



**Graduate School of Development Studies**

**CAUSES AND CONSEQUENCE OF FISCAL  
IMBALANCE IN NEPAL**  
(The Case Study of Three Districts: Mugu, Gorkha and Rupandehi)

A Research Paper presented by:

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## **List of Acronyms**

ADB	Asian Development Bank
ADPR	Annual Development Progress Report
CBS	Central Bureau of Statistics
CG	Central Government
DAP	District Administration Plan
DASU	Decentralization Advisory Support Unit
DANIDA	Danish International Development Agency
DDC	District Development Committee
DDF	District Development Fund
DLGSP	Decentralized Local Self Governance Program
DTO	District Technical Office
FY	Fiscal Year
HDI	Human Development Index
INGO	International Non Governmental Organization
LAFC	Local Authorities Fiscal Commission
LB FAR	Local Body Financial Administration Regulation
LBFC	Local Body Fiscal Commission
LDO	Local Development Officer
LG	Local Government
LSGA	Local Self Government Act
LSGR	Local Self Government Regulation
MOF	Ministry of Finance
MLD	Ministry of Local Development
NDF	Nepal Development Forum
NGO	Non Governmental Organization
NPC	National Planning Commission
PRSP	Poverty Reduction Strategy Paper
Rs	Rupees
UNDP	United National Development Program
USSR	Union of Soviet Socialist Republics
VAT	Value Added Tax
VDC	Village Development Committee



## **Abstract**

This research paper examines the interrelationship between fiscal inequality and fiscal independence in context of Nepalese local self governing system. The key issues regarding the impact of fiscal imbalance on local self governance system are discussed in detail. The study revealed various factors that create the fiscal imbalance such as limited tax authorities, overlapped different types of overheads, capabilities of local government, low political willingness and other geo-political factors. Governmental procedures to overcome financial imbalances are analyzed. This paper looks at the consequence of intergovernmental fiscal transfer with conditional instruction on local self governance system. On the basis of concrete evidence, the study shows that how it helps to minimizing the fiscal gap and increases the local self reliance. It also establishes the important role of local self governance in decentralization process. At the end, the study recommends some policies to policy makers so that the fiscal decentralization process in Nepal would be more fruitful in the days to come.

## **Keywords**

[Fiscal Decentralization, Fiscal Imbalance, Intergovernmental Fiscal Transfer, Local Self Governance]

# Chapter I

## General Introduction

### 1.1 Background

During the last two decades of the twentieth century, the increasing trend of global political and economic development was epitomized by decentralization, particularly, in developing countries. This idea is supported by the fact that decentralization promotes participation of people, ensures their inclusion and involvement in decision making process directly or through representatives, mobilizes local resources and ensures effective service delivery cooperation (Davoodi, 2001; Smoke, 1993). Before the onset of globalization, the world was dominated by strong national governments, and regional governments tended to be either weak or non-existent. In the most countries throughout Europe, with the exceptions of Austria, Germany, Switzerland, and Yugoslavia, as well as in Africa and Asia, Central Governments (CGs) dominated during the post 2nd war era (Pose and Gill, 2002).

Today, however, many of these countries have adopted decentralization. While developed nations have done so through realization of the need to decentralize, donor pressure has been the most significant catalyst for Local Government (LG) reform and decentralization in developing countries. Under structural adjustment policies initiated during 1980s, CGs reduced the growth and scope of their activities and attempted to improve performance of the functions they retained (Smoke, 1993). It is tempting to speculate about common driving forces behind decentralization trends like administrative and fiscal decentralization in Latin America and China, political decentralization in transforming economies in the former USSR states, and deepened political decentralization giving more responsibilities to LG in India (Joachim *et al.*, 2000). In the context of research, a brief introduction to decentralization system in Nepal is in order.

Nepal is a rural dominated beautiful landlocked country lying on the lap of the Himalayas where '84% of population' (CBS, 2001) resides in the rural areas and suffers from acute poverty and lack of basic needs. Nepal lies in the heart of Asia between two giants: China and India. Geographically, it is divided into three ecological belts – *Terai* (Plain Land), Hill and Mountain. Nepal is a multilingual, multiethnic and multicultural country. The way of life and socioeconomic identities of the people are as diverse as the geographical variations. Administratively, there are '5 Development Regions, 14 Zones and 75 Districts' (CBS, 2001). In terms of development, current Human Development Report 2007/08 shows, the Human Development Index (HDI) of Nepal is 0.534, which gives the country a rank of 142 out of 177 countries in the World (UNDP, 2007). Regarding the

governance system of Nepal, it has flow unitary government structure. Central government has a parliamentary system where executive government is formed by the party with majority in legislature and LG formed by National Constitution. There are two tiers of LGs with 75 District Development Committees (DDCs) on top level in addition of 58 Municipalities and 3915 Village Development Committees (VDCs) in grassroots level also known as 'Local Bodies' (GoN, 1999). Legally, all three units of local bodies are independent of each other and enjoy autonomy. However, hierarchically, they are inter-related.

Following the world wide political and economic trends, the decentralization process in Nepal has been progressively changed in past decades. Historically, decentralization and local government system was always the area of interest among kings, politicians and administrators. After the People's Revolution of 1990, the constitution of Nepal 1990 made powerful provisions for decentralization. The Government of Nepal (GoN) formulated Local Self Government Act (LSGA) 1999 unifying separate Acts for each LG under the provision of constitution in 1999. The spirit of LSGA calls for comprehensive transferring of central decision making power and implementing authority on local level development activities to the local bodies (NDF, 2002). It has accepted local bodies as self-governing and corporative thus providing them with rights to impose taxes, plan their needs, implement plans and programmes and manage natural resources. Local Self Governance Regulation (LSGR), 1999 and Local Body Financial Administration Regulation (LBFAR), 1999 are in practice for determining the process of the functions of local bodies (GoN, 1999).

During the 90s, fiscal decentralization and local government reforms were among the most widespread trends in development (Smoke, 2001). Many developing countries had a mandate to decentralize revenue collection and spending decisions. This was seen as a way to improve the efficiency of the public sector, cut the budget deficit, and promote economic growth as aspects of fiscal decentralization (Zhang and Zou, 1998). Changing political climates encouraged the development of LGs and fiscal decentralization in developing countries (Smoke, 2001). After the shifting political scenario in Nepal at 1990, the government adopted fiscal decentralization policy. Consequently, LG has responsibility of basic service delivery at local level as well as to devolve the revenue collection authorities which help to make local self governance system.

However, the process has been deficient due to failure of LG to address local need. This is, in most, due to the fact that local bodies are not as autonomous in practice as they are in law. Many a time, LGs rely heavily on central funding and this effectively destroys the autonomy of LGs due to interference of central direction which does not necessarily

address the local issues. Regarding, the purpose of this paper is to assess the relation between fiscal gap and LG autonomy that has the impact on local self governance system in Nepal.

## 1.2 Indication of Problem

After the enactment of Local Self-Governance Act and Regulation 1999, Nepal has systematized the process of decentralization which is a pertinent issue of local development. Recently, the Interim Constitution of Nepal 2007 has directed clear-cut demarcation of expenditure assignment of central and local government and revenue sharing for balanced development and upliftment of disadvantaged communities (GoN, 2007). Local Bodies Fiscal Administration Regulation, 1999 states that LG can mobilize resources from different sources and manage distribution of resource endowments as well as diversity of the level of socio-economic infrastructural development.

Similarly, LSGA 1999 has a provision of expenditure allocation between the CG and LG. DDC as a LG have 16 types (like, relating to physical development, relating to water resources, environment and sanitation, forest and environment, etc) of expenditure responsibilities which include almost all public services. However, there is no sufficient revenue to accomplish the expenditure responsibility which results into a mismatch between expenditure needs and revenue collection creating vertical as well as horizontal fiscal imbalance.

**Table No 1.1**

**The Ratio between Income and Expenditure of Two Districts (FY 2005/06)** (Rs in Thousands)<sup>1</sup>

District	Area (Sq. Km)	Population	Total Budget (B)	Internal Income (I)	External Support (E)	Ratio Between Expenditure <sup>2</sup> and Income (B: I)	% of Grant Contribution on Total Budget (I/B*100)
Mugu	3,535	31,465	103,859	1,092	102,767	1:0.01	98
Rupandehi	1,160	708,419	250,861	139,891	110,970	1:0.55	44

Source: DDCs, Mugu and Rupandehi, Annual Development Progress Report (ADPR) FY 2005/06 and CBS, 2001

Table 1.1 tabulates annual budgets of two Districts: 1) Mugu - a remote and financially weak District and 2) Rupandehi- relatively prosperous district with significant internal resources. Annual total budget (expenditure) of Mugu for FY 2005/06 was Rs 103,859 thousand which has Rs 1,092 thousand (1.05%) came from internal revenue while the rest of the amount Rs 102,767 thousand (98.95%) came from the CG. The ratio between expenditure and income is 1:0.01. It is called vertical fiscal imbalance. To fulfill these deficits, budget comes from CG increasing dependency on CG transfer and guidelines. In Mugu

<sup>1</sup>Rs 104= Euro 1 (Rate on 14<sup>th</sup> Sep. 2008)

<sup>2</sup> Total Budget=Total Expenditure

district, 98% of the total budgets come from CG transfer. These funds are guided by centrally mandated services in the area of socio-economic infrastructure development sector. This weakens the LG with regards to its autonomy in areas like changing budgets and implementing various programs.

On the other hand, there is increasing horizontal fiscal imbalance between inter-regional and local level bodies. Table 1.1 clearly shows a huge regional inequality between Mugu and Rupandehi. The difference of budget volume between Rupandehi and Mugu districts is massive with budget of Rs 250,861 thousand and Rs 103,859 thousand respectively while the regional inequality ratio is 1:0.41<sup>3</sup>. Similarly, per capita grant<sup>4</sup> for Mugu (Rs 3,266) is higher than Rupandehi (Rs157) in contrast, grant per square area<sup>5</sup> of Rupandehi (Rs96, 664 /Km<sup>2</sup>) is higher than Gorkha (Rs39, 369/Km<sup>2</sup>). Thus, Equitable sharing of central governmental grants and revenues are the important tools for the fulfillment of regional fiscal gaps. Although the main motto of decentralization is to build autonomy of LGs, more dependency on central resources affect their decision making authority.

Thus, due to vertical as well as horizontal fiscal imbalance and low capacity of LGs' financial management, the question arises on the fiscal autonomy of LG. The increasing influence of CG through intergovernmental fiscal transfer creates more dependencies of LGs on CG which affects the local self governance.

### 1.3 Research Objectives

The objectives of this study are:

- To analyze the cause of fiscal gap between expenditure and revenue in LG.
- To examine the role and relevance of intergovernmental fiscal transfer to fill fiscal gap.
- To evaluate the consequence of inadequate fiscal autonomy of LGs.

### 1.4 Research Questions

#### **How does fiscal imbalance influence local self governance in Nepal?**

1. What are the causes of imbalance between LG expenditure and revenue?
2. How do intergovernmental fiscal transfers contribute to reducing or worsening fiscal inequality between districts and regions?
3. To what extent do intergovernmental transfers create dependency of LG on CG?
4. What are the consequences of inadequate fiscal autonomy of local self governments?

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<sup>3</sup>  $103859/250661 = 0.41$

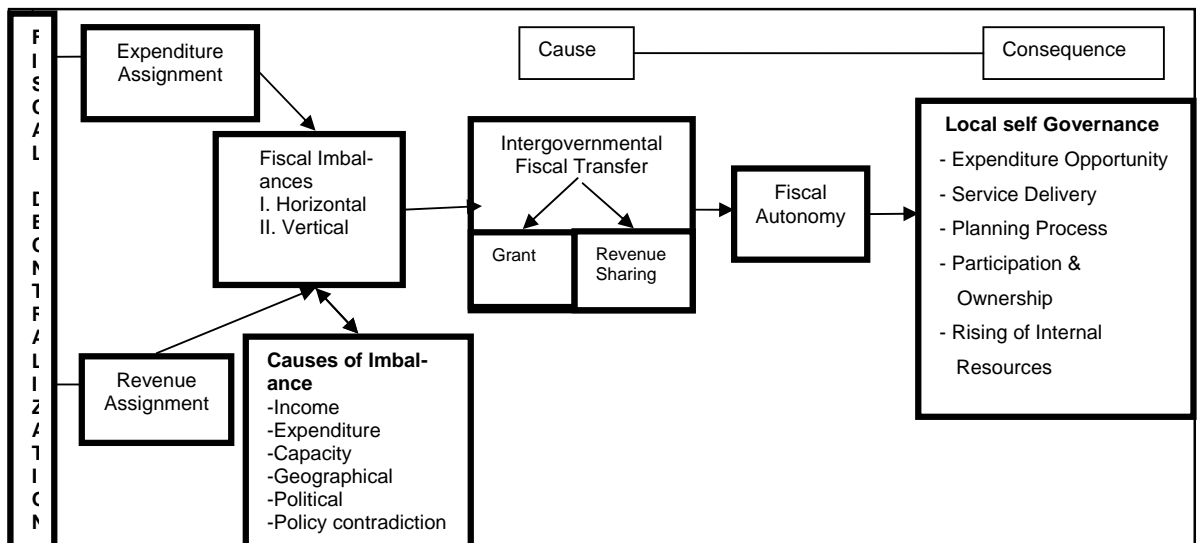
<sup>4</sup> Total Grants/Number of Population

<sup>5</sup> Total Grants/Total Area

## 1.5 Operationalization of the Research

There are two fundamental components of fiscal decentralization, expenditure assignment and revenue assignment. The mismatch between expenditure and revenue creates fiscal imbalance in local level including horizontal and vertical imbalances. To overcome fiscal gaps and build fiscal harmonization CG extends monetary to LGs with conditional guideline creating fiscal dependency. Though LG is an autonomous institution, the CG always wants to influence on LGs autonomy through different regulations and directions. Consequently, dependence of LG on CG weakens its fiscal autonomy and impact on local self governance. Figure 1.1 illustrates relationship between fiscal imbalance and fiscal autonomy with consequence of local self governance system which is the foundation of this research.

**Figure No 1.1**  
**Analytical Framework for the Research**



Source: Base on Conceptual Review of This Study

## 1.6 Methodology

This research applied both qualitative and quantitative approaches. Qualitative techniques are used to obtain an in-depth understanding of a topic in a particular context. Similarly, quantitative techniques are used to test statistical relationship between problems and their cause with the intent of providing evidence of existence of certain problems and to establish clear baseline information (Biekart and Schiphorst, 2008: Class Note-3101). I used sampling method for selection of three districts based on population, geographical location, internal revenue and size of total budget for comparative analysis of small component. These three districts are: 1. Rupandehi 2.Gorkha and 3.Mugu. They have different

economic status, internal revenue and capacity and represent high, median and lower district from three different geographical belts- *Terai* (Plain area), Hill and Mountain respectively (Map in Appendix I). I also used random sampling method for selection of respondents. I applied coefficient method to calculate vertical imbalance and comparative analysis of selected districts to calculate horizontal imbalances.

### ***1.6.1 Source of Data and Analysis***

This study was based on primary as well as secondary data. Primary data was collected using semi-structured questionnaires and interviews with LG officials, central level officers, member of Local Body Fiscal Commission (LBFC) and other related stakeholders. On the other hand, secondary data was taken from published government and fiscal commission reports, revenue and expenditure figures, LG's annual progress report, account books, grant distributions criteria and figures. Besides this, current information was obtained from websites of National Planning Commission (NPC), Ministry of Finance (MOF), Ministry of Local Development (MLD) and other related agencies' websites. To find the entire object of this research, I used some measurement indicators and approaches for information collection and analysis (Detail Indicators in Appendix II).

### **1.7 Limitations of the Study**

Decentralization includes the transfer of fiscal, political and administrative responsibilities to lower levels of government that are essential for promoting local self governance system. My study was primarily focused on fiscal decentralization and its relation with other forms of decentralization. It is to be noted that fiscal decentralization is not the sole requirement of local self governance. However, there is an important factor to determine the local autonomy. Due to financial and time constraints, my study was concentrated on the selected 3 DDCs out of 75 DDCs. Besides, I was only concentrating on DDCs even though LGs comprise of Municipalities and Village Development Committees as well. Due to poor database system of Nepal, my data analysis was based on data from FY 2002/03 up to 2006/07 using simple analytical tools.

### **1.8 Organization of the Paper**

The structure of the paper is as follow. Chapter 2 starts with the definition of decentralization, fiscal decentralization and fiscal imbalance with overview of decentralization and local self governance in Nepal. Chapter 3 critically examines the degree of fiscal inequality including vertical and horizontal. In addition, it focuses on the analysis of fiscal im-

balance on revenue, expenditure, capacity, political, legal, geographical as well as socio economic aspects. Chapter 4 looks at the provision of intergovernmental fiscal transfer including grant and revenue sharing to fulfill those imbalances and its impact on local self governance in Nepal. The final section draws conclusion on the study and recommends some policy implications.



## Chapter II

### Conceptual Framework: Fiscal Decentralization in Nepal

#### 2.1 Decentralization

Tautologically speaking, decentralization is an alternative to centralization (Cohen and Peterson, 1996). However, it is an evasive concept and therefore is no one set definition of decentralization. Most of the definitions used in present colloquia are rather narrow or altogether vague. Some like, 'transfer of planning, decision-making, or administrative authority from the central government to its field organisations, local administrative units, semi-autonomous and parastatal organisations, LGs or NGOs' (Rondinelli and Cheema, 1983: 18) focus on authority and responsibility but do not mention anything about resources which renders the definition incomplete. One satisfactory and accepted definition of decentralization by Falleti expresses that the transfer of authority, resources and responsibilities from central level to grass root level unit (Falleti, 2005) that means breaking down of centralized bureaucratic monopoly and making local institutions more autonomous and capable.

In modern days, decentralization has become a worldwide phenomenon. Developing countries are turning to decentralization to escape from the traps of ineffective and inefficient governance, micro economic instability and inadequate economic growth (Bird & Vaillancourt, 1999). Thus, it is utilized as a tool for public sector reform (Cohen and Peterson, 1996).

Basically, decentralization can be defined in three ways. (i) De-concentration which 'involves the shifting of workload from CG ministry headquarters to staff located in offices outside of the national capital' (Rondinelli *et al.*, 1986:76). (ii) Delegation which 'refers to a situation in which the CG transfers responsibility for decision-making and administration of public functions to LGs or semi-autonomous organizations that are not wholly controlled by the CG but are ultimately accountable to it' (Litvack, *et al.*, 1998: 4). (iii) Devolution which is 'a more extensive form of decentralization refers to a situation in which the CG transfers authority for decision-making, finance, and management to quasi-autonomous units of LG' (Litvack, *et al.*, 1998:6). Devolution assumes full autonomy of the LG where central authority exercises only certain tasks which are not possible to devolve in local level.

Decentralization is an effective way of governance and yet it demands caution in its implementation. According to the World Bank, there are some criticisms of decentraliza-

tion like sometimes decentralization may lead to loss of CG's control over scarce or sensitive natural resources which can ultimately lead to natural or political unrest. At other times, if decentralization is implemented prematurely then efficient and effective utilization of financial, human and other various resources is not guaranteed due to the limited capacity of LGs. Similarly, transferring executive administrative power to local level without adequate financial provision may affect public service output. Moreover, implementation of decentralization without preparation may lead to exploitation of power by local elite or conflict between public and private sector thus undermining cooperation at the local level (Brillantes and Cuachon, 2002).

Nepal has been exercising decentralization in various forms at various periods. Between 1846 and 1949, the *Rana* oligarchy ruled the country. *Rana* Prime Ministers virtually monopolized all the posts and political power and even neutralized the power of the King. In the absence of constitutionalism, a system of patrimony dominated the entire governance process (Dahal *et al.*, 2001). In 1951, the anti-*Rana* movement launched by political forces in the country overthrew the regime and introduced multi-party democracy which opened a window of opportunity for decentralization. Firstly, the interim constitution 1951 contained a brief provision for LG (Shrestha, 2002).

In the *Panchayat* regime<sup>6</sup> (1962-1990) several conceptual innovations were made toward decentralizing resources and authority. The Decentralization Plan 1965, District Administration Plan 1975, Integrated Panchayat Development Plan 1978, Decentralization Act 1982, and Decentralization Working Procedure Rules 1984 had formulated an extensive framework for decentralized planning and local governance (Dahal *et al.*, 2001). Panchayat had played the crucial role at local level for establishment of LG institutions where country was divided in to four tiers National, Zonal, District and Village (Shrestha, 2002). In that sense, decentralization under Panchayat appears to be the hybridization of de-concentration and delegation of administrative power and authorities rather than a true devolution (Dahal *et al.*, 2001). District Administration Plan (DAP) was introduced which aimed at consolidating the model of unified district administrative system. After this plan, all district level offices were kept under the branch of District Administrative Office (Shrestha, 2002).

In true essence, Nepal moved towards political decentralization only after the People's Revolution of 1990 restored democracy. The Constitution of Nepal 1990 made powerful provisions for decentralization (Dahal *et al.*, 2001:24). Its directive principles clearly

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<sup>6</sup> Political period before democracy in 1990

stressed on decentralization. Since then, the country has had several attempts at decentralization in various forms from delegation to de-concentration to devolution. As a developing country, the socio-economic and political situation of Nepal was greatly affected by changing global scenario. Consequently, globalization impacted every sphere of the country. Nepal has adopted liberal and market oriented policies which are clearly mentioned in 8<sup>th</sup> five year plan (1992-1997).

In 1995, based on the recommendation of the High Level Decentralization Coordination Committee formed under the chairpersonship of the Prime Minister in 1996, the constitutionally provisioned LSGA was enacted in 1999 (NDF, 2002). The Act provided the foundation for local self governance system in Nepal. To translate the spirit of the Act into practice, succeeding governments made efforts of varying magnitudes. It statutorily recognized the role of the local self governance and devolution of power by making LG more responsive and accountable to the people (Byanju, 2003). This Act was a very important step towards the promotion of decentralization practices in Nepal. It has been considered a landmark legislation as it is the first attempt at increasing the administrative, fiscal and judicial powers transferred to the local bodies.

Now, Government of Nepal is going to conduct peace building and state reform process (including local governance) with execution through the new Interim Constitution of Nepal 2007. It has directed us towards progressive restructuring of the nation in an inclusive and democratic federal system of governance<sup>7</sup>. The current Interim Three Year Plan (2007-2010) has clearly mentioned decentralization and devolution with long term vision of 'local bodies being restructured according to the concept of inclusion, democracy and federal government system will be capable as the LG to effectively deliver the services' (NPC, 2007:462).

## **2.2 Types of Decentralization**

The sequencing of different types of decentralization (fiscal, administrative, and political) is a key determinant of the evolution of intergovernmental balance of power (Falletti, 2005) and fourth one is market decentralization (Brillantes and Cuachon, 2002). Nepal has experienced different forms of decentralization, ranging from delegation to de-concentration and, eventually, to devolution as envisioned in the Local Self Governance Act, 1999 (LBFC, 2004). To analysis the trend in Nepal, we can say that most of the prac-

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<sup>7</sup> Likewise, the structure of local bodies (local government) will be based on decentralization and devolution that will lead in the direction of institutional development of democracy from the grass root level. (Interim Constitution of Nepal, 2007)

tices of decentralization are administrative purpose with the view of transferring authority from CG to the local level.

### ***2.2.1 Administrative Decentralization***

Administrative decentralization is the transfer of the administration and delivery of social services such as education, health, social welfare, and housing to LG (Falleti, 2005). Related to the Falleti argument, practice of administrative decentralization in Nepal is epitomized by establishment of DDCs which has been playing important role as focal institution of decentralized planning and coordination at the district level. These local self-government bodies have become 'prominent in implementation aspect of local development efforts where the people's representatives are involved in policy making, planning and prioritization of development needs' (LBFC,2004).The overall administrative system, current practices, staffing arrangements and accountability features have to be shifted from their central orientation to the local level. Therefore, there has been resistance, particularly from technical line ministries, to opening of sectoral units under the DDC umbrella (NDF, 2002).

### ***2.2.2 Political Decentralization***

Political decentralization is a 'transfer of decision-making power to lower-level governmental units or to citizens or their elected representatives' (Cohen and Peterson, 1996:10). It constitutes the set of constitutional amendments and electoral reforms designed to open new or activate existing but dormant or ineffective spaces for the representation of sub-national polities (Falleti, 2005). The basic objectives of political decentralization are to increase the efficiency of local political units, citizen representation and participation in decision-making and their freedom of choice in the process of deciding the matter of their primary concern (Dahal *et al.*, 2001).Political decentralization policies are designed to devolve political authority or electoral capacities to sub-national actors (Falleti,2005).

In Nepal, after implementation of LSGA 1999, political decentralization was implemented which institutionalized the process of development by enhancing the participation of all the people including ethnic communities, indigenous people (GoN, 1999). The LSGA has fundamentally transferred comprehensive central decision-making power and resources to the local level through the process of devolution (NDF, 2002). Under the provision of LSGA, Government of Nepal has decided the 14 district as a full devolution

districts on the basis of geographical area, easy access, resource base, institutional capability, level of infrastructure development in the fiscal year 2004/05 (MLD,2006a).

### ***2.2.3 Market Decentralization***

After end of the cold world, the application of neoclassical and neo-liberal theories in policy had lead to market decentralization (Schoorman, 1997). Market decentralization is the passing over the private sector of the functions exclusively performed by government that is implemented by privatization in which government and private sector cooperate to provide the public service i.e. contracting out, public-private partnership. It is also established by deregulation that diminishes the legal rule of the provided public sector (Brillantes and cuachon, 2002). The key components of market decentralization common today in the developing countries like Nepal are: privatization, denationalization, deregulation and de-bureaucraization. Each of these components is intended to promote macro-economic stabilization by reducing the size of government, budget deficits and subsidies (Dahal *et al.*, 2001).

### ***2.2.4 Fiscal Decentralization***

Fiscal decentralization has been the major agenda for strengthening of LG where fiscal decentralization refers to the 'set of policies designed to increase the revenues or fiscal autonomy of sub-national governments' (Falleti, 2005:329). Fiscal decentralization is a core component of decentralization. Central government while devolving greater expenditure and revenue responsibilities to LG are also hoping to improve economic efficiency, service delivery and accountability in LG (Kelly, 1998). Boex argues that 'Fiscal decentralization is the assignment of fiscal decision making power and the management responsibilities to lower level of government' (Boex, 2004:2). It assumes that LG should have a certain degree of fiscal autonomy which helps to decide their expenditure priorities. Thus, fiscal decentralization is transfer funds that was need to deliver decentralized functions and transfer power and authority to collect revenue in local area from CG to LG and also transferred power to LG the authority to decide expenditures (Brillantes and cuachon, 2002).

Due to donor pressure and changing economic pattern, Nepal has been applying fiscal decentralization policy since 1999. Consequently, LGs were handed responsibility of basic service delivery. The devolution of revenue collection authorities was also implemented. The LSGA, 1999 and LBFAR, 1999 state that local self-governance units can mobilize resources from different sources: intergovernmental transfer, internal resources and loans, revenues sharing from CG, taxes and donation taken from various funding agencies.

Grant system and revenue sharing are the major practices in intergovernmental fiscal transfers which help to compensate for fiscal imbalance. In institutional mechanism, the District Development Fund (DDF) has been institutionalized to track all the income sources of the DDC that work as a treasury of the district (LBFC, 2004) which thus becomes one door financial system.

Local Body Finance Commission (LBFC) is a separate autonomous body with mandate to provide independent views on local body financial requirements, local level resource mobilization and budget. It comprises of independent experts representing all stakeholders, who could provide objective analysis and unbiased policy alternatives to all stakeholders for the improvement of the grant as well as overall system of fiscal decentralization in Nepal (Shrestha, 2004).

However, Kee point out some critique of fiscal decentralization like taxpayers may have insufficient information or no political power to pressure local policy makers to make resource-efficient decisions. Local politicians may be more corrupt than national politicians. Furthermore, the quality of national bureaucracies is likely to be better than local bureaucracies since they have better access to human and other resources. Besides, due to limited capacity, local governments often lack good public expenditure management systems to assist them in their tax and budget choices (Kee, 2003). Similarly, Smith argues that decentralization provides power and resources to local elites instead of guaranteeing political equality (Smith, 1995).

## **2.3 Forms of Fiscal Decentralization**

There are four major components or principles of fiscal decentralization which include expenditure assignment-allocation of responsibility for public goods and services among governments and actors, revenue assignment-allocation of various taxes among different level of government, intergovernmental fiscal transfer- transfer system among different level of government and lastly, fiscal regulation-CG regulation of LG fiscal behavior ( Awortwi, 2008:Class Note -4107). All components of Fiscal decentralization, except fiscal regulation, have been discussed separately below as the essence of fiscal regulation is encompassed in other three components.

### ***2.3.1 Expenditure Assignment***

Three important economic functions of government include stabilization, distribution and allocation function (Musgrave and Musgrave, 1984) where ‘allocation and stabilization functions are more important than the redistribution function’ (Helmsing, 1997: 15).

Local governments have public mandate which provides local public goods and service effectively than the CG. Expenditure responsibility is often broken down into the responsibility to provide, finance and regulate a certain government function in a different level of government (Boex, 2004). So, Helmsing argue that the delivery of certain public good or service is not the responsibility for particular types of government but becomes dependent on the delivery of components by various layers of government (Helmsing, 1997).

Actual assignments often broadly correspond to the principle of subsidiarity (Norris, 2006) which refers to ‘responsibilities for the provision of goods and services should take place at the lower level of government that can effectively deliver the goods and services’ (Vazquez, 2004: 5). Assignment of expenditure responsibilities has been a common problem in the decentralization reform of many developing countries like Nepal over the past decade. Expenditure assignment is the first step in designing intergovernmental fiscal system. Designing revenue and transfer components of a decentralized intergovernmental fiscal system in the absence of concrete expenditure responsibilities would weaken decentralization process (Martinez and Vazquez, 2001).

### ***2.3.2 Revenue Assignment***

Revenue is necessary for LG to provide public goods and services. Revenue assignment authority to local bodies enabling them to raise taxes on their own is in itself a separate dimension of fiscal decentralization. An important determinant of the assignment of revenue source to sub national government is the assignment of expenditure responsibilities (Boex, 2004). Charles and McLure (2001) explain that a variety of methods of assigning revenue to LGs can be distinguished which differ in the degree of fiscal autonomy. It is convenient to distinguish four features like, which level of government chooses the taxes from which LG receive revenues; which define the tax base; which sets the tax rate; which administers the tax from the view point of LG fiscal sovereignty (Charles and McLure, 2001). However, the lack of clearly defined, stable and uniform revenue assignments between the centre and local governments created perverse incentives for LGs to either hide locally mobilized revenue sources in extra budgetary funds (Norris, 2006).

### ***2.3.3 Intergovernmental Fiscal Transfer***

Intergovernmental transfer is commonly understood as a transfer from CG to LGs. A sound system of intergovernmental fiscal transfers is a pre-condition for strong and stable decentralization process (Boex *et al.*, 2004). The objectives of the intergovernmental transfer system are: correcting or adjusting vertical imbalances, compensating LGs for

complying with CG requirements or implementing CG programs that are delegated to the LGs, correcting or adjusting horizontal imbalances, correcting or adjusting externalities with public goods provision, ensuring efficiency in LG taxation, benefit spillover compensation, ensuring minimum standards of public services, fulfilling the government's redistributive function and providing CG with adequate flexibility to pursue macroeconomic stabilization policy (Steffensen,2005; Shah,1994). Inter governmental transfer depends both on the assignment of expenditure responsibilities as well as the chosen revenue assignment (Vazquez, 2004).

The design of intergovernmental transfers is particularly important for the social sectors, where CGs maintain a strong interest in certain expenditures and outcomes (Litvack *et al.*, 1998). However, a transfer system should preserve budget autonomy at the sub-national level within the constraints provided by national priorities. Within such constraints, LG authorities need to retain the power to determine their own budgets as well as transfers are also often used simply to assure CG control over LG activities through grant conditions (UNDP, 2005).

## **2.4 Vertical Fiscal Imbalance**

Vertical fiscal balance exists when there is inappropriateness between the expenditure responsibilities assigned to each level of government and the fiscal resources available to them to carry out those responsibilities (Boex *et al.*, 2004). Two major approaches to measure vertical imbalance are: the existence of persistence budget deficit at a particular level of government and the extent to which the different levels of government are able to finance expenditures from their own sources of revenues (Shrestha, 2004). Ebel and Yilmaz clearly mention that vertical imbalance occurs when the expenditure responsibilities of sub national governments do not match with their revenue rising power (Ebel and Yilmaz, 2002). The most common source of vertical imbalance is the lack of revenue autonomy at the subnational level including the perception of the central authorities that most significant taxes should be centrally managed (Vazquez, 2004).

## **2.5 Horizontal Fiscal Imbalance**

Horizontal imbalance arises when there is no broad correspondence between expenditure responsibilities and fiscal capacity across LG to meet the responsibilities. Unreliable fiscal capacity is the result of existing fiscal disparities across jurisdiction (Shrestha, 2004). Commonly, LGs have different tax capacity because they have different economic base.



Horizontal fiscal imbalance can also be attributed to difference in regional and local expenditure needs and variations in the ability of regional and LG to raise their own revenues (Vazquez, 2004).

## **2.6 Fiscal Autonomy**

Most government expenditures and revenues throughout the developing world tend to be under CG control. The general pre condition of fiscal decentralization is providing the fiscal autonomy to LGs, especially in setting tax rates allows LGs to increase local revenues to finance higher levels of services to match the tastes and references of their constituencies (Kelly, 1999). Fiscal autonomy is part of the institutional arrangements which are responsibility and revenue assignment in the different levels of government operations. A common way to compare and assess fiscal autonomy is the extent to which resources and responsibilities are under the control of local and regional government (Blochliger, 2006). Thus, increased fiscal autonomy can also be instrumental in mobilizing more revenue from local sources, which helps to improve a country's overall fiscal position (Shah, 2006).

## **2.7 Local Autonomy and Local Self Governance in Nepal**

The impersonality of local bodies in goods and service delivery can only be achieved when its autonomy is no longer compromised by either central control or captured by local elites (Dahal *et al.*, 2001). Shrestha argues that the autonomy of LG is ineffective unless they get budgetary autonomy (Shrestha, 2002). Bardhan and Mookherjee confer that service delivery at local level is more effective and efficient if there is no central control or capture by local elites (Bardhan *et al.*, 2006). Autonomy is a key element of self-governance which consists of administrative, political and financial autonomy to the local bodies to realize the local self governance in the real sense (Dahal *et al.*, 2001). Related to this argument, the Government of Nepal formulated LSGA, 1999 to make local self governance system. Principles and policies for the development of local self-governance systems are;

*“Devolution of such powers, responsibilities, and means and resources as are required to make the Local Bodies capable and efficient in local self-governance. (b) Building and development of institutional mechanism and functional structure in Local Bodies capable of considering for local people and bearing responsibilities. (c) Devolution of powers to collect and mobilize such means and resources as are required to discharge the functions, duties, responsibility and accountability conferred to the Local Bodies”*  
(GoN, 1999:2)

Local Self Government Act, 1999/section 177 on LG institutions clearly specifies its autonomy as ‘perpetually succeeding self-governing organized entities with separate seal, enjoying the right to acquire, use, dispose and sell off movable and immovable property and, like an individual, sue and be sued in its own name in the court’ (GoN, 1999:66). Similarly, LSGA ensures that the LGs have certain power to make bylaws, collect revenue carry out spending and recruit staffs which make them autonomous legal status. However, the CG still holds some powers to maintain integrity, stability and smooth functioning of overall administration of the country by using section 238<sup>8</sup>.

The LGs do not require budget and program approval from the CG because all local bodies have councils which are the highest legitimate body to approve the program and budget of the LGs. They also function as legislatives (Shrestha, 2002). LSGR, 1999 and LBFAR, 1999 are in practice in order to determine the process of the functions of local bodies (GoN, 1999). They have full discretion on the preparation of program and budget from their internal resources within the broad national policy. The LGs are also autonomous to hire staff other than secretaries from their own funds as approved by respective councils. They are even free to use private consulting firms or individual for specific work (Shrestha, 2002).

Similarly, planning is a tool to ensure the local autonomy and enhance the quality of policy decisions in improving the living standards of the people (Dahal *et al.*, 2001). The LSGA required the LGs to plan through a participatory bottom up planning process which is especially designed from the grassroots level. There are a number of tasks involved in planning process including identification, prioritization, resources estimation and feasibility study. In practice, the 14 steps of planning process developed by United National Development Program (UNDP) has been applied in all level of LGs which starts from settlement level to VDC level to district level. These steps should be included on the provision of LSGA section 195 for ensuring local autonomy and sustainability.

On the other hand, people's participation in governance and development represents an articulate admission of people's power, their ability to be involved in decision making and willingness to accept the payoffs of such acquisition of power (Dahal *et al.*, 2001). The major aims of LSGA for institutionalizing the process of development by enhancing the participation of all the people (GoN, 1999) which ensure the autonomy of local govern-

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<sup>8</sup> Power to Suspend and Dissolve : Government of Nepal has adequate ground of the fact that any Local Body has committed any of the following acts, it may, by stating such reasons in the notice published in the Nepal Gazette, suspend such Local Body(GoN,1999;238)

ance. Thus, the Act takes people's participation as both a means and an end which has been severely constrained by growing poverty, inequality, dependency, isolation, social contradiction and gender biases (Dahal *et al.*, 2001).

## Chapter III

### Fiscal Imbalance and Its Causes

As core chapter of the research, it is organized in two parts: fiscal imbalance including both vertical and horizontal, and causes of these imbalances. This chapter primarily focuses on revenue assignment, expenditure assignment and capacity of local bodies. It also explores political, legal, geographical as well as socio- economic aspect of fiscal imbalance.

#### 3.1 Fiscal Imbalance

Fiscal imbalances between resources and expenditure needs of local bodies occur in two forms: vertical and horizontal imbalance.

##### 3.1.1 Vertical Fiscal Imbalance

In this study, it was found that DDCs in Nepal have low revenue autonomy which does not typically match the expenditure assignment thus creating vertical imbalances. It is measured by using the coefficient method developed by Hunter.

#### Box No 3.1

##### Measurement of Vertical Imbalance

$$\text{Coefficient} = 1 - (\text{Total resources not under sub-national control} / \text{Total expenditure})$$

This coefficient measures the share of the LG expenditures that are financed from revenue sources which are controlled by the sub national government. The coefficient takes values between (0) to (1) where values closer to (0) indicate a larger vertical fiscal imbalance (Hunter, 1997).

**Table No. 3.1**

**Calculation of Vertical Imbalance FY 2005/06** (Rs in Thousands)

S.N	Districts	Total LG Expenditure (E)	Resources not Under LG <sup>9</sup> (C)	Coefficient for Vertical Imbalance <sup>10</sup> (1-C/E)
1	Mugu	103,859	102,767	0.010
2	Gorkha	144,565	142,125	0.016
3	Rupandehi	250,861	110,970	0.55
<b>Average</b>				<b>0.192</b>

Sources: DDCs, Mugu, Gorkha and Rupandehi, ADPR, FY 2005-06

Table 3.1 shows coefficient for vertical imbalance for the selected districts in FY 2005/06. According to the principle of coefficient, there are high degrees of imbalance in all three districts Mugu, Gorkha and Rupandehi 0.010, 0.016 and 0.55 respectively. Mugu

<sup>9</sup> Here: LG resources not under LG control=total resources-internal resources which are under LG

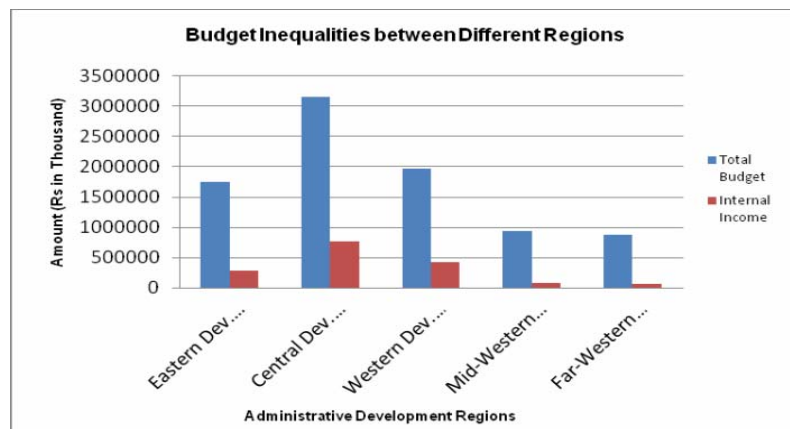
<sup>10</sup> Mugu→ 1-(102767/103859)= 0.010, Gorkha→1-(142125/144565)=0.16, Rupandehi→1-( 110970/250861)=0.55

has the highest degree of vertical fiscal imbalance because the coefficient (0.010) is very near to zero. In fact, lower the coefficient, the higher the degree of dependence on the CG. Mugu had internal resources of Rs 1,092 thousand, only 1.05% of its total budget. The remaining resources were given by the CG. Comparatively, Rupandehi had a lower degree of vertical fiscal imbalance as the coefficient is 0.55. It shows lower level of dependency on central transfer. However, an average coefficient for vertical imbalance of selected districts is 0.192 which is close to zero. Thus, the level of inequality is very high.

### 3.1.2 Horizontal Fiscal Imbalance

Local governments of Nepal have different tax capacities in different regions due to their location, availability of natural resources, demographic pattern and different economic base. According to report of Human Development Index (HDI) 2001, GDP per capital<sup>11</sup> and HDI<sup>12</sup> level of five different regions (UNDP, 2004) are diverse and unequal.

Figure 3.1



Sources: MLD, Annual Development Programs, An Introductory Booklet, FY 2005/06 with Calculation

The figure 3.1 visibly illustrates the inequality between five different regions in terms of total development budget and their own internal incomes. As seen from table 3.2, the central development region had enjoyed 36% of total local development budget whereas on the other hand far western development region had only 10% of total local development budget.

<sup>11</sup> GDP Per Capital of Eastern(1202), Center (1597), Western(1254), Mid-Western(988) and Far-Western (1079)

<sup>12</sup> HDI of Eastern(0.493), Center (0.490), Western(0.491),Mid-Western(0.402)and Far-Western(0.404)

**Table 3.2**  
**Comparative Analysis of Total Budget, Internal Income and Grants of Different Five Regions FY**  
**2005/06 (Rs in Thousands)**

Administrative Development Regions	No. of district	Total Budget		Internal Re-sources	Grant		Ratio between Total Budget and Internal Resources	Ratio between Total Budget and Grant	
		Amount	% on Total Budget		Unconditional	Conditional		Unconditional	Conditional
Eastern Dev. Region	16	1,743,677	20	285,116	223,708	1,234,853	1:0.16	1:0.15	1:0.7
Central Dev. Region	19	3,161,059	36	758,958	270,290	2,131,811	1:0.24	1:0.08	1:0.67
Western Dev. Region	16	1,974,517	23	418,158	215,600	1,340,759	1:0.21	1:0.1	1:0.68
Mid-Western Dev. Region	15	936,752	11	74,368	202,850	659,534	1:0.07	1:0.21	1:0.70
Far-Western Dev. Region	9	882,136	10	62,893	122,252	696,991	1:0.071	1:0.13	1:0.8

Sources: MLD, Annual Development Programs, An Introductory Booklet, FY 2005/06 with Calculation

Table 3.2 clearly demonstrates regional disparity of fiscal condition in LG of Nepal. The ratio between total local development budget and internal resources of the center development region is 1:0.24. While, the far-western development region is 1:0.071. Thus, the far-western development region depends on conditional grant (80% of total expenditure) whereas center development region is relatively less dependent on grant (67% of total expenditure) which evidently indicate regional inequality. Thus, there is an existence of strong horizontal fiscal imbalance in Nepal.

### 3.2 Causes of Fiscal Imbalance

The causes of fiscal imbalance are not only due to economic activities but also due to the unique socio-economic, demographic and geographical characteristics of entire locality (Vazquez, 2004:14). In this study, to analyse the causes of imbalance, two major dimensions i.e. revenue and expenditure assignment and further important factors like capacity of LG, political commitment and other relevant aspect are thoroughly revised.

#### 3.2.1 Revenue Assignment

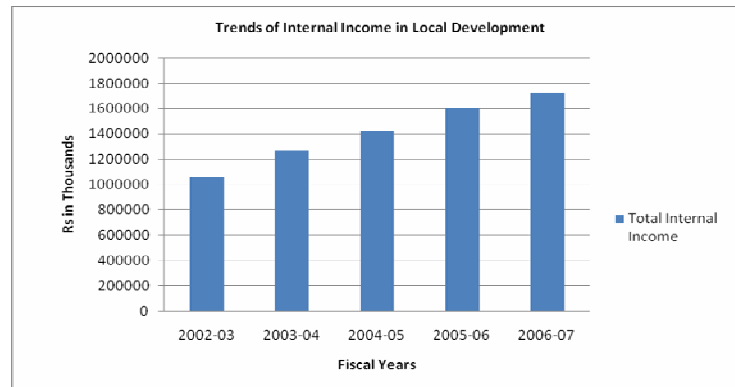
In historical context of giving tax authority to local bodies, in 1963, the *Town Panchayats*<sup>13</sup> were given the authority to impose household tax and house rent tax. In the fiscal year 1975-76, there was a provision of imposing 0.50% trade tax. After the political revolution of 1990, VDC Act, 1992, Municipality Act, 1992, and DDC Act, 1992 were introduced

<sup>13</sup> Before LSGA, 1999, VDC was known as *Town Panchayats*.

which bestowed local bodies with power for the local bodies to impose different taxes. In 1997-98, VDCs and the Municipalities had powers to collect land revenue. Apart from this, to ensure the fiscal power of local bodies and timely improvements in the existing conditions, LSGA 1999 and LSGR 1999 have ensured internal resource of local bodies (LAFC, 2000).

Basically, revenue includes internal resources such as loan and external sources like grants. The major sources of revenues (VAT, income taxes and customs fees) in Nepal are collected by the CG. Yet, LGs have only minor sources of revenue (Shrestha, 2002) some are: natural resource utilization tax, service charge, registration fee, vehicle tax, *baat* (market) tax and such other localized taxes (See more in Appendix III) (GoN,1999). Consequently, local bodies are excessively dependent on external resources (Table 1.1).

**Figure 3.2**



Sources: MOF, Budget Speech from FY2002-03 to 2006-07 with Calculation

Although the implementation of LSGA 1999 has made LGs more capable and innovative in internal resources collection which helps to uplift financial autonomy, this certainly is not enough. Figure 3.2 (Table in Appendix IV) shows the trend of internal resource of local bodies in Nepal from FY 2002-03 to 2006-07. The ratio of internal resources is more stable and progressive. Since 1999, there has been a trend of gradual increase in internal revenue of LG as illustrated by figure 3.2.

**Tax:**

Most of LGs’ revenue comes from tax collection (Table in Appendix V). On the basis of universal principal of tax, LSGA 1999/section 215<sup>14</sup> has clear provisions of local taxes that DDC may impose at the rate approved by the district council not exceeding the rate as prescribed in the district development area.

<sup>14</sup> The DDC may impose tax on roads, paths, bridges, irrigation, ditches, ponds etc. built by or transferred to it. Similarly, The DDC may impose tax on wool, turpentine, herbs, worm and torn goods, stones, slates, sand and bone, horn, wing, leather etc.

**Table 3.3**  
**Share of Tax on Internal Resources** (Rs in Thousands)

Districts	Total Income	Tax	% of Tax on Total Income = (Tax/Total Income *100%)
Mugu	1,092	153	14
Gorkha	7,515	2,440	32
Rupandehi	139,891	74,418	53
<b>Average</b>	<b>49,499</b>	<b>25,670</b>	<b>33</b>

Sources: DDCs, Mugu, Gorkha and Rupandehi, ADPR, FY 2005-06

Table 3.3 shows that taxes have huge contribution to the internal income where an average of 33% of total internal resources comes from tax revenue. Export taxes on natural resources are the main internal resources of the DDCs which are geographically concentrated. For instance, Rupandehi collected 53% of total income by taxing exports of wool, turpentine herbs and river bed materials (stones, slates, sand, and boulder) where as Gorkha and Mugu collected 17% and 14% of their internal income respectively. DDCs are more concerned about collecting natural resources export tax.

However, use of property tax on natural resources is especially problematical in addition to question of the equity and efficiency of assigning tax on natural resources and exploitation of resources by LGs (Charles and McLure, 2001). First of all, natural resources vary according to the geographical condition. For instance, in flat land (Rupandehi) there is abundance of river bed materials in comparison to that of steep landscape (Gorkha and Mugu). Consequently, the accessibility for the commercial utilization of natural resources has made some LGs financially better than others and creates inequality. On the other hand, it could be more hazards in terms of environmental point of view because all of river bed materials are non-renewable in nature. Thus, natural resources utilization taxes are not sustainable sources of tax.

In terms of tax autonomy, LSGA has given authority to DDC for collection tax (GoN, 1999: Section, 215). However, LGs do not have autonomy to determine the revenue base and make threshold of tax. This limit on setting own local tax bases, rates and reliefs reduces local fiscal autonomy (Blochliger, 2006). In regulation, rate for some taxes are fixed by the CG, while the tax range is set by law<sup>15</sup> (GoN, 1999a: Rule 207). Thus, tax policy and administration are basically under the control of CG.

<sup>15</sup> The rate of the tax that may be levied by a DDC shall be as referred to in Annex-23.



### **Service Charge and Fee:**

Collection of public service fee (water supply, solid waste management, means of entertainment and local service facilities) and mobilization of expenditure necessary to create those services by local bodies are considered appropriate. This not only leads to increase in the revenue of local bodies, but it also assists in ensuring best utilization of those resources (LAFc, 2000). LSGA/Section 216 & 217 have clear provisions of service charge & fees. DDCs may impose service charges and collect fees at the rate approved by district councils not exceeding the prescribed<sup>16</sup> rate.

**Table 3.4**  
**Share of Tax on Service Charge and Fee** (Rs in Thousands)

Districts	Total Income	Service Charge and Fee	% of Tax on Total Income
Mugu	1,092	43	4
Gorkha	7,515	405	5
Rupandehi	139,891	14,418	10
<b>Average</b>	<b>49,499</b>	<b>4,955</b>	<b>6.5</b>

Sources: DDCs, Mugu, Gorkha and Rupandehi, ADPR, FY 2005-06

However, the table 3.4 clearly shows that only a small fraction of total internal income is contributed from service charge and fee. An average 6.5% of total internal resources come from service charge and fee in DDCs which is plainly not sufficient. This also leads to inadequate provision of basics services. Thus, a systematic revamp on collection of service charge and fee is necessary in order to make LGs financially competent and reduce fiscal imbalances.

### **Loan:**

Local government borrowing is an important component of the devolution of fiscal power to the local authorities that promotes intergenerational equity, economic development and synchronization of expenditure and revenue flows (Ebel and Yilmaz, 2002). LSGA 1999/Section 219 noticeably mentions that 'the DDC may raise loans, or receive borrowings with or without pledging any of its movable and immovable property owned and possessed by it or under guarantee given by Government of Nepal, from a bank or any other organization, according to the policy adopted by the District Council'(GoN,1999:83).

Due to the absence of clear guideline, procedure, under developed capital markets and risk taking behavior, borrowing is rarely practiced. DDCs do not want to take loan from outside<sup>17</sup>. In practice, only one district (Kathmandu) has got loans from government-

<sup>16</sup> Like; The service charge of the guest house, library clinic, city hall etc. built by it or under its custody

<sup>17</sup> Interviews from Revenue expert, LBFC

tal agency out of 75 districts<sup>18</sup>. DDCs are used to fulfilling their budget deficiencies from central governmental transfer (Table 1.1). Besides, they do not have full autonomy for borrowing because LGs of Nepal can borrow only after getting approval from CG or under guarantee of CG. Thus, they have few incentives and no innovative for borrowing.

### 3.2.2 Expenditure Assignment

In Nepal, government efforts to prioritize programs and activities in the line with Poverty Reduction Strategy Paper (PRSP) goal and strategies helped to bring about some major shifts in the inter-sectoral composition of the development budget in favor of the main focus area of the PRSP. According to the report of strategy and program assessment done by Asian Development Bank (ADB) the share of social sectors like education, health, drinking water and local development have risen from about 35% of actual development expenditure in FY2000/01 to 42% in FY2002/03 and have further increased to 47% of the development budget allocations in FY2004/05 (Table in Appendix VI) (ADB, 2005).

**Table 3.5**  
**Expenditure Ratio of LG on Central Budget (Rs In Thousands)**

S.N	FY	Total National Budget <sup>19</sup> (B)	LG Total Budget <sup>20</sup> (L)	% of Local Development Budget (L/B*100)	Actual Expenditure by LG (E)	Expenditure Percentage (E/L*100)
1	2002-03	96,124,700	4,998,490	5.2	4,469,522	89
2	2003-04	102,400,000	5,529,600	5.4	4,918,569	89
3	2004-05	111,689,900	6,813,084	6.1	6,033,930	88
4	2005-06	126,885,100	8,169,860	6.4	6,271,719	76
5	2006-07	143,912,300	11,579,953	8	9,543,986	82
<b>Average</b>		<b>116,202,400</b>	<b>7,418,197</b>	<b>6.2</b>	<b>6,247,545</b>	<b>85</b>

Sources: MOF, Budget Speech of FY 2002/03-06/07 and MLD, Annual Development Programs: An Introductory Booklet, FY 2002/03 -06/07 with Calculation

The table 3.5 shows the trend of Local development budget on total national expenditure which has increased from 5.2% of local development budget in FY 2002/03 to 6.1% in FY 2004/05 and has increased further to 8% in FY 2006/07. Under the MLD, 43 programs/projects have been implemented using CG resources and external resources which come from donor agencies (MLD, 2008). The share of local development budget (including capital and administrative) in total national expenditure is an average 6.2% which is still extremely short. Thus, the actual level of fiscal decentralization in Nepal is very low. Beside this, expenditure pattern of allocated budget is not satisfactory because only an average of

<sup>18</sup> Interviews from LBFC member

<sup>19</sup> Total National Budget=Total Expenditure

<sup>20</sup> LG Total Budget=Capital+ Administrative Budget

85% of the allocated budget is spend by LG showing low capability of local bodies in terms of expenditure assignment. Thus, on one hand, the LGs are heavily dependent on central funds transfer and on the other hand they are not being able to utilize the allocated budget that is also causes of vertical imbalance.

### **Expenditure Responsibilities of DDC:**

According to LSGA 1999/Section 189, the functions and duties on the basis of subsidiarity principle of the DDC shall be relating to agriculture, rural water supply and settlement, hydropower etc. In addition, DDCs have more agency functions like functions relating to social security for receiving distribution and adjustment of social security fund, function relating to election as well as national and international campaigns such as feeding polio-plus, vitamin A and so on. Specially, DDCs also have responsibilities to prepare coordinated periodic and annual budgets in order to execute their tasks so that resources and efforts are not duplicated (GoN, 1999).

However, the study shows the function and responsibilities are not so visible, as a result there is widespread overlap in the scope of work among the local bodies and between central and local bodies. Central Government continues to do many activities like planning and management of water supply and sewerage as well as operation and maintenance of irrigation. Legally, these are the responsibilities of Local Bodies and would also be handled more appropriately by these authorities (Detail Classification in Appendix IX). For instance, Gorkha DDC allocated Rs 783 thousand to provide safe drinking water for Shreenathkot VDC meanwhile Division Office of Drinking Water Supply also implemented Small Drinking Water Project on the same VDC<sup>21</sup>. This clearly shows duplicity and lack of transparency in those areas which should have been under the legal jurisdiction of LGs.

On the other hand, some expenditure areas such as primary education should be the collective responsibility of different levels of governments in Nepal. There are wide ranges of diverse functions that local bodies are responsible for such as planning, construction and repairing of school building and furniture. Similarly, Ministry of Education is responsible for managing of teachers and their salary as well as the Department of Education is responsible for the design of curriculum while District Education Office conducts training for primary school teacher<sup>22</sup>. Thus, it shows contradictions in proper division of responsibilities. If the division of responsibility is not clear, it is impossible to identify accountability of local bodies and difficult to assess what is the minimum expenditure requirement of local bodies.

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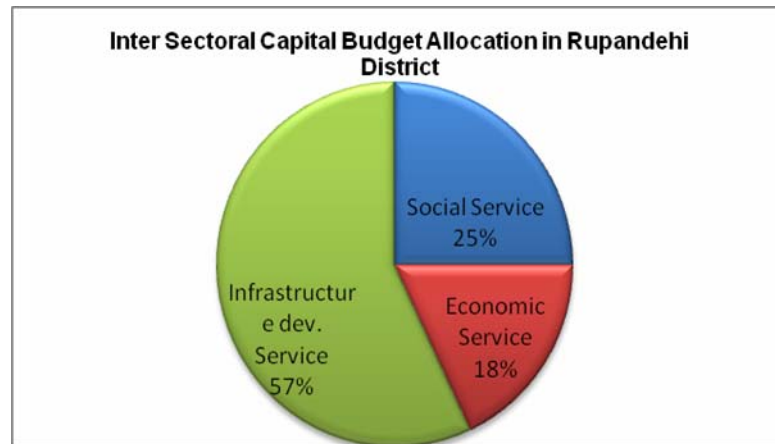
<sup>21</sup> Interview from LDO, Gorkha

<sup>22</sup> Interview from District Education Officer, Rupandehi

### **Composition of Expenditure:**

DDCs spent an average of 78% of the total budget as capital expenditure and rests of 22% of budget as administrative expenditure (Table in Appendix VII) which is a positive trend for development. It is clearly seen that economically poor district (Mugu) spent little money for administrative purpose as compared to resourceful district (Rupandehi). The sectoral allocation of expenditure across the key sector areas are 1) infrastructure development sector which includes road, communication, electricity (Power), 2) social service likes education, health, drinking water and human resources development and 3) economic services which includes agricultural, irrigation and forest.

**Figure No 3.3**



Sources, DDC Rupandehi, ADPR, FY 2004-05

The budget allocation for these sectors was 57%, 25% and 18% respectively out of total development budget allocated on FY 2004/05 in Rupandehi DDC (Table in Appendix VIII). In recent years, investment on infrastructure sector, mainly on rural road, has been increasing which is a pre-requisite for local development. However, infrastructure development sector is centrally guided and does not in reality address the local need of the people. Basically, in mountain and hilly areas, most of the budget is spent on roads and drinking water projects<sup>23</sup> under the direction of central ministry. As a result, they are not compatible with the local level plan prepared at grassroots level.

### **Expenditure Responsibilities on Devolved Sector:**

Local Self Government Act, 1999 has focus on sectoral devolution. On the basis of these provisions, the government of Nepal has already transferred 2263 Primary

<sup>23</sup> Gorkha = 65% and Mugu=69% amount allocation for road and drinking water projects on their total development budget for FY 2004-05 (sources; Annual Development Report, 2004-05)

Schools and 1417 Local Health Institutions (including primary health center, health post, and Sub health posts) to 28 different DDCs (MLD, 2008). Principally, the DDCs are responsible for implementing sectoral devolution guidelines. However, study shows that there is considerable difficulty and confusion regarding their implementation because the guidelines have been produced independently by concerned ministries<sup>24</sup>.

In practice, central grants of devolved sectors are routed through the DDF. But, the role and mandate for approving, monitoring and administering of sectoral function is not clear, for instance, agricultural extension activities were devolved to the DDC but district level agricultural office still have responsibilities to plan and manage the respective program. Thus, DDF only plays a bridging role between sectoral ministries and sectoral agencies to release the budget which make the overburden expenditure on DDC for management of the devolved sector that creates the vertical imbalance.

#### **Expenditure Procedure:**

In LSGA/section 208-209, the DDC shall have to form consumer groups through the concerned body from amongst the persons who receive direct benefit from the project while implementing the projects under the district development plan. Thus, almost all local development plans and projects are implemented through consumer groups. However, the capacities of consumer groups are very weak and it is difficult to ensure the quality control<sup>25</sup>.

Regarding the accounting and auditing system, LGs have dual responsibilities because their accounting system has to follow procedures that are directed by Local Bodies Financial Administration Regulation Act, 1999 as well as Central Government Financial Regulation Act 1998 which leads to confusion and principle errors.<sup>26</sup>

### ***3.2.3 Low Fiscal Capacity of Local Bodies***

The success or failure of fiscal decentralization depends on the capacity of LG to manage transfer of financial responsibilities (Davey, 2006:2). LG fiscal capacity depends on administrative structure, authority, human resources as well as technical and financial knowledge (Dahal *et al.*, 2001). In Falleti's views, there is a likelihood of increasing the dependence of LG on the transfer from the CG if the delegation of taxing authority to LG without support with capacity of local official to collect new taxes (Falleti, 2005). Realizing

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<sup>24</sup> Interview from Joint Secretary, NPC

<sup>25</sup> Interview from District Technical Officer, Gorkha

<sup>26</sup> Principle error occurs whenever expenditure fails to meet any aspect laws and regulations regardless of it being worth while for all practical purposes or not. (Interview from DDC Account Section staff, Gorkha.)

this fact, the CG of Nepal, cooperation from various donor agencies and LG associations, has been actively involved in local development capacity building program providing orientation and training on current laws, accounting system, planning system, information and institutional management. However, Gurung (2005) asserts that at this point in time DDCs do not have capacity to carry out the responsibilities incurred by the LSGA (Gurung, 2005).

According to capacity measurement indicator developed by UNDP there are 9 major indicators which include various sub-indicators and are assumed to be the key parameters of fiscal capacity. The indicators are representatives of the strategic management which includes preparation of district periodic plan, master plan, sectoral plan and annual plan. Organizational structure and internal management of DDC are also important factors to determine the capacity. In addition to that human resource development, accounting management and working process are basic elements for assessing the local capacity. Regarding the measurement of local fiscal capacity, there are huge differences among the three selected districts where Mugu has very low weight (6) while Gorkha has (22) and Rupandehi (26) out of total of (42). Even though Gorkha and Rupandehi have better indicators than Mugu, on average the level of capacity is very low (See more in Appendix X).

Ability of a LG to plan better helps to enhance the LG's fiscal autonomy by being able to choose own plan and program by applying the bottom up approach. Study shows that DDCs have weak capacity to conduct all steps of the planning process from grassroots level to the district level by involving the target group. Due to poor database, lack of technical human resources and weak coordination between line agencies, annual development planning is not going well. Similarly, due to the absence of revenue mobilization plan, LGs find it troublesome to fix the revenue target.

Human resource is an important strength of DDC. But there are many debilitating factors that weaken the DDC in this respect as well. The DDC secretary (called Local Development Officer, LDO) is appointed by CG for two years with responsibilities of operations, management and day to day administration. In practice, LDOs are frequently transferred within six months of their working period because of high political influence. Besides, DDCs have unskilled, less qualified, untrained, less committed, non professional manpower which has a negative influence on fiscal capacity of DDCs. Study shows that ratios of non professional and non technical staff are higher than professional staffs in DDCs leading to improper fiscal management for example an average 58 non professional staff out of total 76 total human resources in selected three districts. Local government

accounting system and revenue management are run by very few professional staffs (on an average 15%<sup>27</sup> of total manpower) in the DDCs. In Mugu district, they have no professional staffs to execute financial management because the professional staffs are not motivated to work in the remote areas where basic facilities are lacking (Table in Appendix XI). Furthermore, an average of only 27% of total staffs have received necessary training like budget preparation, book keeping, accounting software, reporting, resources mobilization and auditing. So, capacity of human resources is not satisfactory.

Similarly, in terms of the organizational structure, the operational relations between District Technical Office (DTO) and DDC are not well defined. For instance, DTO is the technical wing working under the DDC that has the authority to work only when power is delegated by LDO. But, in practice, LDOs do not want to delegate their power to DTOs which is the main cause of low expenditure capacity. Organizationally, only few DDCs<sup>28</sup> have separate revenue collection, internal auditing section which are the key sections for resource management. Administratively, local tax administration, accounting and information system are very weak.

Beside this, CG, especially, MLD does not have a strong ability to monitor, regulate, facilitate and guide decentralized action as well as the local finance (MLD, 2008). Even, MLD has no such unit that would help in regulating the fiscal decentralization. Furthermore, all selected DDCs have high ratio of default<sup>29</sup> amount although they do not have any alternative mechanisms for tracking of defaulters. Financially, LG gives less priority for its capacity development initiatives. Data shows that DDCs allocated only 0.5% of their annual budget<sup>30</sup> for the purpose of capacity development which is not enough money for enhance the capacity of LGs.

### ***3.2.4 Geographical and Demographic Variation***

Nepal is a geographically diversified country. The size of district and demographic characteristic are very different within different areas. So, there are great variations in the expenditure needs across jurisdictions.

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<sup>27</sup> 12/76\*100

<sup>28</sup> Rupandehi and Gorkha have established revenue collection, internal auditing section but Mugu have not established yet.

<sup>29</sup> Mugu=average 6% , Gorkha=13% amount and Rupandehi =21% of their total internal resources for FY 2005/06 (DDCs, Annual Progress Reports, 2005/06)

<sup>30</sup> Source: DDCs, Mugu, Gorkha and Rupandehi, Annual Development Budget FY 2005/06

**Table 3.6**  
**Socio Economic Feature of Selected Three Districts**

Districts	Geo-graphical Belt	Area (Sq. Km)	Population (CBS,2001)	Per Capita Income (Shrestha, 2004)	HDI (UNDP, 2002)	Total Development Grant ( Rs in thousands) DDCs,05/06	Per Capita Grant (In Rs)	Cost Index (Shrestha, 2004)	Development Position (UNDP, 2004)
Mugu	Mountain	3,535	31,465	5,065	0.147	102,767	3266	3	75 <sup>th</sup>
Gorkha	Hill	3,610	288,134	6,985	0.308	142,125	493	2	49 <sup>th</sup>
Rupandehi	Terai	1,160	708,419	6,807	0.361	110,970	157	1	5 <sup>th</sup>

Study shows that the per capita grant for Mugu (Rs 3266) is higher than Gorkha (Rs 493) and Rupandehi (Rs 157) because of higher cost index. The unit cost of service provision is higher in the mountains (3) and hills (2) area than terai (1) areas due to high cost of transportation, labour and living cost. But grant per square area of Rupandehi (Rs 96,664/km<sup>2</sup>) is higher than Gorkha (Rs 39,369/km<sup>2</sup>) and Mugu (Rs 29,071/km<sup>2</sup>) because of size of districts.

Basically, due to physical inaccessibility (like difficulty in transport, communication and water supply) in mountain and hilly region, most of the development budget is spent on the infrastructure development sector like road and drinking water which are three times costlier than in Terai area. Similarly, since higher mountains and hills area occupy large area (Mugu is three times greater than Rupandehi) and have scattered settlement pattern, so more grants are needed for investment on the entire infrastructure development sector. For example, the length of drinking water pipe (or kilometer of road) required per person will be greater in Mugu and Gorkha than in Rupandehi which create budgetary inequality between different districts.

In the same way, natural resources are not equally available in all districts which are the important sources for DDCs. Eastern and western development regions are same in terms of area and demographic profiles. However, western region has collected 46% more revenue than eastern development region (Table 3.2) because of the availability of natural resources. Thus, geographic and demographic variations are important factors that create horizontal imbalance which can be alleviated with equalization transfers from the CG to LG.

### ***3.2.5 Low Political Commitment***

A gradual process of fiscal decentralization will require CG leadership (Bahl, 1999). However, in Nepal, CG has given less priority to implement and enhance the fiscal decentralization. Legally, they have provisions of decentralization implementation and monitor-



ing committee under the chairmanship of Prime Minister as follows to monitor whether or not the acts have been done in accordance with the objective, policies and provision of the LSGA. Besides this, under the direction of decentralization implementation and monitoring committee, MLD works as a coordinator of the working committee and as such is more responsible to actively implement and coordinate policies of decentralization (GoN, 1999; Section, 241).

Unfortunately, after application of the acts in 1999, the meeting of decentralization implementation and monitoring committee has taken place only thrice in past nine years. In addition, working committee is not functioning on a regular basis. Similarly, local tax advisory committee and central advisory committee have major responsibilities to encourage revenue generation. Yet, both committees have not formulated. Besides this, after the outbreak of the Maoist insurgency in rural area, the priority of the government shifted from development to security issue. Thus, fiscal decentralization is still less prioritized in the central political arena.

In the local arena, the essence of decentralization is constantly marred by local politicians who regularly apply minimal range of local taxes because fear of political unpopularity and losing the position on next election if they raise taxes. Thus, decrease the internal revenue of LGs rendering them more dependent on central funds. Legally, DDCs have authority to expose new tax and increase or decrease the tax rate under the range given by CG. Study shows that local political decision makers have less willingness for promoting the internal revenue. They are imposing minimum range of tax rate.

**Table 3.7**  
**Range of Tax Rate Imposed by Selected Districts** (In Rs)

Types of tax	Range of tax	Mugu	Gorkha	Rupandehi	Average
Road tax	10-50	0	25	30	18
Export tax Natural Resources	10-100	15	25	40	27
Export tax recycling good	10-50	15	20	30	22
Service charge	10-100	20	30	40	30
<b>Average</b>		<b>17</b>	<b>25</b>	<b>37</b>	<b>26</b>

Sources: DDCs, Mugu, Gorkha and Rupandehi, ADPR, FY 2004-05

For instance, Table 3.7 visibly indicates that Mugu imposed the service charge of only Rs 20 and Rupandehi only 40 on the given range between Rs10-100. As can be seen from the table, the average taxes on each category for the three districts were on the lower side of the acceptable range. A political body doesn't want to impose new tax as well as to increase tax rate. Study illustrates that during the period of 1999 to 2002, in DDC Gorkha,

tax rate neither increased nor imposed<sup>31</sup>. After 2002, tax rate has been revised only once in 2005 per the MLD's direction and after that rate remained constant.

To make matter worse grant distribution and revenue sharing by the CG are highly affected by political biases (Shrestha, 2004). Mainly, unconditional grant is allocated on the basis of standard formula. However, conditional grant allocation processes are influenced by the decision makers<sup>32</sup> of CG. Similarly, revenue share indicators always change because of political reasons rather than scientific methods which are also important causes to create horizontal fiscal imbalance.

### ***3.2.6 Absences of Elected Local Bodies***

The period between 2002-2006 were not good for decentralization and local governance process in Nepal. On one hand because of high political instability and on the other hand due to armed movement (by the Communist Party in Nepal, Maoist), particularly in the rural area, the presence of the government was largely limited in district headquarters. As a result, planning process was affected which prevented people from participating on development process. Kafle and Karkee clearly indicated that a decreasing trend of participation of local people in planning process creates information gap between people and local authorities (Kafle and Karkee, 2004).

Similarly, the decision taken by Government of Nepal in 2002 not to extend the mandates of existing elected local bodies resulted in suspension of political bodies which created absences of local representatives in the LG (MLD, 2006a). Thus, election of the local bodies could not be held which set back the process of decentralization. After that, all local bodies were run by centrally appointed bureaucrats.

Of course, naturally, bureaucrats have more opportunities to impose new tax and raise LG revenue because they have no threats to losing their position on the election. And also, in the view of local self governance, the local employees need to have accountability to people and the local bodies. However, in practice, the secretaries of the local bodies are bureaucratically accountable to the CG. They have very few mandates to run only daily administrative as well as regular development works. Furthermore, the ratio of transfer of LDO is very high (on an average six month, LDO is transferred to other district) and most of the bureaucrats do not want to take more risk<sup>33</sup> like (impose new tax). Thus, rate of deci-

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<sup>31</sup> From observation in Account section Gorkha DDC

<sup>32</sup> Interview from Joint Secretary, National Planning Commission

<sup>33</sup> Interview from Under Secretary, MLD, Surya P. Acharya

sion has been decreased<sup>34</sup> which directly hampers the expenditure assignment and revenue generation.

### ***3.2.7 Contradiction between LSGA and Other Related Laws***

The MLD realizes that LSGA has not been able to fully implement because 23 laws contradict with it (MLD, 2008). Basically, the contradiction with forest law (royalty for forest product) and tourism law (royalty for tourist entrance fee) creates confusion and conflict on revenue sharing. Thus, DDCs are not able to receive revenues from some potential sectors like mining resources. Due to the dual provision regarding the ownership of natural resources like boulders, aggregates and sand on the forest area, there is conflict between district forest office and DDC which create barrier on revenue generation and sharing<sup>35</sup>.

In the same way, hydropower royalty is an important source of internal revenue of DDCs like, Gorkha, on Fiscal Year (FY) 2006/07, 46%<sup>36</sup> amount of total share revenue came from hydropower generation. However, still, there is no clear scientific norm and indicator to share revenue between Nepal Electricity Authority and LG which hamper the process of internal resources collection of DDCs<sup>37</sup>.

Beside this, in terms of coordination, there are cases where CG and some donors have created parallel and counter local structures. Most of central agencies are not active in devolving the powers to the LG. Thus, there are parallel structures of the government like the District Administrative Office, Revenue and Custom Offices etc at the district level that undermine the autonomy of the LG (Dahal *et al.*, 2001). Consequently, service delivery seems to be overlapping.

### ***3.2.8 Resource Capture by Elites***

People participation in planning process is an important tool of decentralization. In LSGA, it has clear provision for local development planning process to ensure people participation in development work (GoN, 1999: Section, 172). However, in practice, individuals from so called higher caste, local elites and ex-politicians capture the local resources through planning process by leading consumer groups and community based organizations. Capture occurs when local interest groups seize the benefit of local public goods (Smoke *et al.*, 2006). Thus, decentralization process is very vulnerable to attacks from few elite whose interests do not necessarily coincide with interest of many.

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<sup>34</sup> In Gorkha DDC :Number of decision occurred in: 1999/2000 -76, 01/02 -87, 03/04- 96, 05/06-65, 06/07-53

<sup>35</sup> Interview from LDO, Gorkha

<sup>36</sup>  $5229/11367*100=46\%$  (Sources; Annual Progress Report, 2006/07, DDC, Gorkha)

<sup>37</sup> Interview from member, LBFC

**Table 3.8****People Involvement in Consumer Group and Women Participation**

Sectors	Number of Consumer Group	Consumer Group Lead by Ex-Politician		% of Women Participation
		Number	Percentage	
Rural Road	89	58	65	14
Drinking Water	34	25	74	23
School Building	25	21	84	17
Other	47	32	68	18
<b>Average</b>		<b>73</b>		<b>18</b>

Sources: DDC, Rupandehi, ADPR, FY 2004-05

The study clearly shows that an average 136 consumer group out of 195 (73%) are lead by ex local politicians and local elites in Rupandehi. Its means the LG planning tends to be dominated by local traditional elites<sup>38</sup> and local ex-politicians who are not true representative of the targeting groups. For instance, the chairperson of road user group of remote village (VDC Choprak), lives in the district headquarters (Gorkha)<sup>39</sup>. Besides, the practice of illegal contracting system is largely prevalent<sup>40</sup> whereby many consumer groups lead by corrupt elites took the money from DDCs and give the contract to third parties and gain commission.

Similarly, by law, 33% of women participation on consumer group is must. A study has shown that consumer groups where women are active are less prone to corruption then others. However, women participation in consumer group is found to be very nominal (an average 18%) and their involvement is only for formality (for fulfillment of legal requirement) not qualitative. Therefore, this aspect also signifies the need for women participation. In short, if corrupt few get hold consumer groups then they will exploit the resources to meet their own agendas and thus make decentralization less effective by helping to create fiscal imbalance.

<sup>38</sup> Belong to higher caste individuals

<sup>39</sup> Interview from Mohan Porkhal, Gorkha

<sup>40</sup> Interview from account staff, DDC, Gorkha

## Chapter IV

### Inter Governmental Transfer and Consequence of Fiscal Imbalance

This chapter is structured in two parts starting with discussion of intergovernmental fiscal transfer and then analysis consequence of fiscal imbalance. First part describes transfer system in Nepal including grant and revenue sharing. In second part I analyze main consequence of fiscal imbalance in local self governance system in Nepal.

#### 4.1 Inter Governmental Transfer

Local government budget deficits in districts like an average share of grant on total development budget in Mugu (98%), Gorkha (86%) and Rupandehi (52%) (Table in Appendix XII) have been fulfilled by central governmental transfer which refer to a number of different public financing instruments including grants, subsidies, and sharing of tax revenues between the nation and local government (shrestha, 2004). There are basically two methods of intergovernmental transfer implement in Nepal namely- grant and revenue sharing. Both of these are applied in horizontal and vertical dimensions. Since 1980s, there has been provision for MLD to provide the local body each year with ‘minimum grant prescribed and also with additional grants on such basis as population, level of development, possibility and capability of mobilizing revenues and necessity of financial resources of the concerned local body’ (GoN, 1999:Section, 236).

##### 4.1.1 Grant

In Nepal, there are basically two types of grant provided by CG to LG-conditional and unconditional grant. Central grants are provided adhering to norms of autonomy adequacy, equity, predictability, simplicity and transparency (LBFC, 2004). According to Bahl, the grant represents the fund which compensates the difference between expenditure needs and fiscal earning capacity of the local bodies.

#### Box 4.1

##### Meaning of Grant

**Grant = Expenditure Needs of a LB – Fiscal Capacity of the LB**

Where,

Expenditure Needs = Cost of assigned sectoral services, administrative costs, implementing programs of CG priorities, services committed by local bodies and so on, and

Fiscal Capacity = Revenues raised with optimum tax efforts by a local body on the assigned tax base, at standard tax rates

Source: Bahl, 1998

Related to the Bahl argument, the CG transfers still represent the largest source of LG income. An average of 6% of the total development budget allocation is through varieties of programs for the local development (Table 3.5). At least an average of 78% of the LGs' revenue comes from central grants (Table in Appendix XII) in selected three districts.

### **Conditional Grant**

Conditional grant is a specific purpose grant where in the CG specifies the purpose for which the recipient local body can use the funds. Shah argues that conditional grants are best suited for subsidizing activities considered high priority by a higher level government but low priority by LGs (Shah, 1994). The central authority can take the grant as a weapon of making the local bodies accountable because CG can control the policies of local bodies in accordance with national priorities (LAFC, 2000).

Of course, grant helps to fill the gap between revenue and expenditure as well as maintain fiscal equity among the local bodies. However, conditional grant limits the fiscal discretion of LGs, and also affects the allocation decisions of the LGs (shrestha, 2004). Study shows that an average of 86% of the total grant is covered by conditional grant (Table in Appendix XIII) for funding centrally mandated services in the areas like construction and rehabilitation of rural drinking water and sanitation project, rural road, large and local level suspension bridges which do not necessarily address the real needs of the local people.

**Table 4.1**  
**Composition of Development Grant FY 2005/06** (Rs in Thousands)

Districts	Total Budget	Total Grant						Formula Based Grant	
		Total Grant	% of Grant	Conditional		Unconditional		Amount	%
				Amount	%	Amount	%		
Mugu	103,859	102,767	99	85,074	83	17,693	17	4,800	5
Gorkha	144,565	142,125	98	92,556	65	45,299	32	4,270	3
Rupandehi	250,861	110,970	44	58,814	53	40,625	37	11,531	10
<b>Average</b>	<b>166,428</b>	<b>118,621</b>	<b>80</b>	<b>78,815</b>	<b>67</b>	<b>34,539</b>	<b>29</b>	<b>6,867</b>	<b>6</b>

Sources: DDCs, Mugu, Gorkha and Rupandehi, ADPR, FY 2005-06

The table 4.1 clearly depicts the composition of development grant in local development. An average of 67% of grant is conditional grant in the three selected districts where Mugu has 83%, Gorkha has 65% and Rupandehi has 53%. The study noticeably finds out that the ratio of conditional grant to districts is determined by their internal resources. If the DDC is financially strong, they depend less on conditional grant like Rupandehi. On the other hand weak DDCs have more depend on conditional grant like Mugu.

For the use of conditional grant, MLD has provided guidelines to DDC that strictly prohibits the transfer of funds from capital cost to recurrent expenditure. It further pro-

vides guidelines to spend grant to attain expected result of the program determined by national interim plan, periodic plan/sectoral periodic plan or plan of DDC itself. The Guidelines also require the DDC to follow the provisions of LSGA 1999 and related regulations which stress on audit both internal and external and submit report to CG (Detail guidelines in Appendix XIV) (MLD, 2006a).

### **Unconditional (Block) Grant**

For promoting autonomy, unconditional grants are the best as they have no restrictions on assignment of funds to different expenditure. The DDC can spend the money for fulfillment of small local demand and thus have more opportunity to choose and give priority on their required sectors or programs. MLD provides administrative (current) and development (capital) grant as a block grant separately. Study shows that most of the small plans are funded by block grant because DDCs have full authority regarding planning, allocation and selection of the project which gives maximum of flexibility in deciding on the purpose of expenditures. However, the composition of block grant is very low, only 14% of grant is covered by unconditional grant in national level (Table in Appendix XIII) and an average 29% of the amount is contributed from unconditional grant in the selected 3 districts (Table 4.1).

Similarly, Litvack argues that intergovernmental transfers are made using a formula intended both to equalize public expenditure in localities with different needs and capacities and to stimulate local fiscal efforts (Litvack *et al.*, 1998). In Nepal, there are some practices of equalization transfer for enhancing the local revenue generation, making social justice and balancing development possible. MLD has designed an interim formula to allocate block grant for each DDC depending upon factors like human development index, population, area and cost factor of the respective districts. The weight given to these factors are 50, 20, 20 and 10 percent respectively (LBFC, 2004).

In addition to that, after applying the formula, they have further provision for adjustment on the basis of internal resources, where DDCs with higher own income (Rupandehi) get little less than those DDCs who have smaller own source revenue (Mugu). That adjustment helps to stimulate local fiscal efforts. However, population factor plays an important role to increase block grant. For instance, Rupandehi DDC is more resourceful and developed in terms of HDI. But, it gets high amount of block grant (10%)<sup>41</sup> because the size of population is 22 times bigger than Mugu and 3 times larger than Gorkha.

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<sup>41</sup> Compared to Mugu(5%), Gorkha(3%)- Table 4.1

Similarly, the current formula has given more weight to human development criteria which determines the level of development. So, Mid-Western Development Region and Far-Western Development Region have got high ratio of block grants 1:0.07 and 1:0.08 respectively than other regions because both regions are the least developed regions (Table 3.2). However, these equalization transfers make a very tiny proportion of the block grant. For instance, the average equalization transfer made just 6% of the total grant issued in the selected districts.

#### 4.1.2 Revenue Sharing

Under the law, LSGA 1999/section 220 and LSGR 1999/rule 211, there is a provision of vertical and horizontal revenue sharing between centre and local government or among the local government. On the horizontal sharing, 5% to 90% (depending on the amount of collection of the revenue) is raised from house and land registration fee, 50% of the royalty from mines, 10% of the income from forestry sector, 10% of the income to Government of Nepal from electric power house, 30 % of the income from tourist entrance. Similarly, vertical sharing between VDC and Municipality likes 25% of land revenue share between concerns VDC or municipality, DDC also need to share 35 to 50 % (depending on the amount of collection of the revenue) is raised from the sale of boulders, aggregates, sand with the concerned VDC and municipality.

**Table 4.2**  
**Trend of Shared Revenue in Selected Districts** (Rs in Thousands)

FY	Mugu			Gorkha			Rupandehi			Average Sharing
	Total Income	Revenue Share	% of Revenue Share	Total Income	Revenue Share	% of Revenue Share	Total Income	Revenue Share	% of Revenue Share	
2002-03	641	429	67	14,519	5,000	34	76,019	13,683	18	40
2003-04	845	634	75	14,137	8,100	57	74,592	17,647	24	52
2004-05	1,561	983	63	14,338	10,472	73	107,575	12,264	11	49
2005-06	1,092	803	74	7,515	5,075	68	139,891	33,035	24	55
2006-07	1,000	856	86	14,398	11,367	79	199,756	58,000	29	65
<b>Average</b>	<b>1,028</b>	<b>741</b>	<b>73</b>	<b>12,981</b>	<b>8,003</b>	<b>62</b>	<b>119,567</b>	<b>26,926</b>	<b>21</b>	<b>52</b>

Sources: DDCs, Mugu, Gorkha and Rupandehi, ADPR, FY 2002-03 to 2006-07

Table shows the status of revenue sharing in 3 different selected DDCs from FY 2002/03 to 2006/07 which clearly verify that revenue sharing is an important source of local bodies because an average of 52% of total internal resources came from the revenue sharing. Especially in district like Mugu, which do not have other alternative resources<sup>42</sup>, an average of 73% of their resources comes from revenue sharing (land registration fee, tour-

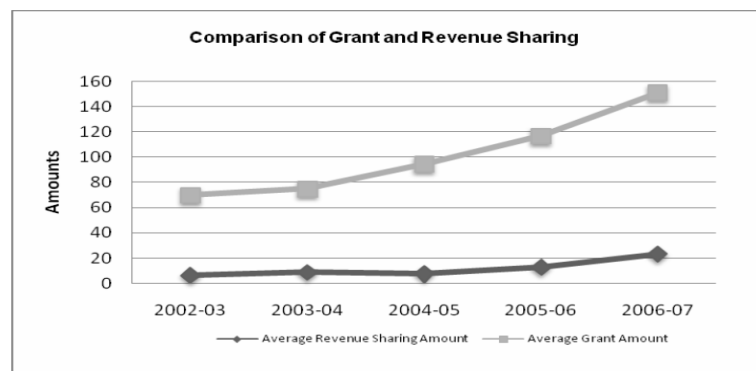
<sup>42</sup> Tax, Service Charge, Borrowing, Fee



ist entrance fee). On the other hand, Rupandehi DDC, which is economically strong, does not significantly contribute from sharing because one of the important indicators is internal economic condition which minimizes their share amount. According to the LSGA, the expenditure authority of revenue is more than grant because DDC can allocate revenue to address the local demands which ensure the local autonomy. However, the part of revenue sharing on the total budget is very low like that of Mugu is 0.72%<sup>43</sup> and Rupandehi is 2.9%<sup>44</sup>.

Regarding transfer autonomy, Steffensen argues that a transfer system should preserve budget autonomy at the local level within the constraints provided by national priorities (Steffensen, 2005). However, local bodies in Nepal are heavily dependent upon the grant from the centre where conditional grants cover huge amount which restrains autonomy. Revenue sharing helps to increase resources at the local level and reduces over dependency which ensures financial autonomy. Thus revenue sharing is a better way of fulfilling fiscal gaps but unfortunately it is not practiced as widely as it ought to be.

**Figure 4.1**



Sources: DDCs, Mugu, Gorkha and Rupandehi, ADPR, FY 2002-03 to 2006-07

The figure is based on the average annual grant and revenue sharing of different selected districts from FY 2002/2003 to 2006/07 (Appendix XV). It shows that the contribution of central grant is increasing rapidly whereas the amounts from revenue sharing are almost constant from 2002/03 to 2004/05 and gradually increase from 2005/06. It clearly illustrates that increasing trend of dependency of LG on the CG grant.

## 4.2 Major Consequences

The promotion of local self governance is one of the important objectives of decentralization in Nepal. However, poor revenue assignments, overlapping responsibilities be-

<sup>43</sup> Mugu =  $856/117960 \times 100 = 0.72\%$

<sup>44</sup> Rupandehi =  $5800/199756 \times 100 = 2.9\%$

tween different levels of government, mismatch between responsibilities and revenue sources, lack of well structured borrowing power along with poor incentives and structure for fiscal autonomy and accountability (Chapter III) have constrained significant move towards effective self governance in Nepal.

### **Limited Expenditure Opportunity**

Due to high fiscal imbalance and over dependency on central grant, only marginal number of local level plans and programs which come from planning process are being implemented that can better handle the local issues. A sound and efficient decentralization requires a close correspondence between responsibility and decision-making authority (Dabla *et al.*, 2002). However, for LG in Nepal, 80% of total budget (Table 4.1) comes from the CG with conditional guideline which is directly controlled by CG which renders LGs quite ineffective. Consequently, many demands and needs of local people are not being addressed.

**Table 4.3**  
**Ratio of Plan Selection Guided by Central Guideline and Applying Local Planning Process**  
(FY 2005/06)

Districts	Total Selection of Plan(P)	Guided by Central Guideline(C)	Applying Local Planning Process(L)	Percentage <sup>45</sup> (L/P*100)
Mugu	45	34	9	20
Gorkha	72	52	20	28
Rupandehi	123	53	70	57
<b>Average</b>	<b>67</b>	<b>47</b>	<b>20</b>	<b>35</b>

Sources: DDC Rupandehi, ADPR, FY 2005-06

The above table clearly shows the need for implementation of more plans demanded from the local level. These plans are important to be executed because they are the best means of assessing and addressing the demand of the public. However, on an average, only 35% of local demanded plans were implemented in these districts. In richer districts like Rupandehi, more than half of its local demands were met through local planning process addressing the local demand. In contrast, in Mugu, a district which depends heavily on central funding, only 20% of the locally demanded plan was implemented. Thus, the consequences of imbalance indicate that LGs having weak revenue base have fewer expenditure opportunities to exercise their planning authorities.

### **Impact on Service Delivery**

Following the norm of Decentralization, the service delivery systems are being handed down to LGs from CG. However, this has been done without making sure that proportional amount of resources, manpower and technologies are also available to LGs to

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<sup>45</sup> % of Implementation of plans come from grassroots level by using planning process

cope with the devolved tasks. Thus, the service delivery pattern gets highly deteriorated after the handover of public services like primary health care, primary school, agriculture and livestock program to LGs. Consequently, people lack trust quality and quantity of the LG service provision and very low level of service are being delivered<sup>46</sup>. The absence of adequate funds create problem for LBs to carry on devolved tasks. As, the local revenue generating potential is widely disparate and allocation pattern of resource for the social sector is discouraging, it highly undermines the concept of minimum service standard for all (DASU/DANIDA, 2003). Thus, local bodies are not able to ensure service standards like providing physical facilities to school building (rooms, and furniture) to health centers (drugs, equipments and medical consumables).

In addition to that, devolution without cooperation with relevant line ministry creates unclear and disputed authority, responsibilities and mandate between LGs and line agencies<sup>47</sup> which directly affects quality of service delivery. For instance, devolution guidelines mention the function, authority and responsibilities of the local bodies. However, the standards/norms set by respective ministries pose challenge for DDCs to estimate expenditure needs for devolved service.

For example, in Rupandehi, Ministry of health handed responsibilities for management and service delivery of over 70 health posts and sub health posts to LGs on FY 2003/04<sup>48</sup> without providing adequate resources for operation and management of the service units. After the handover was made, managerially, number of health care staffs was cutoff due to low budget allocation from DDC. Technically, DDC is not able to strongly monitor and evaluate the service provision due to lack of technical manpower. These factors directly impact on quality control of health service provided in those health posts in Rupandehi. Thus, handing over responsibilities from central to LG does not alone guarantee effective service delivery; it also needs to be backed by providing proportionate amount of required resources.

### **Misuse of Local Resources**

Due to factors like overlapping of functions between different line agencies and exploitation of power by local elite who lead most of the consumer group, misuse of local resources is prevalent in different levels. Overlapping leads to difficulty in monitoring and evaluating development works which leads to corruption. Shrestha expresses that due to unclear and overlapping functions, the CG through its agencies has been continuously

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<sup>46</sup> Interview from Local people (Ram kumar khanal, Shreenathkot, Gorkha)

<sup>47</sup> Interview from Joint secretary, NPC

<sup>48</sup> District Health Office, Rupandehi

bearing the burden of providing all major public services at local level which creates duplication and confusion in the expenditure assignment (Shrestha, 2002). A study find out that users committee in Mugu district takes budget from different sources like DDC, VDC, line agency and Non Governmental Organization (NGO) for implementation of development project (drinking water intake). Finally, they submit same progress report to different sources and misuse additional money<sup>49</sup>. This sort of activity creates a series of problem, including overstatement of the cost of provision of local public goods and diversion of local public goods to non-intended groups (Smoke et al, 2006).

### **High Ratio of Incomplete Plan**

Central government guidelines clearly states about restriction on changing heading of annual budget which comes from the CG. Due to budget freezing system, the government requires most of the annual budget (more than 80% grants)<sup>50</sup> to be finished by the end of a fiscal year (except mountain districts like Mugu). Caused by inflexibility in changing budget heading and sector, most of the plans and projects could be incomplete. In addition, it is difficult to make correct projection of capital investment as project remain incomplete because of defective planning process and weak technical as well as financial capacity. Expenditure pattern of allocated budget is an average of 85% of the total local development budgets (Table 3.5). However, the rates of incomplete plan/program which were funded by conditional grant is extremely high at an average 45%.

**Table 4.4**  
**Number of Completing Plan Funding from Conditional Grant in FY 2005-06**

Districts	Number of Plan Implementation Funding from Conditional Grant	Number of Plan Complete in the End of Fiscal Year	Percentage of in Complete
Mugu	34	14	59
Gorkha	52	30	42
Rupandehi	53	35	34
<b>Average</b>	<b>46</b>	<b>26</b>	<b>45</b>

Sources: DDCs, Mugu, Gorkha and Rupandehi, ADPR, FY 2002-03 to 2006-07

According to the table 4.4, Mugu had the maximum percentage of incomplete plan while Rupandehi had the least. Thus, the completion ratio of centrally guided plan is very low compared to the LG owned plans which come from grassroots level.

### **Participation and Ownership on Local Development Activities**

In the implementation phase, people are more enthusiastic about participating in those programs which truly addresses the problems in the community. They might even organize their own programs (selection by local people). In contrast, people are not moti-

<sup>49</sup> DDC, Mugu, ADPR, FY, 2004-05

<sup>50</sup> (MLD, 2006a)

vated to involve and take ownership on the central guided programs which seldom addresses their issues.

**Table 4.5**  
**Degree of Participation on Plan/Program Funding by Central Grant and Internal Resources**  
(In FY 2005-06)

Districts	Plan/Project Funding by CG Grant		Plan / Program Funding by Internal Resources	
	Number	Degree of Participation	Number	Degree of Participation
Mugu	34	15	9	28
Gorkha	52	14	20	30
Rupandehi	53	10	70	28
<b>Average</b>	<b>47</b>	<b>13</b>	<b>20</b>	<b>29</b>

Sources: DDCs, Mugu, Gorkha and Rupandehi, ADPR, FY 2005-06

The table 4.5 shows that the degree of participation in plan/program funded by internal resources is high (an average 29% total cost from people participation) primarily because they represent the real need of local people by involvement of the planning process. On the other hand, People are less reluctant towards the participation (an on average 13% participation) on central funding plan/program because it goes beyond need assessments which make central planning more prone to being unsuccessful and ineffective. Consequently, they do not feel ownership in one hand and do not represent their need on the other. It leads to failure of most of the program.

#### Less Innovativeness for Raising the Internal Resources

Over dependency on central grant, negatively affects the incentive to collect local resources efforts by the LG. DDCs are not so motivated for raising the internal resources and applying borrowing provision because they get lax due to the availability of central grants. Increased fiscal autonomy can also be instrumental in mobilizing more revenues from local sources, which helps to improve a country's overall fiscal position (shah, 2006). However, the transfer system should not be an incentive to local bodies generating higher amount of own source revenue because there is enough money coming from centre government. DDCs are not motivated to invest in alternative resources generation which could help to alleviate the financial situation in long run. For instance, all three selected DDCs have almost zero budgets<sup>51</sup> on research or study for generation of alternative resources. Because of easy availability of central funds, policy makers have fewer obligations to explore the new tax base and increase tax rate. Hence they almost always apply minimum tax policy which clearly impacts on sustainability of fiscal decentralization.

<sup>51</sup> DDC, Mugu, Gorkha and Rupandehi, Budget Analysis of FY 2005/06,

## **Chapter V**

### **Conclusion and Policy Implication**

#### **5.1 Conclusion**

The study analyzed the causes of fiscal imbalance within LGs, and its consequences on autonomy and local self governance of these governments in Nepal. This paper mainly focused on reasons for occurrence of fiscal gap-both horizontal and vertical. Therefore, a thorough work was done to realize the effects of expenditure and revenue assignments on fiscal imbalance. Furthermore, the impact of capacity and geo-political features of LG on occurrence of fiscal imbalance was also minutely studied. With this understanding, the study focused on obtaining detailed knowledge about procedures to overcome ensuing fiscal gap in LGs. Among others, intergovernmental funds transfer and revenue sharing were explored as means to overcome fiscal imbalances prevalent in LGs in Nepal. Relationship between intergovernmental fiscal transfer and local self governance was analyzed focusing primarily on effects of fiscal dependency on local self governance.

Similarly, the paper discusses broad issues of rising influence of CG on LGs through intergovernmental fiscal transfer thus, increasing their dependency on CG in Nepal. Furthermore, it emphasizes on the hindrance created by over dependency on autonomy of local bodies. It establishes the necessity of decentralization in achieving successes in development works conducted in local level. The research concludes by underlying the importance of self governance at the core of decentralization process and how organized development efforts can be achieved in Nepal by their implementation.

Over the course of time, Nepal has been systematizing the process of decentralization realizing its importance to the issues of local development. Following the world wide political and economic trends, government adopted the fiscal decentralization policy. In 1999, LSGA was constituted which granted autonomous legal status to the LGs bestowing them with authority. However, owing to various reasons, these LGs continued to be plagued by both horizontal and vertical fiscal imbalances which ultimately threaten to undermine their autonomy. The research mainly deals with the causes of fiscal imbalance in detail.

In the revenue aspect of cause of fiscal imbalance, highly unequal distribution of natural resources, less incentive for borrowing, insufficient autonomy to determine the revenue base and threshold of tax are the major factors affecting fiscal inequality. In Nepal, major sources of revenues are still collected by CG which leaves LGs with very little

sources of revenue thus helping to create vertical imbalance. The primary sources of DDCs are export taxes on natural resources which vary geographically. This exacerbates the inequality between districts because districts in terai region like Rupandehi have higher concentration of natural resources than mountainous ones like Mugu. Furthermore, export taxes on natural resources are not sustainable sources of revenue because these resources are non renewable. And the tendencies of LGs to depend on central funds rather than practicing borrowing among themselves have not helped the cause.

Another cause of fiscal imbalance is improper expenditure assignment among governments. Exceedingly small portion (6%) for local bodies in total governmental expenditure is one of the major causes of such imbalances. Function and responsibilities are not so clear; as a result there is widespread overlap in the scope of work between CG and LG. There is considerable difficulty and confusion in implementation of development service because the guidelines have been produced independently by the concerned ministries. This leads to erratic development efforts; where by CG might control projects, like sewage and irrigation, which would have been better managed by LGs. This unclear division of responsibilities leads to confusion in assessment of minimum expenditure requirement of local bodies, which invariably leads to fiscal imbalance.

The size of district and demographic characteristic creates great variations in the expenditure needs across jurisdictions because of per unit cost and different level of development in different geographical location. In all most all districts in Nepal, level of capacity is very low and capacity of human resources is not satisfactory. This makes it difficult for them to conduct local development planning process by involving the target group. Frequent transfer of LDO, low numbers of professional manpower and inharmonious relation among officials have rendered human resources deplorably inadequate. This is worsened by MoLD's inability to regulate decentralized action and local finances.

Additionally, low political commitment in terms of less priority to implement and enhance the fiscal decentralization by CG has been a significant problem. In the recent past, shift of focus from development issues to security issues has forced CG to lower priority for fiscal decentralization. Besides, the "less tax to be popular" attitude of local political decision-maker has not helped the cause. The absence of local representatives in LG has also delayed the process of fiscal decentralization. The contradiction of LSGA and other sectoral laws create confusion and conflict on revenue sharing. Besides, socio-political factors like exploitation of local resources by higher caste individuals and ex-politicians in LGs have also helped to increase vertical imbalance.

Local governments' budget deficits are fulfilled by central governmental transfers in forms of grant and revenue sharing in both horizontal and vertical dimension. This fact is supported by the fact that on average 78% of LGs' revenue comes through central funding for the three selected districts. The majority (86%) of central funding comes as conditional grants which bring the central mandate. However, these central driven projects do not necessarily address the needs of local people and as such may not serve in the best interest of people. Conditional grants, therefore, restrict the decision making power of LGs which is against the creed of decentralization. On the other hand, unconditional transfer and shared revenue allows LGs to exercise full authority regarding planning, allocation and selection of the project and thus allowing them maximum flexibility in expenditure areas. However, local bodies are tending to rely heavily upon the conditional grant rather than unconditional grant and revenue sharing which are not conducive to local self governance.

The promotion of local self governance is one of the important objectives of decentralization in Nepal. The consequences of imbalance find out that LGs have fewer expenditure opportunities to exercise their planning authorities. The lack of adequate funds creates problem for LBs to take on devolved tasks which has a huge impact on service delivery. Due to overlapping of the function between different line agencies misuse local resources in different levels is very high. Degree of people participation and ownership in development works implemented by central guided plans/projects is alarmingly low primarily because they seldom fulfill the local needs. LGs are not so innovative in raising the internal revenues and applying borrowing provision because they have enough money coming from CG.

In conclusion, the study analyzes how fiscal imbalances occur in LGs and discusses their impacts on the local self governance of these bodies. The study also shows how local self governance is at the heart of decentralization by showing how decentralization efforts in Nepal are marred by weak fiscal and administrative capacity of LGs and overbearing presence of CG in local development. At the end, the study recommends some policies and procedures which could help the cause of fiscal decentralization process in Nepal.

## **5.2 Policy Implication**

To reduce the fiscal gap and promote the local self governance in Nepal, the study recommends the following procedures in order to tackle the pressing issues of fiscal decentralization.



The expenditure responsibilities of all levels of governments must be clear and transparent in order to monitor the activities among various levels of government. Functional devolution is not enough for providing basic services because DDC are not able to cover devolved function. Thus, CG should introduce minimum expenditure standards for certain basic services like healthcare, education, drinking water and should also devolve required resources to LG.

Regarding the revenue mobilization, DDCs are more focused on collection of natural resources which are not sustainable sources of revenue. Thus, it is necessary that the DDCs be aware of the ill consequences of excessive use of the natural resources like soil erosion and depletion of bio-diversity. LGs should make effective revenue generation and mobilization plan as well as invest on research and development for alternative source of revenue. CG should make apparent and detailed guidelines for borrowing which facilitates as well as encourages borrowing among LGs which is an important alternative method to fill the fiscal gap.

In terms of intergovernmental transfer, CG should avoid the conditional grant with guidelines and promote block grant which helps to protect local fiscal autonomy. Current interim formula should be revised and an addendum must be made to the present list of financial indicators. Some of these additions could be status of internal resources, GDP of district, poverty level and per capital income of district. HDI indicator by itself is seldom a proper representative of the real situation of the district. Thus, poverty level of the district could be a good indicator that can be observed through economic, social and physical aspects which helps in equitable redistribution of central resources. There is a need to make special arrangement for strengthening capacity of LBFC to make the grant system operationally effective.

The CG should eliminate contradictory provisions and laws that clash with LSGA in order to create harmony among stockholders. All of development activities should be properly integrated into planning process to ensure coordination and command. CG should continuously monitor the local development activities and give technical backstopping as well as advisory support.

To promote the capacity, LGs should provide more attention on thematic areas of capacity development like strategic planning, organizational development, human recourse development, information management, coordination, recourse mobilization and communication. LGs should focus on recruitment of necessary human resource and make them technically capable and enhance expenditure capacity. The coordination among LG, differ-

ent line agencies, Ministries and NGOs should be institutionalized in order to sort out differences and consensually address the issues of fiscal decentralization. Local political as well as administrative executives should be made more aware and enthusiastic for revenue generation because political will and commitment is the leading force for effective implementation of fiscal decentralization policy.

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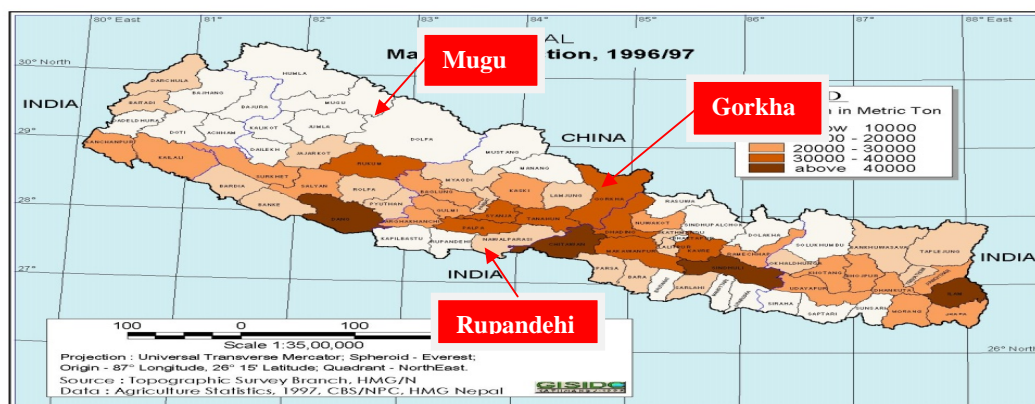


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# Appendixes

## Appendix I

Selected Three Districts in Map of Nepal



Source: MLD, Information Section with calculation

## Appendix II

### Indicators

The Relationship between Variable, Main Aspects and Measurement Indicators

Variable	Main Aspects	Measurement Indicators
Local Government Fiscal Capacity	<ul style="list-style-type: none"> <li>Political Commitment</li> <li>Legal Provision</li> <li>Administrative Structure</li> <li>Planning System</li> <li>Human Resource</li> <li>Financial Flow</li> <li>Use of Technology</li> </ul>	<ul style="list-style-type: none"> <li>Leadership, Meeting of Assembly</li> <li>Financial Authority, Expenditure Responsibility,</li> <li>Clear Division of Responsibility and Authority</li> <li>Participation, co-ordinations</li> <li>Train Manpower, Decision Making Power</li> <li>Channel of Fund Flow, Time Schedule of Reporting System</li> <li>Use of Computer Accounting Software, Communication</li> </ul>
Local Government Fiscal Autonomy	<ul style="list-style-type: none"> <li>Tax Assignment</li> <li>Expenditure Assignment</li> <li>Administrative Freedom</li> <li>Monitoring</li> <li>Reporting</li> </ul>	<ul style="list-style-type: none"> <li>Authority for Setting Tax, Change in Threshold and Rate</li> <li>Degree and Volume of Guideline from Central.</li> <li>Central Monitoring Provision, Auditing System</li> <li>Reporting to Center,</li> </ul>
Local Government Dependency on Central Government	<ul style="list-style-type: none"> <li>Intergovernmental Transfer</li> <li>Regulation</li> <li>Accountability</li> </ul>	<ul style="list-style-type: none"> <li>Volume of Grant, Weight of Unconditional Grant.</li> <li>Direction Provision, Guideline System</li> <li>Reporting System, Review Meeting, Performance Measure System from Center.</li> </ul>
Local Self Governance	<ul style="list-style-type: none"> <li>Decision Making Authority</li> <li>Planning Authority</li> <li>Independent Human Resources Management</li> </ul>	<ul style="list-style-type: none"> <li>Number of Decision Done in Local Government</li> <li>Follow of Planning Process ,Incorporate</li> <li>People's Demand in Annual Planning, Freedom to Decide Governmental Transfer, Follow of Strategic Plan.</li> <li>Recruitment Authority, Delegation of Power</li> </ul>

Source: Base on Analytical Framework of This Study

## Approaches

*(For sub question 1: What are the causes of imbalance between local government expenditure and revenue?)*

- Selected three local government annual actual budgets and programs including central government guidelines and policy using budget from FY 2002/03 to 2006/07 of entire DDCs which were analyzed quantitatively. I used coefficient method to calculate vertical imbalance and comparative analysis to calculate horizontal imbalances. Analyzed the fiscal capacity of sampled local governments by using capacity development indicator.

*(For sub question 2: How do intergovernmental fiscal transfers contribute to reducing or worsening fiscal inequality between districts and regions?)*

- Analyzed the pattern of grant formula, revenue sharing indicator, existing policy and decision of intergovernmental fiscal transfer at central as well as local level by observations and interviews methods and using qualitative methods for analysis.

*(For sub question 3: To what extent do intergovernmental transfers create dependency of local government on central government?)*

- Reviewed of sampled local governments' financial decision pattern from 2002/03 to 2006/07 by analyzing and observe the decision pattern of local bodies, central government guidelines and policies by policy document review using qualitative method for analysis.

*(For sub question 4: What are the consequences of inadequate fiscal autonomy of local self governments?)*

- Review the impact of fiscal contribution on local development by using interview method among local stakeholders.

## Appendix III

### Sources of Revenue of DDC

1.	<b>Tax</b>	<ul style="list-style-type: none"> <li>➤ Wool, solvent extraction, herbs dry grass (bankes) Kabadi (reusable solid waste) boulders, slate, sand, animal bone, horn, feather, hyde (export tax)</li> </ul>
2.	<b>Service charge (in services provided by DDC)</b>	<ul style="list-style-type: none"> <li>➤ Road, bridge, irrigation canal, pond</li> <li>➤ Guest house, library, medical centre, Inn, community hall</li> <li>➤ Canal, water source (irrigation), embankment</li> <li>➤ Local Development Fee</li> </ul>
3.	<b>Fee</b>	<ul style="list-style-type: none"> <li>➤ River rafting, boat, tuin, fishing permission and renewal</li> <li>➤ Registration and renewal fee for water bank</li> <li>➤ Recommendation fee</li> <li>➤ Others</li> </ul>
4.	<b>Sales</b>	<ul style="list-style-type: none"> <li>➤ River sand, aggregates, boulders, slate, soil, swept away wood</li> </ul>
5.	<b>Loan</b>	<ul style="list-style-type: none"> <li>➤ Borrowing from bank or other Institutions with or without collateral with approval from District Council and on guarantee from Government of Nepal</li> </ul>

Source: GoN, 1999

## Appendix IV

### Trends of Internal Income in Local Government in Nepal

Year	Total Internal Income
2002-03	1,054,289
2003-04	1,264,724
2004-05	1,420,531
2005-06	1,599,443
2006-07	1,719,434

Sources: MOF, National Annual Budget from 2002-03 to 2006-07 with calculation

## Appendix V

### Composition of Internal Resources in Rupandehi (FY 2005-06) (Rs in Thousands)

Sources	Amount	% of internal re-sources
Tax	74,418	53
Service charge	225	0
Fee	134	0
Loan	00	0
Land revenue	25,200	18
Last year saving amount	35,127	25
Other income raising programmes	4,787	4
<b>Total</b>	<b>139,891</b>	<b>100</b>

Source: DDC Rupandehi, Annual Development Progress Report FY 2005-06

## Appendix VI

Composition of Development Expenditure, FY1999/00-FY04/05 (Rs Billion)

Item	FY99/00	FY00/01	FY01/02	FY02/03	FY03/04	FY04/05
<b>Social Services</b>	<b>12.41</b>	<b>12.87</b>	<b>11.53</b>	<b>12.19</b>	<b>17.58</b>	<b>22.38</b>
Education	2.57	2.78	2.76	2.73	4.34	6.26
Health	2.13	1.97	1.88	1.62	3.03	4.51
Drinking Water	2.42	2.41	1.75	2.01	3.46	3.57
Local Development	4.14	4.63	4.16	5.27	5.40	6.14
Other Social Services	1.15	1.08	1.00	0.56	1.36	1.89
<b>Economic Services</b>	<b>8.13</b>	<b>8.70</b>	<b>8.27</b>	<b>6.24</b>	<b>10.17</b>	<b>10.42</b>
Agriculture	2.09	2.33	2.56	1.83	2.20	2.53
Irrigation	3.04	3.95	3.14	2.14	2.70	3.10
Forestry	0.52	0.48	0.63	0.62	0.63	0.67
Other Economic Services	2.48	1.94	1.93	1.65	4.65	4.12
<b>Infrastructure</b>	<b>10.52</b>	<b>12.41</b>	<b>9.18</b>	<b>9.35</b>	<b>13.16</b>	<b>13.35</b>
Roads/Transportation	4.70	5.35	4.52	3.73	5.39	5.66
Communication	0.28	0.24	0.27	1.72	0.85	1.34
Electricity (power)	5.54	6.81	4.40	3.90	6.92	6.35
<b>Others</b>	<b>0.69</b>	<b>3.08</b>	<b>2.50</b>	<b>1.25</b>	<b>0.93</b>	<b>1.05</b>
<b>Total Development Expenditures</b>	<b>31.75</b>	<b>37.07</b>	<b>31.48</b>	<b>29.03</b>	<b>41.85</b>	<b>47.2</b>

Source: Asian Development Bank, 2005

## Appendix VII

Composition of Expenditure in Selected DDCs (FY 2005/06) (Rs in Thousands)

Districts	Total Expenditure	Type of Expenditure			
		Capital Expenditure		Administrative Expenditure	
		Amount	Percentage	Amount	Percentage
Mugu	103,859	91,705	88	12,154	12
Gorkha	144,565	100,304	69	44,245	31
Rupandehi	250,861	196,255	78	54,606	22
<b>Average</b>	<b>166,428</b>	<b>129,421</b>	<b>78</b>	<b>37,002</b>	<b>22</b>

Sources: DDCs, Mugu, Gorkha and Rupandehi, Annual Development Progress Report, FY 2005-06

## Appendix VIII

Composition of Expenditure in DDC, Rupandehi

Items	Percentage of Sharing
Social Service	Education
	Health
	Drinking Water
	Human Resources Development
	Other social service
Economic Service	Agricultural
	Irrigation
	Forestry
	Other economic service
Infrastructure Development	Road
	Communication
	Electricity (Power)

Sources: DDCs, Rupandehi, Annual Development Progress Report, FY 2004-05 with calculation

## Appendix IX

### Division of Functions and Responsibilities Between Central and Local Bodies

(Based on Local Self-Governance Act, 1999)

<i>SN</i>	<i>Functions or Responsibilities</i>	<i>Centre</i>	<i>DDC</i>	<i>Muni</i>	<i>VDC</i>
1.	Relating to physical development				
a.	Plan formulation and implementation of land use	✓	✓	✓	✓
b.	Plan formulation and implementation of settlements and Haat (market)	✓	✓		
c.	Residential area plan formulation and implementation	✓		✓	
d.	Quality of buildings and other physical infrastructure	✓		✓	✓
e.	Approval of building designs			✓	
f.	Development of greenbelt, entertainment area	✓		✓	
g.	Public lavatories			✓	
h.	Construction of community buildings and guest house			✓	✓
i.	Water supply and sewerage plan implementation, operation / maintenance	✓	✓	✓	✓
2.	Relating to water resources, environment and sanitation				
a.	Water source protection and utilization	✓		✓	✓
b.	Irrigation programme implementation	✓	✓	✓	✓
c.	Control of soil erosion and river encroachment	✓	✓	✓	✓
d.	Assistance in pollution control, environmental conservation and consolidation	✓	✓	✓	
e.	Management of soil waste and sanitation programme	✓		✓	✓
f.	Generation and distribution of electricity	✓		✓	✓
g.	Management of micro hydro and other energy programme	✓	✓		
3.	Forest and Environment				
a.	Plan formulation and implementation of forestry, geodiversity and soil conservation	✓	✓	✓	✓
b.	Programmes of environment and afforestation	✓	✓	✓	✓
4.	Education and sports development				
a.	Permission for running pre primary school with private resources			✓	✓
b.	Recommendation for permission to open school or close them on priority		✓		
c.	Assistance in management of schools in respective areas and recommendation for opening or closure			✓	
d.	Management and supervision of schools in respective areas				✓
e.	Assistance in making primary school available in mother tongue			✓	✓
f.	Assistance in supervision, monitoring and management of schools	✓	✓	✓	✓
g.	Provision of scholarship for students of depressed committees	✓		✓	✓

Sources: Local Authorities Fiscal Commission Report, Nepal, 2000

## Appendix X

### Capacity Measuring Checklist

SN	Key Areas of capacity	Mugu	Gorkha	Rupandehi
<b>1.</b>	<b>Strategic Management</b>			
1.1	District periodic plan (DPP) prepared & published	-	✓	-
1.2	DPP mid-term review	-	-	-
1.3	Districts prepared VPP in few VDCs	-	-	✓
1.4	Preparation of DTMP	✓	✓	✓
1.5	Capacity gap assessment of DDC	✓	✓	✓
1.6	Gender Budget Auditing of DDCs		✓	
<b>2.</b>	<b>Organizational Structure &amp; Culture</b>			
2.1	Monitoring Guidelines prepared for DDC	-	✓	✓
2.2	Citizen charter published	✓	✓	✓
2.3	OD study report prepared	-	✓	✓
2.4	OD study report review	-	✓	-
<b>3.</b>	<b>Information Management System</b>			
3.1	Well established DIDC	-	✓	✓
3.2	GIS package Installed and maps produced	-	✓	✓
3.3	Resource map-book published	-	✓	
3.4	Poverty map-book published	-	-	
3.5	Social mobilization mapping completed	-	✓	✓
3.6	Deprivation mapping of VDCs completed	-	✓	✓
3.7	DDC website created	-	✓	-
3.8	E-mail, Internet facility available	-	✓	✓
3.9	DIDC equipped with lap-top and LCD projector	-	✓	✓
3.9	District profile published	-	✓	✓
3.10	District profile updated ( after 2060 BS)	-	✓	-
<b>4.</b>	<b>Human Resource Development</b>			
4.1	TNA for DDC staff	✓	-	✓
4.2	Staff trained in GIS (advanced level)	-	✓	✓
4.3	Training to VDC secretaries (more than 35 days)	-		
4.4	Staff trained in financial .management, record keeping/ reporting, planning	-	✓	✓
<b>5.</b>	<b>Accounting and Financial Management</b>			
5.1	Accounting Package Installed (updated one)	-	✓	✓
5.2	Internal audit section established		✓	✓
5.3	Staff appointed in internal audit section		✓	✓
5.4	Make Public the financial report	✓	✓	✓
5.5	Workshop / Study to identify potential internal revenue areas of DDC/VDC	-	-	✓
<b>6.</b>	<b>Working Process</b>			
6.1	Public hearing program organizing by DDC	-	-	✓
6.2	Computer networking	-	-	✓
6.3	PABX (intercom)	-	✓	✓
6.5	Publication of DDP	✓	✓	✓
6.6	Computerized record keeping of DDC plan/projectssection	-	✓	✓
<b>SN</b>	<b>Key Thrust Areas and Major Outputs</b>			
<b>7.</b>	<b>Linkage &amp; Coordination</b>			
7.1	Preparation of NGO profile	-	✓	✓
<b>8.</b>	<b>Other Information</b>			
8.1	No. of Program Officers	-	3	4
<b>9.</b>	<b>Others if Any?</b>			
	<b>Total</b>	<b>6</b>	<b>22</b>	<b>26</b>

Source: Decentralized Local Self Governance Program, 2007

## Appendix XI

### Composition of DDCs Staff

Districts	Administrative staffs			Technical staffs			Account staffs		
	Professional	Non professional	total	Professional	Non professional	total	Professional	Non professional	total
Mugu	2	28	30	6	11	17	-	7	7
Gorkha	6	21	28	5	22	28	3	7	10
Rupandehi	10	32	42	18	29	47	5	15	20
<b>Average</b>	<b>6</b>	<b>27</b>	<b>33</b>	<b>10</b>	<b>21</b>	<b>31</b>	<b>3</b>	<b>10</b>	<b>12</b>

Sources: DDCs, Mugu, Gorkha and Rupandehi, Annual Development Progress Report, FY 2004-05 with observation in selected districts.

## Appendix XII

### Share of Grant on Total Development

FY	Mugu			Gorkha			Rupandehi		
	Total Budget	Grant	Percentage	Total Budget	Grant	percentage	Total Budget	Grant	percentage
2002-03	23,046	21,818	95	93,462	78,943	84	184,796	108,777	59
2003-04	63,277	62,432	99	79,314	65,177	82	178,871	96,632	54
2004-05	87,345	85,784	98	91,538	77,200	84	228,250	120,675	53
2005-06	103,859	102,767	99	144,565	142,125	98	250,861	110,970	44
2006-07	117,960	116,960	99	172,739	145,693	84	394,160	194,404	49
<b>Average</b>	<b>79,097</b>	<b>77,952</b>	<b>98</b>	<b>116,324</b>	<b>100,816</b>	<b>86</b>	<b>247,388</b>	<b>126,292</b>	<b>52</b>

Sources: DDCs, Mugu, Gorkha and Rupandehi, Annual Development Progress Report, FY 2002-03 to 2006-07 with calculation

## Appendix XIII

### Composition of Grant

S.N	FY	Total Development Grant	Block Grant	% of Block Grant on total Dev. Grant	conditional	% of Conditional Grant
1	2002-03	4,998,490	805,000	16	4,193,490	84
2	2003-04	5,529,600	830,500	15	4,699,100	85
3	2004-05	6,813,084	1,013,480	15	5,799,604	85
4	2005-06	8,169,860	1,125,000	14	7,044,860	86
5	2006-07	11,579,953	1,400,000	12	10,179,953	88
<b>Average</b>		<b>7,418,197</b>	<b>1,034,796</b>	<b>14</b>	<b>6,383,401</b>	<b>86</b>

Source: MLD, Annual Development Programs: An Introductory Booklet, FY 2002/03 -06/07 with Calculation

## Appendix XIV

### Central Guidelines to DDCs on the use of Grant Fund

- Uncompleted projects carried forward from the preceding fiscal year should be given priority in the allocation of funds
- Investment to be directed towards attaining the objectives, programs and results as set out or preferred in the Tenth Plan, periodic plan/sectoral periodic plan or the DDC itself.



- Matching fund may be provided in the projects/programs funded by the donor agencies, INGOs, financial institutions or in public/private partnership and sectoral projects.
- Investment may be made after approval of the program in the following cases:
  - Program related to the capacity enhancement of DDC
  - Programs involving cross cutting issues
  - Programs related to minimization of calamity risks and rescue and rehabilitation
- Investment may also be made in the programs aimed at fulfilling the minimum conditions specified in the LSGA (participatory planning process and budget formulation, financial management, accounting and auditing, human resources development, establishment of district information center and operation, program evaluation, review and reporting, enhancement internal revenue sources and its mobilization management, settlement of audit irregularities, social audit, grievances hearing, transparency, etc.)
- Social mobilization and implementation of targeted group programs may be implemented either independently or in partnership  
(Source: Ministry of Local Development, 2006a)

## Appendix XV

**Comparison of Grant and Revenue Sharing (Rs in Thousands)**

FY	Average Revenue Sharing Amount	Average Grant Amount
2002-03	6,371	69,846
2003-04	8,794	74,747
2004-05	7,906	94,553
2005-06	12,971	116,935
2006-07	23,408	151,399

Sources: DDCs, Mugu, Gorkha and Rupandehi, Annual Development Progress Report, FY 2002- 03 to 2006-07 with calculation

## Appendix XVI

### List of the Interviewed and Visited Persons

1. Som Lal Subedi,.....LBFC, MLD
2. Iswari poudyel.....LBFC, MLD
3. Surya prashad Acharya.....MLD
4. Reshami Raj Pandey.....MLD
5. Surya bandana pandit.....MLD
6. Subash sabakoti.....MLD
7. Mukunda Prakash Ghimera.....NPC
8. Chakra pani archarya, NPC.....NPC
9. Bishnu thapa.....DDC, Rupandehi
10. Ram mani Bhattarai.....DDC, Gorkha
11. Narayan Sharma .....DDC, Gorkha
12. Ram Kumar Khanal.....ShreeNathKot VDC, Gorkha
13. Mohan Pokhral ..... Gorkha