all as Nepalis to build a brighter future.

Having experienced monarchy, one-party Panchayat system, multi-party liberal democracy, and a republic; and rule by the royalists, Communists, democrats, and even ethnic and regional parties in different combinations – most people of Nepal no longer harbour any illusions of any particular system or ideology ushering miracles and magical solutions for their development. As federalism has not been tried yet, catchy slogans and promises in its name tend to still attract many innocent and gullible Nepalis into imagining that perhaps that might be the one new system that might deliver us the elusive nirvana. Thus we need to develop the sense of Nepalis that there really is no substitute for pragmatism, hard work, rule of law and good governance to build a brighter future and sustainable development in larger freedom for Nepal, as for any other country.

Maximizing prospects for economic prosperity for all, not a zero-sum game of creating some new winners and losers, should be the guiding principle for restructuring the shape of the future Nepali state. Let us not forget that in the larger scheme of things, compared to many other countries and our own potential, the vast majority of all Nepalis – from the nominally privileged communities as all as the historically marginalized ones – are all poor and under-privileged.

Regardless of whether one comes from a nominally privileged community or the marginalized one, all Nepalis today suffer from weak rule of law, corruption, tolerance of impunity, too many political parties touting outdated ideologies and slogans as “progressive”, and radicalized and partisan trade unions. These are the main culprits for non-implementation of many progressive laws and policies that are in our books now. It is unclear as to how federalism, especially of the ethnic variety, can better tackle these problems.

There is a greater likelihood that federalism might actually make matters worse, if it replicates these fundamental flaws of the current Kathmandu-centric Nepali state into a dozen or more mini-Kathmandus. How the proposed federal structure will truly enhance better governance and increased prosperity for all must be the litmus test of Nepal’s future

statecraft, with acknowledgment of the diversity of our identities as one element of an inclusive and egalitarian democracy along with holistic prosperity.

7.3.3 Capacity Development

The general wise and motif beyond federalized structure in Nepal has been arrived from the expectation of all levels of government need to be a capable, motivated and efficient staff in order to deliver services to the citizens in substantive manner. However, as indentify in prior chapters deployment of capacity in all level of government is always crucial for Nepal's fiscal federalism amendments. This calls for the need for a comprehensive capacity building strategy.

However, at present this study suggests that central government should take the lead role to ensure a comprehensive strategy for human capacity building. The district and block level staff and the elected representatives could be most preferable target group of the strategy. A need based assessment should be carried out. It has to assess what has been done until now and prioritize as to who's capacity needs to be developed. The strategy has to decide on the most suitable capacity building methodology for different target groups and decide on the most appropriate timing of the training, taking into account the suitability of the training to the beneficiaries. Then a capacity building programme could be developed for each province or districts based on a cross-sectoral, integrated approach, with the specific needs in the province/LGs taken into account.

There is undeniable possibility that the Province authorities cannot implement all the development activities of the local nature on their own, thus when the province government face shortage of technical expertise and resources, the next immediate, higher or central government should assist the local authority by providing subsidies both in terms of expertise and resources. Irrespective of the adequate clarity in the redistribution of powers and task between the centre and the local governments, care has to be given not to contradict the principle of subsidiarity where central government assumes excessive statist and paternalistic role creating innumerable intermediate layers of bureaucratic organizations and agencies which ultimately increases spending to develop their own bodies.

Likewise, a very important and ultimate way to address the issue of the shortage of technical, qualified and competent staff at the local level would be the development of an

attractive financial and promotion incentive to attract talented and competent staff to work at the province and local regime. This inquiry also highly recommended that there is an urgent need to develop capacity in subnational level.

7.3.4 Need for Clear Expenditure and Revenues Assignments

A clear delineation of the expenditure and revenue allocations is critical to improve efficiency and accountability of service delivery and revenue functions. Theory and international experience confirm the advantages of allocating functions based on the ‘subsidiarity’ principle. To do this successfully requires a detailed functional analysis, also known as activity mapping, to unbundle each public service to take into account principles of economies of scale, externalities, equity and heterogeneity of demand.

Expenditures and revenues responsibilities need to be unbundled, clearly defined and assigned to the respective tier of central, provincial and local governments, with clarity on the mandatory and permissive functions. Through a detailed functional analysis, it will be possible to more accurately unbundle and assign the appropriate sub-functions to the appropriate tier of government, matching to the extent possible the expenditure and revenue responsibilities, couple with a transparent and objective formula-based intergovernmental transfer system to achieve the efficiency and the accountability needed for enhanced governance and holistic prosperity.

7.3.5 Need for Transparent and Equitable Intergovernmental Transfer System

All countries require an effective system of intergovernmental transfers to address vertical and horizontal fiscal imbalance within countries. In addition to strong political objectives, these intergovernmental transfers and shared taxes can assist in balancing vertical funding needs between central, provinces and LGs, achieving horizontal equity among all tiers of various expenditure needs and fiscal capacity, improving the delivery of national priority merit goods, and compensating for inter-jurisdictional spillovers, among others.

The design and implementation of the intergovernmental transfer system is critically important to realize decentralization results of accountability and efficiency. The grant system in is currently quite complicated, with multiple grant channels dominated by categorical grants, with an ad hoc determination of the annual grant pool, and with only the recent introduction of a formula-based allocation mechanism and the use of performance indicators.

International best practice would call for a simplification of the grant system, a move towards a reliance on formula-based transfers for both recurrent and capital grants, and a dynamic balance between a mix of subnational tiers and categorical grants in line with accountability and capacity for delivering performance. In addition, the establishment of the National Natural Resources and Finance Commission (NNRC) is critical to monitor, analyze, and adjust the intergovernmental system to ensure optimal achievement of government objectives.

7.3.6 Institutional Reform Recommendations

Until the recent time, there was no key lead agency or the task force to take care of the federalization in the country to a desirable degree. Thus, the establishment of the province(s) and LGs was a step forward in the government's effort and intention towards promoting federalized system in Nepal. However as an institutional recommendation, the inquiry strongly recommended to the establishment of a **National Federalism Financial Taskforce Regulation Committee** (NFFTRC hereafter). It could be structurally guided by the vision of constitution. This taskforce should be multi-sectoral and must deal with policy matters related to fiscal matters of the entire nation. It could be specifically mandated to review, enforce, and monitor resource allocation and distribution, taxation and expenditure mechanism policies and plans related to all tyres of governments. A mechanism should then be developed for this national taskforce to report its performance directly to the National Assembly. There should be strong government supports in order to achieve good output from the taskforce and thus the taskforce would go a long way in streamlining the overall fiscal federalisation amendments process and be a strong link between policies and implementations with their strong linkage with another sub-level taskforce at local level.

This institution could serve as an apex functional body responsible for proper implementation of all decentralization policies and plans relating to development planning. This should also include exercising its mandatory monitoring powers especially in holding lower levels of the institutions accountable both to the taskforce and to the constituents. Thus, the immediate institution of the task force is recommended.

A Province and Local Level task force is also suggested in addition to the national level task force. This could further develop the federalization process. A taskforce each is recommendable in each district and these task forces should be vested with full legal

powers to recommend, suggest changes and even amend legal provisions of regulatory or legal instruments of decentralization. It should be specifically mandated to report its performance to the national task force.

7.3.7 Other Recommendations

- ❖ Urgent reform in fiscal federalism in Nepal to address the constitutional issue of fiscal powers among the three tiers of government to redress the prevailing fiscal mismatch at subnational levels of government is strongly recommended. This policy in line with the principles of fiscal federalism should as a matter of urgency increase tax assignment to subnational tiers (Province and LGs) of governments to enhance their access to buoyant revenue sources, and this should be accompanied with matching expenditure responsibilities. The concurrent legislative list that has turned out to be a scheme for usurping local functions by the federal government should be scrapped as this is the basis used to justify federal control of the buoyant revenue sources, and frequent intergovernmental transfers.
- ❖ More fiscal powers should be devolve to the lower tiers of government taking into consideration the trade-offs of fiscal ism on Total National real GDP, resource allocation and distribution mechanism, revenue and expenditure control.
- ❖ There should be total reformation of revenue generation expenditure prioritization and better relations among tiers of government. Also, the public sector expenditure programme should be reviewed and prioritized to enhance efficiency and physical balance. This will go a long way in reducing the challenges of fiscal federalism and aid development in the country.
- ❖ The major four pillars of fiscal federalism (expenditure responsibility, revenue assignment, inter-governmental fiscal transfer and resources allocation and mobilization mechanism) need to be clearly defined and provisioned in the constitution so that province and local governance system would be ensured and promoted.
- ❖ Financial system and its transparency have to be linked up with the management capacity of the local bodies.

- ❖ More autonomy to fix tax base and rate at local level needs to be devolved to local governments for effective mobilization of resources.
- ❖ Financial resources of local bodies should be strengthened through formula-based grant allocation, and revenue sharing on equitable basis.
- ❖ Weak fiscal discipline and less transparency prevailing in the states have hampered local resource mobilization, causing high irregularities, hence well and at least common national fiscal discipline should be sustained.
- ❖ Revenue sharing mechanism should be well defined among the different tiers of governments so that the predictability of resource allocation and maximum utilization of resources could be achieved.
- ❖ There is need to ensure that the distribution of the revenue encourage each state and local government to improve internal revenue generation, not to constantly and wholly depending on the fund coming from the federation account.
- ❖ Government at all levels should be made to face the consequences of their decisions to ensure fiscal discipline. This is possible if the federal government does not bail the state and local debts and the central bank does not act as a lender of last resort to the federal government. This will reduce the trade-offs and increase the gains of fiscal decentralization.
- ❖ Government should aim at achieving macro – economic stability in order to enhance savings and investment which are prerequisites for capital formation and economic growth
- ❖ The need to reverse the age long fiscal dominance by the federal government in order to re-establish a true federal system is strongly recommended. To this end all there is the need for an establishment efficient formula between the centre and states government is recommended. This formula should also satisfy the broad objectives of inter-province(s) equity and balanced national development. To this end the present vertical revenue allocation formula should be reviewed by the federal government to increase the percentage to lower governments thereby strengthen their fiscal capacity and enable them play strong role in nation building.

- ❖ Strengthening democratic governance in three tiers of government in order to build a political culture that will make unstable politics impossible is strongly recommended. The lessons of the immediate past should be sufficient to guide the country as it progresses in the current democratic arrangement
- ❖ The need to diversify and strengthen the fiscal base of subnational governments is recommended. To this end, local tax administration should be improved, unproductive local taxes eliminated, and untapped tax potentials identified.
- ❖ The local government is the vehicle to implement the activities relating to poverty reduction at local level. Therefore, the expenditure assignment should be designed accordingly.
- ❖ The performance based grant system has promoted the participatory planning process and encouraged local government bodies to perform works more effectively and transparently. It has also supported them to make more responsible and accountable for service delivering. So, this system is highly recommended to be established and promoted.
- ❖ The need to reduce the necessity for frequent intergovernmental transfers that causes disruption in the fiscal system is strongly recommended. This practice engenders a dependency of the lower tiers on the central government. If revenue at subnational levels were boosted through increased tax assignment, and efficient local tax administration, the necessity for transfers would be reduced.
- ❖ The appropriate strategies for raising the necessary funds should be adopted while the formula for the distribution of federally collected revenue including VAT proceeds, need to be further amended to increase share of state and local government. This is because, the state and local governments have certain developmental functions that are vital to the people.
- ❖ The need to promote fiscal discipline at all levels of government to sustain macroeconomic stability is strongly recommended. The policy should compulsorily place effective limits on governments' deficits at all levels, consistent with the objective of holistic economic welfare to ensure sustainable national development.

- ❖ For the issue of equal development and substantive welfare, it is necessary to strengthen and enhance financial efficiency, resource planning, computerized accounting, financial reporting, and auditing mechanism including social audits in local bodies. For this, Gender mainstreaming, budgeting, and auditing mechanism should be instituted at all levels of governance structure.

7.4 Contribution to Knowledge

The thesis is concerned with the issue of fiscal ism amendment scenery and macroeconomic stability towards holistic economics prosperity in Nepal. Unlike studies that are based on one or two macroeconomic variables, the thesis is more comprehensive in its scope. In the field of Nepalese research landscapes and the pasture of public economics we hope this study makes significant theoretical and empirical contributions. It filled a gap in the theory on public finance in the area of unresolved macroeconomic impact of fiscal federalism, and unresolved non- correspondence issues which have inhibited the true practice of fiscal federalism in Nepal since the attainment of constitution of Nepal 2015.

Likewise, another contribution of the study provides policy-makers a foundation for sequencing the reforms of government in present scenario to provide an effective way of reducing the vertical and horizontal imbalances and disparities of federal republic government of Nepal as well as promoting macroeconomic stability, if properly structured. Moreover, the formalized theory and the arisen issues generated in the study, provide context-sensitive ideology and dogma with a meaningful specification for estimating the impact of upcoming national development at glance of balanced fiscal welfare between different tyres of governments.

7.5 Suggestions for further research

Although, being almost at the endpoint of this inquiry, we envisage that this is the beginning of many possibilities that have been built on the present exertion. However, while addressing the research agenda “where we stand actually?” deliberate between determinants of fiscal federalism and economic welfare in Nepal through recent constitutional arrangements based on overall macroeconomic situation of the nation and global empirical analysis, some academic and research issues have come out. First, in conducting the research on Nepali circumstance it was felt that developed countries fiscal

policy issues have not attracted adequate research. And, even whatever research is conducted on fiscal issues and topics, the majority of them have macro level consideration rather than local finance.

Second, researchers in present milieu have been highlighting the major challenges of fiscal federalization towards social and economic development of the country. Nevertheless, the greater concern of these studies has been the fiscal federalization from federal government to provincial governments, ignoring the decentralisation to local tier of government. To fill this literary gap, this thesis took the first step in highlighting the importance of local governments in social service delivery. Therefore, we should anticipate that the public finance experts and academic community will pay a considerable attention to address the qualitative and quantitative research questions related to efficacy of local government's empowerment for the improved social services provision and implementing poverty reduction policies.

Third, for the measurement of fiscal decentralisation the IMF's Government Finance Statistics (GFS) is a rich database that provides information of the majority of countries; public finances around the world. However, Nepal is one of those countries that do not have subnational government' finances reported in the GFS. Thus, the GFS should broaden its database of local finances and include Nepal and other such countries. And finally it helps to realise the importance of fiscal decentralisation as policy tool in those countries where substantive public sector reforms are being initiated.

Similarly, while it is encouraging that the results of this study match recent empirical findings show a connection between fiscal federalization amendments and its challenges and possibilities in Nepal, additional theoretical work exploring other possible sources of such a link is clearly needed. As lamination of proper data sources, the present result only emerges from a model based on very minimal assumptions (almost, based on present constitution of Nepal), but exploration of richer models may also be fruitful. Such models could be used to examine, the impact of transmission channels of fiscal federalism, in particular of revenue (taxation) competition, expenditure responsibilities and effective resources allocation mechanism, on the innovation of firms in the different states and local governments needs to be analyzed to obtain more insights in the working of fiscal federalism in Nepal. Finally, other aspects of fiscal federalism such as the convergence and structural perspectives of long-run growth possibilities should be explored in future works.

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