

## Comparative Fiscal Performance of Provincial Governments

*In Nepal, obstacles and mal practices experienced at the federal level have been cascaded down to lower tiers of the government. The province governments have carried out the financial legacy of federal government, a legacy which has drawn much criticisms for its failure to ensure transparency and accountability. The spending of province and local governments has not been as expected. This has largely stifled development activities.*



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### A. Context

Federalism is still a nascent concept in Nepal, and the structural changes associated to the institutionalization of federalism are ongoing (Adhikari and Shrestha, 2019). The Constitution promulgated in 2017 prescribes a three-tier governance system consisting of federal, province and local governments. These three independent government units are provided with exclusive rights to prepare and execute their own budget. During the fiscal year 2074/75(2017/18), all 7 provinces prepared for the first time their

trimester budget, and this marked the beginning of a new era of fiscal federalism in Nepal. In this paper, our aim is to compare and analyze the fiscal performance of all 7 provinces, as reflected in the budget.

### B. Federal Administrative Structure

The new federal structures have resulted in several administrative and structural adjustments in the country. The present structure consists of 77 districts and 753 local units. The local units are made up of 6 metropolitan and 11 sub-metropolitan cities, 276 municipalities (nagar palikas) and

460 village bodies (gaun palikas). Approximately 60% of the country's population are living urban areas. Provinces have emerged as a second-tier government, each having its own governance and administrative structures. All

7 provinces have finalized their capital cities, and 4 provinces have agreed on their names. The table below presents an overall macro-economic scenario of all 7 provinces.

**Table 1: Macro economic scenario of provinces**

Province	Capital	Districts	Area	Population	GDP (In billion NRs.)	%
Province 1	Biratnagar	14	25,905 km <sup>2</sup>	45,34,943	505.85	14.60
Province 2	Janakpur	8	9,661 km <sup>2</sup>	54,04,145	444.50	12.83
Bagmati	Hetauda	13	20,300 km <sup>2</sup>	55,29,452	1432.76	41.36
Gandaki	Pokhara	11	21,504 km <sup>2</sup>	24,03,757	288.21	8.32
Province 5	Butwal	12	22,288 km <sup>2</sup>	44,99,272	452.80	13.07
Karnali	Birendranagar	10	27,984 km <sup>2</sup>	15,70,418	119.26	3.44
Sudurpaschim	Godawari	9	19,539 km <sup>2</sup>	25,52,517	220.96	6.38
<b>Nepal</b>		<b>77</b>	<b>147,181 km<sup>2</sup></b>	<b>26,494,504</b>	<b>3464.32</b>	<b>100.00</b>

*Source: Regional (Provincial) National Accounts (2019), CBS / GDP based on current price*

The province administration includes ministries and other constitutional bodies. The following six ministries and seven constitutional bodies are functioning in each province of the country:

Ministries	Constitutional bodies and entities
1. The Ministry for Economic Affairs and Planning (which includes finance)	1. Provincial Assembly
2. Ministry for Internal Affairs and Law	2. Office of the Chief Minister and Council of Ministers (OCMCM).
3. Ministry for Physical Infrastructure and Development	3. Office of Chief of Province
4. Ministry for Land Management, Agriculture and Co-Operatives	4. Province Attorney General
5. Ministry for Social Development (which includes education and health)	5. Province Planning Commission
6. Ministry for Industry, Tourism, Forest and Environment	6. Province Public Service Commission
	7. Province Treasury Controller Office

**C. PFM Architecture**

Public financial management (PFM) concerns planning, budgeting, accounting, reporting and auditing. Different units are responsible for handling each of these PFM

elements. The Constitution of Nepal has codified the authority of different institutions, including the Financial Comptroller General Office (FCGO), the Auditor General Office (AGO), and National Natural Resources and Fiscal Commission (NNRFC) for the effective facilitation of financial administration in the country. Part 22 of the Constitution has empowered the AGO to undertake auditing of all federal, provincial-level and local government units, including the constitutional bodies. This is further elaborated in Section 3 of the Audit Act 2075. Section 5 of the Federal Financial Procedures and the Fiscal Responsibility Act of 2017 have authorized the FCGO to consolidate the financial statements prepared by government units at all levels, including the province and local levels. The same article also empowers the FCGO to develop the accounting formats and systems that can be used by government units; this is, however, subject to approval by the AGO. In 2009, the Ministry of Finance, the FCGO, has approved the use of a set of Nepal Public Sector Accounting Standard (NPSAS) when reporting the accounts. The FCGO monitors that the financial statements prepared by government units adhere to the requirements as set out in the NPSAS. The FCGO has made several institutional and statutory changes for the smooth facilitation of fiscal federalism. A major intervention has been the revision of the Chart

of Accounts (COAs), making them compatible with the new federal set-up. The use of the COAs has resulted in promoting uniformity in accounting practice and reporting across all three tiers of the government. In addition, the FCGO is in the process of enacting a new financial procedure and responsibility regulation to guide the consolidation of accounts at the province and local levels. The establishment of other provincial institutions such as the Provincial Treasury Controller Office, the Provincial Planning Commission and the Provincial AGO is also under way. Few provincial governments have already developed their provincial financial procedure act, and they are in fact ahead of the federal government in terms of issuing similar procedures at the central level. More recently, the parliament has endorsed several bills relating to the decentralization of financial administration, including a National Natural Resources and Fiscal Commission Bill, an Intergovernmental Fiscal Transfer Bill, and a Civil Service Adjustment Bill. It is expected that the enforcement of these regulations and acts would help set up a firm structure for financial federalism in the country.

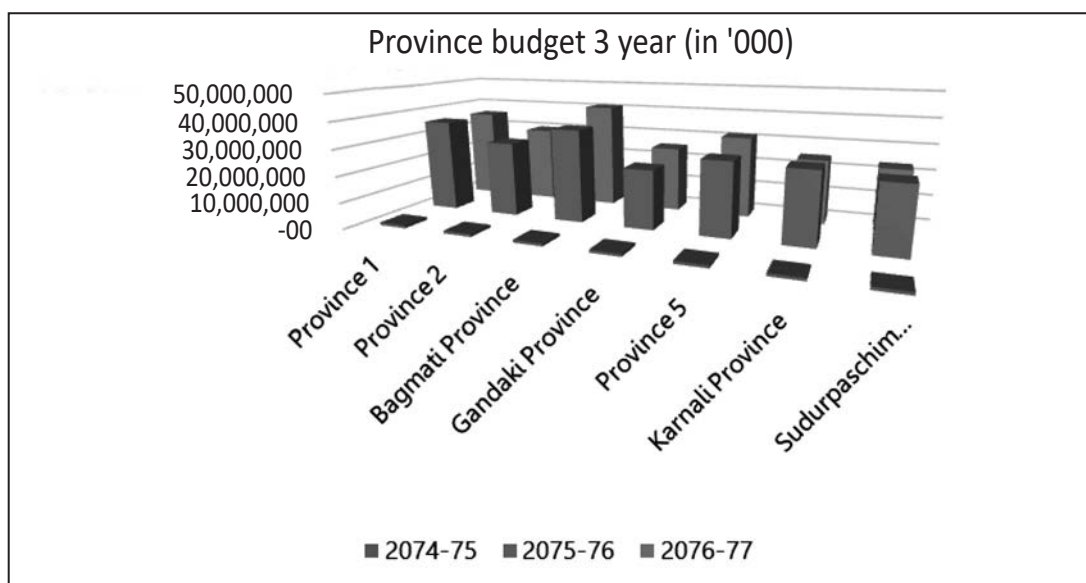
#### D. Provincial Budget Allocation and Execution

Setting up provincial budget was a challenging endeavor. All seven provinces struggled when preparing their first budget due to limited experience, capacity and IT

systems. At that time, the guidelines for an annual budget preparation, the medium-term expenditure framework, the periodic plans were absent. A web-based software system, SuTRA, which was provided by the federal government, significantly helped the province governments to prepare their budget and annexes. In the following years, these challenges envisaged in the budget preparation were gradually addressed through the enactment of appropriate guidance and regulations. Some provinces enacted up to 52 acts and regulations, some of which were related to budget preparation and execution, during the year. The table below shows the initial budget prepared by all seven provinces through the mobilization of the federal fiscal equalization grants. The Bagmati province has the largest volume of budget compared with other provinces.

**Table 2: Province budget for past four years**

Province	Total budget (Rs, billion)			
	074/75	075/76	076/77	077/78
One	1.02	35.93	42.20	40.90
Two	1.02	29.78	38.72	33.56
Bagmati	1.02	35.61	47.60	51.43
Gandaki	1.02	24.20	32.13	34.84
Five	1.02	28.90	36.41	36.35
Karnali	1.02	28.28	34.35	33.74
Sudurpaschim	1.02	25.60	28.16	33.38
<b>Total</b>	<b>7.14</b>	<b>208.30</b>	<b>259.57</b>	<b>264.21</b>



The execution of the provincial budget is largely unsatisfactory. A trend of the high last quarter spending is observed in all provinces. Capital expenditures are relatively low when comparing with recurrent expenditures. The table below depicts the reality of the first budget in effect, as the spending within a period of three months was around 35.23% of the total allocation. Most provinces spent budget on activities such as office establishment, vehicle purchase and training. During the fiscal year 2018/19, the overall budget spending was around 56.39% of the total allocation; another example of unsatisfactory performance. A large portion of the current year budget (2019/2020) is being spent on staff adjustments (Karmachari Samayojan). Below we have compared the budget and actual expenditures of all seven provinces for the last three years.

**Table 3: Actual Expenditure of provinces (Figures in Rs billion)**

Province	Budget	Actual Expenditure			% of utilization
		Current	Capital	Total	
Province 1	1.02	0.44	0.22	0.65	63.97%
Province 2	1.02	0.34	0.27	0.61	60.13%
Bagmati Province	1.02	0.15	0.12	0.27	26.41%
Gandaki Province	1.02	0.15	0.15	0.30	28.95%
Province 5	1.02	0.13	0.07	0.19	18.70%
Karnali Province	1.02	0.12	0.11	0.23	22.96%
Sudurpaschim Province	1.02	0.17	0.09	0.26	25.46%
<b>Total</b>	<b>7.15</b>	<b>1.48</b>	<b>1.04</b>	<b>2.52</b>	<b>35.23%</b>

Province	Budget	Actual Expenditure			% of utilization
		Current	Capital	Total	
Province 1	35.74	9.80	11.44	21.24	59.44%
Province 2	28.79	6.63	8.47	15.10	52.44%
Bagmati Province	35.62	11.10	9.56	20.66	57.99%
Gandaki Province	22.62	5.24	8.72	13.96	61.69%
Province 5	28.09	6.88	12.63	19.51	69.45%
Karnali Province	27.28	4.54	5.42	9.95	36.48%
Sudurpaschim Province	25.07	6.93	7.23	14.17	56.52%
<b>Total</b>	<b>203.20</b>	<b>51.11</b>	<b>63.47</b>	<b>114.58</b>	<b>56.39%</b>

Province	Budget	Actual Expenditure -6 Months			% of utilization
		Current	Capital	Total	
Province 1	35.58	2.48	5.18	7.66	21.52%
Province 2	29.72	1.96	0.72	2.68	9.01%
Bagmati Province	40.86	2.56	2.27	4.83	11.82%
Gandaki Province	25.35	1.77	3.66	5.43	21.42%
Province 5	31.42	3.85	3.65	7.50	23.87%
Karnali Province	24.66	1.38	0.80	2.19	8.87%
Sudurpaschim Province	23.32	1.66	1.56	3.21	13.78%
<b>Total</b>	<b>210.90</b>	<b>15.65</b>	<b>17.84</b>	<b>33.49</b>	<b>15.88%</b>

Source: FCGO CFS 2018/19 and Economic survey 2019/20

The tables show that the budget execution rate is higher in province 5, as compared with other provinces. During this fiscal year, it is expected that the budget execution rate would exceed 60% in this province. This failure to execute the entire allocation clearly signals unsatisfactory performance, as well as a problem in implementing the PFM reforms agreed on. Another issue concerns the quality of spending, which is even more worrisome from the governance and accountability aspects.

### E. Fiscal Arrangements

In the current structure, fiscal transfers from federal to province and local governments are organized in the form of grants and transfers. These transfers are made on the basis of resources required by these governments, as well as their capacity to raise revenues. The National Natural Resource and Fiscal Commission (NNRFC) has developed formulas for resource allocation, considering the macro-economic factors in effect and other requirements as laid down by the federal government. As outlined in the Intergovernmental Fiscal Arrangement Act of 2074, there are 4 different types of grants available to province and local governments:

1. Fiscal equalization grants
2. Conditional grants
3. Matching grants
4. Special grants

These grants are also mentioned and defined in Article 60 of the Constitution. The Constitution states that: “The Government of Nepal shall, on the basis of the need



of expenditure and revenue capacity, distribute fiscal equalization grants to the province and local level. Each Province shall, in accordance with the province law, distribute fiscal equalization grants out of the grants received from the Government of Nepal and revenues collected from its sources, on the basis of the need of expenditure and revenue capacity of its subordinate local level". The distribution of conditional, matching and special grants is mobilized through the Federal Consolidated Fund, following the Intergovernmental Fiscal Arrangement Act and the NNRFC. Grants received by each province in the last three years are presented in the table below:

**Table 4: Fiscal transfers to sub federal governments (Figures in Rs Billion)**

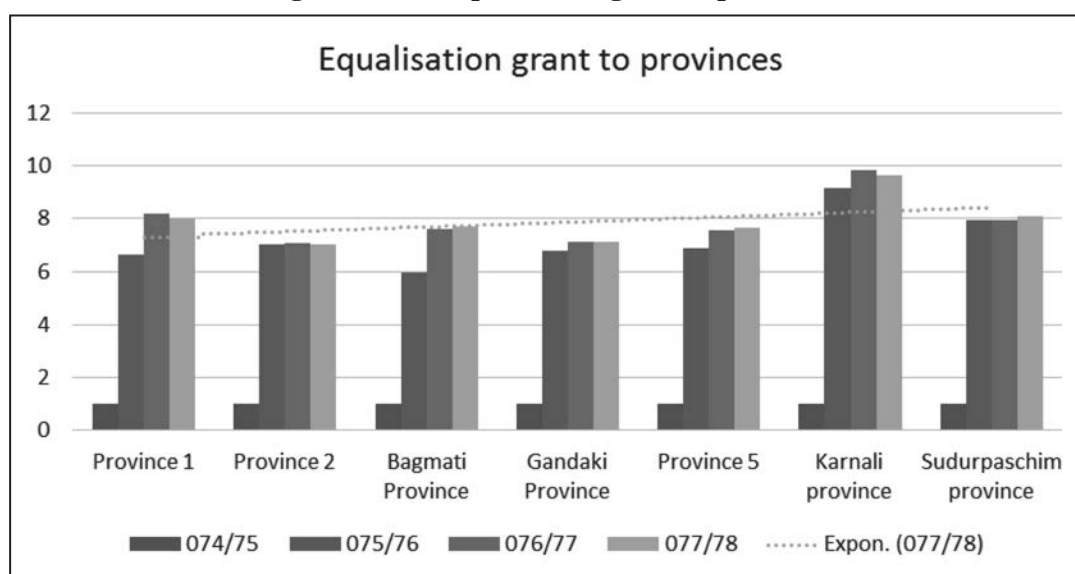
Level of Governments	Province		Local		Total	
	076/77	077/78	076/77	077/78	076/77	077/78
Fiscal Equalization grant	55.3	55.19	89.95	90.5	145.25	145.69
Conditional grant	44.55	36.35	124	161	168.55	197.35
especial grant	5	3.14	5	6.83	10	9.97
Matching grant	5	5.19	5	4.78	10	9.97
Revenue sharing	65	61.07	65	61.07	130	122.14
Total	175	161	289	324	464	485
Ratio of transfer with respect to federal budget (%)	11.41	10.92	18.86	21.99	30.27	32.91

Each local/province government is now allowed to raise certain revenue, and this has resulted in the readjustment of the equalization grant provided to them. In the last two fiscal years, the federal government has allocated NRs. 10 billion for special grants and another NRs. 10 billion for matching grants, the transfer of which are based on demands made by the province and local governments. The table below shows the fiscal equalization grants approved to all seven provinces in the last three years:

**Table 5: Fiscal equalization grant to provincial governments (Figures in NRs Billion)**

Province	074/75	075/76	076/77	077/78
Province 1	1.02	6.61	8.16	8
Province 2	1.02	7.02	7.09	7.02
Bagmati Province	1.02	5.97	7.6	7.72
Gandaki Province	1.02	6.78	7.11	7.11
Province 5	1.02	6.87	7.54	7.64
Karnali province	1.02	9.13	9.85	9.63
Sudurpaschim province	1.02	7.92	7.95	8.07
<b>Total</b>	<b>7.14</b>	<b>50.3</b>	<b>55.3</b>	<b>55.19</b>

**Figure: Fiscal Equalisation grant to provinces**



The amount provided to each province, as part of the fiscal equalization grants, vary based on the formula-based allocation method adopted by the federal government. In comparison, Karnali province has received more grants, as this province has fewer sources to raise revenue. The perceived resource gap has been filled out using the fiscal equalization grants.

**F. Revenue Sources and Borrowing Arrangements**

The Constitution of Nepal has codified exclusive and shared rights to raise revenues at local levels in Schedule 5, 6 and 8. However, several challenges are envisaged when generating revenues through the mobilization of local sources (OSR). A large number of taxes imposed are in fact reckoned to be *shared taxes*.; house rent taxes serving as an example. As a result, many citizens are experiencing a bitter reality of federalism, as they are exposed to multiple taxes imposed by governments at different levels. Few examples of tax overlapping are presented in the table below:

Local taxes, charges and fees	Province taxes, charges & fees	Federal taxes, charges & fees
Wealth/property tax(e.g. land tax)		Customs
House rent tax		Excise duties
Business registration tax		VAT
Land revenue tax	Agro-income tax	Individual income tax
House and land registration fee	House and land registration fee	Business income tax
Motor vehicle tax	Motor vehicle tax	Passport and visa fees
Service charges	Service charges	Service charges
Tourism fees	Tourism fees	Tourism fees
Advertising tax	Advertising tax	
Penalties	Penalties	Penalties
Entertainment tax	Entertainment tax	

The Intergovernmental Fiscal Arrangement Act provides several provisions relating to tax administration. For instance, the act states:

- While collecting income tax, the federal government should also include the tax on agricultural income, this tax has to be levied by the State,

- While collecting vehicle tax, the province should also collect the vehicle tax levied by the local government,
- While collecting house rent tax, the local government should also include the income tax levied on house rent, as part of the income tax collected by the federal government,
- While collecting house and land registration fee, the local government should also include the registration fee levied by the State,
- While collecting advertising tax, the local government should also collect the advertising tax levied by the State,
- While collecting entertainment tax, the local government should also include the entertainment tax levied by the State.

The sharing ratio of the revenue collected by each level of government also varies. According to the provision, 2% administration fee is charged by each tier of government on natural resources, as part of royalties. Details on charging royalties on natural resources are depicted on the table below:

Royalties on natural resources
Electricity production, forestry, mountaineering, mining and minerals
<ul style="list-style-type: none"> <li>• 50% to the federal government;</li> <li>• 25% to respective province governments; and</li> <li>• 25% to respective local governments.</li> </ul>

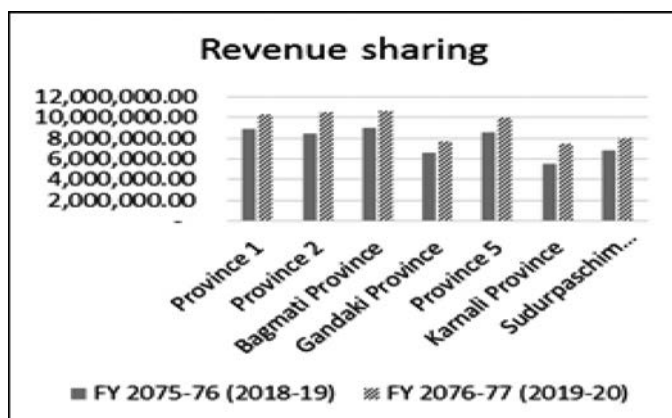
Province and local governments are required to share the collected revenue, using the formula provided by the NNRF. At the federal level, the FCGO makes necessary arrangements for a transfer and distribution of the divisible amounts. The table below shows the total revenue generated and shared by province governments:

**Table 6: Revenue Sharing by federal to provincial government (Figures in Rs Billion)**

Province	075/76	076/77	077/78
Province 1	8.93	10.28	9.54
Province 2	8.48	10.44	9.52

Bagmati	9.00	10.60	9.70
Gandaki	6.58	7.71	7.57
Province 5	8.55	9.91	9.47
Karnali	5.52	7.44	7.40
Sudhuraschim	6.77	7.99	7.87
<b>Total</b>	<b>53.83</b>	<b>64.37</b>	<b>61.07</b>

Source: MOF, Inter governmental fiscal transfer 2075-76, 2076-77



During the fiscal year 2017/18, limited revenues were generated at the province and local levels. However, the share of revenues generated by province governments has increased in 2019/2020, as there is more clarity on this issue.

## G. Borrowing

All levels of governments (Federal, Province and Local) can borrow money from the *domestic* financial markets being within the limit prescribed by the National Natural Resources and Fiscal Commission. However, only the federal government has the authority to borrow externally and to accept foreign grants. The government of Nepal is required to ensure macro-economic stability while authorizing external borrowing. Many provinces have already started internal borrowing, as part of filling the resource gap. Raising loans to address budget deficits is not permitted.

## H. Audit Irregularities

The federal legacy has endured at all levels when it comes to audit irregularities. The level of irregularities

is peculiarly high in certain provinces. For instance, province number 2 has the highest level of irregularities, which account nearly 23% of its total budget expenditures. What is striking is a rise in the level of irregularities every year. Karnali is perhaps an exception where the percentage of irregularities is relatively low. The table below depicts the total audited amounts and irregularities for the fiscal year 074/75:

**Table 7: Irregularities of provinces for FY 2017/18**

Provinces	Total audited amount	Irregularities amount (In NRs, 000)			Total	% of irregularities
		Recoverable	Regularize	Advance irregularity		
Province 1	656,895	112	22,114	116	22,342	3.4%
Province 2	694,395	20,579	36,930	107,100	164,609	23.7%
Bagmati	274,629	3	969	-	972	0.4%
Gandaki	296,377	83	5	452	540	0.2%
Province 5	203,540	218	290	-	508	0.2%
Karnali	237,852	105	72	-	177	0.1%
Sudhuraschim	261,905	5,959	-	-	5,959	2.3%
<b>Total</b>	<b>2,625,593</b>	<b>27,059</b>	<b>60,380</b>	<b>107,668</b>	<b>195,107</b>	<b>7.4%</b>

## I. Conclusion

Decentralization of public service is paramount to ripe the benefits of democracy. However, the very objective of decentralization through the state restructuring has encountered several challenges in Nepal. Indeed, the complex nature of financial federalism is also evident in developed countries (Jochimsen, 2018; Adhikari and Shrestha, 2019; Ter-Minassia et al., 2017). In Nepal, obstacles and mal practices experienced at the federal level have been cascaded down to lower tiers of the government. The province governments have carried out the financial legacy of federal government, a legacy which has drawn much criticisms for its failure to ensure transparency and accountability. The spending of province and local governments has not been as expected. This has largely stifled development activities. The expenditure trend is usually high in the last quarter of the year, creating a space for corruption and malpractices

to flourish. Having said this, there are many issues which give us a great deal of hope for the future. For instance, all provincial governments have now enacted necessary financial regulations and set up institutions, the effective mobilization of which could easily improve accountability and efficiency at the local/provincial levels. What is important is therefore to enforce the regulations, invest on the capacity development of administrators and strengthen the monitoring mechanisms of oversight institutions. Good governance and accountability are also paramount to address the challenges posed by the pandemic.

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## CAI को Digital Learning Hub प्रयोग गर्न सक्ने व्यवस्था सम्बन्धी सूचना ।

विश्वभर माहामारीको रूपमा फैलिरहेको कोभिड-१९ रोगको प्रकोपको यस अवस्थामा सदस्यहरूको व्यावसायिक क्षमता अभिवृद्धिका लागि संस्थाले The Institute of Chartered Accountants of India (ICAI) संगको सहकार्यमा ICAI को Digital Learning Hub प्रयोग गर्न सक्ने गरी व्यवस्था गरेको व्यहोरा सूचित गरिन्छ ।

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