



The Pivotal Role of The National Natural Resources and Fiscal Commission in Nepal's Intergovernmental Fiscal System



This Knowledge Product was produced with the generous financial support of UKaid and produced by the Forum of Federations through the Support for Managing Fiscal Federalism in Nepal (SMFFN) Programme in collaboration with The Asia Foundation. The views expressed here are those of the authors and do not reflect the views of the UK Government.

Suggested Citation:

Steytler, Nico (2021) The Pivotal Role of The National Natural Resources and Fiscal Commission in Nepal's Intergovernmental Fiscal System. The Forum of Federations, Kathmandu.

The Support for Managing Fiscal Federalism in Nepal (SMFFN) programme supports Nepal's spheres of governments in implementing their federal fiscal governance system by providing knowledge of comparative practices and guidance to key stakeholders in intergovernmental relations and coordination. The programme is implemented by The Asia Foundation in partnership with the Forum of Federations with funding from UKaid.

TABLE OF CONTENTS:

| | |
|--|----------|
| Acknowledgement | 1 |
| About the Author | 4 |
| Keywords | 5 |
| The Pivotal Role of The National Natural Resources and Fiscal Commission in Nepal's Intergovernmental Fiscal System | 6 |
| 1. Introduction | 7 |
| 2. Rationale for the Commission | 7 |
| 3. Nature of the Commission | 8 |
| 4. Own source revenue | 14 |
| 5. Federal (and provincial) transfers | 17 |
| 6. Borrowing | 29 |
| 7. Cooperative government and fiscal relations | 30 |
| 8. Conclusion | 31 |
| Annexure 1 | 33 |
| References | 44 |



ACKNOWLEDGEMENT

A pivotal function for any federation is the provision of fiscal resources and the utilization of fiscal powers allocated under its Constitution across all spheres of government. In principle, a federation is defined by two or more levels of government, sharing rule through common institutions and regional self-rule. Certain powers are devolved to constituent units. Neither the federal government nor constituent units are subjugated to the other, both share powers as assigned by constitution, as defined either operationally or via constitutional form.

Following the promulgation of its federal Constitution, Nepal now moves to implement its federal Constitution and provide services across the entire country. These powers and responsibilities are newly founded in Nepal, and amongst other issues defined by the Constitution provide for the supply of fiscal resources to all spheres of government – federal, provincial and local.

One of the pivotal issues in implementing the distribution of powers is that finances must follow function. It is here that the National Natural Resources and Fiscal Commission (NNRFC) plays its greatest part in the federal implementation process of Nepal.

On financial and fiscal matters, multi-level governments benefit from an independent, impartial advisory body that can make recommendations to Parliament, provincial legislatures, organized local government and other organs of state.

The NNRFC is a constitutional body established with the objective to ensure the just and equitable distribution of natural and fiscal resources among federal, state and local governments. The commission makes recommendations to government regarding revenue distribution, equalization grants, conditional grants, internal borrowing and sharing of natural resources among the three spheres of governments.

It is a key institution in Nepal's governance structure, its role as an independent commission cannot be understated; as institutions of this sort are fundamental to the accountable and equitable fiscal practices of many multilevel systems of government. The NNRFC has been mandated to advise, support and monitor the implementation and coordination of fiscal resources and powers across Nepal's three spheres of government.

Institutions such as the NNFRC exist to provide proactive, expert and independent advice towards a sustainable and equivalent intergovernmental fiscal relation (IGFR) system, through evidence based data driven analysis to ensure the realization of national constitutional values.

In early March 2018, the Forum of Federations met with the NNRFC team. At this meeting the Secretary indicated several areas in fiscal federal governance that were of importance to the NNRFC as it moved forward with its mandate to provide advice to Nepal's governments in fiscal management and coordination issues.

The NNRFC team indicated that these areas of fiscal federal governance were acutely critical to the work of the NNRFC; here there was scope for the Forum to provide comparative practices for the NNRFC.

The NNRFC saw great value in learning of the comparative practices in other devolved countries with similar independent fiscal commissions; the case studies of South Africa, India and Australia were raised as countries of interest.



As the role and mandate of the NNRFC was a relatively new one, there was substantial value in lessons from other institutions within similar multilevel systems of government; learning of their experiences, practices and lessons would benefit the NNRFC and its own efforts towards implementing and supporting fiscal federal devolution in Nepal.

Since that time the Forum of Federations has worked closely with the leadership from the national government, newly established provinces and local governments to support the transition, building political and administrative capacity to support the federalisation process.

This has been the focus of the Support to Managing Fiscal Federalism in Nepal (SMFFN) which we have implemented in partnership with the Asia Foundation and the generous support and guidance of UKaid.

The SMFFN programmes pillars forged in those early conversations around three principle challenges of federal transition, determined by Nepal's Constitution, rooted in the reality of Nepal's political economic landscape and informed by global experiences.

Thus the SMFFN programme orientation was on federal fiscal practices, focused specifically on knowledge sharing and capability building to:

- Enhanced knowledge and capacity of beneficiaries in their roles and responsibilities across all three spheres of government;
- Strengthen understanding of intergovernmental practices (IGR) and coordination in development planning and budgeting, targetted at provinces;
- Strengthened institutional capacity of NNRFC to design an intergovernmental fiscal transfer (IGFT) system and procedures;

We have created these knowledge products (KP) each with a particular focus on the SMFFN programmes pillars, presenting comparative practice from various country case studies all curated with the federal implementation challenges of Nepal in mind, presenting observations that we hope will further empower the transition.

These KP were developed with the team of international experts that was assembled from the far reaches of the federal world. The team has a breadth of experience as practioners who have undertaken reforms and lived through transitions and so these case studies depicted in the KP's bear a practical dimension that leaders in Nepal have demonstrated interest in understanding so that they might consider appropriate lessons and indeed learning from the transition mistakes at the same time as success.

These are presented with observations for Nepal that are made with great humility as we do not pretend to understand the complexity of the challenges of Nepal. It is meant to enrich discussion and debate. It is important to emphasize that the history and contexts of countries are vastly different. However, with this in mind there are observations and experience that will be useful for Nepal too.

Learning from one another as we did during the SMFFN programme these KP have been tested over the duration of the programme with its varied stakeholders with inputs from many Nepalese experts. It is our sincere hope that these resources are useful and impactful.

In this context and for this KP titled "The Pivotal Role of the National Natural Resources and



Fiscal Commission in Nepal's Intergovernmental Fiscal System", we must thank with much gratitude all those that have given their insights and time to the developing of these KP over the course of the SMFFN programme.

In particular, I must thank Prof. Nico Steytler of University of the Western Cape and the Former Commissioner of the Financial Commission of South Africa who has written this impressive contribution which provides invaluable insights as to the comparative experiences of other fiscal commissions and fiscal managements presented as case studies on possible ways to address those issues and challenges which the NNRFC faces at this juncture in the federal implementation process of Nepal. He has been a great friend of Nepal for many years and was the key note speaker at our first engagement with the NNRFC back in 2018, his experience and insights have been well received and we hope that these lessons will endure through this KP.

The KP also highlights key principles and practices critical to the unfolding functions and application of powers enshrined by the constitution to the NNRFC. It has identified possible issues that require attention and provided suggestions for Nepal in areas such as data gathering, fiscal transfer, framework, and role - to provide guidance to the NNRFC for realizing its constitutional mandate and purpose.

I express my special thanks to Honorable Chairperson of the NNRFC, Mr. Balananda Poudel for his remarks that the paper has been informative in finding and analyzing the fiscal gap in the federal system of Nepal.

I would like to express my sincere gratitude to Dr. Surya Dhungel for his advisory role and also to Purusottam Nepal for his role as a national expert for the successful implementation of the programme.

I would like to sincerely thank UKaid for the generous financial support to the SMFFN programme and also many thanks to the TAF team for the cooperative partnership throughout the programme.

It is our hope that these materials and insights drawn from the wealth of global experiences and in our research and findings are useful to those that will reference them towards realizing this historic transition in achieving the Federal dream of Nepal.

Federal Transition is long process as and as with any federation the process has no completion point, but each federation continues to evolve and mature, "federalism is more easily understood if it is seen as a process, an evolving pattern of changing relationships rather than a static design regulated by firm and unalterable rules."¹

Phillip Gonzalez
Senior Director, Asia and Australia
Forum of Federations

1 P. 173, Friedrich, C. J. 1968. Trends of Federalism in Theory and Practice. New York: Frederick A. Praeger.



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KEYWORDS

Allocative Decisions
Allocation of Power
Budget Transfer
Concurrent Powers
Constitutional Distribution
Division of Power
Division of Revenue
Exclusive Powers
Federal Expenditure
Federal System
Federal Borrowing
Fiscal Commission
Fiscal Federalism
Inter-Governmental Fiscal Relations
Provincial and Local Governments (PLGs)
Residue Powers
Taxing Powers

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1. INTRODUCTION

In 2015, after years of constitutional negotiations, Nepal finally adopted a federal system of government. This entails, among other things, the division and allocation of powers and functions between three levels of government – federal, provincial and local. At the local level, government authority is exercised by a village council, a municipal council, or a district assembly¹, collectively referred to as ‘local governments’.

A central component of any federal system is the funding of the different levels of government – a system of intergovernmental fiscal relations that enables them to perform their constitutionally-mandated functions and fulfil their responsibilities. In Nepal, like in a number of other federations, an independent, expert-based institution – the National Natural Resources and Fiscal Commission (‘the Commission’) stands central in this system. Its object is to construct and manage a fair system of resource distribution between the three levels of government, that is accepted and implemented by all governments.

The Commission’s mandate is set out in the Constitution of 2015, the National Natural Resources and Fiscal Commission Act, 2074 (2017) (‘NNRFCA’) and the Intergovernmental Fiscal Arrangement Act, 2074 (2017) (‘IGFAA’). Given that the Commission was only established in 2018, there are bound to still be many teething challenges and implementation gaps in the legislative and policy framework.

From the literature available in English, there seems to be no comprehensive and systematic exposition of the legal framework within which the Commission must operate, or possible difficulties and gaps therein. Therefore, this paper aims to examine the role of the Commission in the Intergovernmental Fiscal Relations system of Nepal and identify possible challenges in the system. Furthermore, this paper seeks to suggest, in light of international experience, possible ways of remedying these gaps.

2. RATIONALE FOR THE COMMISSION

Where access to the major sources of revenue is dominated by the federal government, the inevitable consequence is that provinces and local governments are, to varying degrees, reliant on national transfers to perform their constitutional mandates. Within a constitutional paradigm where substantive equality between citizens is a foundational value, the distribution of revenue raised nationally should be done in such a manner that ensures equitable access to state services for all citizens across the country.

The allocation of state resources lies at the heart of politics; political competition is about the ways of dividing and allocating scarce resources. In a federal system of government, the distribution of revenue among the three spheres of government is thus, per definition, a profoundly political question. In a multi-party democracy, provinces and local governments that are not aligned to the governing party may be punished for their opposition through the abuse of transfers of revenue for narrow political ends. This practice undermines not only the system of multi-party democracy but also the federal system of government.

1 Constitution, article 56(4).



In a number of countries measures are taken to guard against the politicisation of allocative decisions. A central feature is that distribution should be made by experts who make their decisions independent of the narrow concerns of the government of the day. Moreover, an institution with independent expertise may assist with the implementation of federalism in numerous ways, for instance, by improving budgetary processes, counteracting patronage systems, and facilitating coordination between different levels of government. Such institutions are found in India, Australia, South Africa, Kenya, and Nigeria. In Australia, an independent commission, staffed by experts, makes the final distributive determinations on the basis of objective criteria, while in India the recommendations of the various Union Finance Commissions have been invariably followed.

With the advent of the new federal constitutional dispensation in Nepal, the NNRFC was established to serve a similar objective, namely that of supporting the implementation of federalism by designing a fair system for distributing intergovernmental transfers and to monitor such transfers.

3. NATURE OF THE COMMISSION

In serving the implementation of federalism in Nepal, the Constitution establishes an independent institution, composed of experts, which provides evidence-based recommendations and advice to the various governments.

3.1 INDEPENDENT INSTITUTION

An institution that is independent of government, such as the judiciary, typically has distinguishing characteristics relating to the mode of appointment, security of tenure and salary, and security of administration. In respect of the Commission's independence, the following similar characteristics are identified.

3.1.1 MODE OF APPOINTMENT AND LENGTH OF APPOINTMENT

The appointment of the Commission, along with the other constitutional commissions, is not a political choice of the Prime Minister (the executive). Rather, it is the choice of the Constitutional Council, which is comprised of the Prime Minister, the Chief Justice, the Speaker and Deputy Speaker of the House of Representatives, the Chairperson of the National Assembly, and the Leader of the Opposition in the House of Representatives². This suggests an inclusive process of decision-making which places the Commission at arm's length from the Prime Minister. Given that office bearers of the Federal Parliament comprise the majority of the Constitutional Council, it is then also fitting that the Commission is accountable to the Federal Parliament, a matter discussed below.

It should be noted that in many federal constitutions, independent constitutional bodies are established with the specific mandate of promoting or facilitating the functioning of the federal system. The most important one is usually the body dealing with the division of revenue between the levels of government. Because of its mandate, the participation of the subnational governments in the appointment to, and functioning of the body is viewed as an important measure to ensure that the subnational governments have trust in it.

² Articles 250 and 284.



For example, in Kenya five of the nine members of the Commission on Revenue Allocation are appointed by the Senate (representing counties). In South Africa, provinces and local government nominate four of the nine members of the Financial and Fiscal Commission.

In Nepal there is no direct link between the Commission and the provinces and local government. The only voice provinces may have is through the participation of the Chairperson of the National Assembly in the Constitutional Council. Although there is no reference to provincial interests being reflected in the Commission's composition, such gaps in the Constitution can readily be filled through the adoption of a provincially inclusive approach to appointments by the Constitutional Council; persons with expertise in provincial and local governments (PLGs) and who enjoy their trust.

3.1.2 SECURITY OF TENURE

Once appointed, the five commissioners (maximum) enjoy security of tenure. Accordingly, they may only be removed from office through an impeachment procedure, similar to the removal of the President and members of constitutional bodies for serious violations of the Constitution or the law.³ The only other way to remove a commissioner is on the recommendation of the Constitutional Council due to his or her physical or mental illness⁴. During the tenure of six years, the independence of the Commission may not be compromised by changing the salary and conditions of service to the detriment of the commissioners.⁵

3.1.3 FIXED TENURE

The appointment is for a single six year period.⁶ There is thus no incentive to dance to the tune of the ruling party in the hope of being reappointed for a further term. This principle is affirmed by the fact that there are no rewards for doing the bidding of the ruling party. Moreover, appointments to other government positions or services are not permissible.⁷ In this regard, a broad exception is made in order to ensure that the skills of ex-commissioners are not forgone: they may be appointed to a political position or any other position which 'has the responsibility of making investigations, inquiries or findings on any subject, or to any position which has the responsibility of submitting advice, an opinion or recommendation after carrying out a study or research on any subject.'⁸ The aim of the exception is to ensure that highly skilled commissioners are still able to undertake tasks similar to those done for the Commission. Executive positions may not, however, be taken up in the administration of the state.

3.1.4 RELATIONSHIP WITH MINISTRY OF FINANCE

As a constitutional body, the Commission does not fall under the control of the Ministry of Finance, the key federal government institution that deals with the federal budget, transfer

3 Articles 250(4)(c) and 101.

4 Article 250(4)(d).

5 Article 250(7).

6 Article 250(3).

7 Article 250(8).

8 Article 250(8) proviso.



of funds, development of conditional grants, and so forth. Because the two institutions deal with the same matters, open communication between the two is necessary. The NNRFC Act thus allows for the federal government to liaise with the Commission.⁹ Although the Commission may work with the Ministry, it should not neglect its role as a guide dog and watchdog of the fiscal system, which requires distance from the Ministry.

Financial independence is also an essential ingredient of an independent institution. It is of concern that the Commission's budget falls under the vote of the Ministry, as it could impact negatively on the perceived independence of the Commission. It is thus recommended that a budget process that would enhance the independence of the Commission, as with the other commissions, be developed which would include a separate budget vote in Parliament.

3.2 BODY OF EXPERTS

The Commission is a body of experts: the eligibility criteria require university graduated persons with expertise in natural resources, public finance, economics, law, or management.¹⁰ It is thus not a consultative or intergovernmental relations structure representing the different levels of government, which negotiates the division of revenue. It is also not a body representing political parties; the Constitution explicitly excludes appointment of commissioners who are a member of a political party at the time of appointment.¹¹

Critical for the effective functioning of the Commission is, of course, the personnel it appoints to do the research work. It requires highly skilled researchers and sector specialists to produce technical reports that the Ministry respects.¹² This, at the moment, is a challenge the Commission faces. As a fiscal think tank, the Commission should be one step ahead of the Ministry in skills and knowhow.

3.3 SIX-YEAR TERM LIMIT

Following the Indian approach of appointing a new Finances Commission every five years, the Nepalese Constitution sets a six-year single term limit. Since members of the Constitutional Council (except for the Chief Justice) may be elected to their positions for only one five-year term, there will mostly be an overlap with the term of the Commission. The principle underlying a single six-year term limit is that there is a measure of congruence between the politics of the day and the Commission. The term limit also ensures a renewal of experts and approaches in managing the intergovernmental fiscal system.

3.4 POWERS

The language used in the Constitution suggests that the Commission has both final decision-making powers and advisory powers depending on the nature of the issue at hand.

9 Section 20.

10 Article 250(6)(a).

11 Article 250(6)(b).

12 Basanta Raj Sigdel and Anita Poudel, 'Role of National Natural Resources and Fiscal Commission', Nepal Administrative Staff College (2021) ('Sigdel and Poudel (2021)').



3.4.1 FINAL DECISION-MAKING POWERS

Although some of the Commission's powers are expressed as 'recommendations' to the federal government, they are in fact binding. The Constitution is very clear: the federal government is under the obligation to equitably distribute the revenue it collected among itself, the provinces and local governments, as recommended by the Commission.¹³ This indicates that implementation of the recommendations are binding on the federal government. The same applies to provincial governments; they too must abide by the Commission's recommendations.

3.4.2 ADVISORY POWERS

A distinction is drawn between 'recommendations' that are binding, and 'suggestions' that are not so. The distinction comes to the fore when the Commission is requested by the federal or provincial governments 'to provide necessary suggestions' relating to the distribution of revenues or taxes levied by them.¹⁴ As advice is given on request, there is no duty to follow it; it is merely of persuasive value. The same principle applies when the Commission's expertise is requested with regard to the protection and utilization of natural resources.¹⁵

3.4.3 OWN INQUIRIES

In contrast to the requested advice, the Constitution – which gives the Commission additional powers, functions and duties – grants a general power 'to make suggestions' to the federal government on the grants 'to be provided' to PLGs.¹⁶ This is a broad power as it covers all grants. As the advice is neither requested nor mandated, it can come only from the Commission's own initiative. This suggests that the Commission has a broad discretion to raise issues and provide advice and make suggestions on a range of fiscal issues beyond the narrow mandate of recommending the distribution of resources.

3.4.4 INFORMATION GATHERING POWERS

The Commission's recommendations and suggestions are only as valuable as the information on which they are based. Access to all information, held primarily by government officials, is thus of paramount importance.¹⁷ In exercising its powers to issue directives or procedures of conduct on the 'smooth operation of its functions' the Commission must be able to request data generated by the governments.¹⁸ This should include directing the standardisation and provision of data that governments generate.¹⁹ There is thus the

13 Constitution, article 60(2) and (3).

14 NNRFCFA, section 3(1)(e) and (f). See Roy W. Bahl, Andrey Timofeev and Serdar Yilmaz, 'Implementing Federalism: The Case of Nepal', International Centre for Public Policy Working Paper 20-10, Andrew Young School of Policy Studies, Georgia State University, June 2020, 13 ('Bahl et al. (2020)').

15 NNRFCFA, section 3(1)(g).

16 Constitution, article 251(1)(g).

17 Sigdel and Poudel (2021).

18 NNRFCFA, section 23.

19 Yanki Ukyab and George Varughese, 'Nepal's New National Natural Resources and Fiscal Commission', Nepali Times 13 February 2019, <https://www.nepalitimes.com/latest/nepals-new-national-natural-resources-and-fiscal-commission/> ('Ukyab and Varughese (2019)').



reciprocal duty on any government agency or official to make available such information requested, as well as assistance required.²⁰ To ensure such access, the Commission may use available intergovernmental forums, and, if need be, legal process.²¹

3.4.5 SELF-REGULATION

Given its status as an independent body, the Commission has the power of self-regulation. As such, it may make the necessary rules for the implementation of the NNRFCA. Only if rules impose a financial burden on the Ministry of Finance will the Commission require the ministry's approval prior to their adoption.²²

3.5 ACCOUNTABILITY

The Commission is one among a number of independent commissions which the Constitution has established. Internationally, independent commissions have been described as the fourth branch of government, alongside the legislature, the executive, and the judiciary. As a relatively new 'branch', the checks and balances between the Commission and the traditional three branches are yet to be developed satisfactorily. Although they are independent, there is still the need for some level of accountability.

In parliamentary democracies there are two forms of accountability: a strong form (referred to as democratic accountability) and a weak form (relevant to independent state institutions). The first form of accountability reflects the traditional parliamentary system of government. Apart from its legislative function, a popularly elected legislature also has an oversight function – the legislature must call the executive to account for the execution of its electoral mandate in general, and the implementation of legislation in particular. The executive is thus accountable to the legislature, on matters of policy as well as implementation. Having elected the executive, the legislature has the ultimate sanction of removing the executive. Short of removal, a legislature's main sanction is censure through the political process.

The second form of accountability is that which the independent institutions owe the national legislature. Usually, this entails the provision to the legislature of annual reports on their activities and on the performance of their functions. Through their reports, constitutional bodies must give an account of the implementation of their mandates and the expenditure of their budgeted funds. However, because of their independence, while the legislature may question them on their actions, it may not prescribe a course of action. The essence of this form of accountability is an independent commission's duty to explain and justify its conduct. Moreover, the legislature's powers of removal, as noted above, do not exist. Therefore, unlike its powers in respect of the executive, the accountability of an independent institution is weak in that the legislature has no powers to call such an institution to account on matters of policy or implementation or give instructions of these matters of substance.

20 NNRFCA, section 8.

21 Ukyab and Varughese (2019)

22 NNRFCA, section 22.



The Nepal Constitution provides that the independent commissions, referred to as 'constitutional bodies', are 'accountable and answerable to the federal legislature'.²³ Each commission must submit a report to the President of Nepal, who presents it to the Federal Parliament through the office of the Prime Minister. In the case of the NNRFC, this duty to submit an annual report is further elaborated on in the NNRFCA, which states that the report must be prepared within three months after the expiry of each fiscal year.²⁴

The Federal Parliament is comprised of the popularly elected House of Representatives (HoR) and the National Assembly (NA), which represents provinces and local governments.²⁵ The NA would thus have a great interest in the work of the NNRFC as it directly affects its constituencies. However, article 293 of the Constitution provides that '[t]he respective committee of the House of Representatives may monitor and evaluate the functions of the constitutional bodies, including reports, other than that of the Human Rights Commission, and issue necessary directives and suggestions.' It is suggested that a narrow view of the HoR's power of issuing directive should be taken to bring this provision in harmony with the Commission's independence as policy maker and implementer. It may issue directives on matters relating to its internal functions and financial probity, but not on the substance of its recommendation on the division of revenue. The HoR's 'suggestions' are just that: suggestions, similar to what the Commission may produce. Why the NA is excluded from this process is not clear. One reason could be that only one house is mandated to give directives. This does not prevent, however, the NA from considering the Commission's annual report and commenting thereupon.

Furthermore, the Constitution provides that a constitutional body may, in its discretion, prepare separate reports of its functions in each province, and submit such a report to the head of each province.²⁶ It may be useful for the Commission to provide detailed reports for each province to elucidate its recommendations on the distribution of funds among local governments.

3.6 PRINCIPLES GUIDING THE FUNDING OF PROVINCES AND LOCAL GOVERNMENTS

The functions of the Commission focus on a number of areas as mandated by the Constitution and legislation which include PLGs' own source revenue, federal and provincial transfers, borrowing, and dispute resolution. These functions are to be performed in terms of a set of constitutional principles that guide the federal system with the aim of securing an 'equitable society based on plurality and equality'.²⁷

The Commission is given specific mandates to make recommendations with regards to transfers, own source revenue and borrowing. These recommendations bind the governments at the different levels for the purpose of ensuring that the fiscal arrangements

23 Constitution, article 293.

24 NNRFCA, section 19.

25 Constitution, article 86(2)(b).

26 Constitution, article 294(3).

27 Constitution, article 56(4).



are supportive of the federal system as a whole. The Commission thus carries out its mandate as guardian of the federal system, responsible for ensuring the long-term viability of the system as a whole. To that end, at least every five years the Commission should review the bases of revenue distribution between the federal and provincial governments and make recommendations for reform.²⁸

A further principle mentioned in the NNRFCFA is that of ‘the performance’ of PLGs. In making any recommendations or suggestions the Commission must take this factor into account. The principle emphasizes that PLGs are not merely passive recipients of transfers; for the federal system to function well, they must be active players in generating revenue and spending both responsively and responsibly. Federalism will not be achieved if it is a top-down affair.

4. OWN SOURCE REVENUE

The funding of provinces and local government relies on two main revenue sources: own source revenue and transfers from the national treasury. Although the percentage that own source revenue contributes to the overall revenue of provinces and local governments may be limited, it is nevertheless an important element in the system of intergovernmental fiscal relations because it advances subnational autonomy. It also features prominently in the determination of transfers. Own source revenue is divided between revenue derived from taxes and revenue derived from service charges and fees. The Commission has a role to play in both cases.

4.1 DISTRIBUTION OF TAX SOURCES

Included in the constitutional distribution of competences among the three levels of government is the allocation of taxing powers to each level.²⁹ These powers are repeated in the schedules to the IGFAA, to which any other tax that can be levied according to any other law is added.³⁰ Table 1 sets out the constitutional distribution of taxing powers to the three levels of government.

The federal government has exclusive powers over the most lucrative tax sources, leaving little for the PLGs.³¹ The dominance of federal taxes is clear from recent figures which show that approximately 80% of tax revenues are collected by the federal government, which also receives 90% of all revenue accrued to the state.³² This creates a large vertical fiscal gap between the PLGs’ expenditure responsibilities and their own tax revenues. The financing model underlying the Constitution is thus that the federal government raises the bulk of revenue in which all the levels of government share. In this sense, the revenue that the federal government collects is not ‘the federal government’s money’. Rather, it collectively belongs to all three levels of government and each one has a claim to a fair share of it. Although subnational taxes are limited, as is shown below, they are not insignificant.

28 Constitution, article 251(1)(g).

29 Constitution, schedules 5, 6 and 8.

30 IGFAA, schedules 1(a) and (c), 2(a) and (c), and 3(a) and (c).

31 Bahl et al. (2020) 5.

32 Dil Bahadur Chhetry, ‘Intergovernmental fiscal transfer in Nepal: Lessons drawn from the international practices’ (2018) 4:4 International Journal of Management and Applied Science.



Table 1: Constitutional distribution of taxing powers to federal, provincial and local governments

| Fed exclusive ³³ | Prov exclusive ³⁴ | Fed, prov and local concurrent ³⁵ | Local exclusive ³⁶ |
|-----------------------------|----------------------------------|--|---------------------------------|
| Customs duty | | | |
| Excise duty | | | |
| Value Added Tax | | | |
| Corporate income tax | | | |
| Individual income tax | | | |
| Remuneration tax | | | |
| | | Royalties received from natural resources | |
| | Houses and land registration fee | | House and land registration fee |
| | Motor vehicle | | Motor vehicle |
| | Entertainment | | Entertainment |
| | Advertisement | | Advertisement |
| | Agro-income | | |
| | | | Business tax |
| | | | Wealth tax |
| | | | Land tax |
| | | | House rent tax |

At the subnational level, there is a significant overlap between provincial and local taxes, specifically in respect of housing and land registration fees, entertainment taxes, and advertising taxes. In order to minimize the confusion and conflict with regard to overlapping powers of taxation, a measure of harmonisation is sought at the tax collection end. First, provinces collect both their own motor vehicle taxes, and that of local governments.³⁷ Second, the local government performs a similar function with regard to the overlapping taxes and fees with respect to building and land registration fees, advertisement taxes, and entertainment taxes.³⁸ This arrangement is, of course, based on a clear understanding of how provincial taxes are distinguished from overlapping local taxes. The Local Government Operation Act of 2074 (2017) has provided some clarity in this respect by delineating local taxing powers. Yet, the unbundling of revenue assignments has still left inconsistencies and duplications.³⁹

33 Constitution, schedule 5 and IGFAA, schedule 1(a).

34 Constitution, schedule 6 and IGFAA, schedule 2(a).

35 Constitution, schedule 9.

36 Constitution, schedule 8 and IGFAA, schedule 3(a)

37 IGFAA, section 5(1)(a).

38 IGFAA, section 5(1)(b) to (d).

39 Madhu Raman Acharya, Parshuram Upadhyay and Amol Acharya, 'The Assignment of Functions across Levels of Government in Nepal', AusAid and Asia Foundation, 2020, 6 ('Acharya et al. (2020)').



4.2 TRADING SERVICES CHARGES AND FEES (NON-TAXES)

At subnational level, provinces and local government provide a range of services, some of which they may charge fees for (trading services), while others are provided free of charge. The provision of electricity to end-users, for instance, is a highly lucrative trading service, which in other jurisdictions renders a considerable income over and above the actual costs of the electricity provided. In other sectors there are licence fees that can be charged. Table 2 sets out the competences of the three levels of government which may provide revenue (trading services).

Table 2: Trading services of federal, provincial and local governments

| Fed exclusive ⁴⁰ | Fed & Prov concurrent ⁴¹ | Prov exclusive ⁴² | Fed, prov & local concurrent ⁴³ | Local exclusive ⁴⁴ |
|-------------------------------|-------------------------------------|--|--|--------------------------------|
| Passport fee | | | | |
| Visa fee | | | | |
| Tourism fee | Tourism fee | | Tourism fee | Tourism fee |
| Gambling | | Casino, lottery | | |
| Services charges / fees | Services charges / fees | Services charges / fees | Services charges / fees | Services charges / fees |
| - | Mass communication | Media | FM radio | |
| - | Movies, cinema, sport | | | |
| | | Electricity | | Small electricity projects |
| | | Health services | | |
| | Mines | Exploration and management of mines | | Mines & minerals |
| | Inter-prov forests | Management of forests, water | | |
| | Industries | Industrialisation, factories, business | | Markets |
| Penalties & fines | | Penalties & fines | Fines | Penalties & fines |
| Other non-tax revenue fed law | | Other non-tax revenue prov law | | Other non-tax revenue prov law |

40 Constitution, schedule 5.

41 Constitution, schedule 7.

42 Constitution, schedule 6.

43 Constitution, schedule 9.

44 Constitution, schedule 8.



The services are allocated according to the division of powers in the Constitution's schedules 5 to 9, with both explicit and implicit overlaps. In Annexure 1 the division of powers are set out in detail, focusing on the overlaps and concurrency. These overlaps may give rise to uncertainty about who is responsible for which trading services and consequently how much revenue provinces and local governments are able to collect. This will complicate the Commission's task of taking into account the PLGs' tax capacity and effort in recommending the sharing of the revenue raised nationally.⁴⁵ The Local Government Operations Act has assisted greatly in detailing the powers of rural and urban local governments, although a lack of clarity still remains to some degree.⁴⁶

The challenge is further complicated by the fact that all levels of government may determine the rate of non-tax revenues. This is a discretionary power subject only to taking into consideration the costs of goods and services provided, as well as operational and maintenance costs.⁴⁷ There may thus be considerable variation in the revenue collected from the same tax base.

4.3 COMMISSION'S ADVISORY ROLE

Given the complexities around the allocation of powers and functions, it is not surprising that the Commission has been allocated a role to bring some structure, coherence and alignment to the expenditure responsibilities of the three levels of government. The mandate is to look at the reform of allocations, drawing the link between responsibilities of expenditure (the mandated functions) and the revenue that may be generated through the execution of those functions.⁴⁸ Given the importance of certainty on the allocation of responsibilities, reform of this area should be a priority.

5. FEDERAL (AND PROVINCIAL) TRANSFERS

The Constitution makes provision for different types of transfers to PLGs with further details provided in legislation. The overall aim is to ensure the equitable or fair distribution of revenue raised by the federal government between the different levels of government. This is done through the sharing of some revenue sources – Value Added Tax (VAT), excise duty and natural resource revenue – while for other revenue sources, more flexible, factor-based grants are used. Underlying the transfers are a set of guiding principles.

5.1 GUIDING PRINCIPLES

The point of departure is that the revenue raised by the federal government 'belongs' to all three levels of government and should be used for their benefit. The distribution of this common pool of revenue should be based on equity or fairness.⁴⁹ The concept of equity refers to what is due to each level of government and to governments in the provincial and local levels. It thus entails both a vertical and horizontal division of revenue. Given the

45 Sigdel and Poudel (2021).

46 Keshav Kumar Acharya and Habib Zafarullah, 'Institutionalising federalism in Nepal: operationalising obstacles, procrastinated progress', (2020) 23:2 Public Administration and Policy 125-139, 134 (Acharya and Zafarullah (2020)').

47 IGFAA, section 4.

48 Constitution, article 251(1)(e).

49 Article 60(2).



broadness of the concept of equity, article 60(8) of the Constitution lists certain factors that should be considered when drafting the federal law giving effect to the distribution of the revenue. Principles are not hard and fast rules, determining outcomes, but point in the direction of an outcome, which is often an elusive goal, such as the 'equitable' distribution to provinces and local governments. Because bases or factors are not rules that apply in an all or nothing manner, they compete with each other, often pointing in opposite directions. Principles may also differ from one another in the weight that they may command. In the end, a balancing of competing factors is required, which brings each of the factors in an appropriate proportion to one another.

The bases or factors seek to ensure two principal outcomes, which collectively constitute the notion of each level's equitable share: fairness in the vertical distribution of revenue between the three levels of government; and fairness in the horizontal distribution of revenue between provinces and between local governments.

5.1.1 FAIRNESS IN THE VERTICAL DIVISION OF REVENUE

Fairness in the vertical distribution of revenue requires the appropriate balancing of the needs and interests of the three levels, with reference to a number of factors identified in the Constitution and legislation.

The first set of factors informs the claim of the national government to retain a portion of the revenue it collects for 'national policy' and 'national needs'.⁵⁰ The needs would include the obligation to meet debt-servicing and repayment obligations, as well as the execution of the long list of exclusive federal responsibilities.⁵¹

Competing with the national government's claim is the demand for the 'autonomy of provinces and local entities' (governments).⁵² The essence of the federal system is that they, as governments, must have sufficient funds to exercise autonomously their powers and functions within the law. More precisely, the PLGs should have sufficient funds to exercise their constitutionally mandated functions and the 'fiscal rights given to them'.⁵³

Some of the functions the various governments must perform include the provision of basic services, which are also constitutionally enforceable obligations in terms of the socio-economic rights listed in the Constitution. They include: the right to education (article 31) and employment (article 33(1)); health care, including clean water (article 35) and food (article 36); housing (article 37); social security for senior citizens (article 41), and social security (article 43). These rights impose obligations on the three levels of government. They transform a competence into an enforceable duty to provide such services for free, which then have huge costs implications. The costliest expenditure obligations are education, health care, and social security, which are spread across the three levels of government. For example, primary and secondary education may be an exclusive local government competence but education in general is a concurrent function of all three

50 Article 60(8).

51 See annexure 1.

52 Article 60(8).

53 Article 60(8).



levels of government.⁵⁴ Health care in some or other form is found in all five lists of exclusive and concurrent competences.

A second set of factors relates to the role that PLGs must play in raising own source revenue. The provinces and local governments' claims for revenue raised federally must be set against the backdrop of their competence and effort to collect own source revenue. Three factors are mentioned in article 60(8): 'their capacity to generate revenue; feasibility and use of revenue; [and] their contribution of development works'. The factor of own initiative is also found when the federal government makes the horizontal distribution through equalization grants to individual provinces and local governments: it is done 'on the basis of their need for expenditure, *their capacity in generating revenue and efforts made by them*'.⁵⁵ This factor is reiterated in the NNRFC: one of the bases is the 'attempts made for revenue collection'.⁵⁶ This factor also applies to the duty of provincial governments when distributing equalisation grants among local governments.⁵⁷

The concept of 'capacity in generating revenue' relates to the objective assessment of the ability – both legal and situational – of levying a tax, duty or levy. The question is what can PLGs be reasonably expected to raise collectively.⁵⁸ The constitutional scheme thus holds that there is a constitutional duty on provinces and local governments to exploit their own revenue generating powers as far as possible, such that transfers do not serve as the sole source of revenue but are instead complementary. This factor furthers the constitutional aim of enhancing accountable and responsive PLGs to their tax paying residents.

The term 'feasibility and use of revenues' seems to refer to the purpose for which transfers will be used. The feasibility must relate to projects planned and how transferred funds would be used for such projects. This is of particular relevance in funding infrastructure related to the utilisation of natural resources.

5.1.2 FAIRNESS IN THE HORIZONTAL DIVISION OF REVENUE BETWEEN PROVINCES AND BETWEEN LOCAL GOVERNMENTS

The third set of factors listed in the Constitution relates to the horizontal distribution of revenue to ensure that there is equity between provinces and local governments given the unevenness in expenditure needs and revenue raising capacity due to geographical, demographical and historical reasons. The factor 'regional imbalance' refers to the degree of overall development (measured against social indicators) between regions, which may be larger than provinces, or cut across provinces.⁵⁹ More specific and measurable are the

54 Constitution, schedules 8 and 9.

55 Article 60(4), emphasis added.

56 Section 15(1)(e).

57 Article 60(5).

58 Current practice suggests that local governments have not made sufficient uses of their taxing powers (USAID, Sajhedari Report – Support for Federalism: Policy Inventory on Federalism, March 2021, 12 ('Sajhedari Report (2021)'); Keshav K Acharya, 'Local governance restructuring in Nepal: From government to governmentality' (2018) 12 Dhulagiri Journal of Sociology and Anthropology 37-49 ('Acharya (2018)').

59 Article 60(8).



social factors of 'poverty and inequality' which may have deep historical roots.⁶⁰

Also of importance for the horizontal division are the revenue raising efforts of PLGs, now focusing on individual provinces and local governments. Given the socioeconomic circumstances of a particular province or local government, what can it be reasonably expected to collect from a particular tax source? Actual tax performance is not the measurement, but remains relevant; the 'tax effort' must be assessed against an objective benchmark of what is possible and reasonable. Where there is underperformance, a subnational entity should not be compensated for poor performance. Nor should good performance – collecting above the benchmark – result in a reduction in transfers as that would disincentive PLGs to perform well.

The NNRFCA brings in a further set of factors that distinguish one province from the other and one local government from the other. They are: population and demographic data; territory (size) and terrain (geography); the Human Development Index; the expenditure requirements (on services), and any other special conditions.⁶¹

5.1.3 GOOD GOVERNANCE PRINCIPLES

In addition to the constitutional principles of equity, consideration should also be given to factors that enhance good governance.

5.1.3.1 EMERGENCY FUNDS

A further factor is 'emergency works and the support of meeting temporary needs'.⁶² As part of risk management, the allocation of revenue should leave scope for unforeseen occurrences such as emergencies. Whereas the other factors respond to the known obligations and needs, this factor speaks to unpredictable and unforeseen events. It is not there, however, to compensate for poor planning and unbudgeted expenditures that should have been foreseen. Moreover, the factor is not confined to emergencies, but also "other temporary needs". Because the latter concept can be elastic in the eyes of a claimant, it should therefore be based on objective criteria.

This factor should be accommodated in both the vertical and horizontal divisions. Since disaster management is a concurrent competency of the federal, provincial and local governments,⁶³ all levels of government should have the resources to respond to unforeseen events.

5.1.3.2 STABLE AND PREDICTABLE TRANSFERS

While emergencies may require quick changes in the distribution of funds, a general principle of fiscal federalism is the need for the stable and predictable allocation of revenue to subnational government. The stable allocation of revenue seeks to avoid sudden and radical changes; the aim is to ensure that any changes are done gradually

60 Article 60(8).

61 Section 15(1).

62 Article 60(8).

63 Constitution, schedules 7, 8 and 9.



allowing governments to prepare for such changes and to cushion their possible impact. The predictable allocation of revenue encourages forward planning and avoids year-on-year short-term budgeting. This is also the point of departure in Nepal; the Commission's framework for the distribution of funds remains valid for five years, after which it must be reviewed.⁶⁴

5.1.3.3 TRANSPARENCY

However rationally the distribution of revenue may be, if the recipients of transfers do not understand how the transferred amounts were calculated, there will be suspicion of unfairness which may, in turn, breed distrust and eventually conflict. The Constitution thus requires that the distribution of revenue between the three levels of government 'shall be transparent'.⁶⁵

A way of strengthening both predictable and transparent transfers is to notify the recipient government of the intended transfers well in advance of their financial year for budgeting purposes. The federal government, 'with the consultation of the Commission', must by the 11th month in the Nepali calendar provide the provincial and local governments with the estimates of the equalisation grant and the revenue sharing of VAT and excise duty.⁶⁶ A similar duty falls on the provincial governments, which, 'with the consultation of the Commission', should provide the local governments with estimates of the transfers they will make to them from their received equalisation grants and own revenue source.⁶⁷ The phrase 'with the consultation of the Commission' refers to the Commission's recommendations on the distribution of the equalisation grants.

5.2 REVENUE SHARING

The Constitution draws a distinction between revenue sharing and other transfers. Revenue sharing refers to taxes raised by the federal government from a particular source (setting the rate and collecting the revenue), which is then divided between the three levels of government in terms of a predetermined ratio. Other transfers, too, are based on the revenue collected by the federal government but there is no fixed ratio, but a formula influenced by factors, the impact of which may change over time.

With regard to funds flowing from revenue sharing taxes, PLGs have the discretion of how to spend them as unconditional grants.⁶⁸ The Minister of Finance is, however, at liberty 'to encourage', but not direct, PLGs on how to spend such funds on the priority areas of health, education, agriculture, economic recovery, and for the benefit of vulnerable groups, as the Minister did in his 2020 budget speech.⁶⁹

64 NNRFCFA, section 15(2). Section 15(3) provides, as a transitional arrangement, for a shorter period if needed.

65 Constitution, article 60(7).

66 IGFAA, section 18(2).

67 IGFAA, section 18(3).

68 Bahl et al. (2020) 7.

69 Ministry of Finance, 'Budget Speech for Fiscal Year 2020/2021', para. 304.



5.2.1 VAT AND EXCISE DUTY

VAT and excise duty are revenue sources that fall in the exclusive domain of the federal government and are deposited in a Federal Divisible Fund.⁷⁰ The vertical division of the revenue so collected is subject to a fix formula prescribed in the IGFAA, namely: the federal government receives 70%; provincial governments 15%; and local governments 15%.⁷¹ The federal government's portion is then deposited in the Federal Consolidated Fund,⁷² while the portions of provincial and local governments are deposited in a State Divisible Fund and a Local Divisible Fund, respectively.⁷³ The deposits should occur on a monthly basis.⁷⁴

The Commission is mandated to provide the criteria and framework of how the horizontal division between provinces and between local governments is to be done.⁷⁵ This would appear to be a final decision, which is implemented by the federal government through an Act of the Federal Parliament.

The criteria and framework should be aligned to the principles set out in the Constitution, namely, those of equity between provinces and between local governments.

5.2.2 ROYALTIES FROM NATURAL RESOURCES

5.2.2.1 FEDERAL ISSUES

Taxing the exploration and utilisation of natural resources can produce high revenues, but also conflict between the regions in which a natural resource is found and the federal government. To prevent conflicts, the allocation of this tax source has been dealt with directly in newer constitutions across the world. The matter is of particular importance to countries where there is a high dependency on, for example, oil and gas revenues. While there is a substantial literature on the topic,⁷⁶ this paper only highlights the key constitutional matters.

Natural resources in a federal context raise three issues, namely, which level of government 'owns' the resources; who controls or manages the resources, and how is revenue derived from these resources shared?

'Ownership' usually means that the federal government 'owns' the resources on the basis that it is part of the national patrimony belonging to the nation as a whole. The federal government then plays a 'guardianship' role over such resources for the benefit of all. It may also be that the SNG in which a resource is found exercises such 'ownership'. The management of the resources usually follows on 'ownership'. 'Management' includes the issuing of licences for exploration, the extraction of the resource, as well as the taxing of such activities. However, the issuing of mining or exploration licences by, say, the federal

70 IGFAA, section 6(1).

71 IGFAA, section 6(2).

72 IGFAA, section 6(3).

73 IGFAA, section 6(3)(a) and (b).

74 Section 6(5).

75 Section 6(4).

76 See, for example, George Anderson, *Oil and Gas in Federal Countries* (Oxford University Press, 2013).



government may have to contend with a provincial or local government's powers relating to land use and environmental protection.

Separate from the question of who 'owns' or manages a natural resource, is the issue of the sharing of revenue that accrues from the taxation of the resource utilization. Revenue is raised by either the federal government or PLGs (or both) through the issuing of licences, royalties, corporate income tax, land-use fees, etc. Both the ownership and the taxing powers are matters often regulated in a constitution. Where the federal government levies the taxes and collects the revenue, a number of approaches to the sharing of that revenue are followed in practice. Such revenue becomes part of the federal consolidated fund from which equitable transfers are made to each PLG.

Another approach is to allocate an additional amount to the producing PLG in terms of the so-called derivation principle. For example, in Nigeria 13 per cent of oil revenue goes to the producing states, while in Brazil that percentage differs according to the type of natural resource.

5.2.2.2 FRAMEWORK

Natural resources are defined broadly in the IGFAA, namely: mountaineering, electricity (hydro-generation), forest, mines and minerals, water and other natural resources.⁷⁷ It is only the federal government that may levy and collect royalties on these resources, as provided for by a federal law.⁷⁸ Given that these resources are unevenly spread across Nepal, the Constitution sets out a broad approach to sharing revenue derived from these resources. Article 59 provides:

(4) The federation, province and the local level entity shall have to make arrangements for equitable distribution of the benefits from the development of natural resources. A certain portion of such benefit, royalty, services or objects, shall have to be distributed in areas affected by projects and to the local communities as provided for by law.

(5) When the federal, provincial and local level entity utilize natural resources, they shall have to give priority to local communities to make a certain percentage of investment if they wish to do that in view of the nature and percentage in the investment.

The underlying principles are, first, the equitable distribution across the nation of the benefits of natural resources utilisation, and second, that local communities (falling within a local government) affected by the utilisation should receive some benefit from this utilisation.

Similar to VAT and excise duty, a Federal Divisible Fund is created for this purpose. All royalties collected from natural resources are deposited in this Fund,⁷⁹ from which the

77 IGFAA, schedule 4.

78 IGFAA, section 3(6).

79 IGFAA, section 7(1).



federal government distributes the revenue vertically according to the following formula: 50% goes to the federal government, 25% to the concerned state, and 25% to the concerned local government.⁸⁰ From this Federal Divisible Fund, the funds allocated to each 'affected' province and local government are directly deposited in their provincial and municipal consolidated funds, respectively.

5.2.2.3 COMMISSION'S ROLE

The Commission plays two distinct roles with regard to the financial aspects of the value chain relating to the utilisation of natural resources.

First, for the utilisation of natural resources the necessary enabling investments should be made. The Commission's task is to determine and recommend the share of investment and the return on that investment that should be made by each of the three levels of government.⁸¹ The NNRFCFA further elaborates on the factors to be taken into account when assessing the shared investments: what is the nature of the revenue and the capacity of each government to collect it; the capacity of each government to make the investment; what should be the proportional contribution obtained from each level of government; what will be the portion of consumption of the resource made from the contribution; the need and condition of the infrastructure; and the economic conditions and geographical terrain.⁸²

With regard to the financial return on the investment (the utilization of the natural resource), a separate set of factors is to be considered, namely: the situation or location of the utilised natural resource; the area affected by the utilization; the dependence of the concerned government on the utilized resource; the population benefitting from the utilisation; the population dependent on the resource; and PLG's participation in the protection and sustainable management of the resource.⁸³ The framework recommended by the Commission is not a fixed formula, but subject to review every five years.⁸⁴ Given its six year tenure cycle, each new Commission must review the framework.

Secondly, sharing the wealth of natural resources is the source of many, if not most, intergovernmental conflicts. Given the overlapping functional areas, as illustrated in Table 3, the risk of such conflict is even higher. The Commission should thus recommend ways in which actions around the utilisation of natural resources could be coordinated (and thus prevent conflicts) and, when conflicts do occur, mitigate their consequences.⁸⁵ These tasks are important given the high level of overlapping functional areas on natural resources. In this area the Commission could play a constructive role in dispute resolution, as it is mandated to do.⁸⁶

80 IGFAA, section 7(2) read with schedule 4.

81 Constitution, section 251(1)(h).

82 Section 14(1).

83 Section 14(2).

84 IFRAA, schedule 4, note 2.

85 Constitutions, article 251(1)(i).

86 NNRFCFA, section 3(1)(c). See further para 8.2 below.



Table 3: Overlapping responsibilities of natural resources

| Government | Schedule | mining/ minerals | electricity | forests | water | other NR parks |
|---|----------|---|------------------------------------|--------------------------------------|------------------------------|--|
| Federation exclusive | 5 | 'mining and exploration' | Mega projects | | Water resources | National parks |
| Federation and provincial concurrent | 7 | 'industries and minerals and infrastructure' | | Inter- provincial forests | Rivers and waterways | environment |
| Provincial exclusive | 6 | 'Exploration and management of mines' | Provincial level electricity | Management of national forests | Water | ecology |
| Federal, provincial and local concurrent | 9 | 'mines and minerals' | Electricity services | Forest | Water use | environment |
| Local exclusive | 8 | Conservation of ... mines and minerals | Small electricity projects | | Conservation of watershed | Conservation of wetlands wild life |

Thirdly, linked to distribution of the proceeds from natural resources, is the Commission's role with regards to environmental impact assessment of the utilisation of natural resources. It should make recommendations to the federal government, based on research on such impact.⁸⁷ The Commission must thus ensure a balance between the short-term revenue gains versus the long-term negative impact on the resource itself and its revenue raising capacity that utilisation may cause.

5.3 GRANTS

Distinguished from the sharing of revenue sources, are the grants that the federal government makes to provincial and local governments, and provinces to local governments. The grants are divided between those that PLGs have a claim to (the equalisation grant), and those which occur at the discretion of federal and provincial governments (conditional grants and special grants). For the effective use of available funds, the purpose of each grant should be clearly understood by all involved in the transfer process.⁸⁸

5.3.1 EQUALISATION GRANT

The principal task of the Commission is the vertical division of revenue in the Federal Consolidated Fund between the three levels of government, and then, once that is done, the horizontal division between provinces and between local governments. This type of transfer should be seen as an entitlement of each province and local government for a share of the revenue raised nationally with which they carry out their constitutionally-mandated functions. It is an entitlement because the PLGs have been excluded from tapping into the major tax sources which have been allocated exclusively to the federal government.

⁸⁷ Constitution, article 251(2).

⁸⁸ Sigdel and Poudel (2021).



Once the grant is regarded as an entitlement, it means that its spending falls to the discretion of the PLGs.⁸⁹ While the federal government may not prescribe how this grant should be spent, the Ministry of Finance may 'encourage' the PLGs to focus on the key development sectors.⁹⁰

5.3.1.1 VERTICAL DIVISION

The Commission's first mandate concerns the vertical division of funds between the three levels of government.⁹¹ This division goes to the heart of the federal dispensation: will provinces and local governments have sufficient funds to perform their mandated functions? Although on the face of it, they have a wide array of powers and functions, their role and position in the federal set-up depend on the funds available to them. Given the PLGs' limited revenue raising powers, if a small percentage of the revenue raised nationally is allocated to them it would indicate their minor role in the federation (and vice versa). In this difficult terrain of decision-making, the Commission plays a vital role by having to provide a framework of how this decision is ultimately made by the Federal Parliament in a division of revenue act. The Constitution thus requires that the Commission determines 'extensive grounds and measures' for this decision 'according to the Constitution and law'.⁹²

The IGFAA provides some guidance. First, the vertical division should be done in light of 'the need for expenditures and revenue capacity'.⁹³ Expenditure needs are determined by the allocation of powers and functions, which in itself is a difficult task given the uncertainty about who does what.⁹⁴ This uncertainty, in turn, also affects the certainty of what the PLGs 'revenue capacity' may entail. As noted above, the concept of 'revenue capacity' relates to the objective assessment of the ability, both legal and situational, of levying a tax, duty or levy, or of charging service fees.⁹⁵

The NNRFCA repeats some of these factors that should influence the vertical distribution: services that PLGs must provide; the PLGs' 'situation of revenue' and their capacity to collect it; and, in general, expenditure necessities.⁹⁶ It is suggested that the shared taxes – VAT and excise duties as well as natural resource royalties – should be brought under the 'situation of revenue', as they contribute to the complete picture of PLGs' financial position. Excluding such revenue would undercut any attempt to provide overall financial equity between the levels of government.

5.3.1.2 HORIZONTAL DIVISION

When it comes to the horizontal division of revenue allocated to the provincial and local levels of government, the guiding principle is equalisation between them. At the core

89 Bahl et al. (2020) 7.

90 Ministry of Finance, 'Budget Speech for Fiscal Year 2020/2021', para. 304.

91 Constitution, article 251(1)(a).

92 Ibid.

93 IGFAA, section 8(1).

94 See Acharya and Zafarullah (2020).

95 Chherty (2020) suggests that the following elements be used: the tax base, tax rate, tax effort, fiscal discipline, and tax rebates.

96 Section 16(1).



of an equalisation system is the goal of ensuring equal citizenship. In other words, the accessibility and quality of services should not be dependent on where a citizen lives. The aim is thus to take into account and compensate for factors that contribute towards the unevenness in development, such as back logs in services and historical marginalisation. The grants to the PLGs under this heading are thus called 'equalisation grants'.⁹⁷

To make recommendations on the distribution of equalisation grants, the NNRFCA sets out a list of factors that must be considered. The first factor to be considered is the measure of inequality, the Human Development Index, relating to social indicators such as education, health, and access to drinking water.⁹⁸ More generally, the second factor compares 'balanced development' in other provinces and local governments.⁹⁹ A third factor refers to the historical level of inequality, namely, 'the situation of economic, social or other discrimination' prevalent within other provinces and local governments.¹⁰⁰ The fourth factor looks at infrastructure development among PLGs.¹⁰¹

The factors that have a bearing on the vertical distribution of revenue are also relevant here: the services that particular provinces or local governments must provide; their revenue capacity and effort; and the necessity of expenditure demands.¹⁰²

The equalisation grant, while seeking to achieve equality in outcomes, is also concerned with the daily functioning of PLGs. The Commission must thus determine, first, what is the minimum amount each province or local government should receive in order to function as a government, and then, secondly, what the equalization portion, informed by the listed factors, should be.¹⁰³

5.3.1.3 STATE EQUALISATION GRANTS

The Commission is also mandated to recommend to the provinces the equalisation grants they have to transfer to local governments in their jurisdiction.¹⁰⁴

5.3.2 CONDITIONAL GRANTS

Conditional grants are conceived of as transfers the federal government makes to PLGs to advance national policies, programmes and standards, as well as infrastructure development.¹⁰⁵ Because the grants come from the federal portion of revenue raised nationally, they fall to the discretion of the federal government to determine, first, whether a grant should be given, and secondly, if so, under what conditions the grant should be given. However, it is not an untrammelled discretion. In terms of the Constitution, the Commission must bring its independent expertise to bear on the matter by conducting research on the

97 Constitution, article 251(1)(b).

98 Section 16(1)(a).

99 Section 16(1)(b).

100 Section 16(1)(c).

101 Section 16(1)(d).

102 Section 16(1)(e), (f) and (g).

103 NNRFCA, section 16(3).

104 NNRFCA, section 3(1)(a).

105 See IGFAA, section 9(2).



basis upon which conditional grants are to be distributed.¹⁰⁶ The Commission could also guard against too many conditions which may compromise the fiscal autonomy of PLGs.¹⁰⁷

It also falls within the Commission's advisory scope to note that the high value of conditional grants vis-à-vis the equalisation grant may hamper subnational autonomy, which is the life blood of a federal system.¹⁰⁸ In his 2020/21 budget speech the Minister of Finance indicated that of the transfers to provinces, 60% came from the equalisation grant with the remaining 40% from conditional grants. In the case of local governments the percentages were almost the reverse; conditional grants accounted for 64.2% and equalisation grants for 35.8%.¹⁰⁹ The high figure of the conditional grants may be acceptable during the transitional period when local governments are being settled in, but it will be of concern if this establishes a pattern which undermines provincial and local autonomy.

The provinces enjoy a similar power; they may also give conditional grants,¹¹⁰ but again on the basis prescribed by the Commission.¹¹¹

5.3.3 COMPLEMENTARY OR MATCHING GRANTS

The IGFAA provides for a 'complementary' or matching grant aimed at infrastructure development. The federal government may bestow this grant upon provincial and local levels of government on condition of the latter also contributing funds.¹¹² Likewise, a provincial government may make such matching grants to local governments in its jurisdiction.¹¹³

Although the Commission plays no direct role in the grant, it should be included in the review of PLG funding in terms of article 251(1)(g) of the Constitution, since it forms part of the overall package on the fair distribution of resources.¹¹⁴

5.3.4 SPECIAL GRANTS

'Special grants' are wide ranging grants with the overall aim of equitable development of specific communities across Nepal. The grants may be used for any provincial or local project concerned with development and delivery of basic services, 'to achieve balanced development' between states and local governments, and 'to uplift or develop the class or community discriminated economically, socially or in any other way'.¹¹⁵ Likewise, a provincial government may also make such grants to local governments.¹¹⁶

106 Constitution, article 251(1)(c).

107 Ministry of Federal Affairs and General Administration, 'Provincial and Local Governance Support Programme (PLGSP): Programme Document (January 2019–July 2023)' (2019) 10.

108 Sigdel and Poudel (2021).

109 Ministry of Finance, 'Budget Speech for Fiscal Year 2020/2021', para. 25. For the financial year 2019/2020, see Bahl et al. (2020) table 2.

110 See IGFAA, section 9(3).

111 NNRFCA, section 3(1)(b).

112 IGFAA, section 10(1).

113 IGFAA, section 10(3).

114 See paragraph 3.4.2 above.

115 IGFAA, section 11(1).

116 IGFAA, section 11(2).



As with the complementary grant, although the Commission plays no direct role in the grant, it should be included in the review of PLG funding in terms of article 251(1)(g) of the Constitution, since it impacts on the overall package on the fair distribution of resources.¹¹⁷

6. BORROWING

Borrowing has become a crucial part of balancing 'deficit' budgets. When revenue collected from all sources are insufficient to cover expenditure for both current and capital needs, money is borrowed. However, in most federal-type countries, PLGs are seldom given a free hand in borrowing money. The principal reason is that subnational borrowing holds significant risks for the national economy. Where a PLG defaults on loan repayments, it sends shocks throughout a country's financial system, with negative consequences for macro-economic stability. Whatever the law might say, the central government is 'obliged' to bailout a defaulting PLG because it cannot allow a PLG to go bankrupt. This implicit 'guarantee' also results in a moral hazard: a PLG has little incentive to guard against risky borrowing decisions in the knowledge that the central government will carry the consequences of the risk.

A number of measures (or a combination of them) are used to address this risk:

- A subnational executive's borrowing decisions are made public and subject to the legislature's approval, thereby increasing local accountability.
- Enforceable borrowing limits are imposed nationally on PLGs.
- Long term borrowing is allowed only for infrastructure development.
- Borrowing is not allowed to cover current expenditures.
- Borrowing is restricted to the local currency, because borrowing internationally, usually in a foreign currency, subjects loans to foreign exchange fluctuations which may increase the cost of borrowing significantly.
- An independent body is created that oversees and monitors subnational borrowing.

The Nepal Constitution follows this general, fiscally conservative, trend. Only the federal government may receive international assistance or borrow on the international market; PLGs are excluded for these sources or financing mechanism.¹¹⁸

All three levels of government may raise loans on the local market – the so-called internal loans.¹¹⁹ However, a number of restrictions apply. First, provinces and local governments may borrow money only with the permission of the federal government. Secondly, only the federal government and the provinces may raise internal loans by issuing bonds.¹²⁰ Thirdly, the borrowing must take place within the Commission's recommended framework about internal borrowing by all three levels of government, based, of course, on evidence,

¹¹⁷ See paragraph 3.4. 2 above.

¹¹⁸ IGFAA, section 12(4).

¹¹⁹ IGFAA, section 14(1).

¹²⁰ IGFAA, section 14(2).



by ‘analyzing the macroeconomic indices’.¹²¹ The IGFAA adds a further, most important, detail from a macro-stability point of view: the Commission recommends the limits of such borrowing by each level of government.¹²² However, when the federal government extends loans to provinces or local governments, the Commission plays no role.¹²³

7. COOPERATIVE GOVERNMENT AND FISCAL RELATIONS

One of the pillars of Nepal’s federal system is cooperative government; the three levels of government must cooperate with one another to ensure that the federal system delivers to the citizens the services the Constitution promises.¹²⁴ A central element in cooperative government is consultation on fiscal matters between levels of government and among provinces and local governments. They may exchange and consult with each other on fiscal matters of common concern and coordinate their activities.¹²⁵ Provinces are also bound to a duty of mutual support on fiscal matters.¹²⁶ Importantly for the Commission (for the calculation of tax effort) is the obligation that all three levels should, as far as possible, coordinate on uniform rates for equivalent taxes or fees.¹²⁷

7.1 COORDINATION AND COOPERATION

Although the Commission is independent and does not form part of the usual intergovernmental relations system in terms of which government executives engage with each other, it does not stand aloof from them either. Many of the Commission’s activities require assistance, coordination and cooperation from all levels of government. The NNRFCA sums up the situation clearly: ‘The Commission may on the basis of necessity, coordinate and cooperate’ with constitutional bodies, and the governments at the three levels.¹²⁸ The Ministry of Finance will have numerous engagements with the Commission, but may not send instructions; it may only ‘liaise’ with the Commission.¹²⁹ The need for cooperative arrangement with the Federal Parliament, the federal government and PLGs is emphasized by scholars; given the binding nature of the Commission’s recommendation, they may evoke contention which may be prevented through engagement.¹³⁰

7.2 INTERGOVERNMENTAL FISCAL COUNCIL

Apart from the principles of cooperative government articulated in the Constitution, a number of consultative forums are provided for. Of particular importance for fiscal federalism is the Intergovernmental Fiscal Council, composed of the finance heads of the federal government, provincial governments, and representatives from local government, and three financial experts.¹³¹ As intergovernmental relations forums are primarily

121 Constitution, article 251(f).

122 IGFAA, section 14(1).

123 See IGFAA, section 15.

124 See Constitution, articles 231 to 237.

125 IGFAA, sections 36(1) and (2).

126 IGFAA, sections 35(1).

127 IGFAA, sections 36(3).

128 NNRFCA, section 7.

129 NNRFCA, section 26.

130 Bahl et al. (2020), 24

131 IGRAA, section 33(1).



bodies comprising of government executives through which they can consult, negotiate, coordinate and cooperate in their fields of government, an independent institution, such as the Commission, is not an automatic member. As an expert body, not beholden to any government, there is no space for negotiating or making compromises. However, the Commission has important expertise that may inform the deliberations of the Council. The IGFAA thus makes provision that the Chairperson (or a representative) of the Commission may be invited to meetings of the Council.¹³² Attendance at such meetings may serve two purposes: the Commission may be informed about the concerns and needs of the three levels of government, and, in turn, may explain its economic and developmental approach.

7.3 DISPUTE RESOLUTION

The NNRFC Act mandates the Commission to play a further role in intergovernmental relations, namely, 'to facilitate and provide assistance necessary to resolve disputes' between the different governments where the conflict relates to the distribution of revenues.¹³³ This provision forms part of a general emphasis in cooperative government systems that governments should avoid litigation among themselves, but rather seek alternative ways in resolving disputes that would strengthen relations between the parties.

This mandate is executed on the basis of the Commission's expertise and knowledge of the intergovernmental fiscal system. Its facilitative role and assistance can take different forms including the following: First, the role can be that of an intermediary in negotiations between two governments, involving advice on an aspect of intergovernmental fiscal relations. Secondly, the Commission may be asked to be the facilitator in a conciliation process, where the facilitator is required to recommend a non-binding outcome or settlement. This task could be performed readily by the Commission on the basis of its expertise. Thirdly, it may also play the role of mediator or even arbiter. The Commission may thus play a constructive role in intergovernmental dispute settlement.

8. CONCLUSION

The Constitution gives the Commission a pivotal role in Nepal's intergovernmental fiscal system. In having to make recommendations and suggestions on the division of revenue raised nationally and a host of other fiscal matters, the Commission is also vital to the health, stability and well-functioning of Nepal's federal system. From a position of independence it can provide expert advice of how best scarce resources can be utilised by the three levels of government in the interest of the people. To fulfil its task successfully, the following factors may be mentioned:

First, to execute this huge responsibility, the Commission must be properly equipped for the task. It must have well-qualified and respected commissioners who can give the necessary guidance to the various governments. They, in turn, are dependent on a team of researchers who makes evidence-based policy making a reality. Critical, then, is the appointment of suitable commissioners and researchers. The success of the Commission will in the end depend on the quality of its work. Respect for the institution does not flow only

¹³² IGFAA, section 33(5).

¹³³ Section 3(1)(c).



from its constitutional status as an independent institution, but from the appreciation by all concerned of its wise, economically sound, compelling and coherent financial products that serve the interests of Nepal's people.

Secondly, and linked to the previous factor, an adequate budget is necessary to enable the Commission to do justice to its mandate. Underfunding the Commission compromises that; it will not be able to adduce evidence-based decisions.

Thirdly, there should be a clear understanding by all players concerned about the role and powers of the Commission. Governments at all three levels must support the fulfilment of its functions. In as much as federalism, and hence the new fiscal system, have fundamentally changed how Nepal is governed, state institutions must adapt accordingly.



ANNEXURE 1:

Allocation of functions and powers to the three levels of government

1. INTRODUCTION

The division of powers between the levels of government as set out in the Nepalese Constitution encompasses the following features. First, the Constitution establishes three levels of government – federal, provincial, and local – and entrenches each of their powers. This produces a higher level of complexity than what one will find in a two level federation. The listing of local government powers in the Nepali Constitution follows the trend set in Brazil (1988), India (1992), South Africa (1996) and Nigeria (1999), among others.

Secondly, use is made of a list of exclusive and concurrent subject areas (areas of competence). Nepal, however, is unique in providing for two separate concurrency lists – one between the federal government and provinces, and another between the federal government, provinces and local governments – which further complicates clarity in the division of powers. The two lists of concurrent powers emphasize the reality that the notion of dual federalism is no longer a viable option: in the modern age, subject matters cannot readily be divided in watertight compartments that clearly show who is responsible for what.

Thirdly, not only is there a great deal of overlap in the case of explicit use of concurrent lists, but also in the exclusive lists of powers of each level of government. Two or three levels of government have jurisdiction over some or other aspect of the same subject matter – overlaps. This makes determining the cut off points between exclusive powers a challenging task. Given that there are many areas of sharing in both exclusive and concurrent powers, the importance of strong and constructive intergovernmental relations is evident.

2. POWERS OF THE FEDERAL GOVERNMENT

The powers of the federal government (both legislative and executive) comprise exclusive, concurrent, and residual powers.¹³⁴ These powers are extensive and frame the exercise by provinces and local governments of their allocated powers.

2.1 EXCLUSIVE POWERS

The Constitution lists in schedule 5¹³⁵ the subject matters over which the federal government has exclusive powers. It is a long list of 35 items, covering a very wide range of subject matters, including the traditional ‘federal’ areas such as defence, foreign affairs, monetary policy and economic unity. It is important to note not only which matters are included in the list, but also which are not. For example, primary and secondary education is the exclusive power of local government and is thus not listed in schedule 5.

Schedule 5 does not give the federal government free range to do what it likes. In fact, many of the subject matters are qualified by words that would restrict the scope of federal

¹³⁴ Constitution, article 109.

¹³⁵ Constitution, article 57(1).



power. Important qualifiers are 'central' or 'national', and 'policy'. The qualifier 'central' means that only those matters that reach beyond the scope of the provinces and that can only be properly done by the federal government belongs to the latter. The subject matters so qualified include 'central police', 'central level mega projects for electricity, irrigation and other projects', 'central university', and 'central health policy'. The word 'national' is similar to central and it, too, suggests a matter that requires federal regulations, for example 'national forest policy'.

The other important qualifier is the word 'policy'. This means the provision of a framework for the exercise of power by the other levels of government. Such a policy can be reflected in legislation but such legislation should not regulate the matter in detail. As seen from the examples above, 'policy' is often combined with 'national' or 'central'. For example: 'Policies and criteria related to the protection and multi-dimensional use of water resources', 'central health policy', and 'national transport policy'.

2.2 CONCURRENT POWERS

Concurrent powers – the sharing of powers in respect of the same subject matters in the same geographical area – are an important feature of the division of powers in the Nepalese Constitution. It shares this feature with a number of federal constitutions world-wide. The German Basic Law provides for a concurrent list of federal and state powers. So does Canada (only three items), India, Brazil, and South Africa. Although the sharing of powers between all three levels of government is not in itself novel – as the Brazilian Constitution illustrates – what makes Nepal unique is that the Constitution includes a second list of concurrent powers, listing the subject matters that are shared by all three spheres.

2.2.1 CONCURRENCY WITH PROVINCES – SCHEDULE 7

The federal government shares power and jurisdiction with the provinces over 25 subject matters listed in schedule 7.¹³⁶ The range of matters is extensive; their content and nature are discussed below under provincial powers. It should, however, be noted that there is an automatic override in favour of the Federation should any provincial law on a schedule 7 matter conflict with a federal law.

2.2.2 CONCURRENCY WITH PROVINCES AND LOCAL GOVERNMENTS – SCHEDULE 9

The federal government also shares power and jurisdiction with the provinces and local government over subject matters list in schedule 9.¹³⁷ Although the list is shorter – only 15 items – it contains important matters, such as 'health', 'agriculture' and 'mines and minerals'. As in the case of schedule 7 subject matters, there is also an automatic override in favour of the Federation should any provincial or local law on a schedule 9 matter conflict with a federal law. The content and nature of the schedule 9 matters are discussed below under local government powers.

¹³⁶ Constitution, article 57(3).

¹³⁷ Constitution, article 57(5).



2.3 RESIDUAL POWERS

Where a federation is formed by devolution – a unitary state that devolves powers to subnational governments – powers that are not listed may be allocated to the federal government. In Nepal, the federal government has the power over all matters that are not listed in schedules, the so-called ‘residual powers’.¹³⁸ They refer to any matter that is neither mentioned in one of the five schedules nor in any other provision in the Constitution. Because the five schedules collectively provide a very comprehensive list of subject matters, the scope of the federal government’s residual powers is very limited.

2.4 OTHER POWERS

It is important to note that the Constitution also allocates to the federal government an additional number of detailed powers over specific matters that affect provinces and local government. For example, article 59(3) provides that a federal law will structure the budgets of both provinces and local governments. A federal law must also regulate the borrowing powers of provinces.¹³⁹ A very important federal power relates to the regulation of coordination between the three levels of government.¹⁴⁰

3. PROVINCIAL POWERS

From a comparative perspective, at the heart of any federal arrangement is the allocation of powers to subnational governments in a constitution. These powers must be substantive, not wholly subject to federal law, and entrenched. An insignificant set of powers, or powers on peripheral matters, would make the subnational governments a hollow shell. Likewise, if all subnational laws are subject to federal law, the result is also a federal sham. Finally, the powers must be constitutionally entrenched so that they cannot be diminished at the discretion of the central government.

On all three counts, the provinces of Nepal are indeed strong federal constituent units. They have exclusive powers with respect to a list of significant subject matters (schedule 6) as well as sharing powers with the federal government on a range of matters listed in schedule 7, and with both the federation and local governments on matters listed in schedule 9.

The allocation of powers to provinces is entrenched in article 57 and the schedules of the Constitution. Provincial powers cannot be unilaterally amended by central government; a change in both the boundaries and the powers of provinces must be effected by a constitutional amendment. In the case of their exclusive powers (schedule 6), it would appear that the provincial assemblies have to consent to an amendment bill, and further, that the bill giving effect to such a change must be ‘forwarded to the Provincial Assembly to garner consensus, within thirty days of the time the bill is presented to the federal legislature’.¹⁴¹ A provincial assembly can either endorse or reject the bill,¹⁴² and if the majority of the provinces rejected the bill, the bill is regarded as void.¹⁴³

138 Constitution, article 58.

139 Constitution, article 203(2).

140 Constitution, article 235.

141 Constitution, article 274(4).

142 Constitution, article 274(5).

143 Constitution, article 274(7).



3.1 EXCLUSIVE POWERS

Provinces have two types of exclusive powers: those listed in schedule 6, and those found in other provisions of the Constitution.

3.1.1 LISTED EXCLUSIVE POWERS – SCHEDULE 6

The subject matters over which provinces have exclusive powers are set out in schedule 6.¹⁴⁴ It contains a list of 21 subject matters over which the provinces have jurisdiction; they can legislate on and exercise executive government powers over these matters ‘in accordance with this Constitution and federal law’. The subject matters are of significance and they compare well with other federal countries. The key subject matters are:

- Policing, including an investigation bureau;
- Electronic media;
- Energy (electricity);
- Transport;
- Household services (including drinking water);
- Social services (including health service, higher education, libraries);
- Agriculture (including irrigation);
- Land management;
- Mining (‘exploration and management of mines’);
- Economy (including trade, factories, industrialisation, business, banks);
- Infrastructure (including highways);
- Environment;
- Culture (including museums); and
- Taxing powers.

Are these powers indeed exclusive? Although the words ‘exclusive powers’ are not used in the Constitution, the clear implication is that schedule 6, like schedule 5 which allocates powers to the federal government, indicates the exclusive use of power.

However, the question remains as to what is the meaning of the phrase that exercise of the provincial ‘exclusive’ powers must be done ‘in accordance with federal law’?¹⁴⁵ Given the scheme of the Constitution, this requirement means that the provincial laws must comply with federal laws that have validly been passed. Thus, where a federal power is restricted to providing a policy (and hence framework legislation) on a matter that the provinces have exclusive jurisdiction over, the federal law cannot provide the details. For example,

¹⁴⁴ Constitution, article 57(2).

¹⁴⁵ Constitution, article 57(2)



although provinces have the exclusive power over ‘provincial level university’, the exercise of such power must comply with federal law on ‘university standards and regulation’ in accordance with schedule 5.¹⁴⁶

The most important limitation with respect to exclusive provincial powers is that the scope of the power is qualified by the word ‘provincial’ before a subject matter. The same qualification is also expressed by adding it after a subject matter, for example, in ‘trade or business within the province’. Thus, a distinction is drawn in Table 1 between federal and provincial powers in the following areas, based on the distinction of ‘provincial’.

Table 1: Overlap between federal and provincial exclusive powers

| Federal power | Provincial power |
|---|--|
| Central police and investigation | Provincial police administration and Provincial investigation bureau |
| Central statistics | Provincial statistics |
| Central level mega projects on electricity, irrigation, etc | Provincial level electricity, irrigation projects, etc. |
| Central university | Provincial level university, etc |
| National ecology management, national forest policy | Management of national forests within the provinces |
| Federal civil service | Provincial civil service |
| National highways | Provincial highways |

The question then arises: when is a matter ‘provincial’ over which the federal government has no jurisdiction? This is a very common problem in federal constitutions which recognise that it is not possible to assign a subject matter neatly into watertight compartments; both the federal and provincial governments must be able to function in the same area, but in distinctive aspects of the area.

How should ‘provincial’ then be defined? The South African Constitutional Court has held that provincial exclusive powers apply primarily to matters which may appropriately be regulated intra-provincially.¹⁴⁷ Intra-provincial matters are concerned with activities that take place within or can be regulated in a manner that has a direct effect upon the inhabitants of the province alone. Thus, excluded from the provinces’ reach are matters with ‘a national dimension’. The same question arises even with provincial powers that are not qualified by the word ‘provincial’. An unqualified subject matter, such as ‘health service’, would also be confined to matters that do not have a national dimension.

146 Constitution, article 57(1).

147 Ex parte President of the Republic of South Africa: in re: Constitutionality of the Liquor Bill 2000 (1) BCLR 1 (CC).



A number of items in schedule 6 of the provincial powers are restricted to the 'management' of a particular subject matter, for example: 'land management'; 'management of mines'; and 'management of national forest, water resources and ecology within the province'. This would suggest provincial powers are restricted to executive action, excluding legislative measures.

This is not an unusual federal feature. In the model of so-called 'executive federalism', exemplified by the German federal system in particular, the power over a particular subject is divided, not according to the subject matter itself, but with respect to what the two levels of government may do in that area. Thus, in Germany, the federal legislature may pass legislation on a particular matter, but the implementation of such legislation (the management) is the prerogative of the sub-national governments (the Länder).

3.1.2 OTHER EXCLUSIVE POWERS

In the Constitution there are also other powers that are entrusted to the provinces. One example is that '[i]n addition to Nepali language, a province shall select one or more national languages that are spoken by majority of people in that province as the language of official business, as provided for by the provincial law'.¹⁴⁸

3.2 CONCURRENT POWERS

As noted above, there are two types of concurrent powers for provinces: those which they share with the federal government and those which they share with both the federal government and the local level.

3.2.1 CONCURRENCY WITH THE FEDERAL GOVERNMENT – SCHEDULE 7

There are a list of subject matters in schedule 7 that are 'concurrent' or 'shared' with the federal government which provinces must exercise 'in accordance with this constitution and the laws made by the Federal Parliament and Provincial Assembly'.¹⁴⁹

The subject matters listed in schedule 7 are far-ranging and bring many matters within the domain of provinces. The most notable subject matters are:

- Criminal and civil procedure;
- Civil law (including family law, contract, property, banking);
- Criminal justice (including preventive detention);
- Social protection (including price control, social security, poverty alleviation, employment, disaster management);
- Social services (including medicine, family planning);
- Environment (including biodiversity); and
- Economy (including industries, minerals, infrastructure, tourism).

¹⁴⁸ Constitution, article 7(2).

¹⁴⁹ Constitution, article 57(3).



In federal constitutions, when use is made of a list of concurrent powers, a conflict resolution mechanism is usually included should there be a conflict between a validly-passed federal law and a subnational law. The Constitution of Nepal is no exception in this regard. While the Constitution provides an explicit override clause with regard to conflicts that may arise when local governments make law which may be inconsistent with the national or provincial laws (the local law is invalid to the extent of the inconsistency),¹⁵⁰ no such override clause exists with regard to conflicts between a federal law and a provincial law dealing with a matter listed in schedule 7.

However, there is an *implicit* conflict resolution mechanism in the form of an automatic override in favour of the federal government. A province must exercise its powers with respect to schedule 7 in accordance with the laws 'made by the Federal Parliament and Provincial Assembly'.¹⁵¹ This means that if the Federal Parliament has made a law on a Schedule 7 matter, the Provincial Assembly must act in accordance with the federal law. If a federal law is passed after a provincial law already exists on a schedule 7 matter, the province (which includes the provincial executive) must exercise its powers in accordance with the federal law. If that law conflicts with the provincial law, the provincial executive must follow the federal law. The difference between this implicit override clause and that provided in article 57(6), is that the provincial law is not invalid; it merely becomes inoperative to the extent of the inconsistency. Once the inconsistency disappears (the federal law is repealed or amended), the provincial law becomes fully operative again.

As concurrent powers form such an important part of the division of powers, the aim is to prevent inconsistencies and conflicts from arising in the first place. In this regard constructive intergovernmental relations play an important role. This is also the point of departure of Nepal's Constitution. It makes specific provision that when the provincial executive exercises any of its powers on a concurrent subject matter, it must do so in 'coordination' with the federal government.¹⁵² However, such coordination does not require from the province the federal government's permission to exercise such power; it merely requires that a provincial executive must seek to co-ordinate its action in areas where they share power with the federal government.

3.2.2 CONCURRENCY WITH THE FEDERAL GOVERNMENT AND THE LOCAL LEVEL - SCHEDULE 9

The provinces share a further set of subject matters with the federal government and local governments listed in schedule 9, which must be exercised 'according to this constitution, and federal law, provincial law and laws formulated by the local level'.¹⁵³ Although there are only 15 items in schedule 9, they cover significant areas and often overlap with exclusive subject matters (schedule 6) and matters shared with the federal government (schedule 7). The details of the subject matters are discussed below under local powers. At this stage, it is important to note that there is an automatic override in favour of the federal government. Article 57(6) provides that a provincial law on these matters must be consistent with the federal law, and if not, the provincial law is invalid and void to the extent of the inconsistency.

150 Constitution, article 57(6) and (7).

151 Constitution, article 57(3).

152 Constitution, article 162(4).

153 Constitution, article 57(5).



4. LOCAL GOVERNMENT POWERS

As noted above, the Constitution of Nepal recognizes the importance of local government in its federal system and thus also entrenches its powers. Local government has both exclusive powers as well as powers with regard to subject matters they share with both the federal government and the provinces.

4.1 EXCLUSIVE POWERS – SCHEDULE 8

The local government level has power with regard to subject matters listed in schedule 8, which local governments must exercise 'according to this Constitution and Federal law, provincial law and laws formulated by the local level'.¹⁵⁴

The list of 22 items contains some very significant subject matters:

- Basic and secondary education;
- Basic health;
- Household services (drinking water, electricity, sanitation);
- Social protection (senior citizens and people with disabilities, disaster management);
- Infrastructure (including local roads);
- Distribution of land;
- Agriculture;
- Environment; and
- Taxing powers (property tax, etc).

Many of the subject matters are qualified by the word 'local'. The same approach to interpretation suggested with regard to 'provincial' matters could be followed here. 'Local' matters are concerned with activities that take place within, or can be regulated in a manner that has a direct effect upon the inhabitants of, the village or local government alone. Thus, excluded from the domain of local government are matters with 'a provincial dimension'.

How 'exclusive' are local powers? As noted above, local government must exercise these powers 'according to this Constitution and federal law, provincial law and laws formulated by the local level'.¹⁵⁵ The same approach to provincial exclusive powers should be followed here as well. Given the scheme of the Constitution, local laws must comply with federal and provincial laws that have validly been passed, that is, within the parameters set by the Constitution.

¹⁵⁴ Constitution, article 57(4).

¹⁵⁵ Constitution, article 57(4).



4.2 CONCURRENT POWERS – SCHEDULE 9

In addition to the ‘exclusive’ powers, local governments also share government with the federal government and provinces over a number of subject matters listed in schedule 9, which must be exercised ‘according to this constitution, and federal law, provincial law and laws formulated by the local level’,¹⁵⁶

Although there are only 15 items in schedule 9, they cover significant areas:

- Agriculture (including irrigation);
- Social services (including health);
- Social security and poverty alleviation (including ‘management of landless’);
- Household services (including drinking water, electricity);
- Mining (‘mines and minerals’);
- Economy (trade, factories, industrialisation, business, banks);
- Environment; and
- Revenue raising powers (including royalties received from natural resources).

It should be noted that because all three levels of government may exercise their powers with respect to these subject matters, no qualifiers or limits are added.

In respect of these subject matters, there is an automatic override in favour of the federal and provincial law. Article 57(6) provides that a local law on these matters must be consistent with the federal law, and if not, the local law is invalid and void to the extent of the inconsistency. The same test applies with respect to provincial laws.¹⁵⁷

5. INTERPRETIVE PROBLEMS

From a comparative perspective, the Constitution has produced a very complex system for the division of powers. The mere fact that there are five lists of subject matters (three exclusive and two concurrent) means that there are numerous overlaps between them, as shown in Table 2. For example, aspects of the subject matters of ‘mining/minerals’, ‘land’, and ‘health’ appear in four or five of the schedules:

¹⁵⁶ Constitution, article 57(5).

¹⁵⁷ Constitution, article 57(7).



Table 2: Overlapping exclusive and concurrent powers

| Government | Schedule | Subject matter: mining/minerals | Subject matter: land | Subject matter: health |
|--|------------|--|---|------------------------------------|
| Federation exclusive | Schedule 5 | 'mining and exploration' | 'land use policy' | 'central health policy' |
| Federation and provincial concurrent | Schedule 7 | 'industries and minerals and infrastructure' | 'land policy and related legal provisions' | 'medicines', 'medical professions' |
| Provincial exclusive | Schedule 6 | 'Exploration and management of mines' | 'land management, record-keeping of the land' | 'health service' |
| Federal, provincial and local concurrent | Schedule 9 | 'mines and minerals' | - | 'Health' |
| Local exclusive | Schedule 8 | Conservation of ... mines and minerals | 'Distribution of land' | 'basic health' |

In order to make this complex system work and avoid unnecessary conflicts, policy makers and courts can draw on some international experiences. The exclusive and concurrent powers each present their own challenges.

5.1 EXCLUSIVE POWERS

As exclusive powers are an important element of any federal system, a careful examination of each subject matter is required to see how best to dissect the various components, to allocate appropriate parts thereof to each level of government. The question is thus to determine the cut off points between the overlapping jurisdictions. In the case of local exclusive powers, the problem is that a subject matter listed in schedule 8 also appears on the lists of the federal and provincial exclusive lists. Thus, if the latter two governments exercise their powers in this subject matter, nothing could be left for local government.

This problem has been addressed by following a bottom up approach to interpreting the division of powers: first define the local government power and what remains falls in the jurisdiction of the provinces and federal government. Thus, in the field of 'health', first define the meaning of 'basic health'. What remains belongs to the province's part of 'health services'. Both provincial and local laws must, however, comply with 'central health policy' as expressed in legislation.

In this regard, the Federal Parliament has played an important role in determining the ambit of powers. The Local Government Operation Act, 2017, provides detailed definitions of the various local competences. However, it has been noted that there is still confusion in the LGOA and conflicts between the LGOA and other sector legislation.¹⁵⁸ Inconsistencies

¹⁵⁸ *Sajhedari Report* (2021) 4; Bahl et al. (2020) 11; Acharya (2018).



and gaps in the assignment of functions are found in the key areas such as education, health, agriculture, and infrastructure.¹⁵⁹ Many cut-off points would remain unresolved. In this regard, intergovernmental agreements concluded between different levels are a useful tool to provide some certainty. As a last resort, the courts may be approached to give clarity on specific issues.

5.2 CONCURRENT POWERS

In most countries where key subject matters are shared between the federal and subnational governments, federal legislation inevitably dominates the field. The biggest reason why this occurs is that the subnational governments do not produce their own legislation in the common areas, and thus, by default, the federal laws dominate. The failure to pass provincial and local laws is often ascribed to a lack of skill in preparing and drafting legislation. This comment has also been expressed with regard to Nepal's provincial and local governments, which is understandable given that they have been established only recently.

When provinces and local governments do get their acts together, coordination in the areas of common jurisdiction is very important. Productive intergovernmental relations are then of vital importance.

¹⁵⁹ Acharya et al. (2020) 2.



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