International Studies Program

Working Paper 02-05
April 2002

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An Overview of Intergovernmental Fiscal Relations in Nepal

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April 12, 2002

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This paper gives an overview of intergovernmental fiscal relations in Nepal, and highlights the issues and direction of reforms for the effective fiscal decentralization in the country. The analysis presented here is based on extremely limited sub-national fiscal data. Nevertheless, it is hoped that the paper could serve as a basis for further exploration in the field of intergovernmental fiscal relations in Nepal. His contact emails are: mks3@u.washington.edu (in the US until June 2002) or mkshrestha@wlink.com.np

Table of Contents

I. A Brief Historical Overview

The practice of decentralization in Nepal[1] is almost four decades old. This makes it perhaps the oldest decentralization process in South Asia. The statutory local government institutions were created as early as 1962 immediately after the replacement of the multi-party democratic system with the so-called party-less Panchayat System in 1960 through a royal takeover. Since then several intermittent efforts were made for about 30 years to strengthen these institutions in different ways and in different times, often sailing with political waves[2]. Many features of intergovernmental fiscal relations in the form of expenditure responsibilities, tax assignments, and even borrowing power were present in the old District Panchayat, Town Panchayat and Village Panchayat Acts.

The enactment of the Decentralization Act in1981 and the Decentralization Rules in 1984 was historical landmarks in intergovernmental fiscal relations during the Panchayat era. These laws for the first time in the 30 year history of the Panchayat rule provided significant expenditure and revenue authorities to these subnational governments, and placed District Panchayat (district local government) in-charge of the development of the district. A bottom-up planning, coordination and implementation system was set up by bringing all district offices of development related line ministries or departments under the District Panchayt's umbrella. But, the implementation could not lift very much off the ground. One of the main reasons was that there were no political incentives, or perhaps genuine political wish, to exercise the provisions made in the laws because of the patronage and vertical loyalty created by the political system. These institutions have, therefore, more or less worked as extended or de-concentrated agents of the central government, and were more loyal and accountable to the centre than to the people in their jurisdictions.

The popular movement of 1990 restored multi-party democracy in Nepal. The decentralization policy was brought in the forefront of national agenda of reforms, and continues to be the main means to translate democracy and development at the grass-roots level. Consequently, District Development Committee, Municipality, and Village Development Committee Acts were passed in 1992 reestablishing local government institutions at the district, town, and village levels. But soon this legislation was seen inadequate by the political forces outside the government, including recently established local government associations, and civil societies. The laws were criticized mainly on four grounds:

- the principles of self-governance were not explicitly taken into account and local; government institutions were still seen as local bodies, not as genuine local governments;
- not enough autonomy guaranteed by law (central government could suspend or dissolve local government);
- not enough expenditure and taxing power; and
- the disadvantaged sections of the society, civil societies, NGOs and private sector were not explicitly brought into the local governance framework as per the pluralistic decentralized governance culture.

In response to these concerns, the government in 1996 formed a High Level Decentralization Committee under the then Prime Minister, and a High Level Working Task Force to come up with a recommendation to further strengthen decentralization and local self-governance in the country[3]. The current Local Self-Governance Act, 1999 and Local Self-Governance Rule, 2000 are largely a result of the High Level Committee' Report, and together set the framework and rules for decentralization and local governance in the country. The key features of the Act include:

- explicit recognition of the local self-governance,
- unified act for all levels of the local government,
- space for the civil societies, NGOs and the private sectors,
- enhanced expenditure responsibilities, taxing and borrowing authorities,
- provision of a Local Fiscal Commission,
- provision of local service,
- establishment of sector office by the local governments,
- a high level decentralization monitoring committee under the Prime Minister for policy direction, coordination and monitoring of the implementation of decentraliation, and
- a decentralization working committee to support and guide the process of implementation.

II. Local Government Structure

Overview of Local Government Structure

Nepal is a democratic unitary state with a constitutional monarch. The Constitution of Nepal, 1991 defines the governance system of the country. The Constitution mandates peoples' participation through decentralization as a fundamental rule in the governance system. It makes reference of local governments at district, municipal and village levels and leaves the creation of these local governments in the hands of the Parliament. Administratively, the country is divided into 5 development regions and 75 districts. Within the district boundary, there are Municipalities and Villages. The central ministries have their units in the region and in the district. Some ministries like agriculture, health also have sub-district level offices[4].

Nepal has two tiers of local government: 1) district, and 2) municipality and villages. The Local Self-Governance Act, 1999 defines the expenditure responsibilities, revenue assignment, transfers, and borrowing authorities of the local governments. It also explains the planning and budgeting system as well as intergovernmental relations and other procedural arrangements for the implementation of the decentralization. Under this Act, currently there are 75 District Development Committees (district local government), 58 Municipalities, and 3913 Village Development Committees (village local government)[5]. In Nepal, all local governments are general-purpose local governments.

The Village

The Village Development Committee (VDC) is the lowest level of local government. It is a cluster of settlements. The VDC is divided into nine wards. The average VDC has 5,900 inhabitants. However, the population of the VDCs declines as one moves from the Terai (the Plain area) up in the hills and the mountains[6] Each VDC has an elected executive and an elected Council. Each ward elects a five-member Ward Committee consisting of one ward chairperson, one women member, and three ward members. These elected ward committees form the Village Council composed of 45 elected members and six nominated members by the Council representing disadvantaged groups and women. The Executive Committee consists of directly elected Chairperson and Deputy Chairperson from the whole VDC, nine ward chairpersons elected each from nine wards, and two members (one must be women) nominated by the executive from the village council representing disadvantaged groups and women. The Village Council meets twice a year for the approval of the annual program and budget, and the tax proposals submitted by the executive. The council also monitors the activities carried out by the executive.

VDCs are devolved with many local level functions and taxing powers. In addition, the central government provides annual grant to these VDCs. The Village Secretary, the administrative in-charge of the VDC, is deputed by the central government (Ministry of Local Development). This means that the central government employee is a key member of the local government executive. The reason for this is the belief that the lack of qualified personnel in many local governments would make it impossible to properly staff and retain the local executive. Majority of VDCs are weak in their resource base, and technical and administrative capacity. The fiscal and administrative capacity of VDC in the mountains are worst followed by the VDCs in the hills and in the Terai leading to increasing fiscal disparities among the VDCs The lack of staff, poor revenue, and high cost of service delivery due to scattered settlement and inaccessibility[7] combined with increasing needs have seriously hampered the effectiveness of village service delivery and the efficiency of local public expenditure in general. Some resource rich VDCs might have successfully generated additional revenues and might be doing well also in terms of providing some basic services, but the majority of VDCs generate almost nothing and are far below in local service delivery.

The Municipalities

The municipalities vary in their size from small town to municipal corporations[8]. There is an increasing trend in creating more municipalities[9]. Twenty two municipalities were added in 1996 making altogether at the present time 58 municipalities. An elected Executive headed by the Mayor runs the municipality. The elected Municipal Council is the most powerful body for the municipality. It approves the annual budget, sets policies for the municipality, approves the tax proposals, and supervises the expenditures of the municipality. The municipality is also divided into wards. The number of wards varies according to the size of the municipality, the bigger the municipality the higher the number of wards. The minimum number of wards is nine. As a result, the size of the municipal Executive Committee and Municipal Council members also vary. The formation of the Executive and the Council is similar to that of the VDC.

Many sector and service related functions and revenue raising authorities have been devolved to the municipalities. Municipalities vary in their revenue base and tax administration capacity. As a result, their service delivery capacity and the scope of service delivery also vary. Municipalities having own source revenue less than NRs 10 million receive a grant from the central government to supplement administrative cost and capital expenditure. The central government (Ministry of Local Development) deputes the Municipal Secretary, the chief municipal officer. He or she is in-charge of day-to-day operation and budget under the general direction and supervision of the Mayor.

Municipalities are better equipped with staff and equipment in comparison to VDCs. In general, they are more independent in their conduct of local affairs because of their fiscal independence. This has sometimes also caused conflict with the central governments over the mandates and on the supervisory role of the district and the central government.

The District

The district local government called the District Development Committee (DDC) lies between the center and lowest level of government – the VDCs and the Municipalities. The district varies greatly in size and socio-economic development. Currently, the district is a mix unit of deconcentrated and decentralized (or devolved) unit. There is an extensive presence of ministerial or departmental units with independent expenditure authorities. The Chief District Officer from the Ministry of Home Affairs represents the central government in the district and coordinates the security, police and corruption issues (as delegated by the Commission of the Abuse of Authority).

The DDC has an Executive and a legislative branch, the District Council. The election of the DDC is indirect giving an implicit status of umbrella organization of the VDCs and Municipalities in the district. The Chairpersons, Vice Chairpersons, Mayors and Deputy Mayors, executive members of the DDC, Member of Parliament (both Lower House and Upper House) representing the district together with six nominated members by the Council from disadvantaged groups and women form the District Council. An electorate collage comprising of all elected executive and council of VDCs and Municipalities in the district elects the Executive Committee. The executive committee is composed of District President, Vice-President, Illaka members and two members (one must be women) nominated by the executive from disadvantaged and women. The whole electorate body elects the District President and Vice President, while the electorate body from the respective Illakas elects the executive members (called Illaka Members). The number of Illaka (more like a sub-district) ranges from nine to seventeen. The district president heads the DDC, while the District Secretary (called Local Development Officer) takes charge of day-to-day operation, management and administration of the DDC.

The District Council is the apex body in the district. It approves the District Periodic Plan, District Development Plan[10], defines district development policies and priorities and approves revenues and other proposals put forward by the executive. The DDCs are devolved with almost all development and service related responsibilities and revenue-raising powers. Besides, they get grants, funds from revenue sharing and specific project support financed by the central government. However, income from these sources is only a small fraction of total expenditure that occurs in the district through departmental units and NGOs. The central government and NGOs continue to provide major services in the district. This has not only jeopardized the incentives for the DDCs to make additional efforts form their side for the delivery of services, but has also created an environment of soft budget constraints. The DDCs also very in their fiscal capacity like the VDCs and municipalities as one moves form the terai district to the hills and to the mountains.

Main Challenges and Reform Issues

Rationalization of the size of the basic governing units: The VDCs

The current small size of VDCs is considered not economically viable in terms of self-governing units due to narrow economic base and lack of economies of scale in the production and delivery of services. Furthermore, large number of VDCs means high cost for technical support, capacity building and supervision from the central government. The small size and large of the VDCs has been a recurrent issue for some years, and recently high on the agenda[11] of the central government. There is no provision and incentive for the VDCs for voluntary merger. Besides, this is a tough political choice as rationalization of the VDCs means loosing the space for lower level political cadres to keep them busy at that level. The challenge is how to rationalize the size of the VDCs so that they become economically viable and at the same time that takes into account the local preferences of the VDCs.

One option is to put in place some incentives that help voluntary merger of the VDCs wherever possible. One such incentive might be to bring together a couple of VDCs and upgrade them into municipalities[12]. As a mechanism, the municipalities can be further subdivided starting from town, for example, with in-built norms and sufficient incentives so that VDCs and municipalities at lower level strive for higher category municipalities. Another option would be to categorize the VDCs according to their revenue base, level of development, and population and rationalize devolved functions and support activities accordingly. This might motivate VDCs to move towards higher category VDC and then perhaps to the municipal level. The other solution is to create Special Districts so that a number of VDCs come together in a cluster for financing inter-VDC services. This concept is new in Nepal, but the VDCs could be provided option to decide by themselves. Yet another approach worth considering would be to reduce the number of the VDCs into less than one thousand coinciding with the number of current Illakas. Administratively, this would not be a costly and difficult exercise as the VDCs are already grouped into Illakas (one Illaka normally has 3 to 5 VDCs). Administrative rationalization of the size and number of the VDCs may possibly drag the districts also into the rationalization discussion. It would, therefore, be rational to review this in totality (rather than on a piecemeal basis) for integrated reform. But any review and rationalization process should include the local governments and respect their voice, as it is a critical choice between the efficiency and accountability of the local governments.

Making local government structure efficient and functional

The current decision making structure of local governments is collective. While it helps to build consensus on decisions, it has often been observed resulting in high cost in terms of non-decisions, late decisions, bargaining (often ended with undue financial benefits) or loose accountability. Furthermore, the large size of the executive and council has not only drained the limited revenue for their remuneration and benefits[13], but also hampered decision process incurring indirect costs. Executive heads are often forced to indulge in making the members happy rather than concentrating on broader agenda of efficient and effective delivery of local services. The issue here is how to make local governments functional and efficient.

First of all, the current pyramiding of the DDCs' political representation (indirect election of the DDCs) should be replaced with the direct election by the voters for a stronger representation of the jurisdictional interests and direct accountability to the voters. As for the functional structure of the local government is concerned, there is no easy solution. Different political structures exist around the world – from parliamentary to presidential model, and several mixes between the two. Under the present structure of the local government, one solution would be to reduce the number of geographical sub-divisions[14] (wards in the VDCs and municipalities and Illakas in the DDCs) based on the classifications of the VDCs, Municipalities and the DDCs[15]. This change in combination of the reduction in the Ward representatives, say from current five to three (one Ward Chair, one Woman member and one Member) would significantly reduce the size of the Executives and the Council. This would result reductions in the direct cost and, hopefully, improve the decision-making. Another approach, more in line with the direct accountability to voters, would be to give power to the elected Heads of the local governments to form its own executives. The size of the executive can be fixed, say from five to nine, according to the classification of the local governments. Ultimately, this is a political choice question – a trade-off between the efficiency and broad-based governance. In the case of Nepal, the real challenge is to strike a balance taking into account the country's political-economy and socio-cultural contexts. However, the direct election of DDCs and broad-based political representatives at the Executive according to the classifications of the local governments could be a step in improvement towards functional governance in this context.

Clarifying the role of District Local Government and its Relationship with the Other Local Governments

The current law is ambiguous about the role of the DDCs. **A**ll three local governments are autonomous by law, and have independent expenditure responsibilities. All three local governments get grants directly from the center[16]. However, the planning and coordination responsibilities mandated to the DDCs implicitly give them some oversight role over VDCs and municipalities. This somehow created the notion of 'subordinate relationship'. This has not been palatable for municipalities, in particular. Besides, DDCs are also assigned some expenditure responsibilities that do not go well with their coordination role. The issue is what status the DDC should have and what role it should play.

Considering the large number of the VDCs that are mostly inaccessible by transport and communication and which require constant technical back-up from the higher level of government, it would be unrealistic to maintain a direct relationship with them from the central government. The DDCs will be in a suitable distance to provide support, supervise the VDCs and report to the center. With municipalities, the case is different. They are accessible and their problems are different from the VDCs that are rural in nature. Their relatively better financial base also gives them more fiscal autonomy. Keeping them under the sub-ordination of the DDCs not only be politically unpalatable to the municipalities, but also be overwhelming and often frustrating for the DDCs in terms of not being able to support the way the municipalities want and also for not being able to supervise them. So, the right move would be to de-link the municipalities from the DDCs and have a direct relation with the center. At the same time, the reform should establish a strong hierarchical relationship of the DDCs with the VDCs, and make the DDCs exclusively responsible for non-municipal areas recognizing explicitly the rural and urban differences.

III. Expenditure Responsibilities

Current Expenditure Assignments

What is provisioned in the law?

The current Local Self-Governance Act, 1999 defines the expenditure responsibilities of all three local governments, the village level, municipal level and the district level. These are devolved functions and are quite comprehensive. DDCs have 16 categories of expenditure responsibilities, while the VDCs and Municipalities have 11 categories of responsibilities each. These responsibilities encompass almost all 'public services', and largely follow the principle of subsidiarity. Apart from the devolved functions, municipalities have 'optional' functions too. The current division of responsibilities as provisioned in law for the local government is shown in table 3.1. The reality is quite different which will be discussed below. The Act also makes the sector Ministries responsible to prescribe and define the tasks into local level, village level, municipal level and district level[17]. This is contradictory to the expenditure assignments (devolution) to the local governments provisioned by the same Act. Besides, the sector Ministries' functions are kept largely untouched during the expenditure assignment process. This by design created overlapping functions and failed to determine clearly which level of government is responsible for what. Sector ministries continued to perform in the conventional ways perpetuating the duplication and confusion in the expenditure assignment.

In theory, the local governments are autonomous in carrying out these functions within the broad national or sector policy framework and guidelines provided to them by the central government. The DDCs gets this framework, including estimation of resources, from the National Planning Commission, while Municipalities and VDCs gets these guidelines from the DDC and concerned agencies. By law, the local governments are also required to prepare coordinated periodic (five year) and annual plan and budget in order to execute their tasks so that resources and efforts are not duplicated.

What is actually happening?

Despite the extensive devolution of expenditure assignments to the local governments, due to mainly unclear and overlapping functions, the central government through their agencies has been continuously enjoying the burden of providing all major public services like health, education, electricity, water, etc at the local level. For the local governments, the devolved expenditure assignments thus remained largely unfunded. The only funding they get is the general block grant, plus some conditional grants for road and suspension bridge construction, and the administrative grant. Although the local governments have discretion on spending the general block grant, the size is so small that its real influence in addressing the expenditure responsibilities is negligible. The system of transfer of the grant, on the other hand, is also non-transparent. This in combination with the access to funds or project support through political connection or otherwise has seriously jeorpardized the possible efforts or motivations of local governments to do more from their side. The flow of donor money outside the local government transfer framework through project support or through NGOs, might have amplified this situation.

What then are the local governments are doing in reality? In practice, the local governments are doing very little in comparison to the expenditure assigned to them. Whatever little they do is also done by other agencies. For example, the drinking water supply scheme could be implemented either by the DDC, or the drinking water supply office (the district unit of the sector ministry), or by the NGOs. Attempts are made to minimize duplication through planning and coordination in general. The Roads is the only assigned responsibility where relatively clear delineation of functions is found. District road is clearly the DDCs's responsibility. Likewise, the Municipality is responsible for the municipal road and the VDC is responsible for the village road. Remaining functions are largely overlapping between the different levels of governments and ambiguous in terms of which level is responsible of regulation, financing and implementation.

Apart from planning and co-ordination function in general, the DDCs provide rural infrastructure services from general-purpose, and conditional road and suspension bridge grant. These services include district roads, suspension bridges, irrigation, pipe water supply, and trails improvement. The mechanism of the project implementation at the DDC level suggests that the central government has heavily engaged the DDCs in executing additional mandates largely discarding funding for the devolved mandates. The execution of the constituency development program by the DDCs for the Members of Parliament representing the area is an example. Similarly, many DDCs are engaged in implementing projects, with little or no discretion, supported by the central government (mostly with foreign assistance) primarily in rural infrastructure field. A capacity building project is also under implementation in most of the DDCs helping them in participatory planning practices and in the implementation of poverty focused community development activities (through social mobilization concept) in a few VDCs. A Local Development Fund (LDF) was created through the support of the project to help fund community development projects largely outside the DDC structure. The matching fund requirements are in most cases met by the DDC's general block grant reflecting little emphasis on a process of creating a hard condition budget constraint for the DDCs to make an effort for local revenue generation. A matching requirement from the local revenue, however small, would have helped to begin the process. Continuous practice of project administration by donors and less emphasis on the process and institutionalization in building confidence, revenue base, or maintenance, and cost recovery mechanism has contributed to make the local governments weaker instead of facilitating towards enhanced capability to manage things by the local governments themselves.

Municipalities, on the other hand, provide minor infrastructure (pavements, market sheds, shopping complexes, etc), general public health (like slaughter house, crematoriums), fire, , solid waste management, and other amenity related services like parks, street lights, games, etc. This has been possible due to better revenue base in the municipalities. The center still provides the the utilities and major infrastructures like roads, communication, or bridge. The VDCs are mainly involved in services like village roads, minor irrigation channel, small drinking water, or supplementing teachers' salary in the villages. These are paid from the VDC grant and community participation. These services also overlap with other agencies, be it the central government, or the DDCs, or the NGOs. The VDCs are not getting funds for other devolved functions. The central government continues to manage services either through its own agencies in the district or through the NGOs that bring external resources.

The local governments also execute some agency functions mandated by the central government from time to time. They include social security payment distributions, election related works (voters' list preparation, updating, etc), participation in national campaign like national wide vaccination, and relief works in case of emergency. These functions are generally funded. What is not covered is the overhead costs associated with these functions. For example, the distribution of social security payment requires issuance of identification documents, and paper work for recording and reporting of the distribution. Other intermittent administrative works, like putting out official notices of the central government, collection of information for the center, etc are typically not funded.

Expenditure Patterns

An analysis of data available for limited period (1998/98 – 2000/01) reveals that the share of local government in the total public expenditure is around four percent, and it is declining (table 3.2). Thus, the actual level of fiscal decentralization in Nepal is very low. This trend is true also with respect to the total revenue and GDP. The share of local governments with respect to the total (internal) revenue is higher in comparison to total public expenditure, because total public expenditure includes financing from internal and external borrowing. It is also noticeable is that the share of national budget in GDP is increasing over the same period indicating a tendency of centralization of expenditure.

Table 3.2
Share of Local Government in GDP, Total Public Expenditure and Total Revenue (%)

	1998/99	1999/2000	2000/01
Share of Central Government in GDP	21.12	21.13	23.34
Share of Local Government in GDP	0.83	0.77	0.71
DDC	0.20	0.19	0.17
Municipality	0.04	0.04	0.03
VDC	0.59	0.53	0.50
Share of Local Government in Total Public Expenditure	4.62	4.24	3.37
DDC	1.09	1.05	0.84
Municipality	0.24	0.23	0.18
VDC	3.29	2.96	2.35
Share of Local Government in Total Revenue	7.39	6.55	5.66
DDC	1.74	1.63	1.41
Municipality	0.39	0.35	0.30
VDC	5.26	4.57	3.94

Source: Compiled from Economic Survey (2001) and Budget Speech (2001/2002), Nepal

Reasons for the small share of Local Government expenditure are low own source revenue (chapter IV) and continuous local service provision by the central government. The major public services like health, education, extension services, water supply, and other infrastructures are provided from the local units of line ministries or departments. Even in municipalities, basic services like water, electricity, communication, sewage, roads are taken care of by central government departments. One another factor contributing to this situation is the mistrust by the central government in local governments in latter's capacity to handle the devolved expenditure responsibilities and to utilize the resources efficiently. As a result, more than two-third of the district budget is spent outside the control of the local government[18].

Data are unavailable, at least in the published form, to highlight the detailed composition of local government expenditures. However, available limited data and my own working association with the local government reveal that local governments are more concentrated in minor capital expenditure, for example, minor infrastructure like irrigation channel, pipe water supply, primary school buildings, small dams, village roads, etc (table 3.3). The reasons are: first, local governments are not getting money for non-capital expenditure, and second, capital projects are visible, easy to monitor and considered not wasteful in general.

Table 3.3
Composition of Local Government Expenditure, 1998 and 1999

	1998			1999		
Percent of total	**DDC[1]**	**Municip**	**VDC[2]**	**DDC@**	**Municip**	**VDC^**
Administrative expenses	30.8	42.7	40.8	39.5	44.5	44.1
Loan repayment	-	3.2	-	-	2.5	-
Social program (and grant)	10.2	3.7	13.1	13.2	4.9	12.5
Capital expenditure	59.0	50.4	46.1	47.3	48.1	43.4

Source: Compiled from Fiscal Commission Report, 2001 and Nepal Human Development Report, 2002
[1] data only for 32 DDCs only
[2] data only for 32 VDCs of 12 districts

Regional disparities in Local Government spending

Very little information is available to analyze the variation in the local government spending, especially for the DDCs and the VDCs. Using two year information[19] for the DDCs (25 out of 75) and the VDCs (21 out of 3913), and Municipalities (all municipalities), the analysis indicated high degree of variation in the local government spending per capita (table 3.4).

Table 3.4
Regional Variation in per capita Local Government Expenditure

Year	Local Government	Mean	Coefficient of Variation	Minimum	Maximum
1998	DDC	143.0	0.95	20.0	529.0
	VDC[1]	697.5	0.60	176.0	2002.0
	Municipality	435.9	0.74	81.1	1802.1
1999	DDC	139.0	0.86	19.0	460.0
	VDC@	716.3	0.72	62.0	2508.0
	Municipality	457..8	0.70	111.4	1727.3
2000	Municipality	493.5	0.69	115.8	1969.9
2001	Municipality	554.7	0.76	126.2	2308.2

Data source: Local Fiscal Commission Report, 2001 for DDCs and VDCs data; and Ministry of Local Development for Municipality data.
[1] VDC figures are in thousand NRs, not in per capita

What caused regional variation in the local government spending? One explanation could be the variation in the own source revenue generation. Though the share of own source revenue in the local government is small, the rich local government might be collecting and, therefore, spending more than the poorer local governments. Similarly, the per capita fiscal transfer may be inequitable resulting to a variation in the local government expenditure. In the case of Nepal, as local government spending is basically a composition of the local revenue (small) and fiscal transfer, the differences of needs might not be significant in explaining regional variation in spending. The local government expenditures are fundamentally guided by the availability of funds rather than the differences in needs.

Reducing regional disparities are essential from an equity perspective. Besides, the disparities in the provision of public services will also increase migration of people and investment in better off areas leading to further regional imbalance. These ultimately may result high social and political costs, sometimes in terms of extreme social and political unrest in the society.

Issues for Reform

Clear Assignment of Expenditure Responsibilities at all level of Government

It is absolutely fundamental that the expenditure responsibilities between all levels of the governments must be clear, stable, and unambiguous as much as possible so that the all level of governments and the people of the jurisdictions know which level of government is doing what. This functional division should also spell out explicit attributions for regulation, financing and implementation very clearly. Besides, a process of dialogue and coordination between the central and local governments and also among local governments should also be institutionalized in practice in order to sort out differences or to build cooperation in addressing issues like spillover benefits, and economies of scale for technical efficiency.

In Nepal, despite extensive functional devolution at the local government level, the regulatory and institutional reforms required in clarifying the division and dimensions of the responsibilities do not seem to have moved much far in the right direction. Most devolved responsibilities are still listed in the functional division of sector ministries. No wonder, the sector ministries continued to retain the devolved functions. The contradictory provision in the local government law providing the sector ministries power to divide functions into district, municipal, village, and local level might have supported for this situation. Besides, there are more than a dozen Acts, the provisions of which contradict with the local government law.

Therefore, the strategic reform process should begin in a number of areas. First, the central government should clarify the existing duplication of responsibilities between the central and local governments by de-listing the devolved functions from the functional responsibilities of the sector ministries with explicit specifications for regulation, financing and implementation. This will establish clear division of responsibilities with functional dimensions. The central government should stop meddling with the devolved functions by intervening with discrete decisions either stopping or redefining the sector or pace of the implementation within the devolved functions by law[20]. Second, the central government should eliminate contradictory provisions in the local government law and other laws mentioned above in order to provide a sound legal basis for the implementation of the local government provisions. Third, as the clarity of functions and building a cooperative relationship require a process of dialogue, the central government should also establish a regular institution in the form of a Committee drawing representatives from the stakeholders like local government associations, sector ministries, Ministry of Finance, and National Planning Commission. This institution should also work as a conflict resolution forum between the central and local governments and among the local governments.

So far as the expenditure assignment between the local governments is concerned, a symmetric assignment of expenditure responsibilities across the level of local governments is followed in Nepal. This means that the VDCs in the Plain get the same responsibilities as the VDCs in extreme remote hills and mountains. This is true for Municipalities and DDCs also. This approach overlooks the reality that the local governments greatly vary in their level of development, and in their fiscal and administrative capacity. Treating all the local government same horizontally in expenditure assignments would not only be unfair distribution of burden, but will also result inefficiency due to capacity differences. A practical approach for the government would be to match the responsibilities with the capacity as far as possible, and establish a system of graduation from one category to higher category within the same level of government. This will require categorization of the local governments based on some simple, objective and transparent criteria and assignment of the expenditure responsibilities accordingly. In Nepal, the local government law provisions for such categorization of the DDCs and the VDCs. The municipalities are already categorized. If implemented properly, this will also create an incentive structure for the enhanced performance of the local governments in order to move to the higher category. It will also help clarify the duplication and ambiguity of functions among the local governments. Any subsequent clarification or cooperation will be dealt by a system of dialogue and cooperation as mentioned above. For example, in running a village health post (which is a VDC responsibility) the VDC, the DDC and the central government representative (in this case from the Ministry of Health) could meet, and mutually decide, for example, paying for the health staff by the Ministry, and paying for common medicines by a mix of service charge (check-up fee), VDC budget and some matching, say 10 percent of the total cost, from the DDC.

Strengthen Local Governments in implementing Expenditure Responsibilities

The clear assignment of expenditures alone will not help unless supported by the appropriate funding and institutional arrangement for the local governments to carry out the responsibilities assigned to them. Currently, instead of providing funds to the local governments, the central government provides most of the services within the devolved functions of the local governments through its agencies, NGOs, and centrally managed projects (but run through the DDCs). Even the projects in the same sector often have different objectives, and different funding windows that are not very transparent. More than two-third of the budget spent at the district level goes outside or parallel to the DDCs. The creation of Local Development Fund with the donor support at the DDC level for community development could go parallel in function to the VDC, if jurisdictions are not properly taken into account[21]. Similarly, the establishment of a national Poverty Alleviation Fund, if fails to embrace the local government and is implemented without keeping the local government at the centre, could be another parallel agency to the local governments. Such practices are not only creating a soft budget constraint for the local governments, but are also marginalizing them and making then even weaker institutions. These are not sustainable policies in the longer run.

The best approach would be to provide funds to the local governments for all the devolved functions, and make them responsible for the provision of those services. Some specific sectors could be funded through conditional or matching grants in order to achieve specific objectives. If it is not possible in the short-term, at least the government should attempt to integrated the different projects of similar nature implemented through the DDCs into a sector budget and transfer funds on the basis of some transparent and objective criteria. The government could also come up with a mechanism whereby the funding to the local government from different sources is monitored and any fund coming from a new source should be carefully directed for right incentives avoiding parallel funding. The local government should bear the responsibilities for the devolved functions, and for this to achieve the funding to the local government should be integrated and the hard budget constraint should be maintained.

Ensuring the provision of minimum desired service levels by the local governments

The issue here is how one should ensure that the local governments provide minimum desired level of services. Although currently the basic services are still taken care of by the central government, but if fiscal decentralization has to succeed, this responsibility has to be taken over by the local government. And, the general grant might not ensure minimum desired service level. This would require conceiving of minimum desired level of services by the central government and also defining of minimum expenditure standard for key services. In Nepal, generally specific physical target with budget allocation approach is followed for service delivery. It does not take into account explicitly the minimum desired service level or minimum expenditure standard to lead to the minimum desired service level. This approach also looses the efficiency considerations in delivering public services at the local government level.

What is required first, therefore, is to define the minimum service level and corresponding minimum expenditure standard for the key services within the jurisdiction of the local governments. Different approaches could be used to ensure minimum service level. A combination of approaches may be the most desirable. Thus, in general, lump-sum funding is preserved, but minimum expenditure standards are introduced for some key services such as education and health, matching grants are used to induce greater spending in areas with spillovers or externalities such as the environment, and reimbursement schemes are used for national program implemented at the sub-national level such as those in social protection and welfare (Martinez-Vazquez, 2001). In addition, the sector policy reviews by the center will provide a general framework and direction of activities in the sector for the local government. It will also indicate the measures that could be taken to improve efficiency in the provision or delivery of the sector specific public services.

Privatization and efficiency in local public expenditures

Private sector participation in the overall local government expenditure is negligible in Nepal. Community activities are mostly carried out from user (beneficiary) groups who share part of the cost of the scheme during construction (mainly voluntary labour). The idea is that the community ownership of the services will increase social efficiency of the services through sustainability and fair distribution (or consumption) of benefits arising from such services. However, there are many activities, particularly in the municipalities, which can be provisioned by the private sector on a competitive basis with least cost. Efficiency is gained when better or more services are provided with low cost. Some municipalities are already using private sector in a small scale for part of the activities related to solid waste management, parking services and construction of public facilities. But there is certainly scope for the more private sector involvement in the local government activities.

Efficiency gains from the private sector provision of services depend on the existence of some preconditions like functioning of the market and competition among the private sectors. The prevalent of these conditions guide where and which services will be best served by the private sector. Considering the Nepal situation, the local government in the most hills and mountains may not have conditions adequate for the private sector to achieve potential efficiency gain. There community approach may replace private sector provision of services. What is required is embracing the efficiency principle in the local government conduct and making conscious effort from the local governments in this direction. In areas where market is functioning, the local government should ask which activities can best be carried out by private sector leading to better or more services with low cost. The local government should also look into their overhead expenses where they can improve their efficiency and save cost. The cost saving realized from the efficiency gains can then be utilized for the provision of better or more services. Even in municipalities, most of the services (which can be best provided by private sector) are provisioned by municipalities itself. This means services are still subsidized and cost recovery and efficiency policies are not applied at local level. Equity is also not taken into account as poor and rich get the same level of services with same subsidy (or price). In some municipalities, solid waste management and parking services are managed by private sector. Similarly, public-private partnerships innovations are also seem working well in some DDCs and Municipalities. Lessons should be learnt and cost recovery policy should be applied with the involvement of private sector. This will release money to target the poor for subsidized services.

Settling the unfunded mandates

Currently, the crucial issue is that the expenditure assignments are not matched with necessary funds from the central government or local revenue raising authority. The general transfers local governments are getting only general fiscal transfers, which are too low to cover the devolved functions. As mentioned earlier, the local governments routinely carry out some agency functions like social welfare payment distribution, emergency relief works, voters' list preparation and updating, etc and so on. The direct cost of these mandates is funded by the central governments. The overhead costs of these activities are not covered, which could be very costly for the poor local governments. The central government should cover this cost. In addition, the local government law should be made explicit in prohibiting the unfunded mandates to the local government for future problems. Furthermore, the institutionalization of the forum of dialogue and coordination mentioned earlier could also serve as resolving of any possibility of unfunded mandates arising from the ambiguity of expenditure responsibilities between the central and local governments.

IV. Revenue Assignments

Tax policy and tax administration are fundamentally under the control of the central government. Local governments have no decision making power over the tax base and very little discretion on the tax rates of the taxes they have been assigned to them.

Current system of revenue assignments

The current revenue assignments of the sources for local governments consist of own revenues, tax sharing and transfers. Own revenue sources and tax sharing are explained in this section, while transfers are discussed in the next section.

Own source revenues

The major sources of revenues (VAT, excise taxes, income taxes, and taxes on international trade) in Nepal are collected by the central government. The local governments, on the other hand, only have minor own sources of revenues. The Local Self-Governance Act, 1999 defines the revenue assignments for these local governments. For the VDCs and Municipalities, these sources mainly include house and land tax (and integrated property tax to municipalities), vehicle entrance tax, business tax, service charge, and a number of fees. The VDCs can also impose the natural resource utilization tax. Municipalities can levy rent tax. The revenue sources under the jurisdiction of the central and local government are shown in Table 4.1.

Land revenue, potentially a good source of revenue for the VDCs and Municipalities, is still mainly levied on a physical unit basis rather than on their productivity or market value. As a result, the land tax has not been able to contribute significantly to local revenues. Similarly, the rent tax in the municipalities has not been effective because of the lack of tax enforcement and poor tax compliance. The system is not in place to keep track of the rent market. Apart from the general sources of revenue, the municipalities also get the share of local development fee levied on imports (1.5 percent of import value) by the central government exclusively for the municipalities. The local development fee, which is collected by the central government, is apparently the dominant source of revenue for the municipalities. A Committee comprised of representatives from the Ministry of Local Development, Ministry of Finance, and Municipalities distributes the amount to all municipalities. The central government has also imposed some exemptions provisions on the Municipalities. These prohibitions include no taxes, charges, fees, duties, etc to the central government, foreign diplomatic agencies and non-profit making organization except the service charges chargeable for the services provided by the municipality. Similarly, they are also restricted to impose any fee or charge on the goods that are meant for the government use or for the projects funded through foreign grant or loan.

DDCs, on the other hand, can mainly levy tax on the use of roads, bridges, canal, etc constructed or maintained by them, and on the commercial use of local raw materials and recyclable materials. They can also earn from natural resource utilization by selling sand, stone, wood swept by river, etc. and by licensing, fees and fines.

Tax sharing

Tax sharing with the central government is another potentially important source of revenues for the DDCs. The tax sharing bases are land and house registration fee (5 to 90 per cent depending on the amount of collection), royalties from mines (50 per cent), royalties from forest (10 per cent), royalties from the hydropower generation plant (10 per cent) and tourist entrance fees (30 per cent)[22].

There is also vertical sharing of revenues among local governments. The VDCs should share 25 percent of the collected land revenue with the DDCs. Similarly, DDCs are mandated to share up to 35 to 50 per cent of the earnings from the charges on the commercial use of raw materials and recyclable wastes, and from the sale of sand, stones, wood swept by rivers, etc to the VDCs and municipalities.

Table 4.1
Summary of the Tax System in Nepal

Central Government	DDCs	Municipalities	VDCs
-Taxes on business income (public, private and joint venture enterprises) -Tax on income from individuals, sole proprietorships, partnerships, and private limited companies -Interest taxes -Capital gain tax -Property tax (Registration fees on property transaction, and urban houses and land tax) -Taxes on goods and services - VAT - Excise taxes on cigarettes and liquor, - Tourism fee - Motor vehicle tax - Air flight tax - Contract tax -Taxes on international trade (import and export duties)	-Natural resource tax on commercial utilization (35-50 % should go to VDCs and Municipalities) -Taxes on infrastructures like roads, bridges, etc. -Service charges (guest house, library, city hall,) -Local development fees -Other prescribed service charges -Licensing and renewal fees (Panighat, water course, boating, tunings and fishing) -Recommendation fee and other fees as prescribed -Sales revenue (sand, stone, wood swept by river, etc) -Fines -Tax sharing 1) Registration fee (transaction of house and land) 2) Royalty (mines, petroleum products,	-House and land tax -Land revenue or land tax -Vehicle tax -Entertainment tax (cinema hall, video hall and cultural show halls) -Rent and tenancy tax including rent tax on property rented -Advertisement tax on sign board, etc -Business/enterprise tax on prescribed industry, trade, profession or occupation -Commercial video tax -Integrated property tax -Service charges on utilities, public facilities, etc -Entrance charges (tourist places, parks, gardens, towers, etc) -Parking charges -Other charges and fees (valuing immovable property, approval, recommendations, etc) -Building permits -Fines	-House and land tax -Land revenue or land tax (25 % goes to DDC) -Shop and market (haat) tax -Vehicle tax -Entertainment tax (cinema hall, video hall and cultural show halls) -Rent and tenancy tax -Advertisement tax on sign board, etc -Business/enterprise tax on prescribed industry, trade, profession or occupation -Commercial video tax -Natural resource tax on the commercial exploitation -Other taxes as prescribed -Service charges (sanitation, drainage and sewerage, solid waste management, performing magic and circuses) -Entrance charges (tourist places, parks, gardens, view towers,

Table 4.1
Summary of the Tax System in Nepal

Central Government	DDCs	Municipalities	VDCs
	forests, water, and other natural resources) 3) Entrance fee (entry of tourists into the DDC area)		etc) -Licensing and renewal fees (television, video and other equipments) Other charges and fees (approval, recommendation, etc) -Revenue from sailing (sand, stones, grasses, etc) -Fines

Source: Local Self-Governance Act, 1999, and IMF Country Report, October 2001

Although the tax assignments are almost similar with the municipalities and the VDCs, there is no conflict between the two because of their distinct geographical boundaries. Besides, many of these revenue bases are only in the law. They have not applied in practice because of low revenue potential and perhaps high tax administrative cost. The overlap between the DDCs and municipalities and the VDCs and between the centre and local government is critical. These overlaps can be seen, for example, in the sale of sand, stone, etc (between the DDCs and the VDCs), in the vehicle tax (between the central and local governments), and in property taxes (between the centre and the municipalities). These overlaps need to be removed to minimize conflict between the different levels of the governments.

Pattern of local government revenues

The composition of local sources of revenues is shown in Table 4.2. Local governments have no discretion over the base, and have very little flexibility on the rates set by the central government. Besides, neither the local governments have made genuine institutional efforts nor the central government has provided support in order to systematically apply the assigned revenue instruments to experience what works and what does not work, and why. Some revenue sources have, theoretically, high revenue potential like land revenue and rent tax. But attempts have not been made to learn lessons and build upon it. Other minor revenue sources, like fees and fines, charges, etc are there under the jurisdiction of local governments. But they have essentially very low revenue potential. These factors together resulted to very low revenue collection performance of local governments in general. As a result, the central government transfer became one of the main sources of revenue for the local governments. An analysis of limited information reveals that more than 80 per cent of DDCs' expenditures and more than 74 per cent of VDCs' expenditure are covered by transfers from the central government (Table 4.2). In case of municipalities too, the share of transfer in their total revenue is high with more than 60 percent[23].

Among own source revenues, it seems that the share of taxes is higher in VDCs than other sources like service charge, fees and sales. Land revenue is the major contributor in the tax category in the VDCs. In the DDCs, two major revenue contributors are tax on recyclable wastes and sale of sand, stones, and wood brought by river (natural resource tax). In the case of municipalities, the tax and fees constituted just around 18 per cent of the total revenue. In fact, one would notice that all other categories of taxes except fees and fines have remained constant or declined in 1998 and 1999. The building permit was the biggest source of increasing revenue under fees and fines category during this period (Table 4.3 in Annex).

Table 4.2
Composition of Local Government Revenue, 1998 and 1999 (in per cent)

Revenue Sources	1998			1999		
	DDC	Municipality	VDC	DDC	Municipality	VDC
Tax	3.8	12.8	14.6	4.1	12.3	14.0
Service charge	0.3	2.4	2.2	0.8	3.2	3.4
Fees	1.3	2.6	4.9	1.1	2.7	6.0
Sales	5.0	-	1.1	9.0	-	1.0
Property rental	-	2.5	-	-	3.0	-
Others	3.5	1.5	2.9	4.8	2.1	1.6
Total Own Source	*13.9*	*21.7*	*25.7*	*19.8*	*23.3*	*26.0*
Transfer	86.1	65.8	74.3	80.2	60.2	74.0
Loans	-	1.2	-	-	3.4	-
Balance forward	-	10.3	-	-	12.1	-
Total Revenue	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*

Note: 1)Data sources are from Ministry of Local Development and Local Finance Commission Report, 2001. Data includes all municipalities, 32 DDCs and 75 VDCs; 2) There is usually balance forward from DDCs and VDCs also. It is not included here because of data unavailability.

Overall, there is a very poor level of own source revenue performance of local governments in Nepal. The preliminary analysis shows that the local governments lack major taxes such as sales tax, and property tax with significant revenue generation potential. Instead, they are given minor taxes with low revenue potential. Besides, the tax administrative capacity is weak (discussed below). The local governments also lack the tax administration structure and the officials lack knowledge on how to do it. The limited staff, particularly in the VDCs, is also a major constraint. In the VDCs there is literally only one staff (VDC Secretary) overloaded with day-to-day general administrative and development management work, and finds no time to handle revenue administration. DDCs also do not have a separate revenue administration. Furthermore, the current intergovernmental fiscal structure with unclear expenditure assignments, and continuous service provision by the central government might have caused perverse incentive not to make genuine effort in raising revenue on the part of local governments. Similarly, the local development fee (surcharge on imports) without any time-bound phase out plan is also affecting the incentives on the part of the municipalities to utilize their stable sources of revenues as evidenced by the stagnant or decline rate of revenue in those sources over the four past years at least. In these circumstances, it seems unlikely that the revenue performance of local governments will increase significantly in the near future.

Vertical and Horizontal fiscal balance

Understanding of vertical fiscal balance between different layers of governments (broad correspondence between the expenditure responsibilities assigned to each level of government and fiscal resource available to them to carry out those duties) and horizontal fiscal balance (broad match between equitable service provision and fiscal capacity among same level of jurisdictions) is important for the policy reforms in expenditure and tax assignments. It is also equally important for reforms in the intergovernmental transfers and borrowing arrangements. Two methods generally suggested in measuring vertical fiscal imbalance are: one, to look at the surplus or deficit position of each consolidated level of government before borrowing but after all revenue sharing and transfers have been implemented, and second, to examine the sub-national government expenditures that are financed with sources of revenues under the control of regional and local governments (Martinez-Vazquez and Boex, 2001). Due to lack of complete data on consolidated local government expenditures and revenues in Nepal, vertical fiscal imbalance could not be estimated. However, Nepal's situation with intergovernmental fiscal relations is not very different from other developing countries. With a narrow tax base and little discretion over the tax rate combined with central government's dominant fiscal role in public sector spending, revenue collection and macroeconomic stability, one could fairly guess for a high degree of vertical imbalance between central and local governments in Nepal.

Like vertical imbalance, there is a significant horizontal disparities observed in the revenue generation among local governments at different levels. Table 4.4 below indicates the variations as measures by the coefficient of variation. Although the data are only for two years, one could also notice that the variation is probably growing.

Table 4.4
Variation in the Own Source Revenues of Local Governments (Per Capita)

Measures of Variation	1998			1999		
	DDCs	Municipalities	VDCs	DDCs	Municipalities	VDCs
Average	10.42	294.86	268.64	16.47	349.65	296.49
Standard deviation	15.78	278.90	662.21	30.34	356.92	890.42
Coefficient of variation	1.51	0.95	2.46	1.84	1.02	3.00
Minimum	0.28	30.68	0.0	0.31	30.58	0.00
Maximum	79.27	1336.20	4942.0	161.87	1899.34	7403

Data sources: Local Fiscal Commission Report (2001). Analysis based on the available data on 31 DDCs and 81 VDCs. In case of VDCs, data are in not in per capita.

The literature on public finance suggests that differences in fiscal capacity (some jurisdictions may be wealthy than others affecting their tax base) and fiscal effort (related to how well local governments exploit the sources of revenues available to them by better administration or by using higher tax rates and so on) are the major reasons of variation in the revenue collection among jurisdictions. Due to the lack of relevant data, it was not possible to correlate the fiscal capacity, fiscal effort and fiscal need with the variation in revenue collection. But intuitively, one could see the differences in economic condition and fiscal needs because of different level of economic activities and different socio-economic condition of local governments across the country (see Table 4.5 in Annex for DDCs). Three other factors that could have contributed to such variations are first, the high degree of differences in economic activities between the jurisdictions. The local governments in the terai areas and some in hill areas with good road accessibility and other basic infrastructure have concentration of market economy, while a large number of local governments in inaccessible and remote areas do not have basic road infrastructure resulting very low level of market economic activities. Second, the distribution of natural resources (one of the tax base assigned to local governments) is not equal among the local governments. The accessibility factor for the commercial utilization of these resources has made some local governments financially better than the others. Third, capacity of tax administration and quality and commitment of leadership also differ among jurisdictions leading to variation in revenue generation.

Local Tax Administration

Local tax administration is weak in Nepal. Tax administration and management information system (for example, records of tax bases, potential tax payers, regular information on revenue collection, collection cost, tracking of defaulters, etc) is almost non-existent. Staff lacks skills in technical (tax assessment, tax information system) and social aspect (promotion of voluntary compliance, etc) of the tax administration. In DDCs, VDCs and even in Municipalities tax administration is not regarded as a priority. The local governments were never forced to increase their tax administration capacity either. Historically, they have been heavily dependent on the central government for funds. On the own source revenue front, major contributors of local government revenues like Local Development Fee (in case of Municipalities) and taxes on recyclable waste and sale of sand, stone or wood swept by river (in case of DDCs) are administered either by the central government (Local development fee) or by private bidders. There is also an element of political economy against local taxation in Nepal. In this sense, Nepal shares experiences with many other countries. Local political executives in Nepal have always considered tax imposition as a non-compensating political cost in term of political unpopularity and loosing the next election. They looked for easy options and political access to get resources from the centre or through other means, like Octroi in the past, avoiding direct burden on local residents. Furthermore, the central government support in terms of technical know-how, and transitional plan for the implementation of the assigned revenues was also lacking. The transfer of land revenue responsibility to local government is an example. The central government transferred all land revenue responsibility at once to all VDCs and Municipalities without preparing them to administer it (which involves complex administration in terms of maintaining the cadastral information, book keeping, maintaining the accounts, what to do with the defaulters, etc) or helping them by making some transitional arrangement like co-administrating the tax from Land Revenue Department for some years.

Another overlooked aspect in local tax administration in Nepal is the weak accountability towards the constituents. This has occurred not only due to the lack of direct link between the service provision and the payment for the service, but also due to the rent seeking behavior of government in general in the past. Voters have yet to see that their local governments genuinely care for them. This situation has also adversely affected voluntary compliance. Local governments could demonstrate the visibility of the tax (through means like informing voters, public disclosure of tax and expenditure information, using display boards in construction sites, etc) and could, as a result, increase the confidence of voters towards paying taxes and towards government's credibility in general. But local governments often choose the easy way out, and refrain from walking on the difficult path of building trust and of promoting tax culture and accountability perpetuating the existing situation.

Reform Issues

Revenue Assignment Structure

Existing revenue assignment structure is clearly in favor of central government likely resulting in a high degree of vertical imbalance, and calls for the rationalization of the current revenue assignment. Such rationalization should consider fully transferring property taxes to local governments (as it is also collected by the central government), and replacing the local development fee[24] with direct and stable revenue sources. Using 1994/95 figures, Kelly (1998) suggested transferring land revenue, urban/housing tax, central vehicle tax, entertainment tax, hotel tax to local governments. Similarly, the Local Fiscal Commission Report (2001) has recommended a number of improvements and reallocation in revenue assignment, including the improvement in house and land tax and transfer of entertainment tax, and cottage industries registration and renewal fees to local governments. It also suggests equal sharing of vehicle tax between the centre and local government, and adding building permit fees to VDCs and tax on sand, stone to Municipalities. In addition, the central government should handover the local services to the local governments (with maintenance, if needed) so that the local governments start running those facilities through employing user charges. Rationalization of the revenue assignments together with adequate central support in developing tax administration capacity would prove to be a good start in the direction of providing a reasonable revenue base for the local governments. It may be possible to use some local piggybacking on personal income tax, on excise taxes for alcohol and tobacco products, and even on motor fuel tax by some sub-national governments.

Tax sharing issues

Currently, there are tax sharing arrangements in the law between the centre and the DDCs, and also between different levels of the local governments (NOT CLEAR??). There is a growing demand from the VDCs and Municipalities on the tax share which the DDCs supposed to get from the centre. The Local Fiscal Commission Report (2001) has suggested a 50 percent redistribution of tax sharing earnings of the DDCs to the VDCs and Municipalities, but it is silent on the mechanism of the redistribution. It also recommended sharing 25 per cent of the VDCs' and Municipalities' earnings (in addition to the earnings from the land revenue) from the fees on the utilization of natural resources like stone, sand, lakes, etc with the DDCs. The redistribution of the central tax sharing may be justified on the ground that the VDCs and Municipalities are inseparable part of maintaining or enhancing the tax base, and they need to be compensated. But so far as the inter-local government tax sharing is concerned, there is no evidence to assess as to what extent the revenue sharing arrangement between the local governments has been effective to date. However, the unwillingness for such an inter-local government sharing of revenue is common. Furthermore, it negatively affects the incentive to collection efforts by the local governments. Alternatively, the government could abolish the revenue sharing arrangement between the local governments, and make the intergovernmental fiscal transfer compensatory, instead, to improve the horizontal balance. This will help reduce the complexity of inter-local government tax sharing, and free the local governments from the disincentives of loosing money.

Similarly, the tax sharing structure in the registration fee, particularly in the upper scale, is regressive. The DDCs' share stops at NRs 6 million, no matter how much is collected above NRs 10 million. The implication is that the districts collecting NRs 10 million and NRs 20 million or more get the same amount. The government should correct the current regressive structure so that there is money in the hands of the DDCs, and focus on establishing a transparent system for the general public for monitoring the use of the resource.

Revenue autonomy

Local governments do not have autonomy to determine the revenue base. They do have some flexibility in fixing the rates depending on the nature of the revenue sources. Rates for some revenues are fixed by the central government, while for some the range (minimum and maximum) is given. There are only limited tax base for which the local governments are actually free to set the rates (Table 4.6).

The whole idea of revenue autonomy is to increase the ability of local government to raise the marginal revenue locally to pay for the fiscal gap. The low current rate set in general by the central government and the lack of discretion to determine the service charges for their own provision of services indicate that the government has been too restrictive in providing revenue autonomy to the local governments. For example, the tax for the land revenue is very low ranging from NRs 0.6 to NRs 10 per hectare for below one hectare and from NRs 2.6 to NRs 150 for larger holdings with exemption provisions in case of natural calamities. As a result, most of the local governments in the remote areas (where most holdings are below one hectare) may not find it incentive to raise land revenue as their tax administration cost might outweigh the collection. In the same way, although the municipalities have not started collecting integrated property tax, there is an upper ceiling of NRs 1500 rather than following the rate structure affecting the revenue potential of the tax. It appears that the cost of tax administration was not given due weight while setting the rates. Rationalization of rate as well as exploration of new bases, for example, transferring of vehicle taxes to the local governments, building permits to the VDCs with small towns, will, therefore, not only increase the revenue autonomy, but will also potentially improve the revenue situation of the local governments.

Table 4.6
Types of Revenue Bases having different Rate Discretion by the Local Governments

Local Governments	No Discretion by Local Governments (Rates fixed by the centre)	Some discretion by Local Government within the Range (Range set by the centre)	Full Discretion by Local Governments (Open for local governments)
DDC	- Exportable goods produced within the district - Prohibited livestock related, forest, agri-byproducts, herbs, and mine related commodities - Reusable materials by industries established in the country - Recyclable wastes - Prohibited bird feathers - Service charge of irrigation channel, embankments, etc - Approval and renewal of rafting, boating, and fishing - Ropeway operation fees	- Natural resource consumption tax - Recommendation fees	- un-prohibited dead animal' export of bones, horns - guesthouse, library, medical centers, pilgrimages, assembly halls
Municipalities	-	- house and land tax - land tax/revenue - vehicle tax (entrance) - entertainment tax - tenant tax - advertising tax - professional tax - commercial video - other recommendation tax - parking fees	- self-construction bus park
VDC	-	- market and shop tax - natural resources consumption tax - other taxes as in municipalities	- service charge

Source: Local Finance Commission Report (2001)

Incentive structure

The local governments are mostly dependent on indirect revenue instruments for their own income. For example, the municipalities' main source of revenue is local development fee levied on imports by the central government. Similarly, the DDCs are earning mainly from the charges on the recyclable wastes and from the sale of stone, sand, wood swept by river, etc. The incidence of such revenue sources falls outside the residence of the jurisdictions. The direct link between the service and the payment for the service is lost in this structure. The pain of tax collection (political and administrative cost) and giving-up of money (by tax payer) is not there forcing for direct public accountability. These factors in combination with the central fiscal transfers might have motivated the local governments not to try hare enough for direct and stable sources of revenues from their voters in general.

Similarly, the revenue sharing provision between local governments also creates disincentives to make adequate tax effort on the part of the local governments to collect more. The unit/area based land tax instead of the market value or productivity combined with very low rate might have also generated negative incentive towards non-collection or limited collection of potentially high yielding land revenue. These distortions need to be reviewed and rationalized in order to give the local governments right kind of signals for the effective and efficient utilization of the local revenue sources.

Accountability and tax culture

In general, people lack trust in the government service provision and welfare because of the historical legacy of the rent-seeking attitude of the government. Unless the local governments develop a solid trust for the people by demonstrating the concrete results in the form of effective service delivery, the current tax culture (avoidance, indifference, passive) is unlikely to improve. In addition, there is an urgent need to improve tax visibility, tax awareness, and public disclosure of revenue and expenditure to improve the current situation. Gradual but steady transformation towards direct linkage of tax payment to service provision is required in order to increase the accountability of political executive to their voters. The central government, on the other hand, should correct the current distortions in the system as well as any undue favor or disfavor from the center that breed the shy-away environment for the local political executives from their voters.

Tax administration

Good revenue design must be backed up by a rational tax administration in order to get expected benefit from the revenue system. Taking into account the weak administrative capacity of local governments, particularly DDCs and VDCs, a Revenue Unit needs to be established in the local government office, and staff has to be assigned. These staff should receive basic level training in technical aspects (recording of revenue base, recording of potential tax payers, assessing the revenue potential, etc) information management and social dimension of revenue administration and management. Political and administrative executives also need to be made aware of the potential benefit of the capable revenue administration. This will be the beginning of institutionalization of revenue administration in DDCs and VDCs. In Municipalities, some institutional base is there. They require higher level of technical and management support, for example, the valuation of property, and perhaps a computerized tax management system.

The central government should continuously monitor the progress and provide support to local governments in strengthening their capacity. They should not be left unattended. One way for a rational start would be to implement the tax administrative responsibility taking into account the administrative capacity and complexity involved in the collection of particular revenue. Some local government can take full responsibility. Some can take partial responsibility, while others can wait till capacity is there. Similarly, for some revenue sources co-administration by the central government might be an efficient and effective mechanism. Efficiency, effectiveness, transparency, and a regular publication of detailed revenue and expenditure data for analysis should be the key in the administration and management of revenues. There should also be a built-in flexibility to regularly monitor the fiscal health of the local government and adjust the required changes accordingly for the improvement of the overall tax structure as well as the vertical and fiscal imbalances in the system. With respect to the capacity building, the existing institutions like Revenue Training Centre (under the Ministry of Finance), Local Development Training Academy and Nepal Administrative Staff College can be supported and mobilized to provide necessary revenue administration training to both political executives and staff working in the revenue administration unit of sub-national governments.

V. Intergovernmental Fiscal Transfer

Current Structure of the Transfer

Central government transfers are the main source of revenue for local government in Nepal. Currently, more than 75 per cent of the total income for these local governments comes from this source (table 5.1). In the Municipalities too, the transfer constitutes more than 60 per cent of their total income. Each local government gets the transfers directly from the central government through the Ministry of Local Development.

Table 5.1
Share of the Transfer in the Local Government Income (in per cent)

Sources of Income	1998			1999		
	DDC	Municipality[1]	VDC	DDC	Municipality[1]	VDC
Own source revenue	16.8	22.7	25.7	18.9	24.3	26.0
Grant Transfers	83.2	65.8	74.3	81.1	60.2	74.0
Loan	-	1.2	-	-	3.4	-

Source: data adopted from Local Fiscal Commission Report (2001)
DDCs figure are based on the data from 31 (for own source revenue) and 32 (for grant) DDCs
VDCs figure are based on the data from 75 VDCs
[1] Rest is balance forward from the past year.

The local governments, in general, receive three types of grants: 1) Administrative Grant, 2) General-purpose Block Grant, and 3) Conditional Grant. General block grant and conditional grant together are referred as Development Grant. The nature, size and distribution mechanism of these grant for different level of local government are described below.

Transfer to the DDCs

Each year the DDCs receive administrative, block and conditional grants. An administrative grant includes the salaries and allowances for the centrally deputed staff at the DDCs, supplementary salary and allowances for the staff hired by the DDCs, welfare fund contribution for the DDCs hired staff, and salary and allowances for the VDCs' secretary. The administration grant to the DDCs (after deducting the VDC Secretaries grant) constitutes a little more than 25 percent of the total DDC grant (table 5.2). The salary and allowances grant for VDCs' secretary should practically be considered VDCs grant and should be reported under the VDC grant. Inclusion of the VDC Secretaries' salary in the DDC grant is a means to keep the VDC Secretaries under the administrative supervision of the centrally deputed DDC Secretary. The administrative grant is calculated on the basis of the standard administrative norms (number of staff positions based on the category of districts, pay scale, allowance rate, welfare contribution, etc) and distributed accordingly to the DDCs. As such, the DDCs have no discretion on the use of these funds, and the way the grants are distributed do not give an incentive to save funds in administration and generally to become more efficient.

The general block grant is an unconditional development grant. DDCs have full discretion to use this fund following the planning and accounting procedures set by local government law. The share of general block grant in total transfer to the DDCs is around 32 per cent during 1998 – 2000. In addition, DDCs receive two conditional grants: district road grant and suspension bridge grant. They also get guidelines for these grants as to how grants should be spent and the progress reported to the centre.

Table 5.2
Grant Structure of the DDCs in Nepal (in percent)

Type/Category	1998	1999	2000
Administrative grant	26.4	25.3	26.9
General block grant	31.9	31.9	31.3
District road grant	40.4	40.0	39.1
Suspension bridge grant	1.3	2.8	2.7
Total Development Grant	73.6	74.7	73.1
Total Grant	100.0	100.0	100.0

Source: Data adopted from Local Fiscal Commission Report (2001)

There is also an unhealthy practice of keeping aside some funds out of the total grant allocated by the annual budget process, which is then distributed to local governments, individuals, or groups through the DDCs in different time during the year[25]. There are no transparent criteria for the distribution of the kept-aside funds, and the amount and frequency of the grant basically depend on the political access to the centre. This is not only a source of soft budget constraint but also a source of clientelism, lack of transparency, mistrust in the system, etc. A clear transparent rules for fund allocation and clear reporting rules should be adopted.

Besides, the DDCs are engaged in the implementation of a number of centrally funded (either from tax or foreign loan and grants) projects and programs[26]. They get fund, technical support and strict guideline to implement the projects, and are accountable to the centre for reporting and submitting accounts. Most of the projects or programs are fully funded. Few programs require matching from the DDCs as a token of commitment and ownership[27]. This matching portion basically comes from the general block grant creating a crowding out of the block grant.

Nevertheless, it has been a pull factor in attracting some additional resources in terms of projects in some fortunate DDCs.

Transfers to the Municipalities

Like DDCs, the Municipalities also get the administrative grant and the development grant. The administration grant is given to all municipalities to cover the salary and allowances of staff deputed from the centre. Here too, the development grant is divided into general block grant and conditional grants for some specific nature of activities like fire fighting, matching fund for town development fund, provision of dumping site, formulation of town planning, etc. These specific activities appear to vary from year to year depending on the need expressed by the municipalities in general or the need felt by the centre or both. Municipal transfer constituted 18 percent administrative grant, 23 percent conditional grant and 82 per cent development grant in 1999 (table 5.3).

Table 5.3
Composition of the Municipal Grant (in percent)

Grant type	**1998**	**1999**
Administration grant	14.2	18.4
General Development grant	60.7	58.1
Conditional grant	25.1	23.5

Source: Local Fiscal Commission Report (2001)

The distribution of the development transfer to the municipalities is based on the local revenue generation of the municipalities. Only those municipalities generating less than 10 million Nepalese rupees are eligible for the development grant from the centre. Besides, they also some time get occasional grant fund kept aside from the general pool depending again basically on the access to power[28].

Transfers to the VDCs

VDCs started to get central general block transfer to a significant amount only since 1996. Currently, they get NRs 500,000 per VDC. They can spend up to 25 per cent in administration and human resource development. Besides, they get salary and allowances for the VDC Secretaries from the centre through the DDCs.

Distribution of transfers

The VDCs get the transfer based on the principle of exact equality. Every year each VDC gets NRs 500,000 irrespective of population, area, and the general price level. Given the inflation rate in Nepal, one could easily observe that in real term the amount of transfer to the VDCs should have declined over the years.

There is no systematic set of criteria or formula for the distribution of grants to the municipalities either. The authorities seem to have intuitively applied the municipal own source revenue generation and the infrastructure needs as main criteria in distributing the grant. The use of the different types of the conditional transfers, for example, grants for town development plan, dumping site arrangements, fire fighting, etc. indicates that the central government need was also important in distributing the transfer to the municipalities. Although these criteria might have been intuitively applied while allocating the grants, the mere absence of a transparent and objective formula makes hard to ascertain why one municipality is getting more or less grant than the others. The actual distribution of transfer to the municipalities is shown in Table 5.4 (Annex).

Likewise, the DDCs' grant allocation also suffers from the lack of an objective and transparent criteria or formula. Looking at the district-wise actual allocation (table 5.5 annex), one could notice relatively more general transfers to the hills and the mountain DDCs. This indicates that the Ministry might have given emphasis to the poorer regions (with low fiscal capacity and greater expenditure needs) attempting to be fair at least. But again there is no objective answer as to how a certain amount is arrived and why there is a variation in allocation between the DDCs.

It is also obvious from the allocation figures that an incremental allocation principle has been in use while allocating the transfers to the municipalities and the DDCs. From the allocation figures, it also appears that the authorities have tried to maintain the previous allocation level, if not equity. Political motive, however small, was also in play in allocating the grant as evidenced by the amount kept aside from the general pool of the grant.

Assessment of the Transfer System

The intergovernmental fiscal transfers are generally used to achieve following objectives in the overall framework of the intergovernmental fiscal relations.

- attaining predictable and stable source of revenue for local government (an issue related to vertical balance),
- equalizing the differences in fiscal capacities among local governments in order to ensure that all citizens of the country, no matter where they live, should receive at least same level of public services,
- pursuing legitimate central level policy objectives, and
- increasing local revenue generation (especially in the case of developing countries)

The transfer system must be objective, transparent, simple (easy to understand and followed by concerned stakeholders) and predictable so that right incentive structure is in place in order to achieve the above objectives.

Is the transfer system predictable, transparent and stable?

The transfer system of Nepal is unpredictable. The divisible pool (the transfer fund) is ad-hoc, and determined each year through parliamentary allocation of the budget put forward by the Ministry of Finance. The local government law is weak in guaranteeing the transfers to the local governments. This is one of the major flaws of the local government law. It has made provision of the 'minimum grant' (and also the sector grants), but failed to guarantee it by defining the ‘minimum grant’ and by linking the grant with some appropriate national parameter for certainty and transparency in the system. As a result, the local governments live in uncertainty until they receive the money in their account adversely affecting their planning of the program and budget. This uncertainty lies at two levels: one, at divisible pool level because until parliament approves, the total amount remains uncertain. Second level of the uncertainty lies at the distribution level. Since there is no transparent formula for the grant distribution, the local governments remain unsure as to how much they will receive out of the total fund.

Although ad hoc, it appears that the central government, so far, has maintained the nominal level of budgetary allocation to the local governments. And, the local governments have been receiving the general grant at least, in nominal terms, not less to the previous years’ allocation. The political promises for the decentralization process in combination with the fear of political unpopularity and centralist image might have forced the consecutive governments to maintain the local government budgetary allocation. But this ad hoc system is unpredictable, and can go wrong for both central and local governments depending on the circumstances. In case of economic recession, the central government will face big difficulty in maintaining the level of the local government transfers. On the contrary, when there is an economic boom or increased tax revenue, the central government may just choose to keep the level of the fiscal transfer unchanged prohibiting the local governments to gain from the general economic development.

Is the transfer system equalizing?

There is no explicit equalization policy objective is in place for the transfer system. This may be one of the reasons why equity is not pursued consciously while implementing the transfer system.

Currently, neither the DDCs nor theVDCs or the Municipal fiscal transfer is based on objective and transparent equalization factors or formula. The system defeats the very purpose of equity in public service provision by the government. It is, therefore, urgent to develop and implement an equalization transfer system so that the system is transparent and fair.

Transfers to the VDCs are based on equality criterion, as every village local government gets equal amount of grant. As a result, the VDC grant may be des-equalizing because of differences in expenditure needs resulting from differences, for example, in population size or cost of living. But the basis of the transfer to the DDCs and the Municipalities is not explicit. There are no objective criteria or transparent formula for the grant distribution. Despite these ad-hoc practices, the idea of some sort of fairness appears to be existent in the back of the head of the authorities while figuring out the distributable amount to the individual local government. In general, comparatively more grant is observed to be allocated in remote hills and mountain DDCs that are inaccessible and poor. A comparison of the coefficient of variation of the limited (31 out of 75) DDCs’ and of the Municipalities’ revenues before and after the fiscal transfer indicates the presence of such an attitude (table 5.4). Although, with the inclusion of all the DDCs the scenario may change, but it indicates the potential scope of equalization that can be achieved if proper equalization system is put in place.

Table 5.4
Equalization Level before and after the Fiscal Transfers, 1998 – 2000 (as measured by the coefficient of variation)

Year	DDC			Municipality	
	Own source revenue	After general block grant	After total development grant[1]	Own source revenue	After total development grant[2]
1998	1.51	0.81	0.61	0.91	0.68
1999	1.84	1.09	0.79	0.95	0.67

Figures are coefficient of variation of per capita allocation.
[1] includes conditional grant
[2] includes conditional grant and loan

Likewise, in the case of the VDCs, when one considers the increasing level of poverty (meaning weak fiscal capacity) and the cost of provision of the service due to the inaccessibility in the hills and in the mountains, an equal distribution of the grant might have been worked out well in favor of the poorer VDCs concentrated in those areas. But this should not substitute the need for an objective and transparent transfer system taking explicitly equalization factors like population, area (larger size may have higher cost of service provision), higher cost of service, and the level of economic development into account.

Is the transfer achieving sector objectives?

Out of the conditional grants given to the DDCs and the Municipalities, the district road grant seems to be the most important. It is almost equivalent to or some time more than the general block grant given to the DDCs.[29] Though general accessibility improvement seems to be the objective of the road grant, there is a lack of clarity or emphasis between the economic dimension and social dimension of the objective. Is it a farm to market link that is the priority or a road connecting to the district head quarter or the sub-district centre for access to health (in emergency) and education is a priority? While the earlier emphasis would concentrate more resources in the economic potential areas in the already accessible plain and hill areas (leading to increased fiscal differences), the latter would allocate more money to the remote hills and mountain DDCs. This confusion is clearly reflected in the allocation of the road grant as the variation between lowest and highest amount receiving district is not big. There is also a lack of clearly laid out factors or formula for the distribution of the road grants resulting ambiguity, uncertainty and unpredictability of the grant for the DDCs. Nevertheless, with limited amount of the conditional grant, it has been successful in supporting the DDCs to come out with District Road Master Plan (a vision for district road development with priorities and tentative investment), construct low cost environmental-friendly (Green) roads, mobilize peoples' participation, and increase employment opportunities in the area. Clear objectives combined with transparent allocation system would not only further contribute to achieve the grant objective, but would also help reduce the regional fiscal and economic variation among the DDCs.

Another challenging issue related to achieving the sector objective is how to integrate different programs (often similar, but competing objectives), and funding agencies having different funding windows (lacking transparent allocation mechanism) so that a coherent sector program and investment is established under the unified transfer framework. This applies to all most all the sectors in Nepal. There is a "basket funding" concept already in use in the education sector, where the World Bank, and other donors have put in money in one pool of fund. But this system lacks transparent allocation mechanism in the allocation of funds to the districts. More importantly the fund is spent outside the local government framework. But this could be improved from the past experiences. An integrated sector programming and investment under the unified sector transfer framework will not only increase the efficiency in the local public investment and service provision, but will also create a hard budget constraint to the local governments for achieving efficiency and effectiveness.

Is the transfer system affecting local revenue generation?

One of the expected outcomes of decentralization in Nepal is the increased local revenue generation. But this objective is inexplicit in the transfer allocation to the local governments. The actual own source revenue has been followed loosely in the case of the municipalities while distributing the grant, as a bench mark of NRs 10 million is taken as a cut off amount. The municipalities generating more than NRs 10 million are not eligible to receive the development grant. Similarly, the authorities do make some adjustments to the DDCs' own source revenues while allocating transfers to the DDCs so that the DDCs with higher own income get little less than those DDCs who have lesser own source revenue. But the system is not objective and transparent and not consciously designed to create a right incentive structure to motivate for the increased revenue generation.

The current practice of adjusting the grant based on actual revenue collection (rather than based on tax efforts) combined with the tax exporting local development fee on imports might have created perverse incentives for the municipalities in generating local revenue. Similarly, the practice of accepting the matching requirement from the transfers (block grant) along with the soft budget constraint environment might not have forced the DDCs to make sincere efforts to increase their own revenue. Correction of such distortions with explicit inclusion of the key objectives and transparent factors in the transfer system would create the right signal to the local governments for enhanced local revenue generation.

Reform Issues

Specify Objectives of the Fiscal Transfers

Since the central fiscal transfers will continue to be the single most source of income for the local governments for some time in future in Nepal, it is very important to be clear as to what the government wants to achieve through such a transfer. Bahl (1999) suggests that the place to begin is always with objectives. One can implicitly draw the objectives from the Constitution and the Local Governance Act, but implicit deductions are not good enough, and often suffer from subjective interpretations. Explicit enumeration of the objectives is essential to give a clear sense of direction. In Nepal, there seems to be a general consensus that the fiscal transfer should be fair (equitable), should reduce poverty and inequality through increasing local public investment, enhance local revenue generation, and promote autonomy and accountability.

Establish Equalization Transfer System

Nepal's current transfer system is fundamentally ad-hoc. As a result, it seems to be suffering from problems like non-transparency, unpredictability and instability. It is also generating the wrong signals, like soft budget constraint and inequity in the service provision, for the local governments. It is, therefore, necessary to replace the current system with an equalization transfer with features of transparency, objectivity, predictability, stability and simplicity. Establishing a transfer (divisible) pool and designing a distribution system are two important dimensions of an equalization transfer system. The central government, local governments and donors involved in the process have all increasingly felt the need for such a transfer system.

The Local Fiscal Commission Report (2001) has suggested an increase in the divisible pool, which is currently 9 per cent of the development budget. It has also recommended including population, area and the local revenue generation as factors in distributing the grants to the local governments. Similarly, the Public Expenditure Review Commission Report (2001) has suggested linking the divisible pool either with the development budget or with the total tax revenue. With respects to the factors, it suggested to include population, area, income, remote area (remoteness) and tax collection efforts in distributing the grants to the local governments. Both Reports refrained from explicitly recommending the size of the divisible pool, an exact base of the divisible pool and the corresponding weight for the respective factors. However, the government could start discussion with stakeholders and come to an agreement for divisible pool and allocation factors and their respective weights. This divisible pool of funds should be fixed for a period of three year or longer as a percentage of the central government revenue collected. This will bring transparency as well as stability and predictability in the system. Similarly, an equalization transfer should be put in place for grant distribution across local governments. The formula should include population, area, some measure of poverty, and cost factor in order to capture the remoteness. An incentive structure perhaps should also be designed for increased revenue generation considering the low level of local revenue. Once an agreement is reached for vertical and horizontal sharing, a time bound phase-in plan should be designed to implement the scheme making the losers harmless from the system.

Setting up a categorical grant system

Besides the equalization grant, the intergovernmental fiscal transfer can also be used to achieve different national policy objectives. To achieve the multiple goals, the government should design a system of transfers using separate transfer programs for each separate objective. The pursuit of multiple goals with one instrument seldom performs as desired (Martinez and Boex, 2001). With clear and specific objectives, the government could introduce a categorical grant for the programs of national policy significance (like education, health), a reimbursement (or compensatory) grant for centrally mandated programs (like implementation of social welfare programs, immunization programs), or a matching grant for stimulating the local governments to increase expenditure in a particular sector as required by the national policy (like community development, etc).

These basic rules are not in place in Nepal. Occasionally, one could see these things happening, but often without clear objective and transparent mechanism and are short lived. What is even more striking is that quite a number of similar programs belonging to a common sector (for example community development and rural road program) are implemented by the DDCs, but with different objectives, funding rules and reporting mechanism. Non-coordination of the programs and the donors is the major issue resulting inequity and inefficiency in resource allocation often combined with conflicting objectives and confused implementation process. An integration of the sector programs into a category (or sector) and allocating the resources in a transparent mechanism will improve the current anomalies resulting an equity and efficiency in the system. Ministry of Finance in consultation with the National Planning Commission and sector ministries should coordinate these. Preparation and implementation of a medium-term sector expenditure framework in line with the national medium term expenditure framework should be made mandatory by Ministry of Finance. The sector expenditure framework will also be useful in coordinating with the DDCs' periodic expenditure plan (a kind of district medium term expenditure framework). These efforts will improve sector expenditure planning, coordination, and efficient use of resources.

Designing a system of stimulating local revenue generation

Stimulating local revenue generation will continue to be one of the important objectives of fiscal decentralization in Nepal. Currently, there is no explicit system in place to achieve this objective. Instead, the existing practice of adjusting the grants on the basis of the revenue collection or accepting the matching from the centrally provided development grant might have provided wrong incentive to the local governments for the local revenue generation efforts. There is a need to review these practices in favor of creating a right kind of incentive for the local government to work towards increasing locally generated revenue. In a fiscal transfer system, the government can pursue this objective either incorporating it in the transfer design formula or addressing it from outside by keeping aside a certain pool of fund to reward the good performing local governments. Since the availability and reliability of the local fiscal data is a problem in Nepal, the government could begin to address the motivation issue (for revenue generation) by setting aside an agreed percentage (weight) of amount for the tax effort from the general divisible pool. This fund will then be used to match the increase tax effort of the local government at a certain agreed ratio (say fifty percent). Parallel to this, the government should also strengthen the regular collection and the publication of the local governments' fiscal information. Once this information is in place, the tax effort factor could be included in the equalization design for motivating the local governments for the enhanced local revenue mobilization.

VI. Local Government Borrowing

Current status of local borrowing

Access to the borrowing by the local governments has not yet evolved very much in Nepal. The Local Self-Governance Act, 1999 provides authority to the local government to resort to borrowing from bank or any other organizations either by itself (with or without collateral) or upon the guarantee of the central government. Before proceeding for such a venture, they require approval from their respective Councils. Although the law seems not to be restrictive for even outside borrowing, it requires mandatory prior approval before the local governments can make any contact with any foreign organization, either be it the foreign governments, international organizations, diplomatic missions or the INGOs.

Experience with borrowing is so far limited at the municipal level. The two main features of the municipal borrowing are: municipalities get loans from the Town Development Fund (TDF), a non-commercial source; and the size of the loan operation is very small (about 2 per cent of total revenue). TDF is supported by bi-lateral grant assistance, and it is sort of subsidized 'on-lending' to the municipalities by the government.

Assessment of the situation

Considering the large number of the village local governments in the rural areas, their low revenue potential for some time in future, lack of administrative capacity and mere absence of financial and capital market, it appears that the borrowing option is far from reality for the village local governments. The supervision cost for such loan operation will also be very high for the central government. As a result, the village governments may have to continue depending on the central transfers to bridge the fiscal gap. Some urban DDCs may wish to resort to borrowing. However, many DDCs still lie in rural areas, and suffer from the similar problems as with the rural VDCs. Even the commercial lending agencies would probably hesitate to go for it, and if they choose to do so, it may only be at a very high lending rate.

It would then, perhaps, be practical to begin with the Municipalities where the financial and capital market are relatively developed, and the residents' awareness and the ability to pay for the service is relatively high. But, even for the municipalities, it seems that the government has never been serious in seeing this happening in reality. The central government's perception of the local governments as having low revenue earning potential, lack of capacity of debt management and fear of forced shouldering (politically) of an ultimate bailout in the case of default might have deterred the central government for not moving fast enough in this direction as one would expect to. Additional reasons for a weak local borrowing practice may be as follows:

- Absence of a well developed criteria, procedure, scope and instruments for borrowing and debt management. Even if some local governments wish to try, they would find difficult to pursue as there is no clear guidelines about it. In a country like Nepal where local borrowing is in infancy, the lack of transparent mechanism creates a room for uncertainty and suspicion among public for the causes of borrowing. For the local governments too, it becomes hard to convince to the public in the absence of such a transparent system.

- Virtually no knowledge of the rules of the game on the part of the local governments, and there is complete absence of active support from the center.
- Almost all basic services (road, water supply, bridges, heath facilities, etc) are provided by the central government, which leave less room for the urgency of the basic services projects by local governments requiring outsourcing of funds,
- Lack of trust on the local governments by the commercial and non-commercial credit sources because of the absence of credit worthiness (no public disclosure of the audited financial statement, non-registration with credit rating agency, lack of credible example of local government projects paid for by the residents, either by tax or by user charges),
- Lack of inter-temporal cost sharing concept in the project investment. This affects the inclusion of the cost recovery idea (a stream of earning for maintaining or covering the cost of service) effectively in the project, which is basic for the financing agencies.

Issues for Reform

Develop an appropriate strategy for local credit

The basic issue is how to move forward with local government borrowing. Should Nepal look for a uniform strategy for all the local governments or should it be different for different local government? What sort of credit instruments should be used? What will be the role of central government? Shall we create a separate financing agency for the local government or shall we stick to the existing commercial and non-commercial sources? Shall we open borrowing to all projects or we limit the borrowing only to capital investments? What will be the check and balance mechanism? Will it be a market mechanism, or regulatory, or both? These are important choices, and can have big implications on the behavior of local governments and thereby on the macroeconomic fiscal conditions. An idea of establishing a separate bank for the local government financing is floating around put forward mainly by the Local Government Associations. The idea requires careful study considering the failed experience of government sponsored (or financed) financial agency in the past and the existence of high liquidity in the financial sector available for investment. Therefore, an appropriate strategy has to be developed after a careful review of all these choices taking into account the emerging financial and capital market development in the country.

Set up a framework and incentive structure

Currently, the detail guidelines with respect to the scope, limitations, conditions and procedure for borrowing as well as the debt management are missing. Similarly, the issues like total indebtedness (ratio of total debt stock to flow of own source revenue) and debt service ratio (the ratio of flow of due interest and amortization to the flow of revenue) also needs to be clear. The local governments wishing to borrow do not know what is appropriate and why, and where to go to for help. Therefore, the central government should come out with a clear and detail guideline within the framework of the laid out strategy. In addition, a number of right structures have to be in place for the right behavior by the local governments. These will include, for example, handing over all the basic urban services (in case of municipalities), imposing a hard budget constraints, introducing commercial accounting practices, public disclosure of the fiscal condition, and credit rating. The aim should be to give clear signal and show restraint to both the creditors and the debtors so that they do not behave irresponsibly in the financial market on the benefit of doubt expecting that the central government will be there ultimately for a bail out, in case of default.

Provision of technical support

As the access to the borrowing for the local governments is a relatively new and underdeveloped phenomenon, they lack know-how, confidence and implications of such financial operations. Removing these barriers through some intermediary technical support will significantly reduce their decision making cost. The presence of some technical support may possibly motivate them to take risk on the basis of better information. The central government alone or in partnership with the local government association could provide such a technical service though contracting a professional financial services agency. This agency will help and guide the local governments by evaluating the investment proposal on the basis of sound commercial norms and recommend with alternatives and their implications. The final decision and the risk associated with it will rest with the concerned local government. Currently, the Town Development Fund provides some resources to the municipalities on individual basis to bear the cost of preparing the investment proposal through the private consulting firms. Since there is no institutionalized neutral evaluation agency, the individual interests in getting the soft loan some how tends to dominate while preparing the project proposals. The subsidized financing of project preparation and investment loan might have also developed this situation. Under this new proposal, the project preparation will be part of the cost of the project. And, only the evaluation cost (for the evaluation agency) will be subsidized in order to maintain the neutrality.

Establish a watchdog agency

An official agency responsible for the monitoring the overall development of the local government borrowing and the level of indebtedness are essential in a country where the local government borrowing is in its primitive stage. The Ministry of Finance should keep track of the information with respect to the sub-national debt, debt management, and public disclosure of the financial information. It should also monitor, coordinate and supervise the compliance of the predetermined framework and conditions put forward for the local government borrowing. This agency will also disseminate the reliable information to the public, which would increase transparency and create a system of early warning for the local government indebtedness (Carmo Oliveria and Martinez-Vazquez, 2001).

VI. Local Government Budgeting

The Local Self-Governance Act, 1999 and the Local Self-Governance (Financial Regulation) Bylaws, 2000 regulate the budget process of all local government in Nepal. These laws provision details of the budget and planning process, spending norms and procedures as well as reporting and accountability requirements.

Budget Autonomy and Accountability

The local government laws elaborate very detail planning and budget process for the local governments. As a process, the local governments do not require budget and program approval from the central government within the limit of resources provided to them. The respective Council is the highest legitimate body to approve the program and budget of the local governments. They have full discretion on the preparation of program and budget from their internal (own source) revenue within the broad national policy. The local governments also have discretion on the use of multiple service delivery options based on their relative merit and effectiveness. The law, in fact, encourages using community (as a priority), NGOs and private sector in the implementation of programs. The local governments are also autonomous to hire staff other than Secretaries from their own funds as approved by respective Councils. They are even free to use private consulting firms or individual for specific work of any nature for a fixed duration.

However, their budget discretion is contained due to the various internal and external factors encountered by them. The relative merits and demerits of these constraints vary greatly with the context and the local government in questions. Nevertheless, they limit the flexibility of the local governments in general. These include:

- Poor local revenue base of the local governments compelled them to depend on the central transfers, matching requirements and other expenditure subsidies. These transfers and subsidies often come with strings attached. The DDCs are more suffered from these conditions (in terms of budget sanction) than the municipalities and the VDCs because the DDCs are more engaged with the programs and other conditional transfers than the municipalities and the VDCs.
- Subsidies coming in the form of the projects or programs bring detail norms and procedures in the planning and allocation of the budget heads, giving the local government almost no flexibility in budget decisions. Often, they face the situation of "take it or leave it".
- Pay scale of locally hired staff cannot exceed the scale of central government employee. But they are allowed to give other benefits and allowances from their revenue, which is again limiting because of the poor revenue base.
- Central government has put a cap on the inter-transfer of budget heads for local governments. The VDCs can transfer only up to 10 per cent from one head to another, while municipalities and DDCs can transfer only up to 20 per cent. These transfers are not allowed into contingency and financial assistance heads.
- Central government appoints Secretaries (Chief Executive Officer) at each level of local government. The Secretaries of the local governments implement the approved budget jointly with the finance staff. In the DDCs, the central government deputes the finance officer, whereas the municipalities appoint their own finance staff. In the case of the VDCs, the Chairman (political executive) and the Village Secretary jointly handles the budget.
- Limit on the administrative expenditure by local government, which is set at maximum 25 percent.

The local governments are made accountable to their constituents by the local government law as per the norms of the representative democracy and local governance. Every local government executive is required to disclose his or her (including immediate family members') movable and immovable property within 30 days of taking oath for the office. The Heads and Deputy-Heads are even required to disclose their property within 30 days of their term is over. The Executive Committee reports to their respective Councils of their expenditure and progress. Each Council in required by law to form an Account Committee from the members of the Council for overseeing the expenditure and accounts of the executive committee and report to the Council. At the project level, the books of account and the progress of the project are required to be disclosed and discussed among the users or beneficiary groups.

However, due to the lack of awareness of the people in general and an honest attempt in disclosing the budget expenditure and performance of the local government in particular, the public accountability in practice is very poor. As a result, the local governments are incurring inefficiency in the form of spending outside the budget norms, and circumventing budget provisions or misallocating resources either for personal interest or for the interest of the close allies. Too often they also come out with an inflated budget, especially by overestimating their local revenue. The motive behind appears to have enough allocation in certain budget heads so that the specific interests can be fulfilled by temporarily borrowing from the central transfers. These temporary borrowings are often not repaid, and keep on carried over in the books of account creating another soft budget constraint for the local governments. The central government's weak monitoring and hesitant attitude towards using the transfer as an instrument of penalty or reward has not been able to improve the situation. The existence of the pluralistic governance system having rival political parties and civil societies was assumed to serve as a watchdog for such unhealthy practices of the local government in power. But, often they fail to stop such malpractices due to the lack of consistent action in making people aware of the situation or sometimes due to the collusion with the ruling group for personal or political interest shifting the cost of inefficiency to the people in general. Mandatory disclosure of detail revenue and expenditure information regularly to the public and the media will help improve the situation at the local government level. There has not been much work done by the central government to improve the administrative accountability. Mandatory "performance audit" of certain percentage of the local government each year in collaboration with the Auditor General's Office, disclosure of the Audit Report to the public and media, and using the transfers or the revenue sharing as an instrument to improve the behavior of local governments will to a large extent create conditions for right institutional incentive for enhanced transparency and accountability at the local government level.

Budget Preparation

Budget preparation in Nepal is a mix of the top-down and bottom-up process. Resource information, like the amount of the transfer or subsidies, flows from the centre to the local government, while the project needs generate from the community. While project identification process is generally transparent (because of bottom-up planning), the budget preparation as such - the hard number game - is not very transparent. As the Executive submits the budget to the Council, the Council neither can verify it nor can disbelieve the numbers proposed. Since the budget normally needs an adjustment afterwards due to the uncertainty of the resource estimates (own revenue and transfers), the Council is left with little choice but to give its authority of the adjustment to the executive for an uninterrupted work during the budget year. Thus, the budget preparation has become a mere formality due to the lack of transparency and efficiency of the people involved in the budget preparation. Besides, the lack of the strict requirement of public disclosure of the local government budget for public reaction breeds further ground for the possibility of an illicit adjustment in the budget despite the uniformity in the structure of the budget, the calendar of the budget preparation, and the heads (line items) of the budget.

Project identification is generally bottom-up in Nepal and is done regularly every year. This has in most cases resulted frustration in the community, as there is usually not enough resources to fulfill the needs generated through the planning process. The uncertainty about the program subsidies on the one hand, and an over budgeting practices on the other hand in the expectation (often rational) of getting more fund from the centre have compromised the predictability of the local government budget preparation[30]. Usually there is a budget ceiling for planning (a sort of expenditure cap). But historically the cap failed to give right signal because the cap was not followed strictly, and sub-national governments also shifted the responsibility upward because of the lack of clear division of functions. When it comes to the actual cut, in case of transfers the local governments themselves accommodate it either by under-funding or increasing the project implementation period. In case of sector projects, mostly the sector ministries adjust the budget.

Historically, the transfers have been fairly stable in nominal amount, although the center unilaterally determines it. The uncertainty more lies with the DDCs as they depend more on the program subsidies. The inclusion of the project or programs beyond the reach of the VDCs or the municipalities in the district plan (a planning process required by law) further increases the budget uncertainty for the DDCs. In order to reduce this uncertainty, a medium term District Development Planning (of three to five years) exercise has been started at the DDC level, and many DDCs have come out with such a plan[31]. The quality and continuity of such a plan is yet to be established, but it will certainly provide a good basis for the National Planning Commission, the sector ministries and the respective DDCs to come up with a rational medium term resource planning and expenditure framework integrating both regular and capital budgets.

Budget Execution and Monitoring

Once the budget is approved, the budget execution basically rests with the executive of the respective local governments. The day-to-day budget operation is handled by the centrally appointed Secretaries in the local governments under the lawful decision or guidance by the executives. The local government laws enumerate the rules and process for budget execution, programs implementation, including procurement, and their monitoring and reporting requirements.

Generally, user group approach to implementation is followed for the project execution. In such cases, the user committee (elected by the user groups) becomes responsible for the budget execution, keeping the books of account, informing users about the progress and expenditure, and submitting the progress and expenditure reports to the concerned local government. The local governments are also open to choose a NGOs or the private sector to implement the activities.

The central fund is released through the District Treasury Office (district unit of Central Treasury called the Financial Comptroller's Office) to all the local governments. Until last year, the transfer to the VDCs was passed through the DDCs. Late release the funds or the release of funds towards the end of the financial year in large chunk are generic issues resulting inefficiency due to under investment in the public service and an unintended budget surplus. In case of the budget cuts, the capital investments suffer most from the adjustment.

With respect to the expenditure monitoring and reporting, the DDCs and the Municipalities directly report to the centre in every four months. The VDCs report to the DDCs. The DDCs are required to compile the information and send it to the centre. The current arrangement of direct transfer of grant to the VDCs (no more through the DDCs) might affect the DDCs' ability to collect the information from the VDCs as the DDCs now can not force the VDCs to comply, if the need arises to do so. At the district level, a high level Supervision and Monitoring Committee is formed under the Chair of the Member of Parliament of the district comprising the DDC executive and some members from the sector units in the district. By law, the committee is responsible to oversee the implementation issues and resolve them, if required, and also act as a link between the district and the centre. Though ideal, this has not been very effective in its role mainly because of the political rivalry between the two key political positions trying to maintain or enhance their personal influence by acting often against each other.

The accounting information is sent monthly and in every four months to the centre in uniform accounting formats specified by the local government bylaw. But so far this information is incomplete, as it does not include the own revenue and expenditure information. The non-publication of complete revenue and expenditure of the local governments have failed to provide reliable information with respect to the fiscal situation of the local governments both to the public and to the central government. This situation is especially true with the VDCs and the DDCs. It appears that the central government has felt the need for such information for better planning and public accountability, but the concrete efforts have not yet been done to improve the situation.

Another monitoring issue for the center is how to cope with the large number of the local governments, particularly the VDCs. The centre might cope with the DDCs (75) and Municipalities (58), but it is practically impossible to keep track of 3913 VDCs. Until now there has been a hierarchical relation between the VDCs and the DDCs. But the recent decision of the government to transfer the funds directly from the centre is expected to alter the current relationship between the two. Any administrative oversight from the center will be highly costly and inefficient. The government still expects the DDCs to play the supervisory role for the VDCs. But it would not be a surprise if the DDCs fail or show unwillingness to continue to play the supervisory role in the new context where they do not have any instrument either to motivate or to force the VDCs to comply the reporting requirements.

Budget Control and Evaluation

Two important provisions as mentioned in the local government law regarding the budget control are an oversight by the Accounts Committee constituted by the respective Councils, and the provision of annual audit of the local government budget. The Accounts Committee monitors the budget expenditure of the respective local government and submits its report to the Council based on which the Council directs the executive committee to take necessary actions in correcting or improving its budgetary behavior. The audit of accounts is another means for the budget control. In case of the municipalities and the DDCs, they themselves do the internal audit while the Auditor General, an independent Constitutional Body, conducts the external audit. For the VDCs, the DDCs conduct the internal audit while the DDC appointed (on the recommendation of VDC Council) registered Auditor carries the external audit. The executive by law submits the audit report to the Council through the Accounts Committee, and takes actions as directed by the Council. Yet another indirect oversight mechanism provisioned in the law is that the central government can suspend and even dissolve the local government, if found guilty, in case of committing misappropriation of any property or income of the local government[32].

Despite these provisions, the audit has not been carried out regularly and on time. Lately the government has imposed a condition of releasing the transfers only upon the completion and submission of the audit report. However, the political soft corner towards releasing the transfers seems outweigh the general policy commitment. As a result, the compliance has become a mere formality and the quality of the compliance (audit) is very poor as evidenced by the increasing amounts of reported advance of the funds and irregularities in the expenditures. As the central transfers have been almost unstoppable, the local governments have developed an attitude of maneuvering more for the transfers rather than maximizing the resource use allocated for local public expenditures (Public Expenditure Review Committee Report, 2001).

Simply auditing of the budget expenditure is not enough to assess the overall performance of the local governments. A performance evaluation becomes necessary taking into account the overall outcome, efficiency and effectiveness of the local government expenditure. The law has provisioned a High Level Decentralization Implementation and Monitoring Committee (DMIC) and a Decentralization Working Committee (DWC) under the Prime Minister and the Minister of Local Development, respectively, in order to supervise and monitor the progress of the Act and clear the way for its effective implementation. The law also provisions Parliamentary oversight, as DMIC is required to submit its report to the Subject Committee of both the Houses of the Parliament every year. Last year a joint government-donor review of the decentralization process was also carried out (ADDCN, March 2001) which resulted the formation of a government led Joint Government-Donor Forum including NGOs, civil societies and the private sector as a platform for discussion and provide suggestions to the government for the effective implementation of decentralization in the country. Recently, the DMIC has made a number of policy decisions of structural reforms for an effective decentralization[33]. An attempt, therefore, towards fulfilling the missing gap by developing a clear, objective and transparent performance evaluation framework for the local government and their systematic implementation and publication of results by the central government will be of high significance.

Reform issues

Increase budgetary autonomy

The autonomy of the local governments is futile unless they get budgetary autonomy. Absence or limited financial autonomy restricts their ability to make a difference in terms of achieving the benefits of decentralization. The local governments in Nepal have, in theory, significant budgetary autonomy. However, the internal and external factors restricting the autonomy are still in place that need to be corrected. One key piece of this fundamental is the own source tax autonomy. This has to be significantly improved so that the local governments increase the size of the budget, at least at the margin, by changing the tax rates. Another, but related, part is the clear assignment and transfer of the service provision to the local governments with any rent or tariff control exclusively under the control of the local government. In addition, the gradual removal of normative barriers, budget restrictions, etc will also increase the local governments' budgetary autonomy when it is combined with increasing accountability towards the voters.

Increase transparency and accountability

Two important reforms with respect to the increased transparency and accountability that require serious attention are: full public disclosure of the budgetary information, and the strengthening of the Accounts Committees of the local government Councils. A full disclosure of the budgetary information should be made mandatory by law (currently it is not explicit in the law) at all levels, from user group level to the institutional level of the local government. At project level, 'project audit' (evaluation by the beneficiaries) should be made compulsory in all projects for increased grass-roots transparency and accountability[34]. At local government level, all executive decisions (which include budgetary decisions) should be made public regularly. Similarly, the program and budget information should be disclosed at least twice a year coinciding with the Council meetings in August and January.

The provision of the Accounts Committees as an internal in-built instrument of increasing transparency and accountability is an extremely significant initiative in the local government system in the country. However, the members of the Committee lack knowledge and training to do their job well. Training of these members by the government in collaboration with the local government associations would significantly contribute in improving the situation.

Increase budget certainty and predictability

Dependency on the central transfer or subsidies (which is fundamentally ad-hoc now) has been a constant source of the uncertainty in the preparation and execution of budget in the local governments. Two-pronged reforms, one in planning side and another in number side, may minimize the uncertainty and increase budget predictability. The current initiative of preparing a periodic plan at the DDC level should be qualitatively strengthened and extended to even the municipalities (later it might be extended to the VDCs with the help of the DDCs). This plan should be used as a basis for medium-term budget expenditure framework for the DDCs as well as for the National Planning Commission and the central ministries. Once the medium expenditure framework is in place, the current system of annual planning process could be stopped, if projects are already prioritized during the periodic planning exercise though the bottom-up consultations. This step will significantly reduce the time and cpst employed in the annual planning by limiting the budget preparation to annual adjustments based on the project progress and availability of the fund (which will again be as per the medium term expenditure framework). If followed systematically, this will provide a reasonable degree of certainty for the local governments in the planning and execution of the budget, and will also improve transparency in the budget preparation.

So far as 'making the number right' is concerned, the central government should follow systematic objective criteria or formula for the fiscal transfer or the subsidies. The problem of having different projects within the same sector with different and unpredictable funding modalities could be improved through sector-wide approach to programming and funding with some transparent mechanism or formula. In the case of the own source revenue, the uncertainty (often resulting from misuse of estimation) can be reduced by following norms like mandatory use of past three years average collection for the budget year's revenue estimates. This will help minimize the number game often used in the budget preparation.

Strengthen the oversight and the audit of the local governments

Although the system of regular audit of the local governments is in place, the regularity and quality of audit is a major problem. In case of the audit of the municipalities and the DDCs, the Auditor General's Office should strengthen its efforts by managing the audit in terms of its regularity, its quality, and monitoring the compliance of the audit recommendations by the local governments. The Auditor General should have a flexible provision to employ private registered companies instead of using all the time its own staff. Building a culture of audit and promoting credible audit firms are also essential through regulating any misconduct of the audit firms. For the VDCs, it will be impractical to keep oversight from the centre. The DDCs should continue to provide this oversight role for the VDCs. The current provision of appointing the auditor by the DDC upon the recommendations of the Village Council does not give an independent audit responsibility to the DDCs. Instead, they should be given full right for making the external audit of the local governments by hiring the auditors registered under the Auditor General's Office. This will increase the audit oversight of DDCs over the VDCs.

Since, like any program, the decentralization will also be judged what it achieves in terms of outcome, efficiency and effectiveness of the local public expenditure, the central government should develop and apply a transparent and objective performance evaluation system. The government should conduct an evaluation of the local governments on a systematic sampling basis every year. The result of the evaluation will prove useful both to improve the conduct of the local governments through instituting some reward or punishment system as well as to streamline the implementation of the decentralization reforms in general. The government should also make the results of the evaluation public for general public awareness and transparency. This will also help improve the behavior of both the local and the central governments.

Annexes of Tables

Table 3.1
Expenditure Assignment to Local Governments in Nepal

Expenditure category	Central Government	District Development Committee	Municipalities	Village Development Committees
Defense and Internal Security	Entire responsibility			
Monetary policy	Entire responsibility			
Justice	Entire responsibility			
Foreign relations	Entire responsibility			
Agriculture	Agriculture development policy, programs, research, extension, etc	District agriculture and livestock development policy, programs, operation and monitoring Agriculture inputs and extension, market and fairs		Agriculture development Agriculture Haat (weekly market), markets and fairs Veterinary hospitals (as per necessity), pasture development
Drinking water	Drinking water policy, programs, implementation	Inter-village drinking water in rural areas	Preservation and utilization of water sources Water supply, drainage	Water supply Preservation of water sources
Hydropower		Mini and micro hydropower and other energy	Generation and distribution of electricity	Generation and distribution of electricity
Works and transport	National policy, highways, trunk roads linking district headquarters, waterway and ropeways, railways	District road, suspension bridges Mass transport Licensing to 'D" class contractor Waterways and ropeways	Roads, bridges and culverts (not under central government) Bus parks and parking places Registration/regulation of push carts, richshws, hoarse carts, etc	Tracks, trails and rural road Repair and maintenance of handed over bridges, twines and embankments
Land reform and land management	National policy and regulation	Protection and utilization of unregistered land, government barren land		
Water resources, Forest and environment	National water resources, forest and soil conservation and environment policies, program and regulation	Preservation of forest, bio-diversity, soil and environment	Preservation and utilization of water resources Prevention of river cutting, floods and soil erosion Pollution control Protection of forest, vegetation and natural resources Solid waste management, sanitation activities	Afforestation forest, vegetation, bio-diversity and soil conservation environment protection

Table 3.1
Expenditure Assignment to Local Governments in Nepal

Expenditure category	Central Government	District Development Committee	Municipalities	Village Development Committees
Education and sports	Education policy, university and research institutions, colleges and schools at all levels	Recommendation for approval or dissolution of schools Supervision and monitoring of schools Adult and informal education policy Sports and physical development	Pre-primary schools Recommendation for approval or dissolution of school Primary level education in mother tongue Scholarship for backward and disadvantaged communities Adult and informal education Libraries, reading halls Sports development	Pre-primary school Primary school in mother tongue Supervision of schools Adult and informal education Libraries Sports development Scholarship to students of disadvantaged and backward communities
Wages for labor		Wage rate for labor and workmanship Child labor abolition activities and rescue of children		
Irrigation, soil erosion and river control	National policy, program and implementation	Inter-village irrigation and embankment Soil conservation and river control		Irrigation, dams, canals, water channels, water bank, etc Soil erosion and river control measures
Information and communication	National policy, regulation	Cinema hall approval (outside Municipality) District level libraries, reading and information centers	Cinema hall approval	
Language, culture, arts, religion and history	National policy, regulation, program and implementation	Inventory, preservation and promotion	Inventory, preservation and promotion	Inventory, preservation and promotion
Cottage industry	National policy, and regulation	Recording cottage industries Development of industrial zone	Promotion of cottage, small and medium industries	Promotion of cottage industries

Table 3.1
Expenditure Assignment to Local Governments in Nepal

Expenditure category	Central Government	District Development Committee	Municipalities	Village Development Committees
Health	National policy, regulation, and all activities related to health	District level health posts, hospitals, ayurvedic dispensaries, health centers and health offices Family planning, mother child welfare, vaccination, nutrition, population education and public health Approval and supervision of sub-heath post in the village Availability (supply) of medicines, equipment and quality monitoring Removal or prohibition of sale, distribution, and consumption of goods harmful to public health	Municipal level hospitals, ayurvedic dispensaries and health centers Family planning, mother and child welfare, vaccination, nutrition, population education and public health Prevention of epidemics and infectious diseases Remove or ban sale, distribution and consumption of goods or objects harmful to public health	Village health post, health centre and sub-health post Primary health education, sanitation, disposal of waste and garbage Herbs development Family planning, maternity and child care
Tourism	Tourism policy, promotion, regulation, air ways	Protection, promotion of natural, historical and touristic heritage	Protection and promotion of natural, cultural, touristic heritage	Development of touristic ares Prevention of pollution in tourist areas
Physical development	Urban policy, town development, all public buildings, regulations	Settlement and market development in rural areas	Land use planning and implementation Housing plan and implementation Green zones, parks and recreation areas Community building, rest house, public toilets Approval the construction of houses, buildings	Community building, rest house and public toilets Development of criteria for housing, buildings, roads and other infrastructure and approval for construction Land utilization planning and implementation Sewage and drainage
Social welfare	National policy, regulation	Women advancement activities Protection of orphans, helpless women, the aged, disabled and incapacitated people Eradication of social ill practices Protection of girls and women	Cremation of heirless dead persons Orphanages for helpless people, orphans and children bereaved of parents Welfare of women and children Control of immoral profession and trade	

Table 3.1
Expenditure Assignment to Local Governments in Nepal

Expenditure category	Central Government	District Development Committee	Municipalities	Village Development Committees
Miscellaneous		District data-base, natural calamities, protection of property	Crematoriums, Pinfolds and slaughter houses Plantation, protection of barren and government land Natural calamities Data-base, inventory of orphans, children and helpless Vital registration Public health and safety (rabid, stray dogs, etc) House numbering, street lighting, fire brigades Markets, fairs and exhibitions Trade, commerce, cooperative and industrial development Honoring distinguished persons	Village data-base, natural calamities, protection of property Human resource development Promotion of employment and self-employment opportunities Vital registration (registration of birth, death and other personal events) Inventory and protection of orphan, disabled children, helpless, women, aged and old an incapacitated persons Elimination of social ill-practice Women uplifment activities
Optional functions			Literacy programs Library and reading halls Guided land development and land use Aged rest house and orphanages Electricity and communications Parks, zoos, playing grounds, museums, etc River pollution control Unemployment data and employment programs Ambulance services and dead body carrier services Preventive and relief works	

Table 4.3: Detailed Revenue Breakdown of all Municipalities, 1997/98 – 2000/01

	1997/98	1997/98 (%)	1998/99	1998/99 (%)	1999/00	1999/2000 (%)	2000/01	2000/01 (%)
Octroi Tax/Local Dev.Fee	0	0.00	0	0.00	0	0.00	0	0.00
Vehicle Tax	96495131	6.08	112880249	7.31	77969142	4.27	34337359	1.61
Octroi and Vehicle Tax	49225492	3.10	21805674	1.41	0	0.00	0	0.00
Professional Tax	16678643	1.05	11200444	0.72	29754628	1.63	32977660	1.54
Roof Top/House Land /Uni. Pro Tax	1966910	0.12	3389799	0.22	5100010	0.28	18938657	0.89
House Rent Tax	833984	0.05	939819	0.06	1377331	0.08	3300999	0.15
Contract Tax	363083	0.02	522983	0.03	466319	0.03	546890	0.03
Local Market Tax	4741833	0.30	6056495	0.39	7786227	0.43	8328041	0.39
Sales Tax: Cattle/Fish	5549345	0.35	5620079	0.36	4586329	0.25	4482739	0.21
Unclaimed Land Tax	859669	0.05	1071566	0.07	2579449	0.14	5180521	0.24
Tax Arrears	1393251	0.09	3193421	0.21	17237216	0.94	7567986	0.35
Other Taxes	24278999	1.53	23257673	1.51	26575136	1.45	63180058	2.96
LOCAL TAXES	**202386340**	**12.76**	**189938202**	**12.29**	**173431787**	**9.49**	**178840910**	**8.36**
Service Fee (Surcharges)	38190002	2.41	48736174	3.15	67726485	3.71	131423215	6.15
Industrial Service Fee	0	0.00	0	0.00	0	0.00	0	0.00
Recommendation Fee	3110061	0.20	4353416	0.28	5732292	0.31	9236342	0.43
Radio License	100723	0.01	79627	0.01	236719	0.01	160487	0.01
Application Fee	1420252	0.09	1427293	0.09	1514507	0.08	2393810	0.11
Appraisal Fee	2579453	0.16	2361231	0.15	3157231	0.17	2172010	0.10
Building Permit	23041956	1.45	25884635	1.68	47827041	2.62	96624111	4.52
Registration Fee	1215306	0.08	1465491	0.09	6412664	0.35	3034438	0.14
Animal House Fee	405348	0.03	269088	0.02	364361	0.02	284942	0.01
Water Fee	114748	0.01	360142	0.02	2123722	0.12	0	0.00
Other Fees/Fines	8447594	0.53	5511399	0.36	6668649	0.36	10984394	0.51
FEES AND FINES	**78625443**	**4.96**	**90448496**	**5.85**	**141763671**	**7.76**	**256313749**	**11.99**
Market/Shops/Building	24484093	1.54	22343843	1.45	27580714	1.51	39005153	1.82
Bus Park	8517054	0.54	9913637	0.64	10835796	0.59	13309664	0.62
Fish Pond	1950552	0.12	1297703	0.08	2190527	0.12	1148695	0.05
Equipment/Others	4698732	0.30	12504131	0.81	9777075	0.54	3871575	0.18
PROPERTY RENTAL	**39650431**	**2.50**	**46059314**	**2.98**	**50384112**	**2.76**	**57335087**	**2.68**
Sand Gravel Sale	2336433	0.15	4004496	0.26	3396444	0.19	7053658	0.33
Land/Building Sale	828312	0.05	2197822	0.14	3093142	0.17	1672130	0.08
Auction Sale	934041	0.06	2583358	0.17	2024407	0.11	1184803	0.06
Tender Forms Sale	2115906	0.13	2048409	0.13	1392230	0.08	1214496	0.06
Confiscation Deposit	6007101	0.38	6778712	0.44	2709995	0.15	1338703	0.06
Misc. Arrears	141420	0.01	0	0.00	1141718	0.06	1981464	0.09

Table 4.3: Detailed Revenue Breakdown of all Municipalities, 1997/98 – 2000/01

	1997/98	1997/98 (%)	1998/99	1998/99 (%)	1999/00	1999/2000 (%)	2000/01	2000/01 (%)
Misc. Revenue/Sale	10776036	0.68	15471139	1.00	13980334	0.77	18362000	0.86
OTHER REVENUES	**23139249**	**1.46**	**33083936**	**2.14**	**27738270**	**1.52**	**32807254**	**1.53**
OWN SOURCE REVENUE	**343801463**	**21.67**	**359529948**	**23.27**	**393317840**	**21.53**	**525297000**	**24.57**
Advance Refund	7410982	0.47	6123151	0.40	9095252	0.50	3666920	0.17
Cost Sharing	5704199	0.36	7411027	0.48	12335726	0.68	20631889	0.96
Other Miscellaneous	2485159	0.16	2901129	0.19	1366070	0.07	1925262	0.09
MISC. INCOME	**15600340**	**0.98**	**16435307**	**1.06**	**22797048**	**1.25**	**26224071**	**1.23**
HMG/Administrative Grant	49234666	3.10	22294923	1.44	34316249	1.88	42535551	1.99
HMG/Development Grant	106290367	6.70	119713993	7.75	98882385	5.41	115655988	5.41
Dist. Dev. Board/Others	82016425	5.17	64790001	4.19	173886454	9.52	168935873	7.90
TDF Grant	24260716	1.53	39976728	2.59	37050859	2.03	15440759	0.72
GRANTS (Transfers)##	**1043760233**	**65.79**	**929547385**	**60.16**	**1223810887**	**66.98**	**1329976919**	**62.21**
Inter/Ext Borrowing	3535847	0.22	40007065	2.59	16728598	0.92	5227284	0.24
TDF Loan	16020165	1.01	12510869	0.81	38277868	2.09	30146038	1.41
LOANS	**19556012**	**1.23**	**52517934**	**3.40**	**55006466**	**3.01**	**35373322**	**1.65**
BALANCE FORWARD	**163704797**	**10.32**	**186969494**	**12.10**	**132288348**	**7.24**	**221170610**	**10.34**
TOTAL REVENUE	**1586422845**	**100.00**	**1545000068**	**100.00**	**1827220589**	**100.00**	**2138041922**	**100.00**

Local development fee is included in the grants (transfers)

Source: Ministry of Local Development

Table 4.5:
Nepal: District Level Socio-Economic Indicators, 1996

Districts	Area (km2)	Population (2001)	Population density/sq Km	Per capita income (NRs)	Per capita PPP income US $	HDI	Adult literacy ratio (%)	Mean years of schooling	Life expectancy
Achham	1680	233257	138.8	5035	778	0.235	24.52	1.277	49
Arghakhanchi	1193	209109	175.3	7857	1214	0.331	33.9	2.282	57
Bara	1190	557093	468.1	6935	1072	0.309	26.42	1.421	58.5
Baglung	1784	268485	150.5	8290	1281	0.337	33.93	1.849	58
Bajhang	3422	167381	48.9	4930	762	0.201	27.39	1.284	42
Bhojpur	1507	205226	136.2	4573	707	0.351	37.09	2.209	64.3
Bhaktapur	119	226860	1906.4	9922	1534	0.393	52.2	3.535	56
Banke	2337	391803	167.7	6061	937	0.309	34.7	2.18	55.5
Bardia	2025	383720	189.5	4424	684	0.304	27.9	1.656	60.5
Baitadi	1519	235131	154.8	5609	867	0.256	36.36	2.149	46
Bajura	2188	108730	49.7	3428	530	0.173	23.34	1.159	41
Chitwan	2218	470713	212.2	8414	1301	0.37	49.46	2.531	56.5
Dang	2955	462896	156.6	7888	1219	0.299	38.21	2.15	49.5
Dadeldhura	1538	126673	82.4	5881	909	0.265	37.85	1.974	47
Dhading	1926	338513	175.8	7435	1149	0.258	25.27	1.517	49
Dhankuta	891	165672	185.9	8247	1275	0.401	44.41	2.643	64.3
Dailekh	1502	226341	150.7	3552	549	0.246	32.36	1.475	50
Dhanusha	1180	686986	582.2	6857	1060	0.329	28.8	2.019	60.5
Dolakha	2191	204744	93.4	8613	1331	0.34	25.31	1.354	62
Dolpa	7889	29653	3.8	4981	770	0.218	20.57	1.053	48
Darchula	2322	121913	52.5	4876	754	0.286	38.41	2.032	52
Doti	2025	208954	103.2	4959	767	0.249	30.2	1.582	49
Gorkha	3610	288101	79.8	6985	1080	0.308	34.81	2.104	54
Gulmi	1149	297316	258.8	7163	1107	0.326	38.98	2.295	55
Humla	5655	40749	7.2	5057	782	0.244	17.57	0.881	54
Illam	1703	282822	166.1	6354	982	0.38	48.63	2.898	61.3
Jajarkot	2230	133770	60.0	3889	601	0.21	25.57	1.251	46
Jhapa	1606	691173	430.4	10950	1693	0.421	54.43	3.511	58.5
Jumla	2531	89478	35.4	4834	747	0.218	23.41	1.141	47
Khotang	1591	232220	146.0	5209	805	0.318	35.02	2.216	58.3
Kalikot	1741	105780	60.8	5184	801	0.177	17.16	0.85	42
Kailali	3235	619131	191.4	6824	1055	0.299	34.88	1.767	53
Kanchanpur	1610	380791	236.5	6388	987	0.332	46.84	2.454	54
Kapilvastu	1738	484232	278.6	6541	1011	0.286	28.84	1.772	53.5
Kaski	2017	381580	189.2	13761	2127	0.45	53.66	3.387	60

Table 4.5:
Nepal: District Level Socio-Economic Indicators, 1996

Districts	Area (km2)	Population (2001)	Population density/sq Km	Per capita income (NRs)	Per capita PPP income US $	HDI	Adult literacy ratio (%)	Mean years of schooling	Life expectancy
Kathmandu	395	1093414	2768.1	20939	3236	0.603	70.62	5.354	67
Kavrepalanchok	1396	385218	275.9	12103	1871	0.38	32.43	2.119	60
Lalitpur	385	336677	874.5	17689	2734	0.523	60.37	4.385	63
Lamjung	1692	177361	104.8	9995	1545	0.375	39.7	3.222	58
Mahottari	1002	553857	552.8	7498	1159	0.322	24.51	1.62	60.5
Makwanpur	2426	389292	160.5	8042	1243	0.309	34.12	1.957	53
Manang	2246	9494	4.2	6952	1075	0.306	36.21	2.488	52.7
Morang	1855	843548	454.7	7609	1176	0.421	48.45	3.192	66.5
Mugu	3535	44127	12.5	5065	783	0.147	18.96	0.813	36
Mustang	3573	14580	4.1	6952	1075	0.316	40.78	2.425	52.7
Myagdi	2297	115351	50.2	4022	622	0.309	35.05	1.871	59
Nawalparasi	2162	562090	260.0	5386	833	0.3	38.38	2.102	53.5
Nuwakot	1121	287643	256.6	10520	1626	0.312	24.95	1.549	54
Okhaldhunga	1074	156339	145.6	4498	695	0.34	33.63	1.941	64.3
Parbat	494	158027	319.9	7245	1120	0.357	43.64	2.816	58
Palpa	1373	267873	195.1	7988	1235	0.337	42.81	2.467	54
Panchthar	1241	202608	163.3	4263	659	0.328	40.66	2.193	59.3
Parsa	1353	494888	365.8	10504	1624	0.355	32.67	1.679	58.5
Pyuthan	1309	212522	162.4	8141	1258	0.323	32.96	1.853	56
Ramechap	1546	212555	137.5	6421	992	0.315	24.81	1.504	61
Rashuwa	1544	44496	28.8	7111	1099	0.246	15.13	0.942	52
Rautahat	1126	547210	486.0	8086	1250	0.308	22.21	1.284	58.5
Rolpa	1879	210869	112.2	5151	796	0.264	29.33	1.451	52
Rupandehi	1360	702523	516.6	6807	1052	0.361	41.72	2.449	60.5
Rukum	2877	187816	65.3	6220	961	0.27	30.39	1.435	51
Shankhuwasabha	3480	159679	45.9	6843	1058	0.365	41.32	2.283	61.7
Salyan	1462	213995	146.4	3640	563	0.25	30.71	1.647	51
Saptari	1363	577438	423.7	9312	1439	0.374	33.09	2.521	62.5
Sarlahi	1259	641864	509.8	8330	1288	0.327	24.53	1.296	60.5
Sindhuli	2491	279990	112.4	6510	1006	0.295	27.14	1.668	56
Sindhupalchok	2542	306037	120.4	6571	1016	0.277	21.18	1.039	56
Siraha	1188	572551	481.9	9257	1431	0.35	24.42	1.888	62.5
Solukhumbhu	3312	107882	32.6	8101	1252	0.354	32.5	1.896	61.7
Sunsari	1257	628405	499.9	8130	1257	0.382	45.18	2.834	60.5
Surkhet	2451	288691	117.8	7719	1193	0.357	45.49	2.446	57
Syangja	1164	316907	272.3	10064	1556	0.378	42.69	2.659	58

Table 4.5:
Nepal: District Level Socio-Economic Indicators, 1996

Districts	Area (km2)	Population (2001)	Population density/sq Km	Per capita income (NRs)	Per capita PPP income US $	HDI	Adult literacy ratio (%)	Mean years of schooling	Life expectancy
Tanahu	1546	316036	204.4	8828	1365	0.384	43.33	2.502	61
Taplejung	3646	135540	37.2	7337	1134	0.363	39.77	2.596	60.7
Terhathum	679	114128	168.1	6830	1056	0.393	52.57	2.92	61.3
Udayapur	2063	288164	139.7	8020	1240	0.355	34.24	1.961	61.3
Nepal	**147181**	**23214681**	**157.7**	**7643**	**1186**	**0.325**			
Average		309529.1	257.5222	7314.733	1130.68	0.3208	34.94733	2.0683333	55.7987
Standard Deviation		211151.6	391.4664	2865.299	442.857	0.07309	10.57149	0.7977752	6.24654
Coef of Variation		0.68217	1.520127	0.391716	0.391673	0.227835	0.302498	0.3857092	0.11195
Minimum		9494	3.758778	3428	530	0.147	15.13	0.813	36
Maximun		1093414	2768.137	20939	3236	0.603	70.62	5.354	67

Source: Nepal Human Development Report, 1998 (UNDP, Nepal)

Table 5.4
Grant Distribution to Municipalities (in thousands of NRs)

Municipalities	Admin Grant 1998	Develop-ment Grant 1998	Fire brigade operating Grant 1998	Additional Develop-ment Grant 1998	Total Grant 1998	Admin Grant 1999	Develop-ment Grant 1999	Firebrigade operating Grant 1999	Total Grant 1999	Population 1998	Population 1999	Per capita grant 1998	Per capita grant 1999
Amargadhi	500	2500	0	500	3500	600	2600	0	3200	18720	19068	186.97	167.82
Baglung	500	1650	0	400	2550	600	1750	0	2350	16058	16182	158.79	145.22
Banepa	200	0	0	0	200	300	0	0	300	14483	14747	13.81	20.34
Bhadrapur	300	1200	200	250	1950	400	1300	300	2000	21597	22565	90.29	88.63
Bhaktapur	200	0	0	0	200	300	0	0	300	73945	75682	2.70	3.96
Bharatpur	200	0	200	0	400	300	0	300	600	94497	101187	4.23	5.93
Bhimeshwar	500	2600	0	600	3700	600	2700	0	3300	21230	21527	174.28	153.30
Bidur	400	1600	0	0	2000	500	1700	0	2200	20307	20518	98.49	107.22
Biratnagar	200	0	200	0	400	300	0	300	600	168544	174207	2.37	3.44
Birendranagar	400	1600	0	0	2000	500	1700	0	2200	34305	36069	58.30	60.99
Birgunj	200	0	200	0	400	300	0	300	600	99265	103880	4.03	5.78
Butwal	200	0	200	500	900	300	0	300	600	61764	64389	14.57	9.32
Byas	400	2200	0	100	2700	500	2300	0	2800	26499	27427	101.89	102.09
Damak	400	1600	200	200	2400	500	1700	300	2500	61704	64876	38.90	38.54
Dasarathchand	500	3000	0	500	4000	600	3100	0	3700	19545	19768	204.66	187.17
Dhangadhi	200	0	200	0	400	300	0	300	600	66931	70385	5.98	8.52
Dhankuta	400	2100	0	0	2500	500	2200	0	2700	20272	20712	123.32	130.36
Dharan	200	0	200	0	400	300	0	300	600	97665	102480	4.10	5.85
Dhulikhel	200	0	0	100	300	300	0	0	300	9548	9516	31.42	31.53
Dipayal-Silgadhi	500	2600	0	100	3200	600	2700	0	3300	15201	15599	210.51	211.55
Gaur	200	0	200	0	400	300	0	300	600	25885	26662	15.45	22.50
Gulariya	400	2800	200	0	3400	500	2900	300	3700	39688	41185	85.67	89.84
Hetauda	200	0	200	600	1000	300	0	300	600	76619	80074	13.05	7.49
Ilam	400	2100	0	600	3100	500	2200	0	2700	16731	17234	185.29	156.67
Inaruwa	400	2000	200	600	3200	500	2100	300	2900	26295	27468	121.70	105.58
Itahari	300	1350	200	250	2100	400	900	300	1600	32901	33874	63.83	47.23
Jaleshwar	400	2000	200	100	2700	500	2100	300	2900	20010	20264	134.94	143.11
Janakpur	200	0	200	250	650	300	0	300	600	78882	82573	8.24	7.27
Kalaiya	400	1600	200	600	2800	500	1700	300	2500	21810	22263	128.38	112.29
Kamalamai	400	3600	0	400	4400	500	3700	0	4200	27953	28506	157.41	147.34
Kapilbastu	400	2600	200	0	3200	500	2600	300	3400	22621	23422	141.46	145.16
Kathmandu	300	0	0	0	300	400	0	0	400	662855	701499	0.45	0.57
Khadbari	500	2600	0	600	3700	600	2700	0	3300	19998	20182	185.02	163.51
Kirtipur	300	2000	0	100	2400	400	0	0	400	43221	45253	55.53	8.84
Lahan	300	1800	200	0	2300	400	1900	300	2600	24639	25450	93.35	102.16
Lalitpur	200	0	0	700	900	300	0	0	300	157475	163632	5.72	1.83
Lekhanath	400	2250	0	400	3050	500	2300	0	2800	36552	37579	83.44	74.51

Table 5.4
Grant Distribution to Municipalities (in thousands of NRs)

Municipalities	Admin Grant 1998	Develop-ment Grant 1998	Fire brigade operating Grant 1998	Additional Develop-ment Grant 1998	Total Grant 1998	Admin Grant 1999	Develop-ment Grant 1999	Firebrigade operating Grant 1999	Total Grant 1999	Population 1998	Population 1999	Per capita grant 1998	Per capita grant 1999
Madhyapur Thimi	300	1700	0	0	2000	400	0	0	400	33780	34047	59.21	11.
Mahendranagar	400	1000	200	250	1850	500	0	300	800	82342	85306	22.47	9.38
Malangawa	400	2100	200	100	2800	500	2200	300	3000	17461	17927	160.36	167.35
Mechinagar	300	1300	200	0	1800	400	0	300	700	43007	43923	41.85	15.94
Narayan	500	2500	0	500	3500	600	2600	0	3200	17085	17286	204.86	185.12
Nepalgunj	200	0	200	0	400	300	0	300	600	63653	65970	6.28	9.10
Panauti	400	2250	0	450	3100	500	2350	0	2850	21253	21368	145.86	133.38
Pokhara	200	0	200	0	400	300	0	300	600	168806	181314	2.37	3.31
Prithabinarayan	400	2200	0	1000	3600	500	2300	0	2800	21817	21991	165.01	127.32
Putlibazar	400	2600	0	200	3200	500	2700	0	3200	27297	27507	117.23	116.33
Rajbiraj	400	1500	200	250	2350	500	1600	300	2400	32624	33861	72.03	70.88
Ramgram	400	2600	200	200	3400	500	2700	300	3500	23979	24806	141.79	141.09
Ratnanagar	400	1950	0	200	2550	500	1100	0	1600	31124	32092	81.93	49.86
Sidharthanagar	200	0	200	250	650	300	0	300	600	47720	48865	13.62	12.28
Siraha	400	1800	0	250	2650	500	1900	300	2700	25203	25720	105.14	104.98
Tansen	400	2000	0	150	2550	500	2100	0	2600	14007	14059	182.05	184.94
Tikapur	400	1800	0	0	2200	500	1900	300	2700	35670	37393	61.68	72.21
Tribhuvannagar	400	1600	200	0	2200	500	1700	300	2500	38342	39696	57.38	62.98
Triyuga	400	3400	0	500	4300	500	3500	0	4000	46925	48450	91.64	82.56
Tulsipur	400	1600	200	200	2400	500	1700	300	2500	31004	32244	77.41	77.53
Waling	400	2200	0	250	2850	500	2300	0	2800	17634	17770	161.62	157
Total	**20000**	**85450**	**5600**	**13200**	**124450**	**25800**	**81500**	**9000**	**116300**	**3136946**	**3269499**	**39.67**	35.57
Average	344.8276	1473.276	96.55172	227.5862	2145.69	444.8276	1405.172	155.1724	2005.172	54085.28	56370.67	85.86774	79.64358
Standard dev	102.8922	1068.702	100.8134	242.8219	1221.707	102.8922	1170.571	151.2201	1216.649	89172.16	94421.32	66.51885	64.01828
Coef of variation	0.298387	0.725392	1.044139	1.066945	0.569377	0.231308	0.833044	0.974529	0.606756	1.648733	1.675008	0.774666	0.80381
Minimum	200	0	0	0	200	300	0	0	300	9548.268	9515.804	0.452588	0.570207
Maximum	500	3600	200	1000	4400	600	3700	300	4200	662855	701499.4	210.5113	211.5472

Source: Ministry of Local Development

Table 5.5
Grant Transfers to the DDCs, 1999 (in thousands NRs)

District	No of VDCs	VDC Secretary Grant	Total Admin Grant	DDC Admin Grant	District Road Grant	Suspension Bridge & Maint. Grant	Minimum Block Grant	Total Dev Grant	DDC Total Grant	Population (2001)	Per Capita Grant to DDCs
Achham	75	4160	5752	1592	2000	275	2050	4325	5917	233257	25.37
Arghakhanchi	42	2040	3521	1481	2500	190	1850	4540	6021	209109	28.79
Bara	98	4360	5667	1307	3200	0	1550	4750	6057	557093	10.87
Baglung	59	3230	4772	1542	3500	325	2050	5875	7417	268485	27.63
Bajhang	47	3240	4984	1744	1200	220	1950	3370	5114	167381	30.55
Bhojpur	63	2940	4349	1409	1000	425	2000	3425	4834	205226	23.55
Bhaktapur	16	870	2200	1330	1500	0	1650	3150	4480	226860	19.75
Banke	46	2230	3554	1324	2700	9.6	1550	4259.6	5583.6	391803	14.25
Bardia	31	1650	3133	1483	2700	0	1750	4450	5933	383720	15.46
Baitadi	62	3770	5362	1592	2800	250	2050	5100	6692	235131	28.46
Bajura	27	1850	4329	2479	1100	250	1850	3200	5679	108730	52.23
Chitwan	36	1750	3057	1307	3800	9.6	1550	5359.6	6666.6	470713	14.16
Dang	39	1890	3224	1334	2700	18	1550	4268	5602	462896	12.10
Dadeldhura	20	1440	3096	1656	1900	190	1850	3940	5596	126673	44.18
Dhading	50	2310	3724	1414	2500	265	1850	4615	6029	338513	17.81
Dhankuta	35	1700	3109	1409	1900	220	2050	4170	5579	165672	33.67
Dailekh	55	3325	4909	1584	2000	190	1950	4140	5724	226341	25.29
Dhanusha	101	4025	5300	1275	3700	0	1550	5250	6525	686986	9.50
Dolakha	51	2570	3984	1414	1800	325	1950	4075	5489	204744	26.81
Dolpa	23	1590	3394	1804	1500	220	2671	4391	6195	29653	208.92
Darchula	41	2830	4597	1767	1500	160	1850	3510	5277	121913	43.28
Doti	50	2880	4464	1584	1900	240	1950	4090	5674	208954	27.15
Gorkha	66	3070	4492	1422	3200	300	2050	5550	6972	288101	24.20
Gulmi	79	3690	5173	1483	3300	250	2050	5600	7083	297316	23.82
Humla	27	1870	3674	1804	1000	235	2745	3980	5784	40749	141.94
Illam	48	2160	3552	1392	2000	190	1850	4040	5432	282822	19.21
Jajarkot	30	1730	3359	1629	1000	190	2050	3240	4869	133770	36.40
Jhapa	47	2020	3295	1275	4000	0	1550	5550	6825	691173	9.87
Jumla	30	1830	3500	1670	1200	160	1850	3210	4880	89478	54.54
Khotang	76	3550	4959	1409	2000	220	2000	4220	5629	232220	24.24
Kalikot	30	1830	3560	1730	1000	160	3425	4585	6315	105780	59.70
Kailali	42	2080	3739	1659	3000	9.6	1550	4559.6	6218.6	619131	10.04
Kanchanpur	19	880	2294	1414	1900	0	1550	3450	4864	380791	12.77
Kapilvastu	77	3425	4732	1307	3000	9.6	1550	4559.6	5866.6	484232	12.12

Table 5.5
Grant Transfers to the DDCs, 1999 (in thousands NRs)

District	No of VDCs	VDC Secretary Grant	Total Admin Grant	DDC Admin Grant	District Road Grant	Suspension Bridge & Maint. Grant	Minimum Block Grant	Total Dev Grant	DDC Total Grant	Population (2001)	Per Capita Grant to DDCs
Kaski	43	2165	3749	1584	3400	185	1700	5285	6869	381580	18.00
Kathmandu	57	2590	3865	1275	3500	9.6	1700	5209.6	6484.6	1093414	5.93
Kavrepalanchok	87	3710	5102	1392	3700	325	2050	6075	7467	385218	19.38
Lalitpur	41	1690	2965	1275	2800	72	1700	4572	5847	336677	17.37
Lamjung	61	3020	4473	1453	2500	275	2050	4825	6278	177361	35.40
Mahottari	76	3030	4559	1529	3500	0	1550	5050	6579	553857	11.88
Makwanpur	43	1990	3382	1392	2700	420	2050	5170	6562	389292	16.86
Manang	12	650	2530	1880	800	160	1700	2660	4540	9494	478.20
Morang	65	2650	3925	1275	4000	0	1550	5550	6825	843548	8.09
Mugu	24	1660	3464	1804	1000	160	2854	4014	5818	44127	131.85
Mustang	16	1040	2783	1743	1000	160	1850	3010	4753	14580	325.99
Myagdi	40	1940	3364	1424	2000	275	1850	4125	5549	115351	48.11
Nawalparasi	73	3425	4889	1464	3300	112	1550	4962	6426	562090	11.43
Nuwakot	61	2430	3790	1360	2500	300	1950	4750	6110	287643	21.24
Okhaldhunga	56	2620	4044	1424	1000	220	1950	3170	4594	156339	29.38
Parbat	55	2565	3989	1424	2000	220	1850	4070	5494	158027	34.77
Palpa	65	2895	4309	1414	3500	250	2050	5800	7214	267873	26.93
Panchthar	41	1975	3384	1409	1900	275	1850	4025	5434	202608	26.82
Parsa	82	3650	4957	1307	3200	0	1550	4750	6057	494888	12.24
Pyuthan	49	2525	3978	1453	1900	160	1650	3710	5163	212522	24.29
Ramechap	55	2570	3994	1424	1500	300	1950	3750	5174	212555	24.34
Rashuwa	18	920	2373	1453	1000	190	1820	3010	4463	44496	100.30
Rautahat	96	4270	5577	1307	3500	0	1550	5050	6357	547210	11.62
Rolpa	51	2600	4229	1629	1000	275	1750	3025	4654	210869	22.07
Rupandehi	69	3070	4377	1307	3500	12	1550	5062	6369	702523	9.07
Rukum	43	2480	4109	1629	1900	220	1750	3870	5499	187816	29.28
Shankhuwasabha	33	1940	3453	1513	1100	220	1950	3270	4783	159679	29.95
Salyan	47	2420	3873	1453	1900	275	1650	3825	5278	213995	24.66
Saptari	114	4550	5839	1289	3500	0	1550	5050	6339	577438	10.98
Sarlahi	99	4000	5275	1275	3500	0	1550	5050	6325	641864	9.85
Sindhuli	53	2450	3842	1392	2000	48	2050	4098	5490	279990	19.61
Sindhupalchok	79	3520	4961	1441	2800	335	2050	5185	6626	306037	21.65
Siraha	106	4425	5700	1275	3500	0	1550	5050	6325	572551	11.05
Solukhumbhu	34	1840	3353	1513	1000	250	1850	3100	4613	107882	42.76
Sunsari	49	2060	3335	1275	4000	0	1550	5550	6825	628405	10.86

Table 5.5
Grant Transfers to the DDCs, 1999 (in thousands NRs)

District	No of VDCs	VDC Secretary Grant	Total Admin Grant	DDC Admin Grant	District Road Grant	Suspension Bridge & Maint. Grant	Minimum Block Grant	Total Dev Grant	DDC Total Grant	Population (2001)	Per Capita Grant to DDCs
Surkhet	50	2410	3893	1483	2000	160	1950	4110	5593	288691	19.37
Syangja	60	3025	4490	1465	3800	160	2050	6010	7475	316907	23.59
Tanahu	46	2120	3534	1414	3700	148	2050	5898	7312	316036	23.14
Taplejung	50	2700	4333	1633	1900	350	1950	4200	5833	135540	43.04
Terhathum	32	1550	3004	1454	1000	250	1950	3200	4654	114128	40.78
Udayapur	44	2160	3552	1392	2000	30	1950	3980	5372	288164	18.64
Sum	**3913**	**190085**	**301407**	**111322**	**176300**	**12308**	**140315**	**328923**	**440245**	**23214681**	**18.96**
Average				1484.293	2350.667	164.1067	1870.867	4385.64	5869.933	309529.1	40.25886
Sat deviation				192.6827	980.8123	120.964	321.461	856.8831	789.7744	211151.6	69.08554
Coef of variation				0.129814	0.417249	0.737106	0.171825	0.195384	0.134546	0.68217	1.716033
Minimum				1275	800	0	1550	2660	4463	9494	5.930599
Maximum				2479	4000	425	3425	6075	7475	1093414	478.1968

Source: Ministry of Local Development

[1] Nepal is in South Asia bordered between China in the north and India in the south, east and west. Nepal has a population of 23 million and an area of 147,181 square mile with an average length of 885 km and width ranging from 145 to 242 km.
[2] Examples of big political events followed by strong political reforms in recent Nepal's history include: 1) the royal takeover in 1960 and enactment of local Panchayts at district, town and villages in 1962; and 2) national referendum (choosing between an improved Panchyat political system and the multi-party political system) in 1979, and enactment of the Decentralization Act, 1981 (after the panchayat system won by a margin).
[3] The author was also part of the working task force as a Special Officer deputed by the Ministry of Local Development.
[4] With an increasing emphasis on local governance, the relevancy of regional administrative units has been in debate. Recently some regional offices have been abolished as part of the administrative reform process.
[5] Until the restoration of multiparty democracy in 1990 they were called District Panchayat, Town Panchayat and Village Panchayat. After 1990, the democratic government did not continue the word 'pahchayat' mainly because of the political legacy associated with the previous Panchayat regime.
[6] Ecologically the country is divided into the Mountain in the north, the Hills in the middle and the Terai (plain area) in the south.
[7] The degree of inaccessibility increases as one goes from the terai to hills and to mountains. In remote hills and mountains, the inter-VDC and intra-VDC inaccessibility varies greatly. Some settlements within a VDC may be four to five days walk from the VDC office. This is also true in case of remote districts.
[8] Municipalities are categorized into Municipality, Sub-municipal corporation and Municipal Corporation based on size of the population, income and provision of basic services.
[9] Two forces are working for increasing the number of municipalities. There is strong political incentive to upgrade the VDC area into a municipality mainly because of prestige and broader taxing power. Secondly, the government sees this an opportunity to reduce the number of VDCs (as there is a strong sense that the numbers of VDCs are unmanageable and their small sizes are not economically viable).
[10] District Development Plan is a comprehensive plan comprised of all development program and budget implemented by local governments, district level sector units, and NGOs. By Act, the sector units do not get budget released for their activities unless approved by the District Council.
[11] Recently the High Level Decentralization Monitoring Committee chaired by the Prime Minister approved a time-bound work plan to review the size and number of VDCs and to submit a rationalization proposal.
[12] This might be politically palatable as politicians see this a sort of status symbol. Besides, municipality may end up getting more resources because of large tax base and taxation powers.
[13] The minimum annual remuneration and meeting allowances of elected officials at local government is estimated to be NRs 225 million (Fiscal Commission Report, 2001).
[14] In the Municipalities, the number of wards vary between minimum 9 to 35. In case of larger municipalities, like Kathmandu, where there are 35 wards means an Executive body of 39 (including Mayor and Deputy and two nominated member). Similarly, in the DDCs the number of Illakas varies between 9 to 17 meaning in case of DDCs with 17 Illakas will have a Executive of 21 members.
[15] Municipalities are already classified. The local government law provides criteria such as population, size, economic condition, remoteness, etc for the classification of the VDCs and the DDCs.
[16] Until last year the VDCs were getting grant via the DDCs, but now the DDCs had no control over the VDC grant.
[17] This somewhat seems contradictory to the expenditure assignments (devolution) to the local governments as to why the Ministries has to redefine the tasks into various levels when this has already been assigned to local governments. One reason might be to bring sector Ministries on board the process of decentralization.
[18] This is an average ratio between local government allocation and district level development budget allocation in 2000/01.
[19] Local Fiscal Commission study collected expenditure data for two years. However, these data are incomplete and covers only limited DDCs and VDCs. Though the analysis of these data would not provide reliable picture of the variation in regional spending, but it could still indicate the general nature and extent of variation.
[20] Recently, the government through budget speech of 2001-2002 has reemphasized the commitment to gradually handover primary education, primary health, postal services, agriculture extension and animal health to the local governments. This raises confusion and wrong signal as to what about the other sectors which are by law devolved to the local governments.

[21] Local Development Fund (LDF) is established at the DDC level, and is managed by a separate Board consisting of DDC President (Head) and other specialized members. The participating DDCs and the VDCs within the DDCs contribute some matching fund (mainly come from the general grant). LDF provides subsidy to the Community Organizations formed in the VDCs for community development projects like irrigation, water supply. These supports can be in parallel to the functional jurisdictions to the VDC. LDF also provides credit (revolving) to the Community Organization for income generating activities to its members.
[22] The centre collects these taxes and supposed to give to the districts directly. There are contradictions between the local government law and forest law with respect to base and rate of the royalties from the forest. Similarly, there are ambiguities with respect to royalties from the hydropower and tourist entrance fees. In the case of hydropower generation, the revenue base is not clear as to whether it is the revenue from the total power generation, or the revenue the centre receives from the Nepal Electricity Authority or the revenue earned from the consumption of the electricity in a particular DDC area. In the same way, in the case of tourist entrance fees, it is not clear whether it is the tourist visa fees or the special entrance fees levied in the entrance to some protected area.
[23] Municipal own source revenue share increases to 70 per cent if local development fee (which is in fact a transfer) is included in the own source revenue. In the reporting of municipal fiscal information, the local development fee is kept under municipal tax heading.
[24] Local Development Fee (additional 1.5 per cent fee on important value) was imposed in 1999 at a temporary measure to replace Octroi. But the Local Development Fee suffers from the same demerits as Octroi as such it does not meet the principles of local taxation, and it distorts trade and industry.
[25] In 1998, this fund was equivalent to around 3 per cent of the total grant.
[26] In 1999, there were at least 25 different project or programs under the Ministry of Local Development were implemented through the DDCs. Each DDC has at least one centrally funded project or program. Occasionally, DDCs also get funds to implement small projects from sector ministries (for example, tourism related infrastructure development or renovation from Ministry of Tourism).
[27] A few examples where matching fund required are Local Governance Program, Participatory District Development Program, District Development Fund Program, and Rural Community Infrastructure Development Program.
[28] In 1999, it was around 5 per cent of total municipal grant.
[29] The amount of road grant was 17.3 million NRs and the general block grant was 16.65 million NRs in 1999, while the grant for suspension bridges was only 1.6 million NRs in the same year.
[30] Over budgeting is often rational approach in budget preparation in Nepal because budget cut is normal. One rationally hopes that after cut one would end up with the expected amount of budget (which may not be true always).
[31] The local government law requires preparation of periodic plan and annual plan by all local governments for the development of their respective jurisdictions. But, the periodic planning exercise was not started until recently in the DDCs. Municipalities are behind in this exercise, and VDCs are far from this. DDCs motivation for this exercise is the result of two factors: one, they are better prepared through capacity building project support from UNDP, UNCDF, DANIDA and SNV often with financial and technical support; and two, preparation of periodic plan has been made one of the conditions for eligibility for the establishment of sector unit by the DDCs.
[32] Two other conditions for suspension and/or dissolution of local governments are: (a) jeopardizing the sovereignty, integrity, nationality or communal harmony of the country in a manner to be contrary to the Constitution of the Kingdom of Nepal, 1990; and (b) obstruction in discharging of functions of the local government by not holding the meeting of local government for up to one year, except of any cases of the existence of any circumstance beyond control. In such cases, the investigation has to be completed within three months, and the information of such suspension or dissolution must be furnished to both Houses of the Parliament.
[33] Important policy decisions include review of number, size, and structure of local governments, work out clear division of responsibilities of sector functions at different levels of government, gradual implementation of the recommendation of the Local Fiscal Commission recommendations, including designing of transparent and objective fiscal transfers.
[34] Currently the practice of public audit is limited to a few projects. The Rural Community Infrastructure Work Program (supported by UN World Food Program) implemented through the DDCs is an excellent example of using 'public audit' at the beneficiary level by beneficiaries themselves.

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